

Balanced Fund Managers Discuss Portfolio Income

An Interview With Ned Notzon and Charles Shriver

Article Highlights

- The proper mix of stocks and bonds is based on an investor's age, tolerance for risk, and confidence in the economy and the financial markets.
- Dividends coupled with the potential for price appreciation offer an attractive combination for total return.
- An important consideration is to ensure that a potential investment is a good company.

Ned Notzon and Charles Shriver are portfolio managers in T. Rowe Price's U.S. Asset Allocation Group. I spoke with them in late July about their balanced stock/ bond funds and what investors need to know when analyzing income investments.

—Charles Rotblut, CFA

Charles Rotblut (CR): *You are allowed a certain amount of leeway on how much you allocate to stocks and how much you allocate to bonds. What factors cause you to favor one asset class over the other?*

Ned Notzon and Charles Shriver (NN and CS): We believe most people would like to have a mix between stocks and bonds. The mix is based on factors such as their age, their tolerance for risk, and their confidence in the economy and in the financial markets. We develop neutral weights for the market sectors and overweight or underweight these sectors based primarily on valuations. Ideally, we would overweight sectors that have done poorly, where the factors responsible for that poor performance are gone and the market has not responded. Often the market takes six to 18 months (or even longer) to respond.

CR: *In terms of income, with the Federal Reserve's quantitative easing programs coming to an end, have you shifted more toward stocks than bonds?*

NN and CS: We are overweighting stocks—since the economy seems to be improving modestly, we think interest rates could go up, which would hurt high-quality bonds. However, our overweight to stocks is based more on the positive features of stocks, rather than the negative features



of bonds. In fact, we still have an overweight to high-yield bonds.

It is important to emphasize that when we are overweight high yield, we are overweighting a specific fund, the T. Rowe Price High Yield Fund (PRHYX), rather than overweighting the broad high-yield market by mimicking an index such as the Credit Suisse High Yield index. T. Rowe Price's high-yield strategy reflects a focus on fundamental credit analysis in its security selection process. Mark Vaselkiv,

who manages PRHYX, evaluates high-yield bonds, looking for names that could endure a recessionary environment.

Our focus on fundamental research has been instrumental in helping to avoid defaults. While holdings may see yield spreads widen along with the broad high-yield market in an adverse market, the ability to mitigate default risk represents a significant source of potential long-term performance advantage. Additionally, a strategy of avoiding riskier issuers with less sound business models helps lower volatility relative to the high-yield market and peers.

CR: *The threat of future higher interest rates is a concern for many of our members. What impact do rising interest rates have on dividend-yielding stocks, and at what point do higher interest rates start to create concerns or downside risk for them?*

NN and CS: While rising interest rates would likely have a varying degree of impact on different dividend-paying stocks, the impact of interest rates on broad economic growth is an important factor to consider. Although it is difficult to say at what level interest rates become problematic for stocks, the

Table 1. T. Rowe Price Funds Managed by Ned Notzon

	Total Return				Yield (%)	Expense Ratio (%)
	YTD (%)	2010 (%)	Last 3 Yrs (%)	Last 5 Yrs (%)		
T. Rowe Price Balanced (RPBAX)	5.0	12.5	4.9	5.2	2.1	0.66
T. Rowe Price Personal Strategy Balanced (TRPBX)	5.1	13.7	6.3	5.7	2.1	0.77
T. Rowe Price Personal Strategy Growth (TRSGX)	5.8	15.3	4.9	4.6	1.4	0.85
T. Rowe Price Personal Strategy Income (PRSIX)	4.3	11.6	6.6	6.1	2.4	0.66
Average of Domestic Balanced Funds	4.4	11.6	4.6	4.6	1.7	0.93

Source: AAI's Quarterly Low-Load Mutual Fund Update, January and July 2011. Data as of June 30, 2011.

downside risk becomes much more pronounced when the level of interest rates begins to weigh on economic growth.

Based on historical analysis, there is a positive correlation between the 12-month excess return of stocks relative to bonds and the 10-year U.S. Treasury bond yield when the yield is below 6%. In this environment, rising interest rates are generally consistent with an improving economy and supportive of the outlook for stocks, while falling interest rates would be a sign of a weakening economy.

When the 10-year U.S. Treasury bond yield is above 6%, there is a negative correlation between the 12-month excess return of stocks relative to bonds and interest rates. In this environment, rising interest rates can be an indication of an overheating economy and associated efforts by the Federal Reserve to rein in economic growth. This is generally negative for the outlook for stocks. The negative relationship between excess returns for stocks relative to bonds becomes more pronounced when the yield on the 10-year U.S. Treasury bond is above 10%. Interest rates falling from these higher levels back toward 6% reflects an easing of financial conditions, which can be supportive for the equity outlook.

