Alley Company Quarterly Letter
<u>Transition</u>

July 17, 2013

In late May, Federal Reserve Chairman Ben Bernanke signaled that a "transition" is in the offing as the Fed considers winding down, or "tapering" its unconventional bond buying program in favor of allowing the economy to run more on its own power. The reaction in the bond market has been noticeable, as the yield on the ten-year Treasury spiked to 2.60% from a recent level of 1.60%. Since bond prices move in the opposite direction of yields, this abrupt change has left most sectors of the bond market with negative rates of total of return through the first half of 2013. Reduced bond buying, or quantitative easing (QE), by the Fed implies a stronger economy. This in turn implies a constructive backdrop for corporate profits and equities.

Before Bernanke's landmark commentary on tapering QE, many investors wondered if equity exposure in portfolios should be reduced after the strong first half returns in 2013. Now, with fixed income investments showing negative returns during the same period, reducing bond exposure is being discussed. In fact, some investors wonder why owning bonds makes any sense at all if interest rates move higher and total returns continue to be negative over the ensuing period.

The transition to higher interest rates and the corresponding effect on bond and stock investments will be an ongoing challenge for investors. Bonds are an important component of an asset allocation program in that they provide current income and a volatility dampening effect on the overall portfolio. It should also be recognized that as interest rates rise, reinvestment rates for bonds will get progressively more attractive. But bonds also need to be owned in the right proportion compared to the relative attractiveness of other investment choices. Consider that over the past six years, bond funds have received massive inflows while equity funds have experienced outflows. If the scenario is one of a stronger economy, rising interest rates, and negative total returns for bonds, it is possible that money will be flowing out of bonds and into stocks for an indeterminate period of time.

As investors contemplate reducing bond exposure in favor of stocks, one question we pose is, "will a bond investor seeking current income first move to the riskier areas of the equity market like small and mid-cap stocks, or will the first move be to the more conservative income oriented areas of the stock market like dividend paying stocks?"

Alley Company LLC
585 Bank Lane, Suite 2400
Lake Forest, IL 60045
Phone 847-482-0938
Fax 847-482-1237
www.alleycompanyllc.com

We expect the answer to be the latter as dividend paying stocks "bridge the gap" between current income generation and upside potential in stocks. The table below supports this shift as we highlight some blue chip American companies with dividend yields that exceed their respective ten-year bond yields. For example, if the question is to buy Merck common stock at a 3.5% dividend yield or its ten-year bond at a 3.1% yield, we'd opt for the stock.

Company	**Industry**	**Dividend Yield**	**Ten-Year Bond Yield***
Philip Morris Int'l	Consumer Goods	3.80%	3.35%
McDonald's	Restaurants	3.05%	3.00%
Intel	Technology	3.80%	3.30%
Merck & Co	Health Care	3.50%	3.10%
Conoco Phillips	Energy	4.20%	3.15%
Verizon	Telecom	4.10%	3.40%

All yield data as of 07/15/13
*Closest corporate bond to ten year maturity
Source: Thomson Reuters, Charles Schwab

The breadth of the economic recovery has improved, and notwithstanding slowdown concerns in China and the lingering Eurozone malaise, there continue to be several large fundamental trends that underpin the economy: an improving job market, an improving housing market, a strong auto sector, a growing U.S. energy sector, mobile handset productivity, a healthy banking sector, and improving consumer sentiment. In other words, many economic metrics are trending positively which makes the tapering of QE probable, and in this context investors need to carefully analyze their asset allocation exposures between stocks and bonds.