

THIRD QUARTER 2011

POINT *of* VIEW

OUR PERSPECTIVE ON ISSUES AFFECTING GLOBAL FINANCIAL MARKETS

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Payden & Rygel

333 S. Grand Ave
Los Angeles, CA 90071

Robots: The Rise of Machines and the Economy



Robots either terrify or disappoint. That's because the word "robot" itself conjures one of two images in our minds. First, one might think of Hollywood's "evil" robot creations, such as the computer Hal from *2001: A Space Odyssey*, and fear the end-result of technological progress. Or, alternatively, one might lament the fact that the world of *The Jetsons*—the 1960s cartoon about a family living in a future world with flying cars, a nine-hour work week and a personable robot who cooks, cleans, irons clothes and seems to enjoy menial household tasks—has yet to come to fruition.

“BUT, ONE RARELY THINKS OF ROBOTS AND ECONOMICS. AFTER ALL, WHAT DO ROBOTS HAVE TO DO WITH ECONOMICS?”

But, one rarely thinks of robots and economics. After all, what do robots have to do with economics?

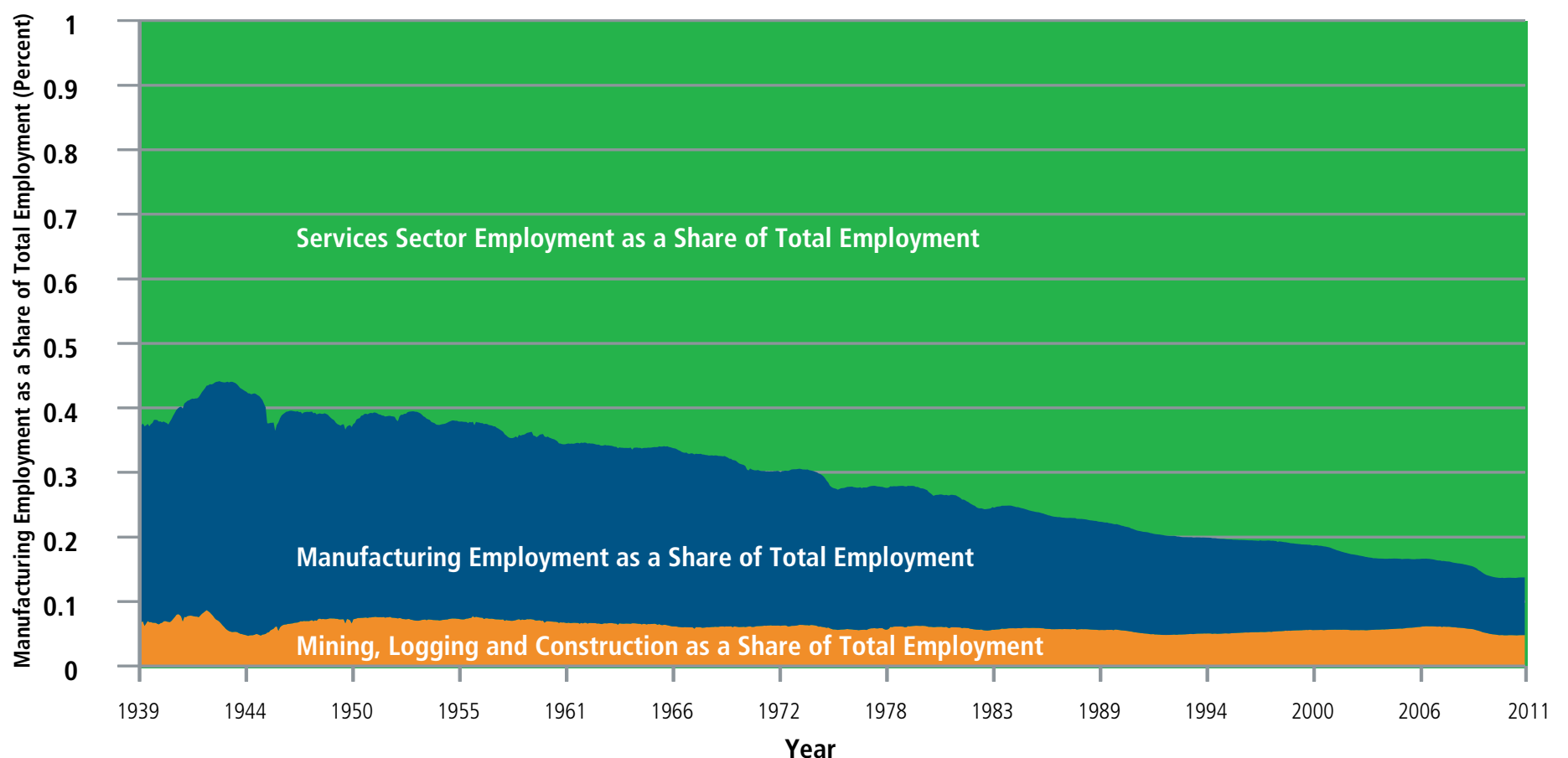
The answer is: everything.

THE RISE OF THE MACHINES

Thinking (and worrying) about robots, defined as “mechanical intelligent agents,” goes back centuries and features in works from Greek myths to Leonardo da Vinci's sketches. The modern focus on machines begins at the dawn of the “industrial era” as machines entered our daily lives primarily through the production process. While for most of human history physical labor, trade and specialization drove output, by the dawn of the industrial revolution technology, combined with knowledge, became the key ingredient in economic growth.

This shift immediately prompted concerns. In the 19th century, the French political economist Frederic Bastiat highlighted worries about “machines” in human society. Living in the early stages of the industrial revolution as mechanization swept across the continent, Bastiat wrote:

fig. 1 ARE MACHINES STEALING OUR JOBS?



SOURCE: Bureau of Labor Statistics, Payden Calculations

“A curse on machines! Every year their increasing power condemns to pauperism millions of workers, taking their jobs away from them, and with their jobs their wages, and with their wages their bread! A curse on machines!”

Sound familiar? These worries are echoed in modern times on the evening news and across newspaper editorial pages. While Bastiat’s writing was in jest these concerns remain popular to this day: the rise of machines portends the decline of civilization. But is this true?

Bastiat’s answer to this question paints reality in a different light. He argues that thinking and inventing new ways to save ourselves from doing work (that is, prefer “leisure” over “labor”) is actually what makes us rich, not poor. In fact, machines are “labor saving” devices: complements to human labor—not substitutes. To the extent that machines are able to complete tasks otherwise tackled by humans, this liberates human time (a scarce resource itself) to pursue other productive activities.

BUSINESS CYCLE BUSTS AND MACHINES

Of course, the modern objection is that, especially in times when jobs are scarce and labor is plenty, machines do not help matters much. In fact, they replace workers, allowing corporations to operate efficiently and productively without the use of employees. This is true—but only in a crude sense. Yes, the advent of ATMs and online banking services replaced human tellers. But, Bastiat’s response to this question is telling. He argued that the inhabitants of a city would be unwilling to flee to the machine-free countryside to live and work. Our modern version would be to suggest living for a year machine or appliance-free. How many people would accept that challenge?

Or, imagine if a country were to ban shipment of goods by truck or train, and instead force industries to rely on human labor to carry goods. We certainly would create thousands if not millions of new jobs. But, would we be “better off”? Hardly.

