With interest rates at 40-year lows and dividend payouts skimpy by historical standards, what is an investor who needs current income to do? That was the question addressed at a recent seminar by Fiduciary Trust Company’s Chief Investment Officer, Paul Curtis, and three other members of Fiduciary’s Investment Committee: Mike Mullaney, Chris White and Mike Costa.

**Perspective:** Paul, can you help set the stage for this discussion on income by sharing with us Fiduciary’s economic outlook, specifically your forecasts for growth and inflation?

**Paul Curtis:** Over the last 20 years, real gross domestic project (GDP) has grown at an average rate of about 3.2% a year with the four components of economic activity (the consumer, business, government and exports) accounting for varying percentages of overall growth. Coming out of the 2001 recession, consumer spending has risen by between 4% and 6% a year, driven in large part by “cash out” refinancings. Household debt service, as a percentage of disposable income, is now at 20-year highs. The consumer, therefore, would not appear to be a major driver of growth going forward.

The business side, however, presents a more positive picture: capital spending is now at a higher annual level than even the late-90’s record levels and after-tax corporate profits are increasing at better than 30% in 2005. The federal budget deficit is at record levels in absolute dollars (but not when measured as a percentage of GDP). Total federal debt as a percentage of GDP has climbed over the last four years, but is still significantly below the levels seen through most of the 1990’s. The trade deficit has grown steadily for the last 12 years, although it has only been since 2001 that this has been reflected in the declining value of the dollar.

Our conclusion is that a combination of strong government and business spending, offset by a weak export picture and a relatively neutral consumer will lead to growth in real GDP in 2006 of about 3%, slightly below the average of the past 20 years. On the inflation front, while the current official rate is about 3.6%, some sectors such as energy and health care are showing substantially higher increases. We do not think that these are temporary spikes and believe that inflationary pressures are building.

**Perspective:** What about bonds? Are there any values out there?

**Mike Mullaney:** 10-year Treasury yields are near 40-year lows. Even by historical average standards, rates are low. If you ignore the “bubble” years of 1980 to 1985, the average yield on a 10-year Treasury is around 5.8%. The current yield is 4.6%. The 10-year Treasury has historically provided a “real” return (after inflation) of around 2.5%. The current real return is approximately 1.5%.

**Exhibit 1: Real Yield: 10-Year Treasury Less CPI**

Over the last 25 years, the growth in nominal GDP has closely tracked the 10-year Treasury yield, but the last two years have seen GDP growth rates substantially in excess of Treasury yields—an anomalous situation. Either rates should be about 2
percentage points higher than they are or growth should be slower – in either case, this is a warning flag for the economy.

The shape of the yield curve also has departed from its historical norm. Over the last 30 years, there has been, on average, a 2 percentage point (200 basis points) spread between the yield on 3-month Treasury bills and 10-year bonds. The current spread is less than 100 basis points, so long rates look pretty “rich” right now.

**Perspective:** Is there any value in sectors beyond the Treasury market?

**Mike Mullaney:** Unfortunately, the opportunities are quite limited. Over the last 20 years, investment grade corporate bonds have yielded about 140 basis points more than Treasuries. The current spread is about 80 basis points, so they are fully-priced.

A similar picture emerges when you compare the spreads between US Treasury and Government Agency bonds. Higher-yield or “junk” bonds look even richer when compared to Treasuries. On the positive side, municipal bonds are currently yielding almost 90% of a comparable Treasury, compared to a 10-year average of less than 85%. For investors whose marginal tax bracket is 15% or higher, a municipal bond will therefore provide more after-tax income.

**Perspective:** Is there anything new in the bond area that investors might not be familiar with?

**Mike Mullaney:** While not exactly new, in 1997 the Treasury began issuing a class of bonds called Treasury Inflation Protected Securities (or TIPS). These are Treasury bonds whose principal value and interest increase annually by the consumer price index (CPI). (Note: the annual increase in principal value is treated as taxable income, even though no cash is paid out.) The initial yield on these bonds was around 3.5%, but this has fallen by half to a current level of around 1.75%. Whether or not to use TIPS depends on one’s forecast for inflation. The market is currently forecasting that inflation will average about 2.5% for the next ten years. If inflation turns out to be higher, TIPS will provide a better real return. (Note: the current CPI is around 3.6%)

**Perspective:** It doesn’t sound like bonds offer much to investors today. What about equities?

**Chris White:** Unlike bonds, the equity market does have some good news in the income department. Not only are companies paying more in dividends, but the government is letting you keep more of your dividends and capital gains. Exhibit 4 on the following page shows the growth in value of the S&P 500 Index from 1985 to 2005 and the growth in dividends paid over the same time period. The two growth rates were very close until the late 1990’s when dividend growth lagged significantly. During the bubble years, companies preferred to use profits to buy back stock rather than raise dividends. The 2003 Tax Act significantly reduced the maximum federal tax rate on qualified dividends to 15% and dividend growth returned in a big way. From a shareholder’s point of view, therefore, dividends are now just as attractive on an after-tax basis as long-term capital gains.
The percentage of companies in the S&P 500 raising their dividends has increased from under 33% in 2001 to over 50% in the first half of this year. As a result, investors are starting to receive more income from the equity component of their portfolios.

