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Investment Theme:

The Quest for Income and Growth (QIG) – Part 2 – Sustainable High Dividend Stocks

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In Part 1 of this two-part series (WMM, 12/22/10), we discussed the feasibility of meeting investors' income and growth objectives with a Supplemental Income Portfolio (SIP). Certain asset classes provide income via high yields, while other asset classes offer growth. This month we discuss an asset class that provides both income and growth: sustainable high dividend stocks. From a 30,000 foot perspective, high dividend stocks are attractive on two counts. First, given the decline in bond yields and money market rates during the past several years, many blue chip and other large-cap stocks have quite competitive dividend yields. Second, while developed economies are in an expansion phase, growth rates are likely to be slow reflecting, in large measure, a hangover from the global financial crisis. As a result, returns from stocks could be influenced more significantly by dividend yields.

Moving down to a 20,000 foot perspective, we believe it is important to evaluate sector exposure. Several economic and financial challenges are likely to persist for a few more years at least. Some of these include the unemployment rate, housing, and fiscal issues at all levels of government. Consequently economic sectors with perceived advantages should be emphasized, and those with perceived headwinds are to be deemphasized or avoided completely. For example, the financial sector is more astutely invested in through bonds rather than stocks, in our opinion. The financial sector faces many challenges, and the sector's bond spreads have widened considerably relative to industrial bonds. Sectors that we favor for stock selection include consumer staples, consumer discretionary, utilities and telecommunication services. We expect consumer spending to help sustain the recovery, and several companies in this sector offer wide product and geographic diversification. The utilities and telecom sectors consist of stable companies that pay high dividends.

Moving down to 10,000 feet, we prefer to utilize individual stocks versus high dividend exchange-traded funds (ETFs) in building a high dividend stock portfolio. We want to own companies that are on a growth trajectory, thus insuring the sustainability of dividend growth. ETFs will likely own some dividend stocks that are not screened or analyzed for growth prospects and will cut or eliminate dividends at some point. Owning some "bad" dividend stocks will inject a measure of income volatility into the portfolio as these companies fail to deliver. It follows, then, that a carefully selected portfolio of individual dividend stocks will probably outperform an ETF portfolio over time.

Finally, as we reach the ground, we would like to roll out our top ten sustainable high dividend stocks. The selection process involves screening for key financial metrics, such as cash flow return on investment, and analyzing each stock from a fundamental perspective.

The following table shows dividend yield, past and projected dividend growth, and historical total return for the stocks in comparison to the S&P 500 Index:

SUSTAINABLE HIGH DIVIDEND STOCK PORTFOLIO

STOCK	SECTOR	DIV YLD	5-YR DIV GR	EST 3-YR DIV GR	5-YR RETURN
Top 10 Holdings					
Nextera Energy	Utilities	3.7%	7.1%	5.8%	9.5%
Dominion Resources	Utilities	4.6%	6.4%	6.3%	8.8%
Coca-Cola	Consumer St.	2.8%	9.5%	7.7%	8.3%
3M	Industrials	2.4%	4.6%	5.1%	2.9%
Darden Restaurant	Consumer Disc.	2.8%	38.2%	13.3%	9.4%
PepsiCo	Consumer St.	2.9%	13.4%	4.8%	6.5%
V F Corp	Consumer Disc.	3.0%	17.2%	4.1%	9.4%
Chevron	Energy	3.1%	10.2%	6.2%	10.6%
Vodafone*	Telecom	3.3%	11.2%	6.4%	2.9%
Astrazeneca*	Healthcare	2.9%	18.6%	5.9%	10.8%
Average		3.2%	13.6%	6.6%	7.9%
S&P 500 Index		1.8%	0.2%	8.6%	0.2%

*American Depository Receipts (ADRs)