MACHINES AND THE DECLINE IN MANUFACTURING EMPLOYMENT

Another popular myth in the United States is that “cheap foreign labor” is the culprit behind the labor market stagnation. Bastiat addressed this nearly 200 years ago:

Humans have a natural inclination, if they are not prevented by force, to go for a bargain—that is, for something that, for an equivalent satisfaction, spares them labor—whether this bargain comes to them from a capable foreign producer or from a capable mechanical producer.¹

What are the facts? First, manufacturing employment as share of total US nonfarm employment has been on the decline since the end of World War II. As a share of total US employment, manufacturing fell from nearly 40% in the 1940s to less than 10% today (See Figure 1). While this is often attributed to “outsourcing” or “off shoring” of manufacturing capabilities, the real culprit may not have a face or a name. In fact, as a share of world gross domestic product, manufacturing activity is also on the decline everywhere.

“AT PRESENT, THE WORLD ROBOT POPULATION IS ABOUT 8.6 MILLION—WHICH IS SLIGHTLY LESS THAN THE POPULATION OF LOS ANGELES.”

“A CURSE ON MACHINES! EVERY YEAR THEIR INCREASING POWER CONDEMNS TO PAUPERISM MILLIONS OF WORKERS, TAKING THEIR JOBS AWAY FROM THEM, AND WITH THEIR JOBS THEIR WAGES, AND WITH THEIR WAGES THEIR BREAD! A CURSE ON MACHINES!”

But is this bad? No. In fact, US manufacturing workers are far more productive today (combining labor and technology) than ever before. In 1950, the average US manufacturing employee produced about \$20,000 in output per year. By 1976, the amount had doubled to \$39,000. By 1997, output per worker reached \$75,000—nearly double the level in 1978. And by 2010, this figured doubled again, to \$149,000. This increase in output per worker represents phenomenal productivity increases, engendered by the use of machines.

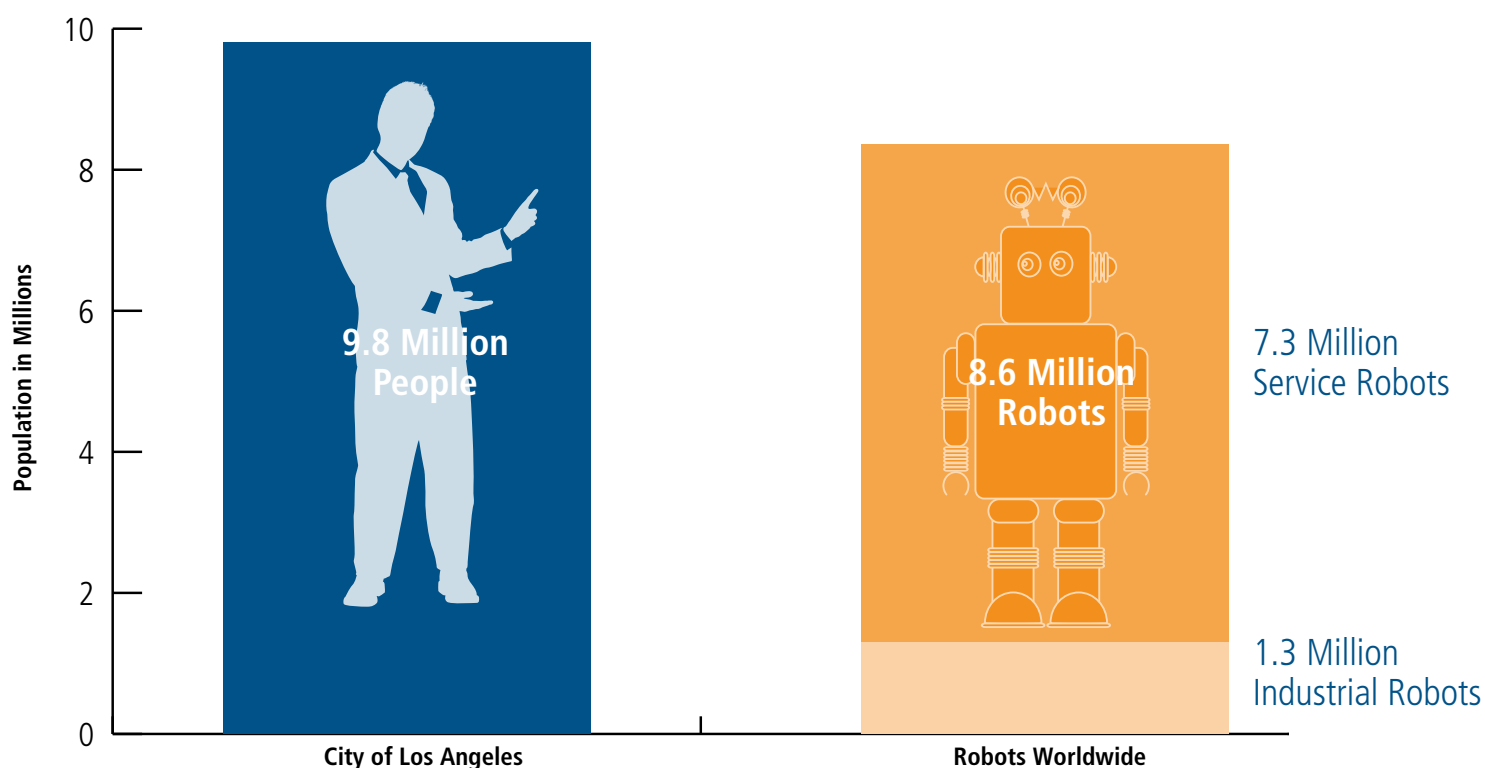
The vast increases in output also allow most workers to transition into services-producing positions—in education, medical services and beyond—as the world economy develops. The real culprit in the decline of manufacturing employment: machines!



DID YOU KNOW?

By the early 1980s, computers used in robots by researchers executed about one “million instructions per second” or MIPS. Each MIPS includes a basic instruction, such as summing two large numbers. By the 1990s, computational power jumped from 10 MIPS to 50,000 MIPS in high-tech desktop computers, meaning they could handle many times the number of tasks as their ancestors. In fact, today, the Apple MacBook computer, which costs around \$1,000, juggles 10,000 MIPS. Soon, robots may be equipped with technology. But, the human brain is the world’s greatest computer. In order to simulate the capabilities of brain power, computers would need to execute 100 million MIPS, or 100 trillion instructions per second. In short, the PC on your desk would have to be 10,000 times as powerful to perform on par with the remarkable functions of your brain.

fig. 2 THE RISE OF THE ROBOT



SOURCE: Payden Calculations, IRS Statistical Department

THE UBIQUITY OF MACHINES

From the other group of people—those who do not fear the rise of machines—we have another objection: the disappointment that we do not have a robot doing our laundry, mowing our lawn or trimming our hair.

The reality: machines are everywhere. At present, the world robot population is about 8.6 million—which is slightly less than the population of Los Angeles (See Figure 2). About half of those robots are in Japan and another 15% in the United States.

What kind of robots? There are two major categories: industrial robots and service robots. Industrial robots are prevalent in the motor vehicle manufacturing industry, electronics, chemical, rubber and plastics, food and communication—and as of 2008 totaled about 1.3 million.

The industrial success of robots has promoted funding and research into “service robots”—and the number of service robots worldwide dwarf the industrial units. As of 2010, there were about 7.3 million “service robots” worldwide.² Approximately 30% of those robots are involved in the defense sector, including unmanned vehicles and demining robots. Another 25% are milking robots. Next, cleaning robots and medical robots account for 8% and 7% shares of the market, respectively.

Beyond “robots,” machines are everywhere. In fact, they are so ubiquitous we take them for granted. In fact, they are so ubiquitous we take them for granted. According to the U.S. Census Bureau, as of 2005 nearly 90% of US households have a “clothes washer” or “washing machine.” Not quite Rosie the Robot, but a step in that direction.

And, finally, many US workers do spend their time in an air-conditioned environment, behind computer screens, “pushing buttons” (much like George Jetson!).

