Alley Company Quarterly Letter
Water in the Desert

April 13, 2016

In previous writings we have noted the strength of the U.S. economy relative to the rest of the world. There may be no better indication of this relative strength than the divergent central bank policies being employed around the world. In the U.S., Fed officials have embarked upon the process of *gradually raising interest rates*, while in Europe and Japan, monetary policy has drifted into unchartered territory as short term rates are being set at *negative levels* in an effort to spark growth and fight deflation. The implications of these negative interest rates in significant parts of the world is unclear, but what is clear is that investors are increasingly faced with a desert-like environment when it comes to producing investment income within a portfolio.

In a period where investors are being punished with limited investment income from fixed income investments, the notion of a growing stream of income that is determined by the *success of a company*, rather than the vagaries of central bank interest rate policy, appears to be an attractive proposition. We are strong proponents of high quality, dividend-paying companies given that dividends represent over 40% of the total return from stocks and, thus, believe these companies can represent the centerpiece of an investor’s portfolio. With investment income as scarce as it is today, the dividend component as well as its potential for growth carries added appeal.

For a company that consistently grows its dividend, “yield-on-cost” can be an effective measurement for evaluation. Yield-on-cost is the annual dividend divided by the original purchase price. By way of example, a company with a dividend yield of 3% that is able to grow its dividend 7% annually would produce a yield-on-cost of 5.9% ten years from now. This level of investment income and growth in income is a lot more attractive than a U.S. ten year government bond with a yield of 1.75% or, for that matter, a Japanese ten year government bond that would deliver a - 0.10% return annually if held to maturity!

To be sure, low to negative rates can create scenarios where investors mistakenly reach for investment income in lower quality investments with leveraged balance sheets. The carnage within the energy sector and, in particular, Master Limited Partnerships (MLPs) over the past 12 months is a prime example. The change in the price of oil and natural gas dramatically impacted the cash flow of these companies and, in turn, their ability to pay the dividend. A focus within our fundamental analysis process is to constantly assess the ability of our companies to not only maintain their dividend, but also grow it in a sustainable fashion.

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As we wrote last summer, history indicates that coming out of a major financial crisis, interest rates can stay *lower for longer* than most investors realize. Negative interest rates outside of the U.S. may put downward pressure on U.S. interest rates for some time to come and elongate the path to more normal rates of interest. This current environment of limited income from fixed income investments is akin to a walk through a desert without water - tolerable in the early stages, but increasingly difficult for the long haul. In our opinion, dividend income from high quality, blue chip companies can be a cold glass of water for investors during this walk through the desert.

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