



GROESBECK

Investment Management Corporation

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## Dividend Growth Is Alive and Well

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- With all the news over the past 6 to 12 months regarding companies cutting their dividends and the year-to-date underperformance of dividend stocks, we want to remind investors of the merits of our strategy and the strength of its long-term results.
- After three of the four bear markets since 1972, high yield stocks posted accelerating excess total returns over the S&P 500.
- While a straightforward dividend yield strategy has proven successful over time, we believe that raising the bar, and investing in companies that not only pay a dividend, but have a record of increasing it can provide an even more efficient portfolio (lower risk, higher return).
- Our recent performance is not an indication of the long term success of our process.(see bottom of p.7)
- Our portfolio compares very favorably to the S&P 500 based on valuation, yield, growth rates, ROE and risk. 37% of our portfolio companies garner the highest ranking (A+) from S&P for earnings and dividend consistency compared to 7% for the S&P 500.
- We are positive about how the Growth of Income portfolio is positioned and its ability to extend the record of long-term outperformance we have built over the years.

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### The Argument for a Dividend-Based Investment Strategy

Recent financial news has included numerous stories of companies cutting dividends to preserve capital. The reality of the situation is that the dividend cuts have been concentrated in financial and deep cyclical stocks. While the ratio of companies with positive dividend news compared to those with negative dividend news has declined, the instances of good news still outnumber the bad. So far in 2009, 80 companies increased or initiated the dividend compared to 63 that cut or suspended the dividend, according to S&P 500 data.

Empirical evidence supports the case for a dividend-based stock selection strategy. As illustrated in Table 1, dividends consistently accounted for a significant portion – and sometimes the majority - of total returns in the S&P 500 index. On average, since 1940, dividends contributed approximately 43% of the total return provided by the S&P 500.

**Table 1: Dividend Portion of Total Return of the S&P 500**

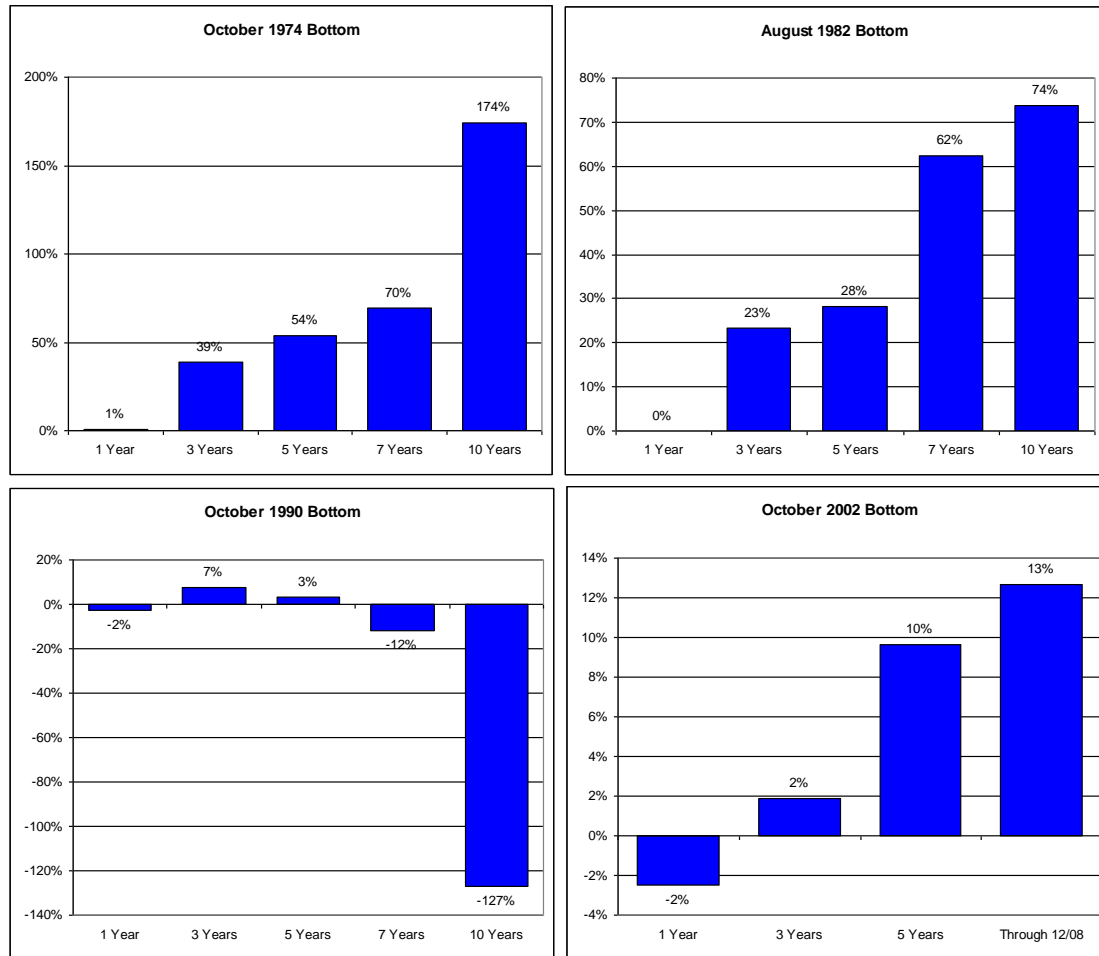
Decade	Annual % Change	Annual Dividend	Annual Total Return	Dividend % Total Return
1940s	3.0%	6.5%	9.5%	68.3%
1950s	13.6%	5.8%	19.3%	29.8%
1960s	4.4%	3.4%	7.8%	43.7%
1970s	1.6%	4.3%	5.9%	72.7%
1980s	12.6%	5.0%	17.5%	28.2%
1990s	15.3%	2.9%	18.2%	15.8%
2000s*	-4.3%	1.5%	-2.9%	NM