THE NEXT REVOLUTION: ARTIFICIAL INTELLIGENCE?

Over the last century, the world economy has doubled every 15 years, increasing at a pretty steady pace. Prior to that, economic history is more punctuated, characterized by sudden shifts that alter the pace of economic growth. Thus far, machines have been useful not by replacing human beings, but by doing tasks humans could not do or helping humans accomplish tasks more quickly. However, for countries like Japan, which faces a long-term decline in working age population, fully-functional robot workers may be a welcome arrival.

Is it possible? Earlier in 2011, IBM’s super-computer named “Watson” debuted and defeated champion *Jeopardy!* players in a head-to-head matchup. Impressive, yet not quite on the scale of human intelligence and imagination (See “Did You Know?” box). IBM has suggested that Watson may play the perfect role as “physician’s assistant”—not replacing the human touch but quickly running symptoms through an exhaustive database and helping arrive at correct diagnoses. That’s because Watson does not walk around or recharge his own batteries. As Steven Pinker, Professor of Psychology at Harvard University writes:

The main lesson of thirty-five years of AI (Artificial Intelligence) research is that the hard problems are easy and the easy problems are hard. The mental abilities of a four-year-old that we take for granted—recognizing a face, lifting a pencil, walking across a room, answering a question—in fact involve some of the hardest engineering problems ever conceived.³

So we are a way off from Artificial Intelligence. But, as Frederic Bastiat taught us, the inexorable human inclination is toward sparing expense and labor to increase output. The rise of machines is revolutionary because, just as mechanization sent agricultural and manufacturing output on an exponential growth path, machines could one day revolutionize medical services—a category that has been outpacing the overall Consumer Price Index (CPI) for years as health care becomes more expensive and expansive. It stands to reason that we are in the early stages of the rise of machines. Though an essential element of our daily lives (whether we realize it or not), the future holds more than just a robot vacuum that zooms around the floor in your home and the only limits are human ingenuity.

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The Importance of Failure

What do Thomas Edison, Bill Gates, and Henry Ford have in common? Innovation, wealth, and success are a few words that come to mind. Conversely, bankruptcy, tribulation, and failure are not words most would use to describe these pioneers. However, at one point in their careers, these men were failures. Clearly, they will long be remembered as tremendous success stories, yet small doses of failure may have been the key ingredient toward significant success.

In an evolving world where “the bottom-line” is generally the barometer for success, it seems difficult to accept that failure is not always bad. In fact, failure has been a very necessary means to an end for individuals, corporations, and economies alike. Failure encourages innovation, improves economic efficiency, builds character, and provides meaningful insight into future decisions in ways that succeeding falls short.

FAILURE, DEFINED

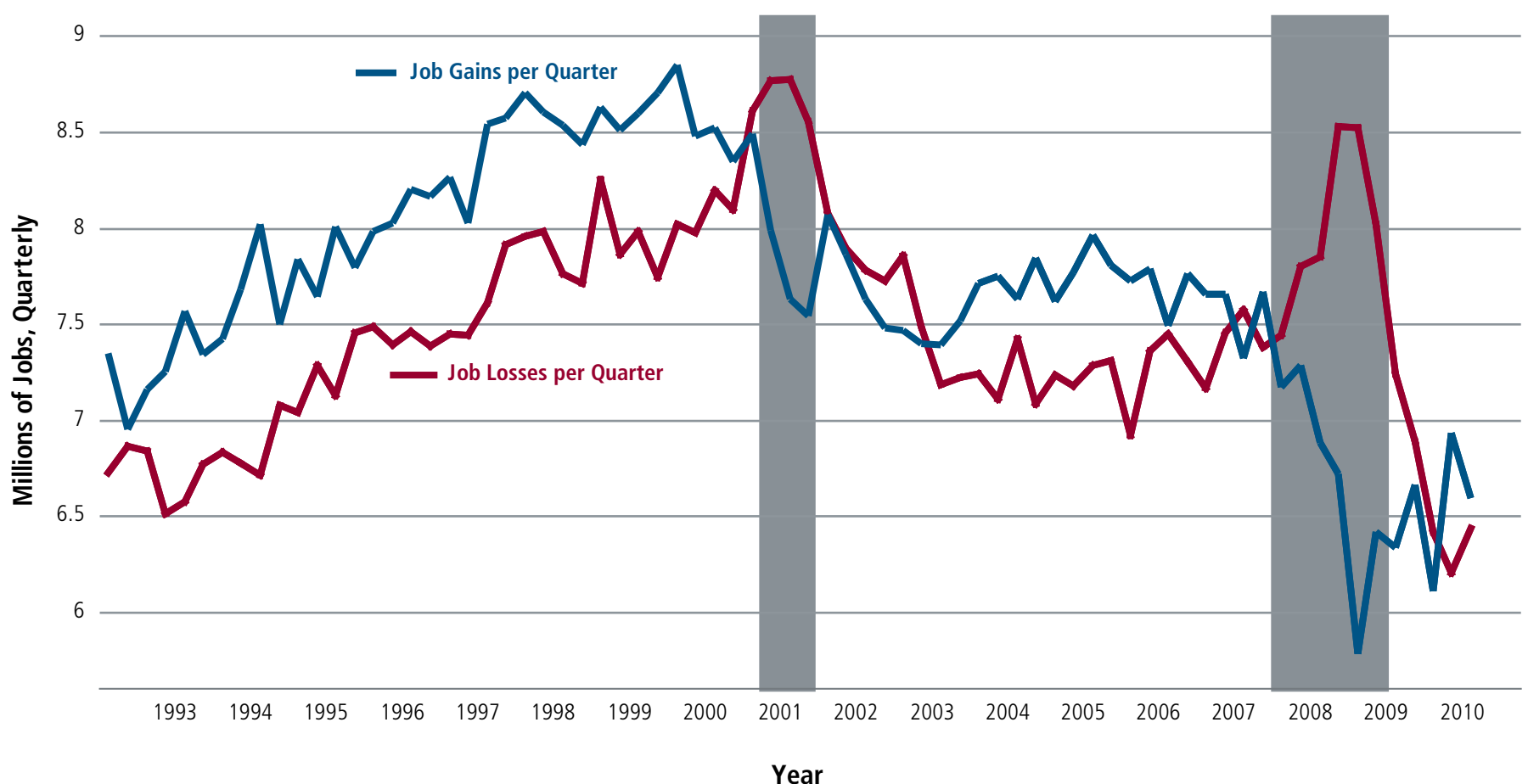
The word failure is defined as, “an act or instance of failing or proving unsuccessful; lack of success.” On the surface, the definition seems bounded and discouraging. Yet the definition does not suggest that failure is a perpetual bout of unsuccessful results. Instead, the definition refers to an “act” or “instance,” implying failure can be a temporary phenomenon. The definition of failure is certainly in the eye of the beholder. Henry Ford once said, “Failure is just a resting place. It is an opportunity to begin again more intelligently.” Indeed, failure can either be a resting place or an end point. Not all failure leads to eventual success, but oftentimes success is the result of prior failure.

Perhaps the most famous story of repetitive failure, innovation, and ultimate success is Thomas Edison and the incandescent light bulb. History shows that it took Edison over 9,000 attempts to perfect his modifications to the light bulb. In the midst of his experimentation, Edison was asked how he felt about failing over 10,000 times at something. His response was, “I have not failed. I have just found 10,000 ways that won’t work.”

Although eventually successful with mass distribution and use of the light bulb, most people don’t know that Edison was not as successful with his record company. Edison Records were introduced in 1902, which was 25 years after Edison invented the phonograph. Although relatively well-received at first, the First World War disrupted the supply of materials Edison needed for record production. Consequently, competitors were able to capture market share and Edison Records went out of business in 1929. Edison Records is dubbed as one of the worst business failures in history.

