CEDAR HILL
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High Dividend Stocks: The Yin and The Yang

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While high dividend stocks were in favor during the first part of 2016, the third quarter marked a reversal in this trend. Below, Managing Director Chris Engelman discusses investors' search for yield, their subsequent reversal, and how these trends have affected active and passive management strategies.

Why did high dividend stocks perform so well in the first half of 2016?

While most investors started the year expecting interest rates to rise, the 10-year U.S. Treasury yield actually declined to 1.6% at the end of September from 2.3% at the beginning of the year. As a result of falling interest rates, investors who require current income to meet their living expenses flocked to stocks that paid high dividends, especially in the utility, telecom and consumer discretionary sectors, in the first half of the year. These stocks offer dividend yields that are not only greater than the average stock, but also greater than the average investment-grade bond.

How did investors implement this high dividend strategy?

Many investors turned to high dividend-oriented ETFs, which own a specific basket of stocks that pay above-market yields. As money poured into these strategies, the ETFs were required to purchase the exact same basket of securities, regardless of what the stocks were worth. All else being equal, the more money invested in an ETF, the higher the underlying stock prices will go. As a result of money flowing into high dividend ETFs during the first half of 2016, stock prices rose and these ETFs performed very well.

Have you witnessed this market behavior before?

Whether it was investors chasing the 50 stocks with the largest capitalizations in the 1970s (the Nifty 50) or technology stocks in the late 1990s, it's not uncommon for investors to flock to certain securities for a period of time without paying attention to underlying fundamentals. While the valuation disparity this time is not as large as it was during the Nifty 50 or dot-com boom, history shows time and again that investment strategies are highly cyclical, reversion to the mean inevitably occurs and fundamentals win in the end.

How has yield-chasing affected active stock management?

Most active managers, such as Cedar Hill, have a valuation component to their stock selection process, whether they seek reasonably priced growth stocks or buy value stocks at discounts to their intrinsic value. Given the choice

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of chasing a trend or sticking to their stated discipline, managers prefer the latter.

With valuations rising for high dividend stocks, most active managers either avoided or underweighted these securities. This approach, however, led to most active managers underperforming passively managed ETFs in the first half of 2016.

What happened in the third quarter to reverse this trend?

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The current market environment reminds us of 1999-2000. During this period, broader market averages traded at elevated price-earnings ratios, but many individual companies with strong fundamentals were undervalued. Subsequently, active managers outperformed passive strategies, sometimes by very wide margins, as fundamental investing returned to favor. Though there is no guarantee, markets do have an uncanny way of repeating themselves.

What environments are favorable for active managers?

Periods of more evenly distributed stock performance, times when value stocks outperform growth stocks, or the onset of a bear market are all favorable to active stock management. As we noted above, we believe sentiment began to shift in favor of fundamental-based investing in the third quarter.

Given the potential valuation flaw discussed earlier, are ETFs still appropriate for long-term investors?