Source: Bloomberg data, Groesbeck Investment Management

\* Through 6/1/2009.

Researchers Eugene Fama and Kenneth French have also done extensive work on dividend stocks and their returns relative to the non-dividend payers. We used this resource to analyze the relative performance of a dividend strategy in market conditions similar to those we see today. Namely, we looked at total returns for various periods following a market bottom.

The study analyzed returns for the 1-, 3-, 5-, 7-, and 10-year periods following the market bottoms of October 1974, August 1982, October 1990, and October 2002. Fama and French compiled monthly value-weighted total returns for dividend payers and divided the group into deciles. We then compared the aggregate excess total returns for the five highest deciles (the dividend paying stocks with the highest yields) compared to the S&P 500.

**Charts 1 to 4: Cumulative Excess Total Returns for High Yielding Stocks**

Source: Fama and French\*, Bloomberg, Groesbeck Investment Management

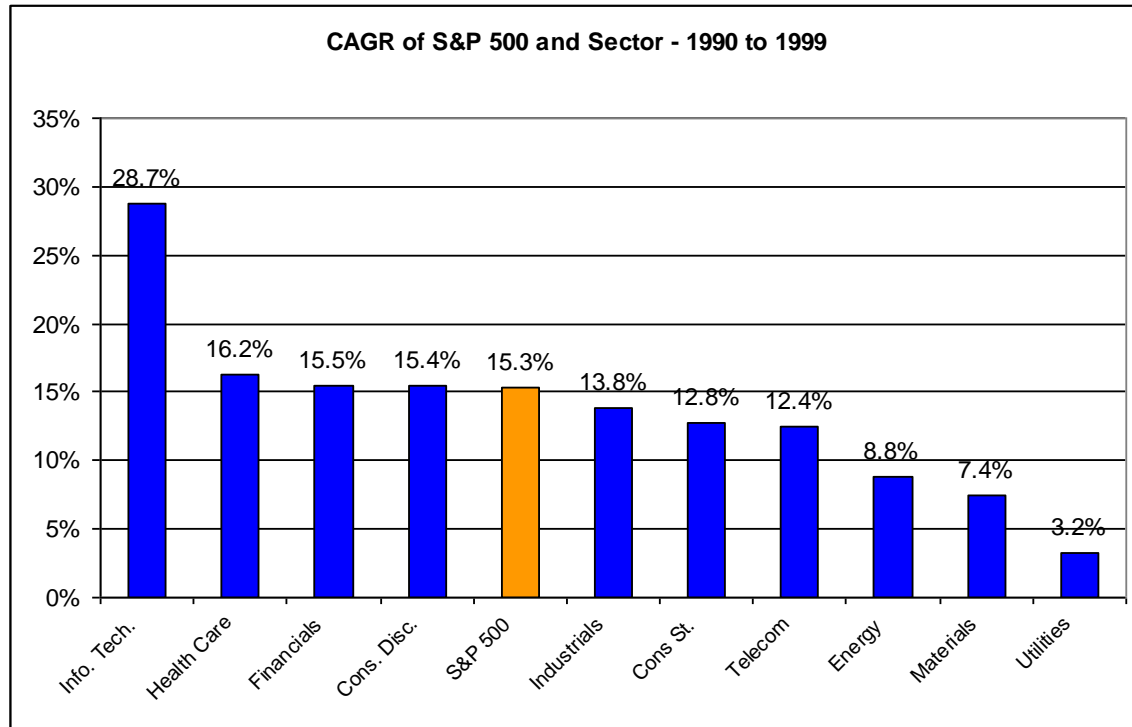
\* Fama and French created this file with CMPT\_DP\_RETs using the 200901 CRSP database.