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fig. 3 FAILURE: ARE JOB LOSSES AS IMPORTANT AS JOB GAINS?

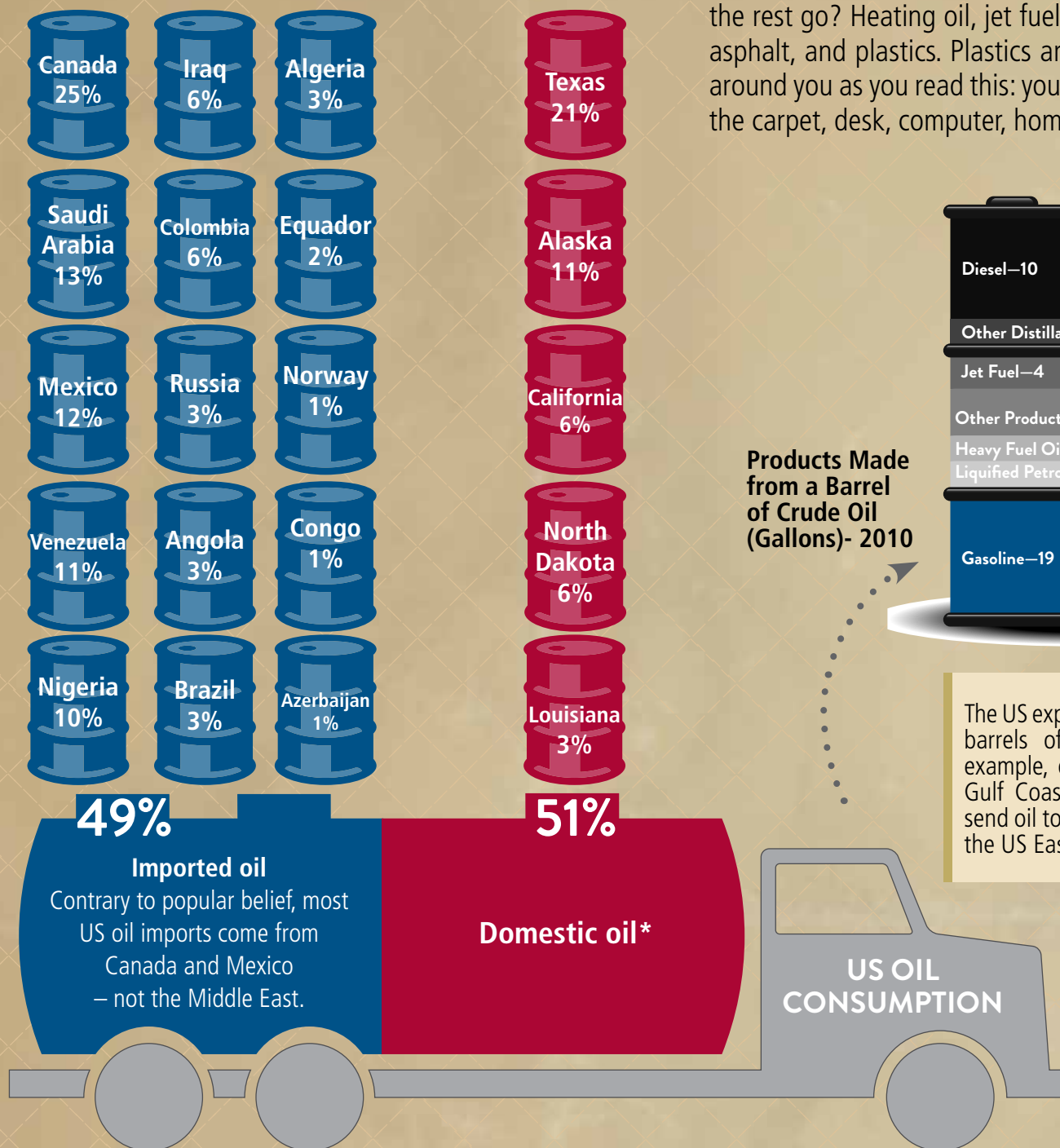


Source: Bureau of Labor Statistics

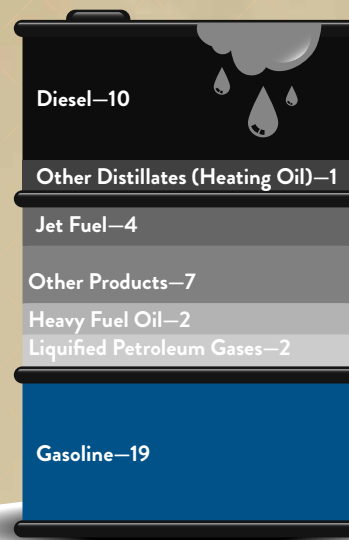
THE WORLD OF OIL



Oil is the lifeblood of the US economy—not just the fuel powering your car or truck. In fact, only 46% of oil imports go into gasoline. Where does the rest go? Heating oil, jet fuel, tires, cosmetics, lubricant for wind turbines, asphalt, and plastics. Plastics are key building blocks for everything you see around you as you read this: your smart phone, shoes, the fabric on your chair, the carpet, desk, computer, home appliances and even most of your car.

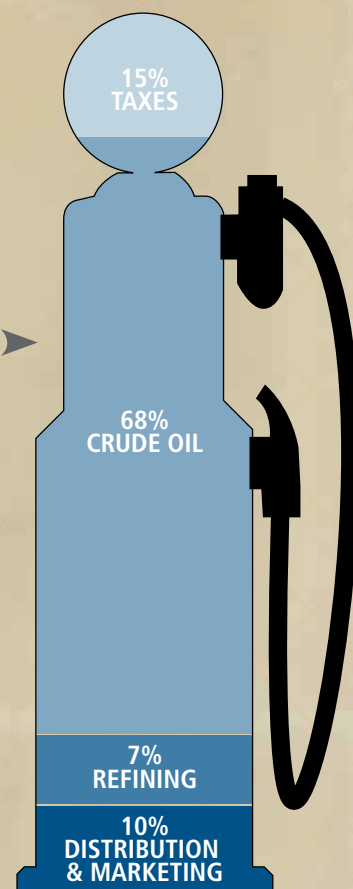


Products Made from a Barrel of Crude Oil (Gallons)- 2010



DID YOU KNOW
The US exports about 2 million barrels of oil per day. For example, oil refineries in the Gulf Coast region frequently send oil to Mexico rather than the US East Coast.

What Makes Up the Price of a Gallon of Gas?



Source: Energy Information Agency

*Top 5 domestic oil-producing states listed above

“THREE EPOCHS OF OIL PRICES”



A chart of real (inflation-adjusted) oil prices dating back to 1861 paints a dramatic picture: oil prices were remarkably stable for nearly a century with volatile, multi-decade periods as “bookends.” The volatile periods, from 1861-1878 and 1973-2009, occur 100 years apart, but as it turns out, have a lot in common. Both periods were characterized by supply limitations and surging demand.

In the first period, rapid industrialization was led by the emergence of the United States as a global economic power. From 1860 to 1880, US manufacturing output rose by a factor of three, the US population doubled and oil consumption surged. In the second period, the rise of East Asia (Japan and China) drove demand for oil. First Japan, followed by Taiwan and South Korea and then China. In fact, between 1970 and 2000, Chinese industrial output grew by a factor of 21.