There are many unique factors influencing the current environment for stocks, bonds and interest rates, such that it is difficult to identify a specific level at which interest rates become problematic for stocks. An increase in yields from current low levels and consistent with an improving economy could be posi-

tive for stocks.

In the current environment, there are dividend-paying stocks that offer a 2.5% to 3.5% yield, with the opportunity to participate in long-term growth. These dividend yield levels compare with a yield of close to 3% for 10-year U.S. Treasury bonds. In a potential environment characterized by rising interest rates and rising inflation, dividend-paying stocks can help provide a hedge against inflation by offering an income stream that can grow over time. The income stream from bonds, however, is fixed, and the real value of the income stream would be eroded over time by increasing inflation.

It is important to note that should interest rates increase to a higher level, at that point, some investors in dividend-yielding stocks might seek more competitive yields from bonds. An environment of higher bond yields would potentially lower demand for dividend-paying stocks.

CR: *How does holding dividend-yielding stocks impact an investor's bond decisions? Does it have any impact on his decisions concerning duration or credit quality?*

NN and CS: Dividend-paying stocks offer attractive attributes for equity investors, including the potential for income. Common factors such as interest rates can influence the valuations of both dividend-paying stocks and bonds; however, over a full market cycle, the behavior of dividend-paying stocks is more similar to that of the stock market than that of the bond market. While dividends represent an important

element in what investors are willing to pay for dividend-paying stocks, the dividends are not guaranteed. Additionally, dividend-paying stocks represent equity and consequently are at the bottom of a firm's capital structure, below any of a company's obligations to bondholders.

Quality is an important consideration in selecting dividend-paying stocks. At T. Rowe Price, the views of our fundamental equity analysts regarding the strength of a company's balance sheet or its general financial condition represent an important part of the security selection process. Quality can be observed through statistics such as return on equity or return on capital.

Individual investors might also look to the S&P common stock quality rankings as a supplemental resource in evaluating the historical growth and stability of a company's earnings and dividends. Persistent dividend growth over many years is a positive reflection on a company's underlying business and can be an important input in assessing how safe a stock's dividend is.

Beyond duration (a measure of interest rate sensitivity) and credit quality, dividend-paying stocks can offer unique attributes to a portfolio in terms of their volatility as well as correlation with other stocks or bond holdings. Calculating and quantifying the duration of dividend-paying stocks is a source of discussion, such that the duration for dividend-paying stocks would represent subjective estimates. In our asset allocation portfolios at T. Rowe Price, we separately evaluate the duration and quality of fixed-income securities; other

managers with different investment objectives may approach this differently.

The highest-dividend-yielding equities may not necessarily be an investor's best approach to dividend-paying stocks. The highest-yielding stocks may be concentrated in certain industries, such as utilities or real estate investment trusts (REITs), or the high yields may be reflective of distressed conditions.

One approach to investing in dividend-paying stocks is to look for companies that have been able to consistently increase their dividends over time. A company's ability to consistently increase the dividend across business cycles and economic environments is a positive attribute. This represents one factor for consideration in selecting securities based on dividend yield, but investors should also take into consideration other company-specific factors.

CR: *How correlated are high-yield bonds and high-yielding stocks?*

NN and CS: The correlation between the S&P High Yield Dividend Aristocrats index and the Credit Suisse High Yield index is 0.40, based on monthly returns since January 2000. The S&P High Yield Dividend Aristocrats has a 0.75 correlation with the S&P 500 index. This compares with a 0.63 correlation between the Credit Suisse High Yield index and the S&P 500 index.

These correlations between the

High Yield Dividend Aristocrats and high-yield bonds suggest that there is only a moderate amount of commonality among factors that would impact the performance of an investment approach based on companies that have been able to consistently increase their dividends over time and factors influencing high-yield bonds. Additionally, the High Yield Dividend Aristocrats index has a slightly higher correlation with equities than do high-yield bonds. Neither the High Yield Dividend Aristocrats nor high-yield bonds behave exactly like the S&P 500, but the High Yield Dividend Aristocrats tends to behave more like the equity market.