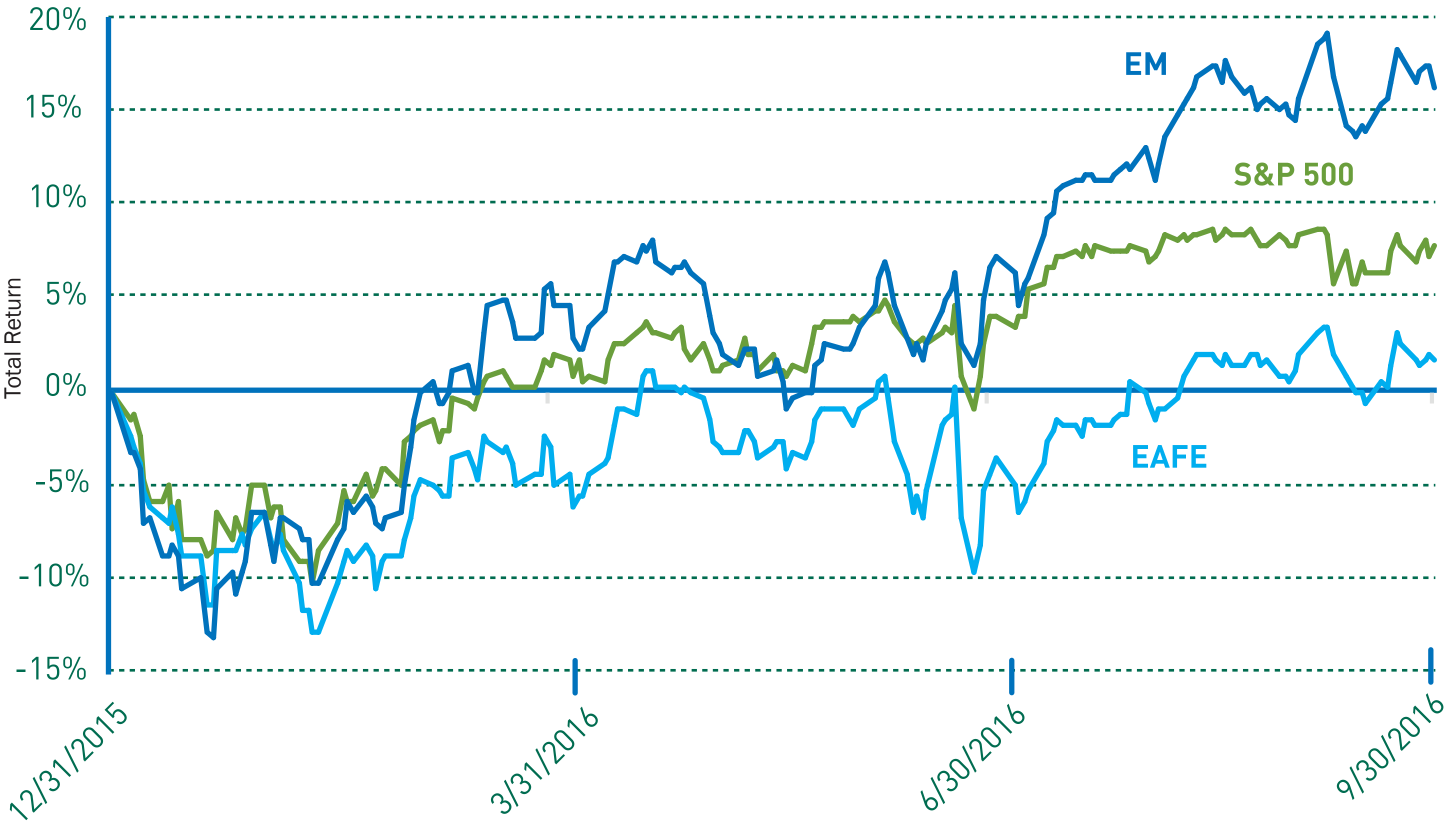
Yes, but investors need to consider valuations and take a disciplined investment approach. Even at Cedar Hill, where we pride ourselves on opportunistic investment management, we use passively managed ETFs occasionally to gain exposure to different investment themes and strategies. Our clients reap the benefits of ETFs, including low fees, diversification, tax advantages and liquidity, but they also receive professional guidance from managers who are actively monitoring when to sell.

Market Outlook

Third quarter brings solid stock performance and high valuations, but rate hike increasingly likely after election

Stocks reported solid performance during the third quarter, as each of the major global equity indices closed the quarter in positive territory. U.S. stocks finished the quarter near new record highs, as the S&P 500 gained another 3.9% during the quarter (7.8% YTD). International equity returns were even more impressive, with the international developed market index (MSCI EAFE) posting a third-quarter return of 6.4% (1.7% YTD) and the emerging market index (MSCI EM) gaining 9% (16% YTD).

YTD Equity Market Performance



Source: Bloomberg

Global monetary policy grabbed many of the market headlines in the quarter, yet the still-dovish central banks signaled they will continue to foster growth programs and provide ample liquidity, which supported equity prices. The U.S. Federal Reserve remained the only central bank considering a rate hike, but during the September meeting, it also decided to hold rates steady. A post-election rate hike in December seems increasingly likely based on commentary provided from the September meeting, but the Fed is not in a hurry to raise rates given persistently low inflation trends in the United States and somewhat mixed economic data of late.