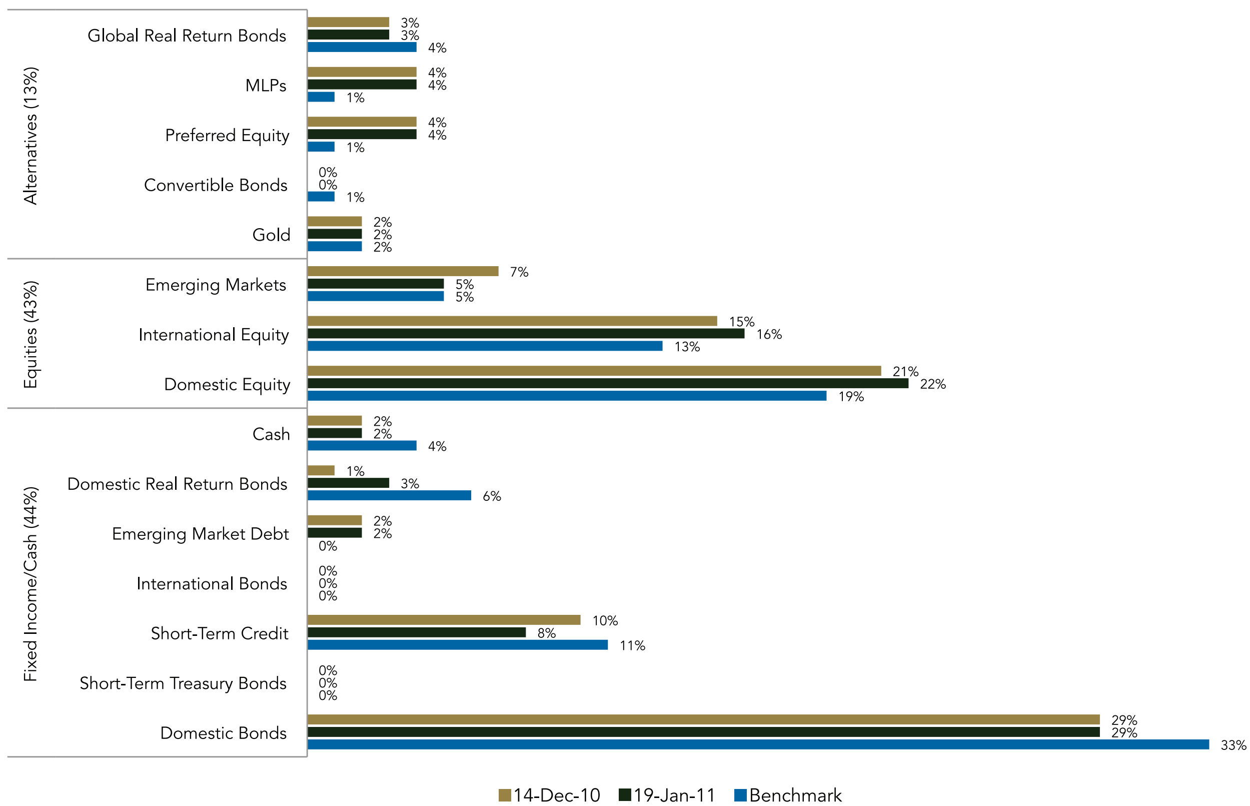
Dividend yield on the Sustainable High Dividend Stock Portfolio is almost twice that of the S&P 500 (3.2% vs. 1.8%). Historical dividend growth has been much faster. Slightly slower prospective dividend growth reflects a degree of catch-up by the S&P following dismal growth the prior five years. In addition, our confidence level is higher for dividend growth in the individual stock portfolio. In the important area of total return, the portfolio produced a near 8% annualized return versus flat S&P performance the last five years.

We anticipate a low turnover rate on the portfolio. Our sell discipline encompasses: 1) change in the fundamental outlook; 2) impairment of dividend-paying ability; and 3) overvaluation.

ASSET ALLOCATION RECOMMENDATION

So far this year, we made two minor changes to the model. We reduced the 2% overweight in emerging market equities to neutral and increased domestic and international equities by 1% each. This change was made based on negative momentum affecting the emerging markets asset class. In addition, monetary tightening is increasingly being employed in these markets to combat inflation. We reduced the extent to which we were underweight domestic real return bonds due to rising inflation expectations. Broadly speaking, we remain overweight equities and underweight bonds.

Provident Balanced Strategy
Previous/Current Allocation vs. Benchmark Allocation (January 19, 2011)



MARKET CLOSES		
S&P 500 Index: 1,283.35	**Dow Jones Industrial Average**: 11,871.84	**10-Year Treasury Yield**: 3.40%

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