In an environment of increasingly volatile markets and persistently low interest rates, where can investors turn for upside participation, downside protection and a reliable income stream? This is a question on the minds of many pension plans, insurance companies, endowments and foundations, as well as individuals anticipating extended retirement years.

In a recent interview, Clare Hart, portfolio manager in J.P. Morgan’s U.S. Equity Group, explained why she believes an equity income strategy like the one she and her team manage, offers a solution well worth considering. However, Hart is quick to point out that this is not just an interim “waiting for rates to rise” strategy, but rather, one designed first and foremost, to offer attractive risk-adjusted returns along with a healthy income component, over the long term. Here is what she had to say.

**Question: Why invest in dividend-paying stocks?**

**CLARE HART:** While one obvious part of the answer is “income,” especially with 10-year Treasury yields in the 2% to 3% range, the real answer is that dividends have accounted for more than 40% of the total returns from the market over a long time horizon (since 1929). In some years, dividends have accounted for an even larger share of returns (Exhibit 1).

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**Exhibit 1: S&P 500 Total Return, Dividends vs. Capital Appreciation**

Dividends have been an important component of total return over time

<table>
<thead>
<tr>
<th>Year</th>
<th>Dividends</th>
<th>Capital appreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1926-1929</td>
<td>4.7</td>
<td>13.9</td>
</tr>
<tr>
<td>1930s</td>
<td>5.4</td>
<td>13.6</td>
</tr>
<tr>
<td>1940s</td>
<td>6.0</td>
<td>3.0</td>
</tr>
<tr>
<td>1950s</td>
<td>5.1</td>
<td>13.6</td>
</tr>
<tr>
<td>1960s</td>
<td>4.4</td>
<td>3.3</td>
</tr>
<tr>
<td>1970s</td>
<td>4.2</td>
<td>1.6</td>
</tr>
<tr>
<td>1980s</td>
<td>4.4</td>
<td>12.6</td>
</tr>
<tr>
<td>1990s</td>
<td>2.5</td>
<td>15.3</td>
</tr>
<tr>
<td>2000s</td>
<td>1.8</td>
<td>4.1</td>
</tr>
<tr>
<td>1926-2009</td>
<td>5.5</td>
<td>13.6</td>
</tr>
</tbody>
</table>

Source: Standard & Poor’s, Ibbotson, J.P. Morgan Asset Management. Data are as of 12/31/10. Total return assumes the reinvestment of income. Charts and/or graphs shown are for illustration and discussion purposes only.

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Clare Hart
Portfolio Manager, U.S. Equity Group
Q: Many investors think of these dividend payers as stodgy, uninteresting companies. Is this an accurate view?

CLARE: No. I would attribute that view to our memories of the 80s and 90s when capital appreciation dwarfed dividends. The fact is, over roughly the last 40 years, dividend paying stocks within the S&P 500 have outperformed non-dividend paying stocks and by a significant margin (Exhibit 2).

I believe this is because companies that can commit to a recurring dividend payment in cash are inherently healthier companies.

Q: Why is a low payout ratio important?

CLARE: A low payout ratio generally means that these well-managed companies can reward investors with a dividend today while leaving capital available to grow shareholder value and enhance the dividend for tomorrow.

Q: How do you identify companies that meet your investment criteria?

CLARE: Ours is a bottom-up, fundamental research strategy, supported by a team of more than 25 sector-specialized analysts. We spend a lot of time going through the numbers and meeting with management teams to find the companies that exhibit the characteristics we seek.

Q: Can you provide an example of the type of stock that makes it through your rigorous research and due diligence?

CLARE: Sure. Hershey’s is a great example—and not necessarily the first stock that comes to mind as an innovative investment idea. It has dominant market share (compared to other packaged food companies) and strong pricing power, which has allowed it to dampen the impact of higher commodity prices. What’s more, demand for its products (primarily chocolate and related confections) is relatively steady across economic cycles. And, management has exhibited a clear bias toward dividend growth as a top capital allocation priority.

Q: With current market weakness, more companies are meeting your 2% or better dividend yield criteria. Has this made a difference in the companies likely to appear in your portfolios?

CLARE: It has, but while 2% yield is a hurdle for companies in our portfolio, it in no way assures them a place. There are a handful (not a whole host) of companies that we have viewed as strong contenders for inclusion, but that only now meet our 2% criteria or look attractively valued at this point in the market.

Q: Where do you see the most promising market opportunities today?

CLARE: We have been adding money in the consumer space which seems counter intuitive given the stresses on the consumer. But there are companies that have been oversold from our viewpoint. In addition, we have been adding selectively to high quality financials for the same reason, especially given the market dislocation we saw in August.

Returns for S&P 500 dividend paying stocks have significantly exceeded those of non-dividend paying stocks

Exhibit 2: Equal-Weighted Geometric Average of Total Returns 1/31/1972—6/30/2011

Source: Ned Davis Research, Inc.
Q: Not only have you consistently beaten the Russell 1000 in terms of returns, you have done so with lower average volatility than the market. How have you been able to accomplish this?

CLARE: That is correct: for over nine years since its inception, our strategy has generated over 200 bps of alpha annually, on average, with an average beta of .78. Essentially, the strategy has provided investors top quartile returns with bottom quartile volatility.

There are a number of components of our risk management approach behind those results. While we are benchmark agnostic, that doesn’t mean we take huge bets. In fact, a high degree of diversification across sectors and holdings is a hallmark of our strategy. In addition, we tend to avoid extremely cyclical stocks and stocks with a high sensitivity to commodity prices.

Q: And what role, if any, do derivatives play in your strategy?

CLARE: The answer is none. We don’t use derivatives because we want the capital appreciation that comes with owning equities; earning a premium for taking the risk that the stock gets called away or put back to us at an inopportune time means trading away capital appreciation for current income. Our approach is straightforward—we own dividend paying stocks, so there is no guess work around embedded risk in the portfolio from derivatives, synthetic instruments, etc.

Q: What about the role of non-U.S. stocks?

CLARE: Ours is a U.S. large cap value strategy. However, the companies we do invest in may sell goods and services overseas, which can boost growth potential. And while we draw mostly on the research expertise we have in the U.S., the walls between countries and across continents have come down in the global economy. It is therefore a real advantage to be able to tap into our global research platform and have people on the ground watching for trends in Asia, Europe and the rest of the world that can influence the sectors and companies we cover.

Q: Are there some market environments that are more/less challenging for equity income strategies? How do you address this?

CLARE: In general, a market driven by strong relative outperformance in technology is challenging for the way we run our equity income strategy as technology stocks typically do not have much yield. A sharp rally in poor quality companies can also be a challenging environment. We navigate this by looking where others are not investing—essentially by going in the other direction to see what great companies may be attractive as people sell them to chase a theme elsewhere in the market.

Q: What do you see for equity income strategies as you look ahead over the next year or so?

CLARE: The economy and markets are likely to remain in a “muddle through” mode for quite some time, with investors’ thirst for income likely to persist. Chasing the highest dividend-yielding stocks, however, will probably not be the answer. We see considerable opportunities among the types of companies we invest in with durable franchises, strong balance sheets, healthy cash flows and disciplined management teams for whom dividend growth is a high capital allocation priority. Such competitors should emerge even stronger once markets return to “normal” and be positioned to provide enhanced shareholder value and persistent income streams over time.
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