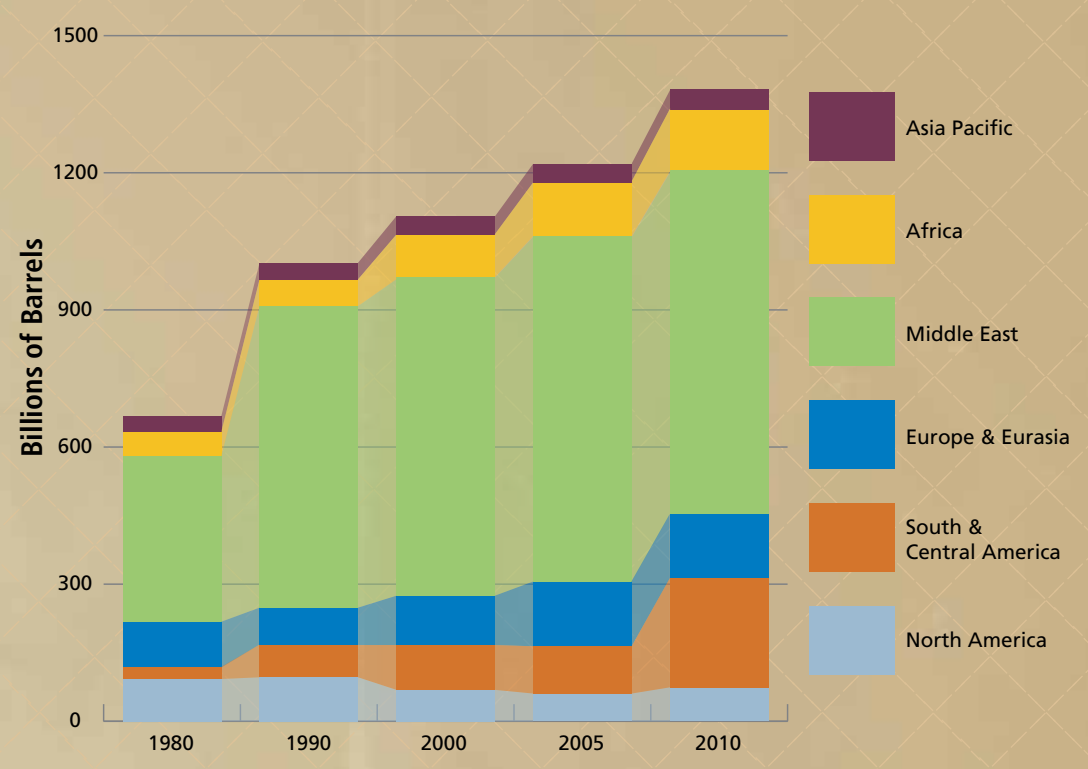
In terms of supply, it was the year 1878 that saw the debut of the Tidewater long-distance oil pipeline, which disrupted the railroad monopoly over the transport of oil and helped unleash supply. A flood of additional supply in the Depression era in East Texas helped lower prices persist into the 1970s. But, in 1970, US oil production peaked and since 1973, world oil production has been operating near capacity, and the role of OPEC in restricting supply has made higher, more volatile oil prices the norm ever since.

The lessons: volatile and high oil prices may not continue indefinitely, but limited supply and strong demand growth are a recipe for high and volatile prices.

Source: Eyal Dvir and Kenneth S. Rogoff, “The Three Epochs of Oil”, August 16, 2010.

THE FUTURE OF OIL?

DISTRIBUTION OF PROVEN RESERVES



Source: BP Statistical Review of World Energy

Proven reserves are quantities of oil resources "that geological and engineering information indicates with reasonable certainty can be recovered in the future from known reservoirs under existing economic and operating conditions." The distribution of proved reserves has evolved over the last two decades. In 1990, 66% of total world oil reserves were in the Middle East region. By 2010, this share had fallen to 54%. What accounts for the decline? The rise of South and Central America's share of proven reserves, which jumped to 17.3% in 2010 from 7.1% in 1990, with Venezuela comprising most of the gain.

Net imports of crude oil (imports minus exports) accounted for 49% of total US consumption.

The US consumed 19.1 million barrels per day of petroleum in 2010 (22% of total world consumption).

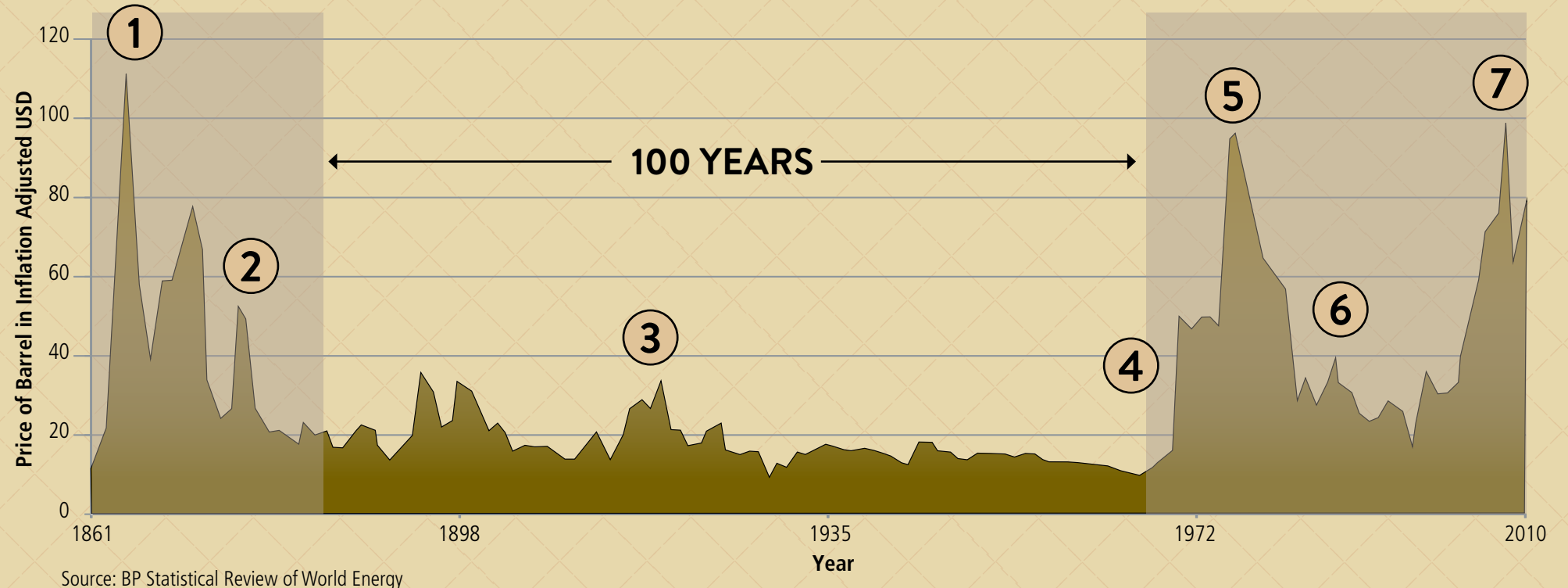
OPEC members includes: Iran, Iraq, Kuwait, Saudi Arabia, Qatar, United Arab Emirates, Algeria, Angola, Ecuador, Libya, Nigeria, Venezuela.

Persian Gulf Oil Producers: Iran, Iraq, Kuwait, Saudi Arabia, Qatar, United Arab Emirates, Bahrain.

"Sweet crude" is a type of petroleum characterized by its sulfur content. Light sweet crude is highly sought after because its low sulfur content makes it ideal for processing into gasoline. Light sweet crude makes up the oil underlying the West Texas Intermediate oil futures contract traded on futures exchanges and delivered in Cushing, Oklahoma. In contrast, "Brent" crude oil refers to oil from the North Sea region. Petroleum prices from Europe, Africa and the Middle East are tied to this Brent benchmark. The difference in the type of oil also explains the difference in price between two oil benchmark prices quoted in the media, WTI (which is based on light sweet crude) and Brent crude (which is based on North Sea oil).