The results we found are encouraging, and are illustrated in Charts 1 to 4. After three of the four bear markets, high yield stocks posted accelerating excess total returns over the S&P 500. Importantly, excess returns from dividend payers were nearly flat or negative in the first year following the market bottom, but investors that stuck with the strategy would have been handsomely rewarded over the longer-term in three out of the four scenarios.

Looking a bit more closely at the October 1990 market bottom, high yielding stocks held their own for the 3- and 5-year periods but underperformed for the 7- and 10-year periods. Breaking down the S&P 500's price performance by sector for the decade provides insight into why dividend payers underperformed. As shown in Chart 5, Information Technology (with relatively few dividend payers) well outperformed all other sectors in the S&P 500, driven by the Internet Boom. Adding to the disparate returns is the fact that typically higher yielding Utility stocks made up the worst performing sector in the index over the same period. Do note, however, that dividend stocks started to outperform considerably during 2000 and did so for the next couple of years by a wide margin. This is illustrated on Chart 9 which shows dividend payers

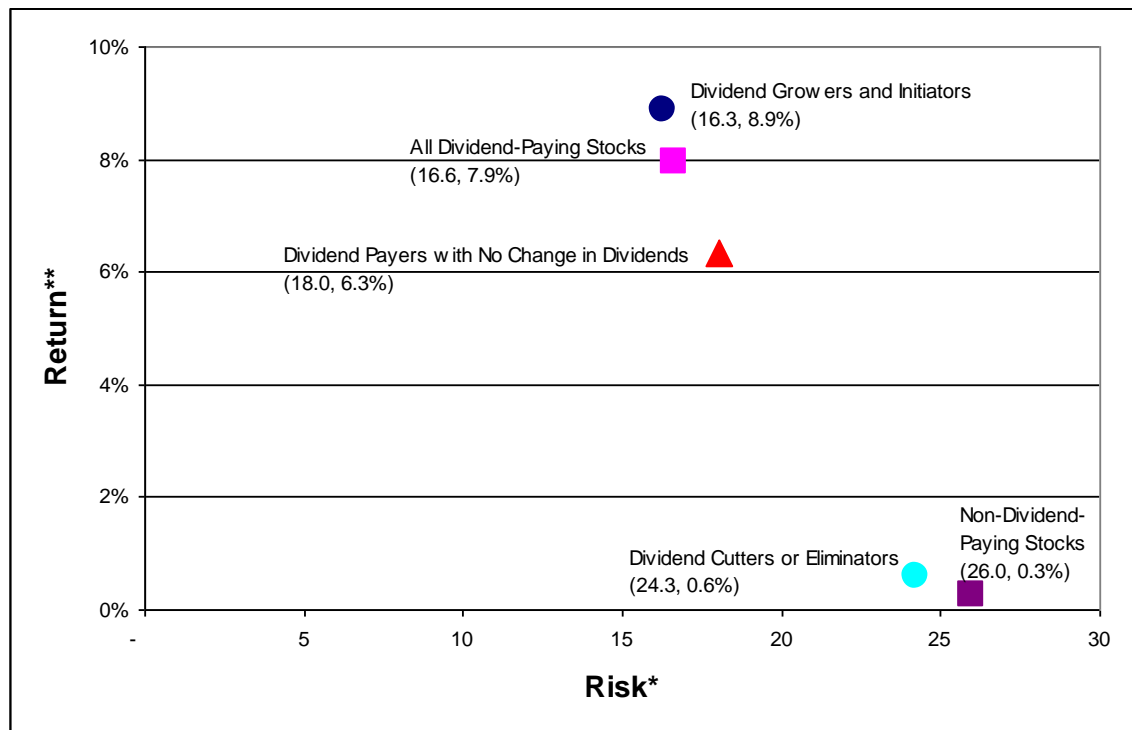
outperforming significantly from 2000 through 2002. This was reflective of the stock market returning to low-beta, high quality stocks, and away from the high-beta, low quality dot com names that drove the market during the technology bubble. Since our strategy focuses on generally lower beta, high quality stocks, we produced strong outperformance during this period.