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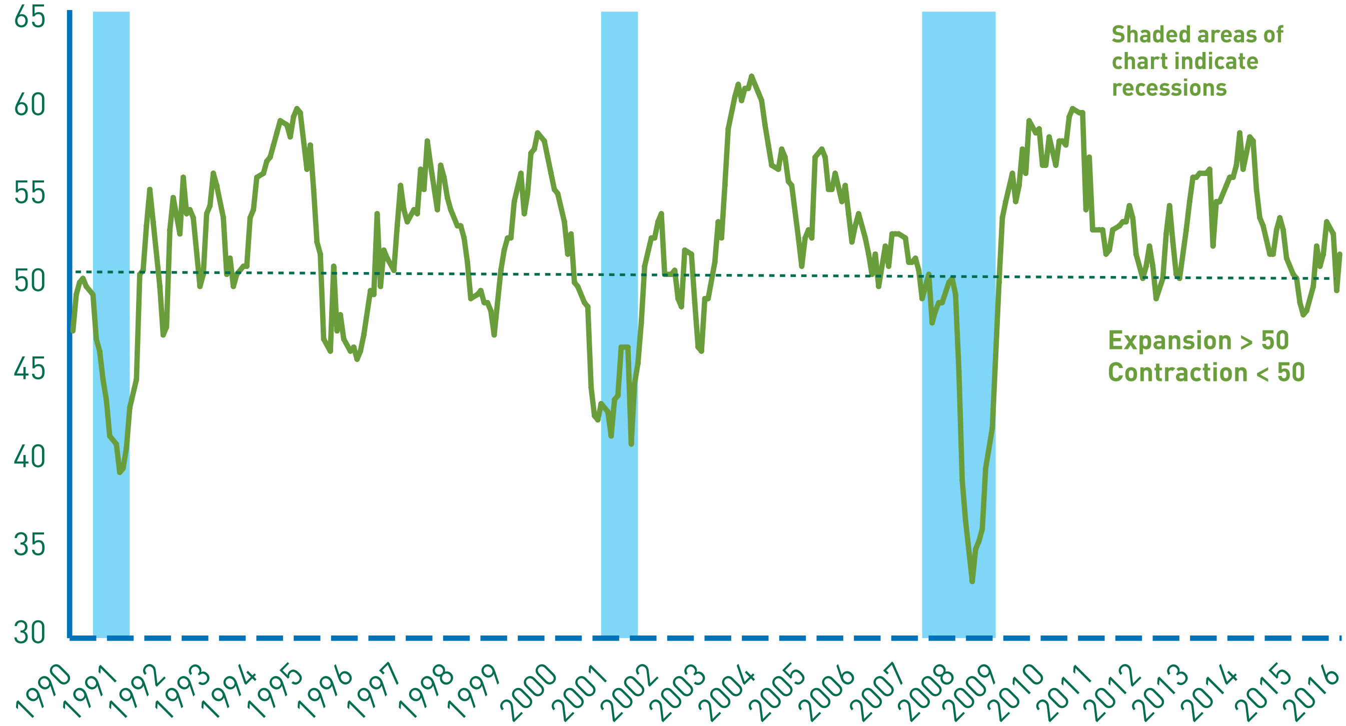
One of the more discouraging economic trends is the sustained lull in corporate investment, which is weighing on business productivity and manufacturing expansion. The Institute for Supply Management's (ISM) Manufacturing Index, a historically reliable indicator of economic inflection points, has been oscillating in and out of contraction territory (the dividing line is 50) since late 2015. It contracted once again in August (49.4), before bouncing back during September (51.5).

ISM Manufacturing Index



Source: Bloomberg

The ISM Index is a gauge that warrants close monitoring given the strong correlation of manufacturing activity to past recessions. It's important to note, however, that this recession indicator also signaled false positives for recession during the mid-1990s, 2003 and 2012. We believe the most recent period of feeble ISM data will resemble those mid-cycle dips, which did not result in recessions. The threat of a recession over the near term still appears limited in our view, as unemployment remains low (5%), U.S. payroll growth is still trending positively (albeit at a slower pace as the economy approaches full employment), wages have finally started to rise, consumer balance sheets are strong, and the housing market continues to strengthen. Against this backdrop, it seems reasonable to assume that the U.S. economy can sustain annualized positive growth of at least 2% over the coming quarters, consistent with its 2.2% average annual growth rate since the recession ended in mid-2009.

