ATR Advisors

ABSOLUTE TOTAL RETURN
FOURTH QUARTER 2012 COMMENTARY

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National Politics and Investing for Total-Return

The stock market climbed its proverbial "Wall of Worry" in 2012. The major equity indices achieved very satisfying returns in spite of all the political and economic turmoil. In addition, the 2012 election, and related national political events, have had a significant effect on investment portfolios.

Our ATR portfolio rode along with the general equity market this past year, but with one crucial difference:

For the broader stock-market indices, the vast majority of 2012's return came in the form of stock-price increases. On the other hand, for our own ATR portfolio only about half of our total-return came from stock-price increases, with the other half coming from regular dividends and other cash distributions to shareholders.

This differentiation in the nature of our returns is by design, since our stocks are selected precisely because we believe their dividends are reliable and sustainable. As a result, no matter what happens to stock-prices over any particular time period, the ATR portfolio will generate at least some return to shareholders from regular dividends and cash distributions.

This has been the pattern since I started researching this strategy over a decade ago as a Management Professor teaching business statistics.

Back then we wanted to become expert at predicting dividends for the following reasons:

1) We could see that people needed income from their investments. And with the inexorable 30-year decline in bond yields (the so-called “Great Moderation,”), it was becoming harder and harder to get that income from the traditional fixed-income (bond) sources that people had relied on in earlier time periods.

2) We could further see that steady income could also be obtained from non-bond investments like stocks, REIT’s, closed-end funds, and publicly-traded partnerships. But – and this is a big “but” – you couldn’t just invest in these things and hold onto them forever, as you did with bonds. Someone had to continuously monitor them in order to make sure that the dividends continued to be reliable, grew over time, and were worth the risk of the investment.

3) We observed, in addition, that dividends were much more predictable than company earnings. All the sell-side analysts seemed to be focusing their formidable resources on predicting quarterly earnings. But they usually weren’t that accurate in their earnings forecasts in the first place. And, secondly, even if they got lucky with predicting earnings, they still couldn’t predict what the “Price/Earnings Multiple” would be, so they were often way off in predicting the overall stock-price.

With dividends on the other hand, once a company makes a commitment to its shareholders to pay a regular quarterly or monthly dividend, that company’s management becomes very reluctant to cut their dividend.

4) Finally, we found that if one could predict dividends on stocks that had a significant yield, you didn’t have to worry about the “Price/Earnings Multiple” at all. There were enough income investors out there, so that when the dividend of the stock went up, the stock-price itself would also eventually go up in order to keep the level of dividend-yield relatively constant.

Over the past decade, we've refined our process in predicting dividends, and it has paid off handsomely for our investors. Since 2011, our ATR portfolio has been rated "5-stars" by Morningstar (their highest rating). In addition, PSN/Informa has given us their "Best of the Best Manager" rating for 4 out of the past 5 quarters through 9/30/12. This means that out ATR strategy was among the top ten performers within our national peer group reporting to PSN/Informa. PSN is the longest running investment manager database in North America.

Our best investment category for 2012 was Business Development Companies which lend to and buy equity in small, privately held businesses. This sector, represented by the Wells Fargo Business Development Company Index, returned a whopping 33% (with dividends re-invested) in 2012.

Our second-best category was Mortgage-REIT's which invest in residential and/or commercial mortgages and mortgage-backed securities. This sector, represented by the Ishares FTSE NAREIT Mortgage Plus Capped Index, returned 21% (including dividends re-invested) in calendar-year 2012.

Another favorite sector, the energy Master Limited Partnerships (MLP's), represented by the AMZX Index, returned "only" 4.8% in 2012. The reason that MLP's lagged other sectors was that, due to the enormous growth in unconventional oil and natural-gas energy in 2012, MLP's were required to raise large amounts of equity capital to fund additional investments in energy infrastructure. This had the effect of diluting their returns to shareholders in 2012. As a result of these greater long-term investments, the category should provide growing distributions in future years.

Finally, the recent Congressional agreement to avert the so-called "Fiscal Cliff" had a lot of pluses and minuses. But one little-noted aspect was especially promising for us, and for the ATR portfolio. For the first time in over a decade, tax rates on dividends are finally permanent. Now, dividend investors don't have to be worried about surprise changes in their tax rates.

Even more importantly, for the fourth time in recent history, the Congress and the President reaffirmed that dividends should be taxed at equal rates to long-term capital gains. For most of the 20th century, there was a two-tier tax regime that was heavily biased against dividends. Now, dividends and long-term capital gains have permanently equal tax rates.

This should make those companies and managers which are committed to regular dividends and cash distributions to their shareholders even more attractive.

Thank you for the opportunity to serve your investment management needs in 2012. We look forward to continued success together.