OIL PRICES: 1861-2010

1. Pennsylvania oil boom, 1859 to 1873
2. Russian oil exports begin
3. Oil shortage fears after WWI
4. Yom Kippur War
5. Iranian revolution
6. Iraq invades Kuwait
7. 2008 Commodity Surge



Source: BP Statistical Review of World Energy

But was Edison Records really a failure? A pure business perspective would argue that it was a failure because the company lost money and ultimately went out of business.

However, prior to its demise, Edison Records created a wax cylinder record that played two minutes of music or entertainment, which became an industry standard and paved the way for future record production. The existence and failure of Edison Records led to the success and growth of the record industry as we know it today.

CREATIVE DESTRUCTION: FAILURE IS MORE COMMON THAN YOU THINK

Many famous and highly successful entrepreneurs have been victims of these statistics, including Bill Gates. In 1972, Gates started a company called Traf-O-Data with Paul Allen and Paul Gilbert (Both eventual pioneers with Microsoft). The company was designed to monitor and relay traffic data from traffic counters to traffic engineers.

Traf-O-Data only produced a few thousand dollars and ultimately went out of business as the State of Washington decided to offer free traffic processing services to clients. However, during the Traf-O-Data experience, Gates, Allen, and Gilbert designed and developed hardware and software for a small microcomputer that would eventually be a mold for Microsoft's first prototype. Was Traf-O-Data a failure or a success? On the surface it was a failure, but Bill Gates, Paul Allen, and Paul Gilbert have stated that the rise of Microsoft would have been substantially delayed without this experience.

Ford Motor Company's release of the "Edsel" car line was heavily marketed by Ford and highly anticipated by the public. Ford officially launched the Edsel on September 4, 1957 (marketed as "E-Day"). The Edsel offered a few interesting and innovative features that made the car attractive, but the combination of several factors overwhelmed any chance for success.

First, Ford launched the Edsel as a brand-new division, yet did not give the car line its own manufacturing facility. Next, some of the new features of the car were complicated and most mechanics were unable to fix them. To make matters worse, Edsel offered its most expensive models first while competitors were discounting previous models, as the United States was in a recession. The Edsel sold only 64,000 units in its first year, production of the car lasted only three years, and Ford Motor Co. lost \$250 million dollars on this new line.

Was the Edsel a mistake? Henry Ford once said, "The only real mistake is the one from which we learn nothing." Learning from mistakes like the Edsel and making adjustments supports why Ford Motor Company remains a large force in the automotive industry over fifty years later.

FAILURE AS THE PATH TO SUCCESS

Winston Churchill said, "Success is not final and failure is not fatal. Success is going from failure to failure without loss of enthusiasm." Certainly, the idea of failure is not an optimal outcome for corporations, and a string of consecutive poor business decisions or unsuccessful products could be enough to put a company out of business. However, the idea of perpetual success without failure along the way is ignorant.

So how do corporations strike a balance between the two? Douglas Merrill, a vice president with Google engineering said, "Fundamentally, everything we do is an experiment. The thing with experimentation is that you have to get data and then be brutally honest when you're assessing it. Google has remained true to a 'fail fast' strategy: launch, listen, improve, and launch again."

This approach taken by Google is becoming popular among many other companies. Founded in 2004, Dogster.com succeeded where Pets.com failed years earlier. The concept of both companies was the same, but Dogster.com was more versatile in its approach, launching features and ideas

“WITHOUT START-UPS THERE WOULD BE NO NET JOBS CREATED OVER THE PAST 30 YEARS. BUT, HERE'S THE CATCH: APPROXIMATELY 50% OF NEW BUSINESSES GO FROM "START UP" TO "BELLY UP".

quickly, while modifying them once feedback was received by end-users. This approach has been labeled "strategic failing." Other large companies like Intuit and Eli Lilly have annual "failure parties."¹ These failure parties are designed to highlight what went wrong in the evolution of a product or idea, whether it is marketing, advertising, pricing, or poor timing.

COMPLEXITY MEANS FAILURE: CAN YOU BUILD A TOASTER FROM SCRATCH?

Anecdotes and success stories abound about rising from the ashes of failure—but is there a deeper reason why failure is to be not only expected but celebrated? Yes: because the world is simply too complex and knowledge is too dispersed for any one person to correctly guess and understand what products or ventures will eventually "work." In short: nobody knows, and lots of things need to be tried to figure out what works.

This is perhaps best described by F.A. Hayek in his path-breaking "The Use of Knowledge in Society," published in 1945. Hayek writes: "the fact that the knowledge of the circumstances of which we must make use never exists in concentrated or integrated form but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individual possess."²

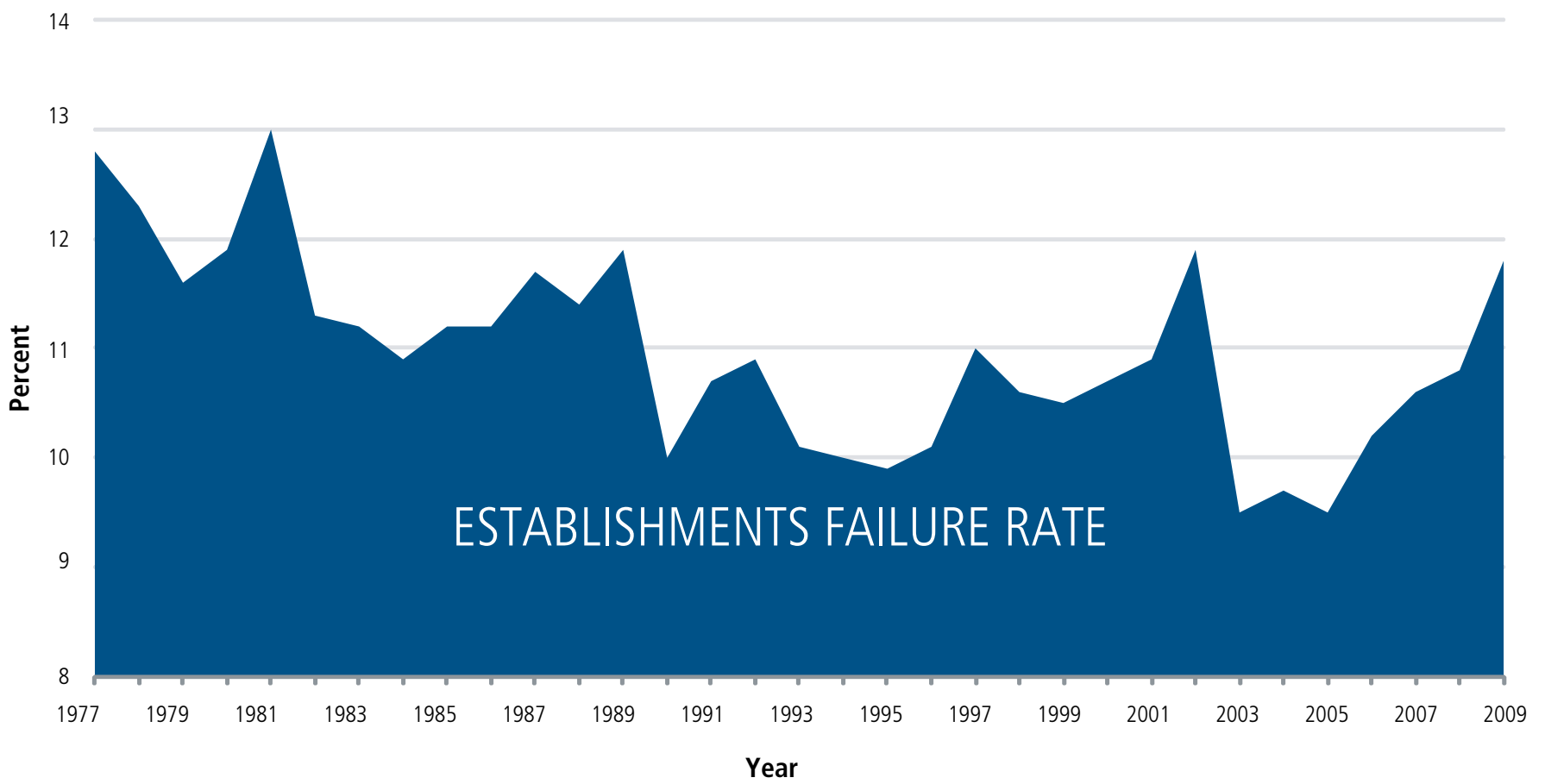
Take, for example, New York City or London. In each city there may be over 10 billion distinct products with millions of new products arriving in stores each month. The sheer complexity of coordinating and producing even one product is mind-boggling.