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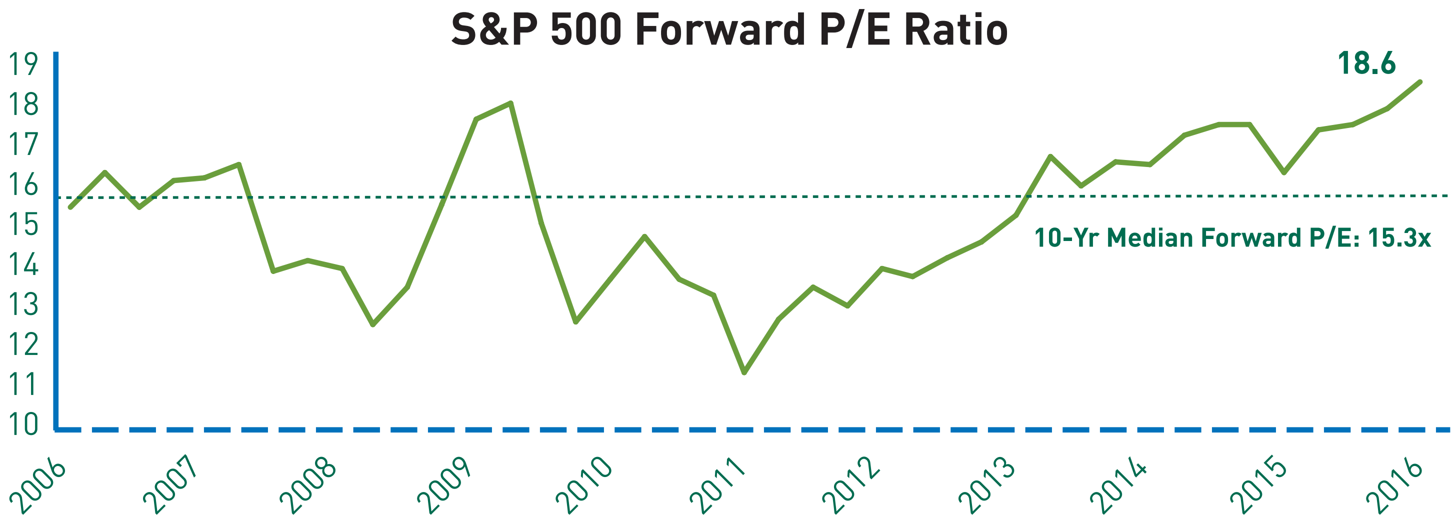
While this rate of economic expansion is far from robust, we believe it will support equity prices by providing a stable foundation for reacceleration in earnings growth. Third-quarter earnings for S&P 500 companies are expected to be down for the sixth straight quarter, marking the longest "Earnings Recession" since 2008. The decline in energy profits is the main reason for this earnings downturn. On the plus side, the worst of the profit recession is likely behind us. Excluding the energy sector, S&P 500 earnings were up 4% year-over-year in the second quarter, versus a 1% year-over-year decline in the first quarter. With oil prices stabilizing around $45 over the past six months, the energy sector will become less of drag on aggregate earnings heading into 2017. According to FactSet consensus estimates, the energy sector is actually projected to report the highest earnings growth (307%) and be the largest contributor to earnings expansion for the S&P 500 in 2017.

