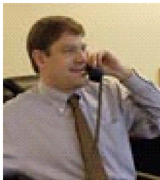
INVESTMENT UPDATE NEWSLETTER

ALLEN TRUST COMPANY

FEBRUARY 9, 2009



William A. Harris, CFA
Portfolio Manager

What the Markets Yield

The cash our investments pay us on an ongoing basis matters immensely. This fact tends to get overshadowed by rising asset prices in bull markets and by falling asset prices in bear markets. But always it matters: while our eyes draw naturally to movement (price volatility!) income quietly delivers a big chunk of our returns – for the eight decades 1926-2005, coupons on intermediate government bonds returned 4.7% annualized, and large stock dividends returned 4.2% (Ibbotson data). As a proportion of total compound annualized return, that's about 95% and 40% respectively.

What are the markets yielding now, and how sound is the outlook for income at a time when most economic and financial news is ugly?

Market Yield Survey February 6, 2009

6-month T-Bill	0.39%
10-year Treasury	2.98%
Merrill Muni Master	3.34%
BarCap Aggregate Bond Index	4.59%
Dow Jones Corp Bond Index	6.48%
S&P 500	2.95%
Dow Jones Utility Average	4.24%
Gold	0.00%*

**Due to storage costs, actually slightly negative.*

These numbers look low (some of them very low), but they improve at least in the context of recent inflation, which last year was nearly zero.

I particularly want to address the importance of income to stockholders. You'll note I refer not to stock traders but stock *holders*. The former, by necessity, care what other people think their assets are worth, while the latter focus on durable cash flows irrespective of market opinion. We count ourselves among the latter group, and believe that if our dividend cash flows persevere, what the market wants to pay for our assets is an issue (literally!) that will eventually take care of itself.

This attitude – that a financial asset's value derives from the cash it issues – is antique perhaps, but then again so are notions such as living with regard to your means, borrowing just what you can repay, and putting up seed corn for next season's sowing. While the stock market's plunge reflects the gloom of popular opinion, it concerns us less than the readings we're getting on the prospect for dividends. Whereas prices by their nature whip about, dividend returns have historically been a steady series, with a serial correlation of 0.89 and standard deviation of just 1.5% (Ibbotson). When a reliable series starts falling apart, it troubles us more than when a typically volatile series (price level) increases in volatility.

Last Friday Standard & Poor's issued a press release entitled "S&P 500 Dividends Projected to Decline 13.3% in 2009; Worst Annual Decline since World War II." The need to rebuild balance sheets (or at least stanch the depletion thereof) led 62 companies in the S&P 500 to cut their dividends last year, and with 14 already having done so in 2009, the trend may be accelerating. Add in political pressure on dividend payments by companies receiving Federal aid, as well as the likely destigmatization of cuts as they become more common, and the income picture dims for stocks as a whole.

Since we are not passive index investors, we do not buy stocks "as a whole," and we have been dramatically underweight financials in particular for a couple of years now, so our stock portfolio yields have yet to suffer much. But that can change. I'll write more on this in the months ahead, and explore the implications for how we structure portfolios.

William A. Harris, CFA