

September 14, 2012

"So there may well be reasons for market enthusiasm, but they certainly have nothing to do with the economy. As we saw in 2006-2007, the markets and the economy can enter into a trial separation for a period of time, but they never get divorced."

-DAVID ROSENBERG, CHIEF ECONOMIST AND STRATEGIST, GLUSKIN SHEFF

This week's EVA takes a look at the two most frequently asked questions we've been hearing from readers and clients. We are often prodded to name some of the more underappreciated risks facing the financial markets. Also, many questions have been fired our way from those wondering about the impact of the changing tax rates on dividend-paying stocks. Below you will find responses to both those questions. Next week, EVA will look into the implications of central bank easing and how it is impacting the equity markets. If you like this week's EVA, I'm happy to take all the credit! If you don't like it, you can blame Jeff Eulberg and Tyler Hay who authored this edition, as they periodically do. For those loyal readers (all five of you) who feel like their EVA world is off its axis, not to fear-I'll be back in full swing next week, quirky humor and all!

Is now the right time to get back into the market? Should we really be defensively positioned now that the market has stabilized? Recently, numerous existing and prospective clients have been asking questions very similar to these. Below, we want to briefly address the many reasons why we still feel caution is warranted.

Legendary market technician Bob Farrell has a famous list of rules for investing that we should all follow. Whenever I notice that I'm answering questions similar to the ones above, I'm reminded of Bob's Rule #5 for investing: "The public buys the most at the top and the least at the bottom." Here at Evergreen, we developed our Right Cycle Investing process as a way to help our investment committee avoid going down the same road as the public. We are contrarian by nature but, as we always like to say, we are rational contrarians. At this point, we feel quite contrarian because we're not bullish on the market and consequently see reason to proceed cautiously. Below, I will attempt to outline our major concerns for the markets and the economy over the next 12 months and why we feel being conservatively positioned will be rewarded.

The first major concern prompting our conservative stance is the lack of fundamental reform in Europe. Many market bulls have been signaling the all clear on Europe of late. As a result, this perceived relief has been the driving force behind the 15% rally in the S&P 500 over the last three months. Mario Draghi, the head of the European Central Bank (ECB), has been the biggest cheerleader for this rally. In July he went as far as saying that "[t]he ECB will do whatever it takes to save the Euro, and it will be enough." It's important to keep in mind that statements don't simply change economic trends. To that point, economic numbers coming out of Europe don't appear to be turning positive anytime soon; in fact, they're continuing to deteriorate. German GDP is now only expected to grow .8% this year, down from a previous estimate of 1.2%--not exactly stellar for the strongest economy in Europe. Yet, considering it is one of only a handful of countries that is actually expected to grow, it is perceived as positive.

To be fair, some upbeat news has come out of Europe over the last three months. First, in late June the EU did agree to work toward developing a plan for a banking union between member countries. This is a step in the right direction if you believe that a fully united euro is the solution to the EU's problems. We have issues with that view, but I'll save that for future EVAs and

Evergreen GaveKal's daily communiques. Next, Mario Draghi outlined a bond purchasing program that allows the ECB to buy member countries' bonds in an effort to lower their borrowing costs. However, this won't be done out of the goodness of the ECB's heart; there will be conditions attached to any bond buying. Finally, on Wednesday the German constitutional court gave the European Stability Mechanism (ESM, the bailout fund that was developed to aid struggling countries) the approval that was needed to ratify the fund. However, some significant conditions were imposed on Germany's continued involvement, including limiting the amount of future funding that Germany will be able to provide. Specifically, the ruling court stated that Germany will not be allowed to contribute more than €190 billion to the fund.

These mechanisms that have been put in place over the last three months appear to us as band-aids and repackaged solutions. They have been tried before and lead to the exact same place: more summits. The most concerning element of these programs seems to be their finality. If the ESM runs out of money and needs to bail out Italy or France, the German constitutional court announced Wednesday that its answer will be NEIN! The market continues to focus on summit meeting after summit meeting in Europe and doesn't seem to care that the Eurozone appears to be drifting increasingly deeper into a recession. We don't think it will be long before the market changes its focus from the ECB news to the fundamentals of the individual countries, and it won't be pretty when it does.

The next major concern that we have relates to the US. Although we would agree that the US economy and our corporations are much better off than Europe's, we are far from experiencing a booming recovery. The old adage of not fighting the Fed has definitely played a huge part in this summer's rally. We continue to observe soft economic news from the US, the primary reason the Fed is on the verge of firing up the printing press. Our major concern is that this round of easing will provide the same pop to the economy as its second iteration, QE2, which was very little by most accounts. The markets will then look at the result and ask: What's next? Unfortunately, we don't think there is much left that the Fed can do. If the Fed appears to have shot its last arrow and missed, it could spark a healthy selloff.

We also see many political headwinds in the near future. The election will likely spark negative headline news that could increase the volatility of the markets. Then, once the election is decided, the fiscal cliff will need to be addressed and the winning administration will have exactly one month to come up with a suitable resolution. We can't help but think back to the debt ceiling argument of 2011 to remember how these political issues can negatively affect the markets.

