June 2012

Monthly Investment Commentary

Commonwealth Bank & Trust Company

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Risk assets experienced a steep sell-off in May. The intensifying sovereign crisis in Europe drove equities down around the world, particularly in the foreign developed and emerging markets. For the month, the MSCI EAFE was down (11.31%) and the MSCI Emerging Markets index was down (11.20%). U.S. risk assets held up relatively better than foreign markets, but were still down significantly. The S&P 500 was down (6.01%) and the Russell 2000 was off (6.62%). Volatility spiked sharply during the month, reflected by the CBOE volatility index (VIX) up over 40%, causing investors to seek the safety of fixed income. The Barclays Aggregate Bond index was up 0.90% and the Barclays Municipal Bond index was up 0.83%.

REVIEWING THE RISK AND REWARD OF INVESTING IN DIVIDEND PAYING STOCKS

Economic uncertainty and the poor returns of stocks the past decade have led investors to seek higher yielding securities in the hope of better returns and lower volatility (risk). Traditionally, fixed income assets like Treasury securities and other types of bonds were the answer to investors' desire for higher yields and lower risk. However, with bond yields hitting record lows and priced to deliver poor total returns the next few years, this is no longer the case. While bond investments may offer a level of comfort near-term in volatile markets, we do not believe they will meet the yield, total return and risk objectives that investors have in the intermediate and long-term.

In our opinion, investors can meet some of their income and return objectives by investing in high and growing dividend yielding stocks. While we will go into greater detail below, here are some of the reasons investors should consider dividend paying stocks. Historically, dividends have accounted for a large portion of the overall return in the US equity market. High yielding stocks have significantly outperformed stocks which don't pay a dividend, particularly in times of slow economic growth. Current payout ratios for dividend paying stocks are relatively low, and the likelihood of firms increasing their dividends remains high.

While high dividend yielding stocks look attractive on many fronts, investors should also consider the potential negatives of owning dividend stocks. Here are a couple of reasons to be cautious. During 2011, high dividend yielding stocks outperformed their non-dividend paying counterpart, but during the first 10 weeks of 2012 this was not the case. The high yielders underperformed other equities and this caused investors to cast some doubt on the high yield strategy. The most significant concern to investors considering high dividend paying stocks is the expiration of the Bush Era tax cuts in first quarter of 2013. If these tax breaks expire and no new legislation is passed, taxes on dividends will increase causing a high dividend yielding stocks to be negatively affected.

Here is a compilation of the main reasons investors should consider investing in high dividend yielding stocks as well as some of the reasons investors should remain cautious.

REASONS TO FOCUS ON DIVIDEND YIELD

1. HISTORICAL IMPORTANCE – Since 1930 dividends have accounted for over 40 percent of the 9.2 percent total return in the US equity market. This statistic makes a strong case for focusing on dividend yields when selecting equities in which to invest. In sideways markets we expect the percentage of total return to be even higher.

Exhibit 2

Dividends Have Accounted for Over 40% of Total Return Since 1930

S&P 500 Total Return: Price and Dividend Contribution

	Total Return	Price Appreciation	Income Return	As a Share of Total Return	
				Price App.	Div. Income
1930's	0.1%	(5.3%)	5.7%	na	na
1940's	8.9%	3.0%	5.7%	33.6%	64.5%
1950's	18.9%	13.6%	4.7%	72.0%	24.7%
1960's	7.7%	4.4%	3.1%	57.2%	41.0%
1970's	5.8%	1.6%	4.1%	27.8%	71.1%
1980's	17.2%	12.6%	4.1%	73.2%	23.8%
1990's	18.0%	15.3%	2.3%	85.1%	12.9%
2000's	(0.9%)	(2.7%)	1.8%	na	na
2011	2.1%	(0.0%)	2.1%	0.0%	100%
2003-2011	6.2%	4.0%	2.0%	65.8%	32.9%
1930-2011	9.2%	5.1%	3.9%	55.5%	$\boxed{42.4\%}$

Source: Factset, Morgan Stanley Research

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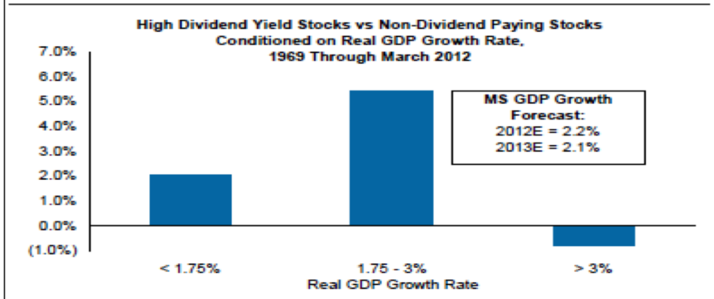
2. ECONOMIC LANDSCAPE – It is our belief that the developed economies are in an extended deleveraging process that will lead to slower than normal economic growth, the so called "New Normal". In periods of low economic growth, equities with higher dividend yields outperform equities with lower yields, and tend to be more attractive to investors seeking higher returns.