**Chart 5: S&P 500 and Sector Price Performance – 1990 to 1999**



Source: Bloomberg, Groesbeck Investment Management

While a straightforward dividend yield strategy has proven successful over time, we believe that raising the bar, and investing in companies that not only pay a dividend, but have a record of increasing it can provide an even more efficient portfolio (lower risk, higher return). Chart 6 illustrates the results of a study conducted by Ned Davis Research comparing the risk/return profile of dividend growers and initiators to those of other dividend paying companies, and non-dividend payers. As shown in the chart, the lowest risk and highest returns during the period from 1/31/1972 to 12/31/2008 were achieved by companies that either grew their dividend payouts or initiated one.

**Chart 6: Risk/Return Profile of Dividend Payers and Non-Payers (1/31/72-12/31/08)**

Source: Ned Davis Research

\* As measured by standard deviation. \*\* Based on equal-weighted geometric average total returns.

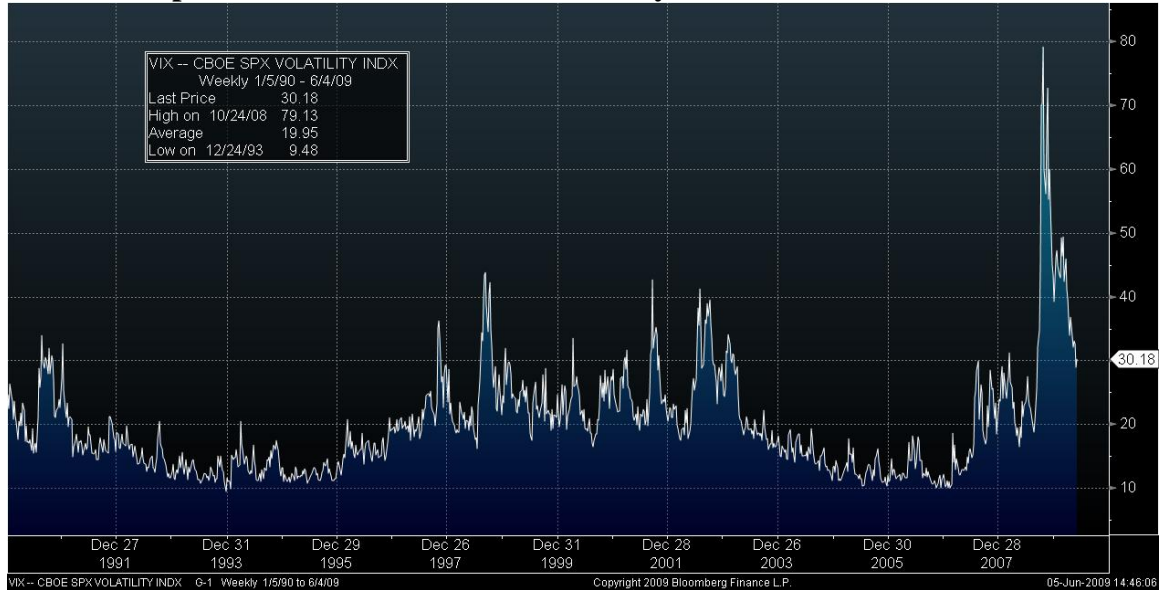
The empirical evidence presents a strong case that our dividend-growth strategy is successful. Because of its favorable risk/return characteristics, the strategy warrants an allocation in a well-constructed and diversified investment portfolio for the following reasons:

- Dividend paying stocks are typically less volatile than the overall stock market, thereby reducing risk. (Our Growth of Income composite has a ten year standard deviation and beta of 14.8 and 0.62, versus 17.0 and 1.0, respectively, for the S&P 500)
- Consistent dividend payout policy is an indication of a well-managed, fundamentally sound company
- Regular dividend payments help align management and shareholder interests, and provide a deterrent to investing in low-return capital projects
- A dividend increase is a positive signal of future financial strength

### Market Commentary and Outlook

The past two years (certainly since the bankruptcy of Lehman Brothers in September of last year) have seen unprecedented times in the stock market. The credit crisis and global recession resulted in extreme volatility as shown in the graph below showing the VIX index. As can be seen, volatility accelerated throughout 2007 and reached exorbitant levels in the fourth quarter of last year. The VIX index has dropped considerably in the last couple of months and is only now beginning to approach “normal” levels.

