Alley Company Commentary
The Case for Dividend Investing

December 20, 2012

With bond yields at record lows and savings rates mired near zero, investors have understandably been searching for more attractive investment income in other places. Meanwhile, dividend yields on stocks are now *higher* than the 10-Year Treasury yield, which is significant because this relationship last existed in the 1950s.

As the table below showcases, yields from traditional sources of income (e.g., money markets, certificates of deposit, and Treasury bonds) are at anemic levels – and investors are at risk of losing purchasing power even with only modest levels of inflation. The dividend yield on the S&P 500 of 2.1% is more competitive, but what is remarkable is that many high quality companies with strong track records of dividend payout have far more attractive dividend yields, even relative to their own issued corporate bonds.

Current Yield Environment

Asset Class	Yield	Company	Dividend Yield	Bond Yield
Money Market	0.01%	McDonalds	3.4%	2.2%
1-Yr. CD	0.6%	Johnson & Johnson	3.4%	2.1%
5-Yr. Treasury	0.8%	Intel	4.4%	2.7%
10-Yr Treasury	1.7%	ConocoPhillips	4.5%	2.5%
S&P 500 Index	2.1%	AT&T	5.3%	2.6%

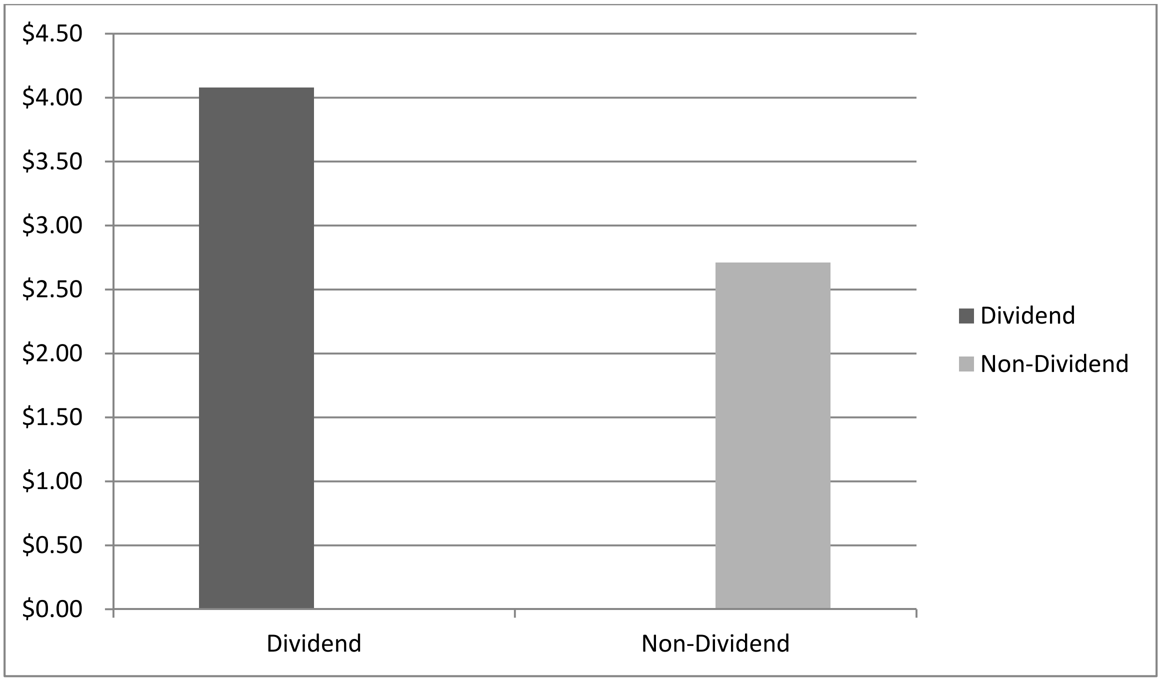
Source: Thomson Reuters and Charles Schwab Institutional. Yields displayed are as of 12/18/12. Each company's bond yield represents the yield-to-maturity of its issued bond that is the closest to having ten years remaining until maturity.

Superior Total Return and Lower Risk

While the current income from dividends can clearly be viewed as appealing, this should not take emphasis away from the long-term capital appreciation potential of dividend-paying companies. Historically, the powerful combination of dividend income and capital appreciation has produced superior total return for dividend-paying stocks relative to non-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

Historical Total Return Chart: Dividend Payers vs. Non-Dividend Payers



Source: S&P Capital IQ and The Wall Street Journal. Dividend-paying stocks in the S&P 500 produced an annualized total return of 12.1% from 1980 through July 2012 compared to 10.7% for non-dividend payers. This means an initial stake of $1 would have grown to $4.08 for the dividend payers compared to $2.71 for the non-dividend payers.

In addition to superior long-term returns, dividend-paying stocks have also been among the more conservative areas of the equity market. Statistically, according to research from Barclay's for the period 1969-2010, the highest dividend yielding quintile of the largest 1,000 firms by market capitalization had the lowest risk (as measured by standard deviation of return) while the lowest yielding quintile had the highest risk. As markets get more volatile, the cash dividends paid from companies that have the corporate culture and financial wherewithal to continue paying them serve as a stabilizing mechanism.