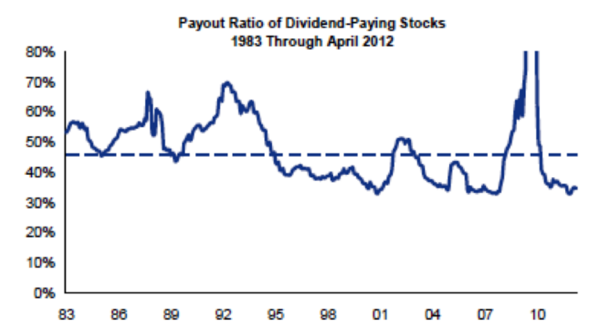
A "Muddle-Through" Scenario Is Good for High Yielders



Source: Factset, Morgan Stanley Research

3. PAYOUT RATIOS ARE NEAR AN ALL-TIME LOW – The payout ratios of dividend paying stocks are near historic lows. Over the last several decades, the payout ratio of dividend paying stocks has averaged around 45.5 percent. Currently the average payout ratio is hovering just above 30 percent. Morgan Stanley in a recent research report pointed out that over the past several years firms have been compensating their executives in restricted stock rather than with stock options. These executives are now more likely to increase dividends because of the additional incentive they have to increase their own net worth. Companies could increase their current payout ratios and still remain below the historic average.

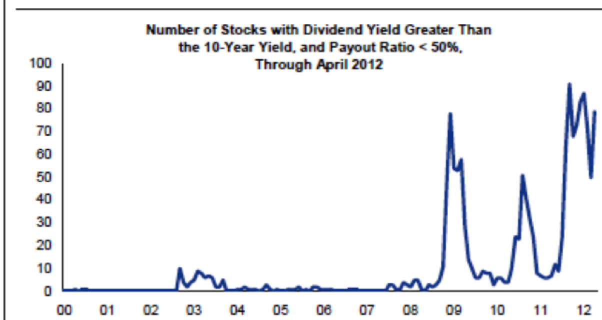
Payout Ratio of Dividend-Paying Stocks Is Low



Source: Factset, Morgan Stanley Research.

4. ATTRACTIVENESS TO THE 10-YEAR – It is our belief that stock returns, in general, are priced to deliver mid-single digit type returns the next five years, however, we think high quality dividend paying stocks are priced to deliver mid-to-high single digit returns with lower volatility over that same time-frame. With the 10-year treasury yield near historic lows, many equities are beginning to look very attractive compared to fixed income assets, particularly with the 10-year treasury yielding around 1.5%. In today's market there are now more stocks than ever before that meet the criteria of having a dividend yielding more than the 10-year treasury. In addition to the favorable dividend yields, the possibility of companies increasing their dividend yield makes these stocks even more attractive to investors.

Percentage of Stocks Yielding More than the 10-Year with Low Payout Ratios



Source: Factset, Morgan Stanley Research. Universe is top 500 stocks.

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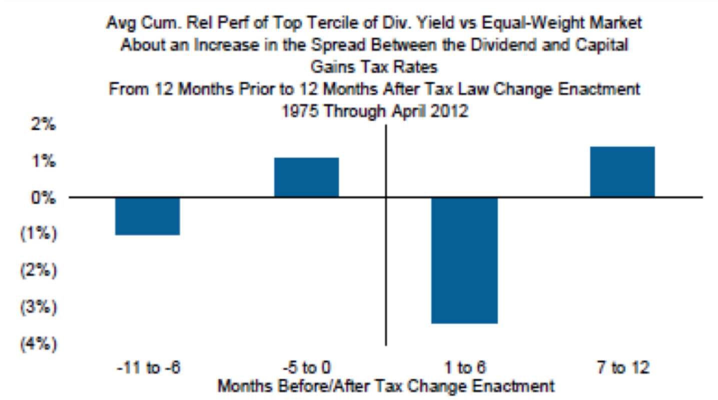
SHORTCOMINGS OF THE DIVIDEND THESIS

1. RECENT WEAKNESS – While high dividend yielding stocks outperformed lower yielding stocks by some margin in 2011, during the first 10 weeks of 2012 the higher yielding stocks underperformed their lower yield counterparts. The poor performance of the higher dividend yield equities has caused some concern for investors in the early part of the year. Despite the poor performance early in the year, the high dividend yield stocks are rebounding and starting to perform again. Over the past several months the top three performing sectors have been telecommunications, consumer staples, and utilities. These three sectors also happen to be the sectors with the highest dividend yield.

2. DIVIDEND TAX LAW – The likelihood of the dividend tax rate increasing is the biggest concern for most investors when considering investing in high dividend yielding equities. The way that the current tax law is written, taxes on dividends are set to increase in the first quarter of 2013. A higher tax on dividends would presumably have a negative effect on higher dividend yielding stocks. A recent Morgan Stanley report estimated that the negative effect may not be as severe as investors believe. Their research shows that dividend paying stocks have historically outperformed their non-dividend paying counterparts significantly more when the dividend tax rate fell between a 32 percent to 50 percent range. If the current tax breaks expire in 2013 and no new legislation is passed, the tax rate will fall between this 32 to 50 percent range. Further research has shown that dividend paying stocks do not experience any negative side effects in the months leading up to the enactment of the legislation, but rather experience negative performance in the first 6 months after the legislation has passed. Investors may want to reduce their exposure to high dividend yielding stocks in the first six months or so after the tax rate increases, but face no significant risk in months leading up to the enactment of the new tax rates.

The Market Does Not Anticipate Tax Increases in High Dividend Yielders and Recovers After 6 Months



Source: Factset, Morgan Stanley Research.

SUMMARY

After weighing the above pros and cons of dividend paying stocks in today's market environment, we are firmly in the "pro" camp, and think they should play an important role in most portfolios. In summary, we believe dividend stocks offer solid income growth advantages relative to fixed income assets and attractive total return potential relative to the general stock market, with potentially less volatility. Our investment strategies will continue to emphasize identifying world-class companies that have the ability and desire to pay a growing dividend stream to shareholders, a strategy that we believe is well suited for the volatile times we see ahead. If you have any questions or would like to learn more about this topic please contact us.

– CB&T Investment Team (6/12)