In fact, consider the case of Thomas Thwaites who, as a graduate student in London, embarked on a project to build a toaster – from scratch. He discovered along the way that the basic toaster has 400 parts, required copper, iron, nickel, mica, and plastic materials. Aside from acquiring the raw materials was the attempt to mold them into usable parts for his project. He visited mines and flew to an oil rig to look for crude oil for plastic. In the end, he surrendered and cut corners, acquiring parts and components along the way. His conclusion: "I realized that if you start absolutely from scratch, you could easily spend your life making a toaster."³

But, remarkably, fully functional toasters that line the shelves at Wal-Mart elicit little attention from customers. Somehow, businesses and markets coordinate and plan this activity, which today often crisscrosses the globe. How? It is trial and error—or failure and success—that led down the path to success.

Below the surface of the economy, failure and success are constant features. Every quarter in the US, approximately 6 million workers are fired and 6 million workers are hired (See Figure 3). On net, from 1977 to 2005, existing companies shed workers at a rate of approximately 1 million per year. Further, more than 10% of existing businesses perish—fail—each year as the creative destruction process churns (See Figure 4). New businesses, on the other hand, added an average of 3 million jobs per year. That means that without start-ups there would be no net jobs created over the past 30 years. But, here's the catch: approximately 50% of new businesses go from

fig. 4 FAILURE IS A PART OF A HEALTHY ECONOMY: 12% OF BUSINESSES FAIL ANNUALLY



Source: Bureau of Labor Statistics

“start up” to “belly up” in the first year alone. Further, one-third of all new businesses that survive the first year fail by the two-year mark and nearly 60% do not last beyond four years. The result: We need trial and error, start up and failure, to have the economy and labor force thrive.

CONCLUSION: TOO BIG TO FAIL OR NOT ENOUGH FAILURE?

We need failure. Failure is directly correlated with competition, and society stands to benefit from both competition and certain forms of failure. The potential for failure increases competition and forces companies to innovate and improve. This dynamic should reduce costs and directly benefit the consumer as companies find ways to streamline processes and increase the bottom-line. Additionally, failure reduces dilution, allowing only the most efficient and successful companies to survive. This elimination of excess will lead to improved resource utilization. Lastly, failure certainly builds character and provides a prospective point-of-view regarding past mistakes and why next time will be different. Failure is the conduit for understanding and appreciating success. Indeed, the great Truman Capote said, “Failure is the condiment that gives success its flavor.”

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The Convergence of Stocks and Bonds: High Dividend Stocks as a Source of Income

Income-oriented investors face a difficult challenge: low bond yields in the developed government and corporate bond markets have resulted in a tireless search for coupon income elsewhere. In recent years, this exhaustive search for higher yields has expanded to longer-maturity bonds, lower-rated bonds, and foreign markets, both emerging and developed. But, have all the investment income stones been left unturned? Not quite. While bonds, of course, will still occupy an important place in an income-oriented investor's portfolio, we think it is prudent and possible to look beyond bonds for cash flow.

Our answer to the income challenge: seek out high dividend paying stocks.

THE ORACLE OF OMAHA: STOCKS AND BONDS MORE SIMILAR THAN AT FIRST GLANCE

Stocks, you say? Indeed, for many fixed-income investors the suggestion of augmenting coupon income with stocks may come as a surprise. However, 30 years ago, "The Oracle of Omaha" Warren Buffett was comparing stocks and bonds in the pages of *Fortune Magazine*:

For many years, the conventional wisdom insisted that stocks were a hedge against inflation. The proposition was rooted in the fact that stocks are not claims against dollars, as bonds are, but represent ownership of companies with productive facilities. These, investors believed, would retain their value in real terms, let the politicians print money as they might. And why didn't it turn out that way? ***The main reason, I believe, is that stocks, in economic substance, are really very similar to bonds.***

I know that this belief will seem eccentric to many investors. They will immediately observe that the return on a bond (the coupon) is fixed, while the return on an equity investment (the company's earnings) can vary substantially from one year to another. True enough. But anyone who examines the aggregate returns that have been earned by companies during the postwar years will discover something extraordinary: the returns on equity have in fact not varied much at all.¹

In short, Mr. Buffett highlights two key considerations: the similarities between stocks and bonds and the overall importance of understanding the economic backdrop (inflation, interest rates and growth) in building an investment portfolio.

In terms of the first consideration, when you buy a stock, you become a partial owner of a company. If the enterprise thrives, you get a share of the profits, either through a rise in its stock price, reflecting growing earnings power, or through dividend income. If the company's earnings and prospects take a turn for the worse, the investment is likely to lose value as well, as the stock price drops and the dividend payments are reduced or suspended.

Bonds, on the other hand, are a different type of investment. When you buy a bond, you lend money to a company or government entity. In exchange, the borrower agrees to pay you a fixed rate of interest, or bond coupon. As opposed to the variable dividends on stocks, these are legal obligations. Because the payments are largely established at a predetermined rate, bonds are known as fixed-income investments.

However, in the end, there is a bottom line: both stocks and bonds represent claims on future income—income that is subject to risks, from bankruptcies to inflation, that could erode the value of your investment. While the safety afforded to bondholders may be appealing, it is not the only concern in every economic environment.

THE APPEAL OF DIVIDENDS

The second consideration is the macroeconomic environment. In Mr. Buffett's 1970s America, the worry was protecting equity holders from the vicious phenomenon of inflation, which erodes income. Today, the primary concern is that the low interest rate environment will continue for longer than investors expect, providing a disappointing stream of income on a bond portfolio while dividends continue to look attractive.

Why? In particular, the aftermath of the 2008 financial crisis has seen bond yields largely fall while dividend yields have been rising. This disparity between dividend yields and bond yields has two big drivers:

1. The Federal Reserve has maintained a record low level of short-term interest rates in an effort to stimulate economic growth, lending, and employment.
2. On the other hand, large companies cut costs quickly during the recession and are now flush with cash and cash-like instruments.