Net, the combination of superior total return and lower volatility (i.e., attractive risk-adjusted return potential) creates an investment option that is highly attractive for a broad spectrum of investors and can be a cornerstone in many portfolios.

Deconstructing Total Return

Over time, an equity investor's total return is comprised of dividend payments and capital appreciation.

Total Return = Dividends + Capital Appreciation

Put simply, to reach the same total return, a company with a modest dividend yield (or no dividend) must rely on higher capital appreciation compared to a company that starts out with a higher dividend yield.

As the ancient proverb says: *"A bird in the hand is worth two in the bush."*

While companies that pay cash dividends are not legally bound to continue doing so (that decision is made each quarter by the Board of Directors), there is a major signal effect of corporate health and management optimism that comes from dividend policy decisions. As a result, dividend payouts are generally viewed as long-term commitments to shareholders and many companies articulate that cutting their dividend would be considered a last resort.

The more certain element of the “bird in the hand” has obvious appeal. Nonetheless, prevailing market conditions still cause the contribution of dividends to total return to vary widely from period to period. As the table below illuminates, during the bull market periods of the 1980s and 1990s, *capital appreciation* accounted for the bulk of total return. In the 1930s and 2000s, however, the investment landscape was starkly different and it was *dividends* that provided the only solace for investors.

Over the long term (the past 85 years), it is notable that dividends have accounted for fully 43% of total return with capital appreciation representing the remaining 57%.

The Component Parts of Total Return

Time Period	**Dividends**	**Capital Appreciation**	**Total Return**
1930s	5.4%	-5.3%	0.1%
1940s	6.0%	3.0%	9.0%
1950s	5.1%	13.6%	18.7%
1960s	3.3%	4.4%	7.7%
1970s	4.2%	1.6%	5.8%
1980s	4.4%	12.6%	17.0%
1990s	2.5%	15.3%	17.8%
2000s	1.8%	-2.7%	-0.9%
1926-2011	4.1%	5.5%	9.6%

Source: Standard & Poor’s. Table represents the component parts of total return for the S&P 500 Index.

Dividend Taxes

As the table below depicts, the current maximum tax rate on dividends is an attractive 15%. Unless Congress acts with different legislation, however, taxes on dividends are scheduled to revert back to ordinary income tax rates in 2013. While the debate on the potential impact on dividend stocks is multifaceted, the evidence suggests that any knee-jerk reactionary decline would represent a buying opportunity for long-term investors.

Historical Tax Rates: Dividends and Capital Gains

	1979-1981	**1982-1986**	**1987**	**1988-1990**	**1991-1992**	**1993-1996**	**1997-2002**	**2003-2012**
Dividend Tax Rate	70.0%	50.0%	38.5%	28.0%	31.0%	39.6%	39.6%	15.0%
Capital Gains Tax Rate	28.0%	20.0%	28.0%	28.0%	28.0%	28.0%	20.0%	15.0%

Source: The Tax Foundation. Rates displayed represent the maximum rate for that period. From 1980 through 2002, a period of higher dividend taxation before the favorable tax rate regime that started in 2003, dividend-paying stocks produced a total return of 14.1% compared to 11.3% for non-dividend paying stocks (source: S&P Capital IQ and The Wall Street Journal).

Even under the scenario where dividend income would be taxed at ordinary income tax rates:

- Dividend income would not be disadvantaged relative to bond income (which also would be taxed at ordinary rates). Thus, investors would be left to judge the relative attractiveness of each with similar tax consequences.

- Not all dividend stock holders would pay the highest marginal rate. In fact, a high percentage of dividend stocks (50% according to Fidelity Investments) are held in tax-advantaged accounts such as IRAs, 401(k)s, endowments, or foundations. These holders are indifferent to dividend tax changes and thus would not be expected to change their behavior regarding their holdings.

- The historical total return chart on page 2 shows the outperformance of dividend-paying stocks. As the table above reveals, this experience was achieved across many different tax regimes. Furthermore, the outperformance of dividend-paying stocks relative to non-dividend paying stocks was even *more* pronounced in the period 1980 through 2002, i.e., *before* the favorable dividend tax rate regime that started in 2003.

Net, the historical experience is far from conclusive that the tax environment has a detrimental effect on dividend-paying stocks.

Secular Demand

With or without higher tax rates, dividends are poised for secular upswing. In particular, as ten thousand baby boomers are expected to turn 65 years old in the United States every day for the next 18 years, demographic-driven demand for income will assuredly remain strong. At the same time, the current dividend payout ratio (percent of earnings paid out as dividends) in Corporate America is approximately 30% compared to the longer-term average of approximately 50%. With the current health of corporate balance sheets as an added benefit, companies are in a strong position to maintain the supply of dividends that investors will demand.

Alley Company Investment Philosophy

The Alley Company investment philosophy focuses on striking the right balance between attractive dividend yield and dividend growth. Simply “reaching” for the highest dividend yield can lead to a lower quality investment and increase the probability of a dividend cut down the road.

A rigorous fundamental research-based approach, including in-depth analysis of sustainable free cash flow and balance sheet strength, is critical in selecting companies for a dividend-focused portfolio. This disciplined investment process can help a portfolio capture the powerful combination of dividend income and capital appreciation potential over time.