ATR Advisors

ABSOLUTE TOTAL RETURN
SECOND QUARTER 2013 COMMENTARY

By: Shawn Blau, PhD

Total Return Strategies in an Era of Rising Rates

The first half of 2013 was a strong one for the US equity markets. The S&P 500 Index was up over 13% on a Total Return basis. The Russell-3000 broad market equity index was up over 14%. Global markets trailed somewhat, with the MSCI World Index up a little under 9% for the first half of 2013.

Most US dividend stocks also did well, with the Dow Jones US Select Dividend Index up 13.9% for the half, and the Morningstar Dividend Leaders Index up 14.3% for the half.

As of the most recent ratings, we were again honored that our ATR strategy achieved Morningstar's highest (5-Star) ranking, on a 1-year basis, a 3-year basis, and 5-year basis. In addition, Informa/PSN, which is the other major independent rating agency, gave us their PSN "Top Gun" award for six out of the past seven quarters.

What was most surprising in the past quarter was the very sudden rise in US Treasury interest rates. The benchmark 10-year US Treasury yield jumped from about 1.8% in early May, to almost 2.5% at the end of June. The main reason was fear in the bond market that the US Federal Reserve would begin to "taper" their "Quantitative Easing Program" earlier than expected.

One sector in particular – the residential mortgage-REIT's -- corrected along with bonds as rates rose. Other total-return sectors held their own.

Many clients have asked us how our total return strategies might perform in an era of rising interest rates so we did some historical research to investigate previous eras when interest rates went up steadily.

The quick answer is that over the long term, total return strategies have performed just as well during eras of rising interest rates as they did during eras of declining rates. Although they do typically correct somewhat in the short term, when interest rates first begin to rise, after an initial period of adjustment, total return strategies have out-performed in every era of rising rates since 1973.

The research firm, Ned Davis Research, has done some breakthrough work in this area. They tracked stocks which grew their dividends (dividend-growers) versus non-dividend paying stocks (non-payers) during each of the three-year periods of rising rates since 1973. To do this they tracked these stocks for 3 years following every initial Federal Reserve rate increase from 1973 to the present.

During each of these 3-year periods, dividend-growers consistently out-performed non-dividend stocks. In fact dividend-growers have out-performed non-dividend stocks in every single one of the past 6 rate-rising cycles. In addition the dividend-growers had lower volatility than the non-payers.

Although dividend stocks do tend to correct early on in a rate-rising cycle, they more than make up for it as the cycle continues. When you think about it, this makes sense. Usually the Fed raises rates because the US economy is growing more rapidly than before. In these circumstances dividend stocks should be able to increase their earnings and then increase their dividends to shareholders. In addition dividend-growers should generate more cash than other companies and be able to take advantage of the growing economy.

What this means for us is that our ATR strategy is likely to continue to do well when the Fed begins to raise interest rates. Our whole strategy is designed to identify those companies which can reliably maintain and grow their dividends and cash distributions to shareholders. According to the Ned Davis historical research, this type of company has out-performed in every one of the last six rate-rising cycles.

Two of our largest categories at this point are: 1) energy Master Limited Partnerships (MLP's); and 2) Business Development Companies (BDC's). Both of these sectors are projected to raise their dividends/distributions significantly over the next 24 months. So although they may correct temporarily as interest rates are volatile, in the long run they should continue to out-perform.

Since 1926 calculations by Goldman Sachs show that approximately 40% of the US stock market's total return has come from dividends. The Ned Davis research demonstrates that dividends out-perform in eras of rising interest rates as well. We are confident that our ATR strategy will take advantage of these opportunities, to continue building long-term wealth for our clients.