While the correlation between the highest-yielding stocks and high-yield bonds is likely higher, this may not represent a well-diversified investment strategy, as mentioned. Looking at the correlation between REITs and high-yield bonds, REITs, as measured by the Wilshire US REIT index, have a 0.61 correlation with high-yield bonds. By comparison, utility stocks, as measured by the S&P 500 Utilities Sector index, have a 0.39 correlation with high-yield bonds.

CR: *How do preferred stocks and convertible bonds fit into the asset allocation equation?*

NN and CS: Several mutual funds at T. Rowe Price invest in convertible bonds; however, strategies that regularly

invest in preferred stocks are notably less common. Convertible bonds can offer good value for diligent investors. Convertible bonds are complex investments that can be valued more like bonds in certain environments and more like stocks in others. The ability to invest in convertible bonds represents an opportunity for potential outperformance for an investor who can undertake the necessary research to understand the valuation of a convertible bond across a range of interest rate and market scenarios.

CR: *In terms of industry concentration, should an investor be concerned with overlap between his stock and bond holdings?*

NN and CS: We think you can relax about your diversification if your stocks are well-diversified relative to your stock benchmarks and your bonds are diversified relative to your bond benchmarks.

CR: *How do you evaluate a company's ability to continue paying or raise its dividends?*

NN and CS: There are several measures that can be helpful in evaluating a company's ability to continue paying or raise its dividends. Trends in a company's earnings and the variability of earnings are important considerations. Similarly, the level of a company's payout ratio and the variability in the payout ratio can offer perspective on a company's ability to maintain or raise its dividend.

Factors to Consider in Evaluating Mutual Funds

Ned Notzon and Charles Shriver suggest investors consider the following factors when evaluating a mutual fund.

- **Fund Objective:** Understand a fund's investment objective and approach.
- **Role in Portfolio:** Ensure that you know the role a fund plays within your overall portfolio.
- **Diversification:** Determine whether a fund helps to diversify your overall portfolio or provides more concentrated exposure to certain sectors or attributes.
- **Risk-Adjusted Performance:** Look for favorable long-term risk-adjusted performance.
- **Performance in Up and Down Markets:** Evaluate relative performance in up markets and down markets.
- **Style Consistency:** Check whether a fund maintains a consistent style with its investment objective and across time.
- **Expenses:** Seek competitive fund expenses.
- **Portfolio Turnover:** Assess whether portfolio turnover is consistent with the investment strategy and appropriate for your tax situation.
- **Manager Tenure:** Look for consistency in portfolio management.
- **Fund Company Values:** Research the fund company, not just the fund.

It is important to evaluate a company's payout ratio relative to peers in the same industry or sector. Companies in more defensive industries or sectors, such as health care, consumer staples or telecommunications services, can generally support a higher payout ratio than companies in more cyclical sectors.

Additionally, reviewing the amount of a company's dividend payment over time can provide insight into a company's commitment to maintaining its dividend. A proven record of consistently raising the dividend can provide a strong signal of value, both in terms of a company's commitment to its dividend policy as well as its ability to sustain its dividend policy across business cycles and economic environments.

CR: *How much weight do you put on a company's ability to continually raise its dividends, such as the members of the S&P Aristocrats index have done?*

NN and CS: A company's ability to consistently increase the dividend across business cycles and economic environments is a positive attribute. This represents one factor for consideration in selecting securities based on dividend yield, but investors should also take into consideration other company-specific factors in addition to a stock's dividend yield.

A company's ability to consistently increase dividends over a period of 10, 15, or 20 years generally reflects a management's commitment to maintaining the dividend and also reflects on the durability of the underlying business. A firm's historical dividend policy can offer insight into management's intent to preserve the dividend across market environments, or similarly it might suggest whether management might favor other methods of returning cash to shareholders, such as through share repurchases.

In addition to looking at a company's ability to increase dividends over time, it is also worthwhile to understand the quality of a company's earnings and to evaluate a company's ability to consistently generate sufficient free cash flow to support the dividend.

CR: *What about going overseas for dividends or bonds? What factors and risks do investors need to consider?*

NN and CS: An investor constructing a broadly diversified balanced portfolio might consider including allocations to both international stocks and bonds, in developed and emerging markets. These investments offer potential opportunities, but they may include additional sources of risk, such as currency risk and the risk that certain markets may be less developed and less liquid, than the U.S. market.

Going overseas provides both more diversification and access to a larger opportunity set. However, investors should be certain that they are getting advice or investment decisions from qualified investment professionals. Investors may also see more volatility in their overall portfolio when they include international exposure.

Historically, many European stocks have had a more progressive dividend payment policy. There may be tax considerations that favor or disadvantage dividends relative to other methods of returning cash to shareholders, such as share repurchases.