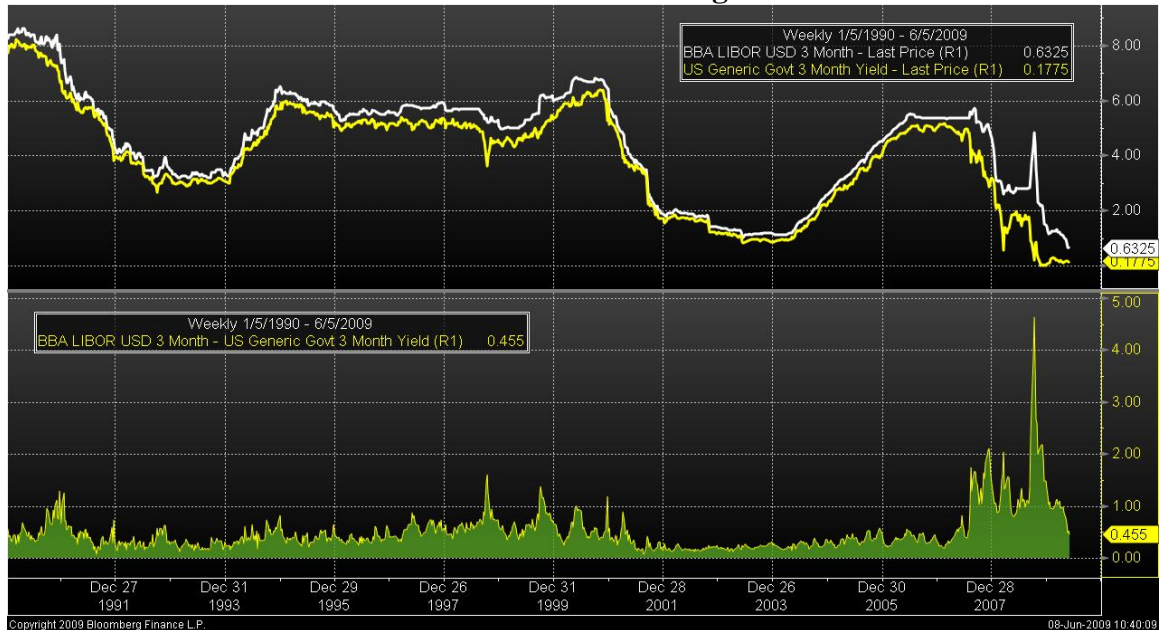
**Chart 7: Unprecedented Stock Market Volatility**



Source: Bloomberg

To demonstrate the extent of the credit crisis that engulfed the markets in 2008 and especially after the Lehman bankruptcy, we include below a graph of the TED spread. This graph shows the spread between 3-month treasuries and LIBOR. The greater the spread, the higher the level of risk aversion, resulting in increased difficulty in securing financing. You can see the enormous spread reached in the fall of last year. It too is only now approaching more “normal” levels.

**Chart 8: Risk Aversion in Credit Markets Returning to More Normal Levels**



Source: Bloomberg

These unprecedented times have resulted in many investment strategies and well-regarded money managers producing substantially below normal returns during this period. The next graph shows dividend-paying stocks (using the S&P 1500 index) underperforming so far in 2009. The graph shows that they (and Groesbeck) have outperformed in 5 out of the 8 years since the beginning of 2000.

**Chart 9: Relative Return of S&P 1500 Dividend Payers and Non-Payers**



Source: Bloomberg

Dividend stocks have underperformed year-to-date due to their smaller gains since the market rally started on March 9th. In the case of our portfolio, we actually were flat with the S&P 500 at March 6th before the rally began. The steep rise in the market has been led by lower quality, high beta stocks that were previously the most beaten down names (and heavily shorted) over the preceding 12 months. The stocks we own are high quality, lower beta names, and tend not to be heavily shorted. In addition, the market rotated to sectors with names levered to an early cycle recovery in the economy. In particular, technology stocks have been very strong, and while we have exposure here, our weighting is less than half that of the S&P 500's. We also had a cash level of around 15% as the rally began (it is now 5%) as we sold our remaining bank and REIT stocks during the 1st quarter.