**Perspective:** If inflation is creeping back as you forecast, how do dividends help?

**Chris White:** Dividends historically have been an excellent way to preserve real purchasing power as well. With the exception of the period from 2000 to 2003, growth in dividends on the S&P 500 very closely tracked the CPI over the last 20 years. Fortunately, the dividend increases since passage of the 2003 Tax Act have more than offset those four lean years.

**Perspective:** What if interest rates rise? Won’t that be bad for the stock market?

**Chris White:** In fact, the market has historically done well in years when interest rates rose. Since 1928, there have been 39 years when rates rose. As illustrated in Exhibit 6, the market was up in 31 of those years.

Our forecast for future growth in the market is, however, more muted. For the 20 years ended 2003, the annualized total return has been around 13%, coming from earnings growth (7%), dividend yield (2.7%) and change in P/E multiple (3.3%). Our current forecast calls for 5.5% earnings growth, a 2.5% dividend yield and little change in the P/E multiple for a total return of only 8%. Notwithstanding this more modest forecast, we feel that:

- Equities provide a brighter picture than fixed income
- After-tax returns are especially attractive
- Equities can outperform even in an environment of rising interest rates and higher inflation
- For risk control investors should use a well-diversified portfolio of high-quality, large-cap stocks, in many cases complemented by mid-cap, small-cap and international equity positions
- Both dividends and capital gains (total return) should be considered to meet income needs

**Perspective:** Is there anywhere else an investor can go to find income today?

**Mike Costa:** At Fiduciary, we believe that a well-diversified portfolio should include several asset classes. Real estate is one of several so-called “alternative” investments that many investors consider (others include hedge funds, private equity, timber, commodities, oil and gas, and precious metals). Real estate offers the following advantages:

- Diversification
- Attractive returns
- Current income
- Hedge against inflation

Investing in real estate is very different from owning a house or speculating on property values. It involves investing in actively-managed, real estate-based businesses. These investments provide current income and capital appreciation that compares favorably with equity returns.
Perspective: How does one go about investing in real estate?

Mike Costa: There are three main ways to invest in real estate: direct ownership, private real estate funds and publicly-traded real estate investment trusts (REITs). REITs are the vehicle most commonly used in Fiduciary portfolios because of their liquidity and the ability to obtain both geographic and economic diversification. REITs are companies that own, operate and develop commercial real estate and were created by Congress in 1960 to improve investor access to commercial real estate. There are more than 200 publicly-traded REITs with a total market capitalization of $400 billion. Nine REITs are in the S&P 500 Index. REITs have a special tax-free status: as long as they distribute 90% of their taxable income to shareholders, they do not pay corporate tax. (For this reason, dividends from REITs do not qualify for the lower 15% federal tax rate applicable to “qualified” dividends.) As Exhibit 7 illustrates REITs have provided very attractive total returns: they have outperformed the NASDAQ, small-cap stocks and both the Dow and S&P 500 over the 1-, 3-, and 5-year periods ending in 2004 and all but NASDAQ over the same 10-year period.

Another attractive feature of REITs is that they have tended to “zig” when stocks “zag” so adding REITs to a portfolio of stocks and bonds both increases the return and reduces the risk (or volatility) of an investment portfolio.

Perspective: Real estate has had a pretty good run over the last few years. What are the current income yields?

Mike Costa: From 1984 through 2004, the annual income return from REITs averaged 8.3%. Current income yields are only 4.5% due to recent exceptional price appreciation. REITs have also provided a good hedge against inflation: the annual dividend growth from REITs has exceeded the CPI in 14 of the last 18 years. Investment dollars flowing into real estate remain strong and fundamentals in the industry continue to improve, but valuations are near all-time highs and yields are near all-time lows. For this reason, we currently recommend an underweight position for real estate relative to the long-term strategic target allocation.

Perspective: Given that the three major asset classes (stocks, bonds and real estate) are only providing about half of their 1980-2004 average yield, what is your advice for an investor who needs current income?

Paul Curtis: You really have two choices. You can have a portfolio that provides current income but is very heavily invested in bonds. Alternatively, you can build a diversified portfolio with lower current income and adopt a policy of withdrawing some principal each year to provide the same cash flow as the income-focused portfolio. Assuming that the same amount was withdrawn from each portfolio every year, over the last 15 years the diversified portfolio kept pace with inflation and provided better performance than the income-focused portfolio as illustrated in Exhibit 8.

Responding to a low-yield environment by focusing on current income provides little inflation protection and capital appreciation. Fiduciary’s recommendation for an investor who needs current income is therefore to structure broadly diversified portfolios focused on total return.

Please contact your account officer if you have any questions or if you would like to obtain a copy of the seminar’s presentation.