International bond investments, in both developed markets and emerging markets, can provide exposure to economies and interest rates that may behave differently from those of the United States.

Investing in securities outside the U.S. involves special risks not typically associated with investing in the U.S. Foreign securities tend to be more volatile and less liquid than investments in U.S. securities, and may lose value because of adverse political, social or economic developments overseas or due to changes in the exchange rates between foreign currencies and the U.S. dollar. The risks of foreign investing are heightened for securities in emerging market countries. Emerging market countries tend to have economic structures that are less diverse and mature, and political systems that are less stable, than those of developed countries.

There can be tax law changes, both domestically and abroad, that can either

positively or negatively affect the relative attractiveness of dividend-paying stocks. For example, the December 2010 extension of the Bush tax cuts through 2012 provides for comparable tax rates for dividends and capital gains. A comparable tax rate on dividends and capital gains is generally perceived as a positive factor helping support demand for dividend-paying stocks. Changes to the tax laws over the next several years may or may not be beneficial for investors in dividend-paying stocks.

CR: *Regarding the concept of total return, do you first seek price appreciation or dividend income? Alternatively, is there a certain mixture you seek, and how do you decide what that mixture should be?*

NN and CS: Dividends coupled with the potential for price appreciation offer an attractive combination for total return across a wide range of market scenarios. The dividend yield can help offset declines in equity value in a down market. In a more healthy market environment the potential for capital appreciation helps to highlight the benefits of dividend-paying stocks relative to bonds. In an environment of an improving economy, which would generally be favorable for stocks, there is often upward pressure on interest rates that can lead to capital depreciation for bonds.

An important consideration in selecting portfolio holdings is to ensure that a potential investment is a good company. As an investor, you want to have sufficient confidence in the long-term business prospects of a company and confidence in the management team to be comfortable holding the stock through the full economic cycle, and potentially add to a position in a challenging environment. It can be difficult to discern when a stock's dividend yield is attractive for what may be temporary or technical factors or when it may be a reflection of more fundamental problems. Understanding a company's business model and management can help avoid a situation of having to make a difficult investment decision at the wrong time, such as in the middle of

Definition of Terms Used in Article

Convertible Bond: A bond that can be converted into shares of stock if certain conditions are met. These are mostly issued by companies with weaker credit ratings.

Correlation: A measure of how similar two securities or asset classes' returns are. Values range between +1.0 and -1.0. A correlation of 1.0 means the returns move in the same direction. A correlation of -1.0 means the returns move in the exact opposite direction.

Duration: Most commonly used for bonds, this calculates the impact a change in interest rates will have on a security's price. Duration is typically shown as a number

of years. Longer durations imply a greater level of interest rate sensitivity.

Payout Ratio: The percentage of earnings paid out as dividends. It is calculated as dividends per share divided by earnings per share.

S&P High Yield Dividend Aristocrats Index: Managed by Standard & Poor's, this index is comprised of the 60 highest-dividend-paying companies within the S&P Composite 1500 index that have consistently raised dividends for 25 years. The S&P Composite 1500 combines the S&P 500 index, the S&P MidCap 400 index and the S&P SmallCap 600 index.

an adverse market environment.

Dividend-paying stocks may lag other equities in a major market rally, where price appreciation represents a more significant part of total return. As the economic cycle shifts from recovery to modest expansion, returns become increasingly scarce and the contribution of income to total return becomes more material. Dividends also tend to matter more in a difficult market environment. For the decade from January 2000 through December 2009, the S&P 500 had an average annual total return of -0.95%. Over that period, average income from the S&P 500 earned investors 1.82% annually, representing

the only positive component of total return helping to offset declines in the equity values.

***CR:** Finally, what are your thoughts about dividend reinvestment programs?*

NN and CS: For an individual, a dividend reinvestment program can save broker commissions. However, you should periodically (once a year) check your portfolio to be certain you haven't migrated to a different risk profile and that you are satisfied with your security-specific decisions.

Dividend reinvestment programs can offer an efficient means for purchasing additional shares to more fully

benefit from the effect of compounded growth over time. Participation in a dividend reinvestment program would be more suitable for an investor who does not need to rely on dividends as an income source for meeting regular living expenses.

The decision to participate in dividend reinvestment programs is at the discretion of the individual portfolio managers at T. Rowe Price. Several managers routinely participate in dividend reinvestment programs, while others elect to receive the cash from the dividend. Our asset allocation funds follow the participation policy of the underlying portfolio managers. ▲

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