Short term performance can deviate from the market. Over the past eleven years there have been 9 quarters where the return of our Growth of Income composite has been more than 500 basis points below the S&P 500 and in one of those periods by more than 11%. Conversely, there have also been 8 quarterly periods where the portfolio's return was over 500 basis points better than the market and in four of those instances the return was 10% or more over the market return. As this strategy was conceived by Bob Groesbeck in 1972, over the past 35 years, there were 8 years where the growth of income return was over 500 basis points below the S&P 500 and 15 years where the return was 500 basis



points better than the S&P 500. The point here is that you can't judge a strategy based simply on short term return numbers relative to a particular benchmark.

Our performance over the past 12 months through June 3rd (-32.7%) has been very close to the S&P 500 performance (-31.6%). As of May 31, 2009, our ten-year record of 2.0% per annum is better than the market's return of -1.7%. It is important to note that while the return for the S&P 500 was negative over the past ten years, our strategy of growing dividend payers has produced a positive return.

As the market's risk aversion continues to move towards more normal levels, we expect our strategy will start to perform more in line with its historical record. Over the next few years, we expect economic growth will not be particularly robust and is unlikely to allow unemployment levels to decline much below 7%. As is usually the case, unemployment levels will continue to increase even as the economy starts to recover, and may not peak until 12 months or more after the economy bottoms out. In addition, due to all the monetary and fiscal policies enacted over the past 12 months to stimulate the economy and to excessive national debt levels, inflation is likely to accelerate. We are already seeing expectations of this as interest rates and commodity prices are rising. These types of macroeconomic conditions have historically favored high quality companies with dominant market positions and the financial strength to thrive in a slow growth environment. We expect the fastest economic growth will come from certain foreign countries like China and India, where many of our consumer staple, healthcare, and industrial holdings will benefit from their international diversification and product/service leadership.

### **How We Are Addressing This Market**

The compelling evidence in favor of a dividend-based investment strategy and particularly, dividend growers, proves that owning companies with superior earnings and dividend growth will translate into superior portfolio performance.

Our selection process provides potential for a superior return compared to a simple focus on yield by seeking companies with a record of consistent dividend growth (see "The Argument for a Dividend-Based Investment Strategy" above). That growth must be supported by a history of improving operating EPS and a clean balance sheet. Accordingly, we purchase best-in-class companies in terms of quality fundamentals and sustainable competitive advantages.

Our research starts with a quantitative analysis that evaluates a company's revenue, earnings and dividend growth; degree of financial leverage; payout ratio; return on equity; and trading liquidity. The next step is a more in-depth analysis of fundamentals that would include our analysis of growth sustainability; free cash flow generation; industry analysis; and valuation.

The result is a portfolio of stocks with superior fundamentals compared to the market. The high quality of these fundamentals is important because it speaks to the companies'



ability to drive superior returns. This, in turn, has historically resulted in premium valuations for the stocks, and combined with a growing dividend payout, a superior total return for the portfolio. Regarding dividend increases, 29 out of the 30 stocks in our portfolio have increased their dividend over the past 12 months, which speaks volumes for their financial strength and management's commitment to shareholders.

Our portfolio compares very favorably to the S&P 500 based on several metrics:

**Table 2: Portfolio Fundamentals Compared to Benchmark**

	<b>Groesbeck Growth of Income</b>	<b>S&amp;P 500</b>	
Trailing 12 Month P/E	12.8x	21.4x	Lower
Dividend Yield	3.5%	2.5%	Higher
1 yr EPS Growth	2.0%	-44%	Better
5 yr EPS Growth	4.0%	-7.0%	Better
1 yr Dividend Growth	14%	-3.5%	Better
5 yr Dividend Growth	14.8%	3.4%	Better
Projected 3 yr Dividend Growth	6.1%	-5.0%	Better
Dividend Coverage	2.5x	1.6x	Better
Payout Ratio	43%	63%	Better
Price to Book	3.6x	3.2x	Higher
Price to Cash Flow	8.7x	10.8x	Lower
Price to Sales	1.6x	1.5x	In-Line
Average ROE	26.4%	24.6%	Better
Portfolio Beta	0.77	1.00	Less Volatility
5 yr STD Deviation	15.3	14.3	Above
10 yr Std Deviation	14.8	17.0	Less Volatility