What happens next? With bond yields near historic lows, the risks are tilted toward higher interest rates in the future, not lower. If this occurs, it will cause bond prices to decline. Meanwhile, dividend yields are high, dividend tax rates are low and will continue to be low, which means that dividend paying stocks provide an opportunity for both current income and perhaps even some moderate price appreciation as the economy recovers. In fact, the type of economic environment ahead will dictate how dividend-paying stocks perform:

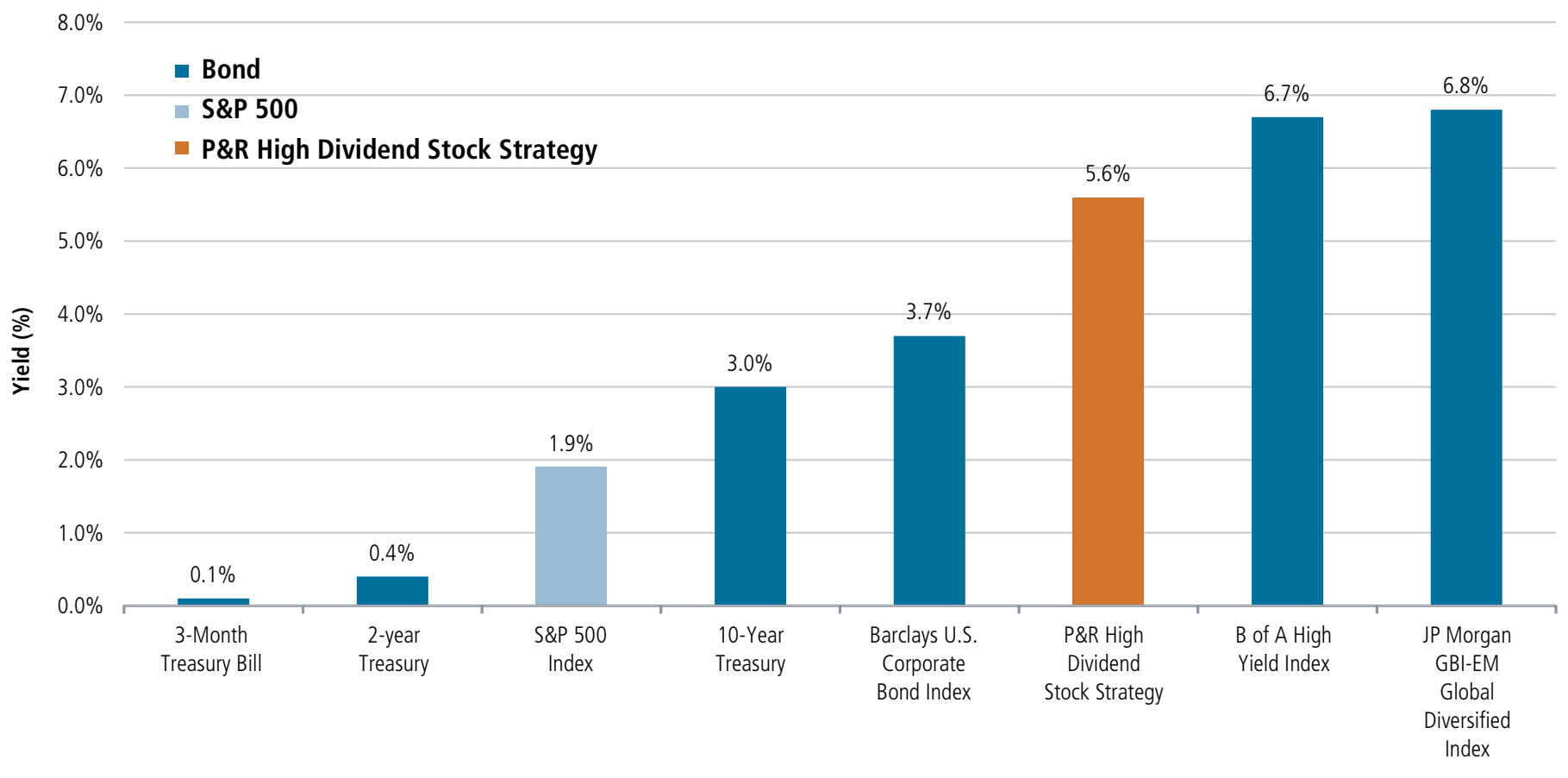
Scenario 1) Slow Growth: Stock prices should increase moderately along with earnings growth, and dividends should continue to increase given healthy corporate balance sheets and strong cash flow. Interest rates will remain low.

Scenario 2) High Growth: Stocks will appreciate quickly, and dividends should continue to increase, but comprise a smaller component of a stock's total return. Dividend paying stocks will perform well on an absolute basis but most likely lag high growth names in such an environment. Interest rates will rise.

Scenario 3) Double Dip Recession: Companies may be forced to cut their dividends, and a resulting drop in stock prices is a possibility. Interest rates will fall.

As a result, dividend-paying stocks work well in two out of three economic environments. The current macroeconomic environment has enabled stocks to provide attractive yields compared to bonds amidst robust corporate profits and improving fundamentals (See Figure 6). Currently the companies in the S&P 500 Index have over \$3 trillion of cash and short-term investments on their balance sheets. As a result, dividend payout ratios (the percentage of profits paid out as dividends) have been on the rise and are expected to rise further. Additionally, the extension of the Bush tax cuts will keep qualified dividend income tax rates at low levels for at least another two years, making after-tax yields particularly attractive.

fig. 5 THE HIGH DIVIDEND STOCK STRATEGY STANDS OUT VERSUS BONDS



Source: Bloomberg As of 5/31/11

A VARIETY OF DIVIDEND PAYING STOCKS

At this point, it is important to note that dividend-paying stocks come in several forms. Types of stocks offering attractive dividend yields are not limited to common stocks. Other investment options include:

- 1. Preferred stocks**—Preferred stocks are senior in the capital structure to common stocks, but higher yielding, with fixed dividends. These stocks tend to be less sensitive to interest rate movements compared to bonds and are yielding between 5% and 8%.
- 2. Real Estate Investment Trusts (REITs)**—REITs offer attractive yields and capital gains potential, in exchange for exposure to real estate fundamentals dependent upon occupancy rates and the absorption of construction. The current steep yield curve also provides attractive financing rates (funding in short-term rates, earning longer-term rates). Current yields for many REITs are greater than 5%.
- 3. Business development corporations (BDCs)**—BDCs are portfolios of small private companies, where most profits are distributed to shareholders, offering yields similar to REITs.

- 4. Master limited partnerships (MLPs)**—MLPs are publicly traded limited partnerships that are often in the business of transportation and/or storage of energy commodities. Pipelines, processing plants and storage facilities often fall under this category, and have steady to increasing cash flow, which translates into dividends of 5% and higher.

The “value added” other than merely observing the attractiveness of dividend paying stocks is to craft a portfolio that is well diversified across sectors and security type. Currently, we favor utilities (electricity and gas), telecommunications (primarily wireline), pharmaceuticals and select banking names. Furthermore, we focus on companies that can maintain or increase dividends due to stable or improving cash flows.

ANOTHER WEAPON IN THE INCOME ARSENAL

It is often said investors are faced with a decision: to partition their portfolios among stocks and bonds, with the fixed-income portion securing income and the stocks granting investors a share of the upside in the economic expansion. But, is it really a choice of one or the other? In an economic environment characterized by low interest rates, our answer is a resounding, “NO!” The message is clear: look beyond the fixed-income market in your quest for income. High dividend-paying stocks provide an alternative source of income to help survive the period of low interest rates. Sluggish US economic growth and strong demand for fixed-income assets could keep yields (and thus coupon income) low for an extended period of time. Investors must leap over the stock-bond divide and seek out high dividend-paying stocks as another option on the investment menu.

SOURCES

- 1 Warren Buffet. “How Inflation Swindles the Equity Investor”. *Fortune Magazine*. May 1977

“HAVE ALL THE INVESTMENT INCOME STONES BEEN LEFT UNTURNED? NOT QUITE. WHILE BONDS, OF COURSE, WILL STILL OCCUPY AN IMPORTANT PLACE IN AN INCOME-ORIENTED INVESTOR’S PORTFOLIO, WE THINK IT IS PRUDENT AND POSSIBLE TO LOOK BEYOND BONDS FOR CASH FLOW”

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333 South Grand Avenue
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617 807-1990

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