Finally, there are several other currently ignored issues of concern that should give investors pause. By simply opening up *The Wall Street Journal* on a Wednesday morning, we can see a myriad of issues that I haven't even mentioned yet. In the first section alone, you can read articles addressing the slowdown in China (that appears to be worse than expected), the tragic death of the US ambassador to Libya, or the boiling tension between Iran and Israel. Fears of a de facto recession in China or a Middle East eruption have the potential to spark panic selling if they continue to deteriorate.

In sum, we believe that this market has far too many unknowns to increase our exposure to risk assets. Current market valuations appear to us to be pricing in a perfect scenario. In this "Happy Days" script, European economies start to grow again and no future bailouts are needed, the US starts growing at a faster rate and avoids the fiscal cliff in a timely manner, China dodges a hard landing, attacks on US interest in the Middle East subside, and Israel and Iran are able to

amicably work out their differences. Obviously, we don't feel like the market will be able to avoid all of the negatives and, thus, at these levels we want to stay defensive. It's important to realize we are not advocating being out of the markets. However, increasing risk at this point, though it might be rewarded in the immediate near-term, is likely to cause considerable regret in the not-too-distant future.

With a looming tax rate increase in 2013, what potential impact does Evergreen GaveKal expect on dividend-paying companies?

This question has been asked by countless existing and prospective clients, so we thought it might be of interest to EVA readers. Recently, we came across a white paper published by Copeland Capital Management on this topic. It's probably longer than most readers would enjoy, so we've attempted to summarize its findings.

Copeland looked at the effects of tax rates on dividends from two perspectives. First, do share prices of dividend-paying stocks move inversely to the corresponding changes in tax rates? More simply put, do higher taxes drive down the price of dividend-paying stocks (and vice versa)? The second effect Copeland studied was the corresponding behavior of companies that pay dividends when tax rates change. Said differently, do companies pay out less to shareholders knowing that Uncle Sam gets more of the pie (and vice versa)?

1) Tax rate changes' effect on dividend-paying share prices

As most of you know, tax rates on dividends are currently 15%. Should the Bush tax cuts be allowed to expire in 2013, dividends will be taxed at a substantially higher 43.8% for those in the highest bracket (this rate also includes the new Medicare surtax). This is a serious increase. Copeland's study attempted to go back in history and determine what effects major tax changes have had on the share prices of dividend-paying companies.

As it always seems in life, such analysis wasn't as easy as initially thought. With tax rates in steady decline since 1960, there weren't many observations to be made. In fact, there were really only two significant time periods eligible for analysis. In the early 1990s, over a four-year period, the highest marginal tax rates moved from 28% to 39.6%. Then in 2002-2003, tax rates were reduced from 35% to 15%. In both scenarios the Copeland's back-tested portfolio, used to represent dividend-paying companies, outperformed the S&P 500 index. Interestingly, the dividend payers actually outperformed more during the tax INCREASE, than the decrease, phase.

(TRIVA BONUS: Any guesses as to what the top marginal tax rate was 52 years ago? Answer: Ninety-one Percent. Ironically, no matter how high or how low the top marginal bracket has been, tax revenues as a percentage of GDP have varied minimally from the long-term average of roughly 20%.)

2) Did changes in tax rates affect corporate behavior on dividends?

Dividend payouts have also been steadily in decline. In the 1960s, dividends payouts as a percentage of corporate profits were about 65%. Today, however, the number is more like 27%. So dividend payout ratios have been in a steady decline over the last 50 years or so, regardless of what the prevailing dividend tax policy has been. Thus, there was no statistically expressed relationship between dividend payouts and tax rates. For those of you who speak nerd like we do, the R-squared, or correlation coefficient, was .0009. For those of you who are

more familiar with Steve Nash than John Nash, this simply means there has been almost no connection between tax structures and corporate dividend policies.

Conclusion:

Copeland's findings eventually revealed that dividends aren't materially affected by changes in tax policy. Instead, their fluctuations are more closely linked to economic conditions. While Copeland's logic and analysis is thorough and well thought out, it faces external constraints. First, there are only two examples on which to base a conclusion. This is no fault of Copeland's, but it should not be ignored. A second issue is that neither of the historical instances matched the magnitude of the coming tax change. We aren't suggesting that the size of the coming tax increase leads us to deduce something different than what Copeland found. However, we do feel that it increases the uncertainty facing this tax change in contrast to those analyzed in the study.

Another, interesting way to look at this is to consider the context of the investor. Such perspective allows us to look a bit more closely at demographics. Consider that over the next 20 years roughly half of the US workforce (79 million people) will be vacated. Those people who have amassed retirement savings will be in search of cash flow. Many boomers will turn to bonds, as they are considered a safer income generator than dividend-paying stocks. Yet others will flock to the inflation protection and growth potential that dividend-paying stocks have to offer.

Our conclusion shouldn't surprise our clients or readers of EVA. We believe that high-dividend stocks serve a vital role in the construction of a properly diversified income portfolio. Many investors seem to only see risk in one regard and that is company-specific risk. Simply put, most investors worry primarily that if a company goes bankrupt the underlying stock or bond will go belly up as well. But there are other risks, perhaps equally serious, such as inflation. To be clear, we don't see inflation as a risk in the current market environment. However, building a portfolio with no consideration for potential changes in the inflationary environment isn't prudent in our opinion. Ultimately, the conclusion we've reached is that we aren't inclined to eliminate dividend-paying stocks from our portfolios simply for fear of rising tax rates.

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