Source: Standard & Poor's, Groesbeck Investment Management

S&P Quality Rankings rates companies based on their consistency in earnings and dividend growth over a ten year period. All of our rated holdings are ranked a minimum of B+. While two companies are not ranked, we consider them high quality. McGraw Hill (MHP) is the parent of S&P and does not rank itself. Kinder Morgan Management (KMR) does not yet have a ten year record for earnings and dividends. The table below shows our rankings versus the S&P 500 based on the number and portfolio weighting:

**Table 3: S&P Quality Rankings**

<b>S&amp;P Quality Ranking</b>	<b>Companies</b>		<b>Weights</b>	
	<b>GOI</b>	<b>S&amp;P</b>	<b>GOI</b>	<b>S&amp;P</b>
A+	11	36	37%	17%
A	6	42	19%	11%
A-	6	50	21%	11%
B+	5	137	16%	28%
B	0	104	0%	18%
B-	0	58	0%	5%
C	0	16	0%	2%
NR	2	57	7%	9%

Source: Standard & Poor's, Groesbeck Investment Management

Standard & Poor's conducted an analysis of A-rated companies and the results showed a higher return than the general stock market with lower volatility. This has also been the case for our Growth of Income portfolio over a long-term period as it has outperformed the market with lower volatility based on our higher rates of return and lower standard deviation measures. Our portfolio's composition of A rated companies is 77% versus 39% for the S&P 500. S&P also found that many of these higher ranked companies exhibited strong characteristics of higher gross and net margins, lower debt levels, and a higher return on equity. These are the same metrics we screen for in our portfolio holdings. The study further found that during down markets the decline in the high quality stocks is less than the lower quality stocks. This is the same for the Growth of Income strategy.

Given the high standards we impose for inclusion in our portfolio, even companies that initially met our criteria occasionally fall short. Of course, the failure to increase the dividend triggers an automatic sale of the stock. However, we also constantly monitor the portfolio for signs of weakening sales and earnings, declining margins, reduced dividend growth rate, or full valuation.

During 2008, we experienced extraordinary volatility driven in large part by the dislocation in credit markets. For stocks, nowhere was the credit crisis more impactful than in the financial industry. At the beginning of the year, financials represented about 22% of the holdings in our portfolio. Since then, all but two (T Rowe Price and Aflac) of the financial companies we owned have been sold, which lowered our current weighting in this sector to 5.5%.

Recently, bank stocks have made an impressive rally from the March low and are up 63% over the past three months. This breathtaking move may turn out to be short lived as the P/E for this sector at the end of May was 22.4 times 2009 estimates, far above the S&P level of 16.8 and way above the sector's 5-yr average of 11.1. We do not see the hard times as being over for bank companies as earnings pressure will continue, given ongoing foreclosures, and increased loan losses in commercial real estate, consumer and commercial loans. The troubled securities are still on bank balance sheets and uncertainty over the government purchase program is ongoing.

A question that we often get from investors is whether our ability to find suitable new ideas for the portfolio has been hampered by the breakdown in financials and banks in particular. Despite the well-publicized difficulties in the financial sector, there are 42 banks and financial companies with market caps greater than \$2B (61 companies with market caps greater than \$1B) that have increased the dividend payout over the past year. These are all potential candidates that could be considered for the Growth of Income portfolio, so we are not necessarily precluded from adding banks or other financials if we think conditions warrant such a move. We are quick to note, however, that we apply a bottom-up approach to portfolio management. We do not target sector weightings, other than limiting the maximum exposure to any given sector for risk management purposes.

As the economy and the markets have shifted over the last two years, so has the Groesbeck investable universe. Financials have very significantly diminished in their number of potential candidates; subsequently, utilities ( D, FPL), consumer staples ( CL, PEP, MCD), and industrials ( GD, LLL) became available, in some cases at valuations we have not seen for as many as twenty years. These opportunistic valuations, coupled with robust earnings growth, offer bright prospects for superior returns down the economy's road to recovery, since historically they've traded at P/E's 20% to 50% above today's levels. (See Appendix A for a list of our holdings' earnings and dividends history).

We are positive about how the Growth of Income portfolio is positioned and its ability to extend the record of long-term outperformance we have built over the years. We are seeing compelling opportunities, albeit in sometimes different places than in recent years. For the most part, the recent rally has been concentrated in high-beta names that fall outside our investable universe. However, we believe that a previous overreaction to the downside in those names and short covering accounts for a good portion of those recent short-term returns. Ultimately, we expect investors to refocus on sustainable returns and growth rates once the low-hanging fruit available to bottom feeders is gone.

### **Summary and Conclusion**

We remain focused on maintaining the high performance and investment standards of our strategy. While we have under-performed the bench since 3/6/09, we have captured 62% of the upside since then – not a dramatic shift from our historical upside capture of approximately 75%. Also, we would expect our capture rate to be lower in a period of such dramatic increases (approx +39% for the bench in just 3 months). This suggests that for the past three months, relative performance for the portfolio has been in line with historical levels. We remain confident in our investment process, and as always are happy to discuss any questions or concerns our clients may have.

**Appendix A: Historic growth rates of earnings and dividends for portfolio holdings**

<i>Company Name</i>	<i>Earnings Growth</i>			<i>Dividend Growth</i>		
	<i>5 year</i>	<i>10 year</i>	<i>20 year</i>	<i>5 year</i>	<i>10 year</i>	<i>20 year</i>
Aflac Inc (AFL)	16.1	17.7	16.9	24.8	24.0	18.4
Abbott Laboratories (ABT)	8.5	8.2	10.9	8.2	8.9	11.7
Becton Dickinson & Co (BDX)	15.5	12.8	12.0	18.4	14.5	12.6
Colgate Palmolive (CL)	9.6	11.4	11.7	11.3	12.3	12
Chevron Corp (CVX)	21.0	26.8	11.7	12.2	7.9	6.8
Dominion Res Inc (D)	7.4	8.6	4.2	5.3	3.1	2.5
FPL Group Inc (FPL)	11.1	7.5	4.6	8.4	6.2	2.7
General Dynamics Corp (GD)	19.0	15.6	9.5	16.7	12.2	13.3
Illinois Tool Wks Inc (ITW)	6.9	6.3	10.4	20.6	15.2	16.3
Johnson & Johnson (JNJ)	10.4	13.2	13.3	13.1	13.9	14.3
Kinder Morgan Energy Partner (KMP)	6.1	4.3	-	8.9	11.6	-
L-3 Communications Holdings Inc (LLL)	19.6	26.4	-	45.5	-	-
McDonalds Corp (MCD)	18.9	11.3	11.3	36.2	26.1	18.1
McGraw Hill Cos Inc (MHP)	9.2	11.9	9.4	9.3	7.7	6.6
McCormick & Co Inc (MKC)	8.4	10.9	11.9	12.1	10.9	13.2
Medtronic Inc (MDT)	12.6	14.4	17.7	20.9	19.3	19.9
Microsoft Corp (MSFT)	14.1	11.4	25.6	15.8	-	-
Owens & Minor Inc (OMI)	10.7	12.2	-	16.9	16.5	-
Paychex Inc (PAYX)	13.2	15.0	22.0	21.4	22.7	33.2
PepsiCo Inc (PEP)	8.0	12.1	10.3	19.4	12.6	13.3
Proctor & Gamble Co (PG)	10.5	10.2	11.2	11.9	11.9	11.5
Praxair Inc (PX)	17.5	12.4	-	23.5	19.0	-
Sysco Corp (SYY)	6.2	13.6	13.6	13.5	17.0	20.8
AT&T Inc (T)	13.5	2.2	5.6	3.1	5.3	4.8
Price T Row Group Inc (TROW)	7.1	8.4	14.3	21.9	17.5	20
United Technologies Corp (UTX)	14.3	14.0	10.8	16.8	15.6	10.7
VF Corp (VFC)	5.8	5.1	7.2	18.1	10.9	8.8
Waste Management Inc (WMI)	10.5	0.7	18.7	23.0	-	-
Wal Mart Stores Inc (WMT)	9.9	12.6	15.4	19.7	18.5	20.1
<b>Average</b>	<b>11.8</b>	<b>11.6</b>	<b>12.4</b>	<b>17.1</b>	<b>13.9</b>	<b>13.5</b>
<b>S&amp;P 500 (SPX)</b>	<b>1.3</b>	<b>3.4</b>	<b>4.1</b>	<b>5.5</b>	<b>4.1</b>	<b>4.4</b>

Source: SRC Securities Research Company and Groesbeck Investment Management Corp.

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