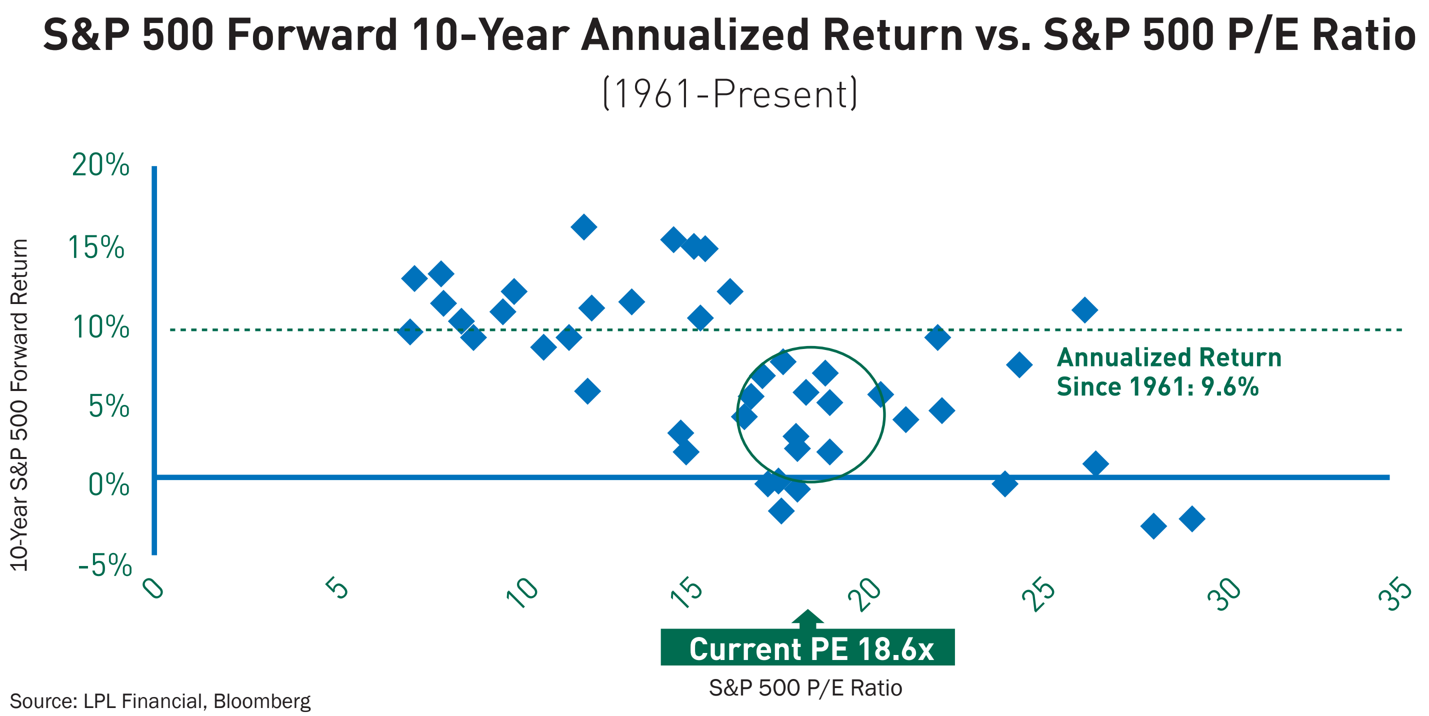
With the S&P 500 trading at a forward P/E multiple of 18.6, U.S. equity valuations have reached a new post-financial crisis high and are notably above the multi-decade historical median P/E multiple of 16.4.



Source: Bloomberg

The market's admittedly elevated valuation has some investors concerned that equities are on the brink of a significant market correction. As we've said before, today's premium valuation over historical multiples for stocks is likely warranted given the lower discount rate used to calculate the present value of corporations' cash flows in the current interest-rate environment. Moreover, P/E multiples have been poor beacons of short-term market performance in the past.

Prevailing valuation levels do determine market returns over longer time periods, though. As shown in the following graph, high P/E multiples typically result in lower subsequent 10-year annualized returns for the market. Although we don't believe the market's current P/E multiple indicates a significant downturn is imminent, we do expect lower annualized returns over the coming years based on today's elevated valuation levels.



Source: LPL Financial, Bloomberg

Even though equity returns are likely to be lower going forward than they were earlier in the cycle, when valuations were lower, we don't believe drastic changes to long-term asset allocations are warranted. At 86 months and counting, this economic recovery has stretched well beyond the post-war average expansion of 58 months. That said, we do not yet see the warning signs that typically precede a recession or bear market. Investors should expect increased market choppiness in the coming months, especially if it becomes more apparent that the Fed will start raising rates by year-end. Pullbacks may increase in both frequency and magnitude in the coming quarters, but we believe this will occur within the context of an ongoing secular bull market. As such, we plan to use this market volatility to our advantage by rebalancing around our targeted long-term equity weightings.

Investment Overview

Core Portfolio

During the third quarter, we initiated positions in NXP Semiconductors and Calpine Corp.

NXP Semiconductors is a Netherlands-based semiconductor manufacturer that sells High Performance Mixed-Signal (HPMS) semiconductor solutions into a wide range of end-market applications. Most notably, NXP is the largest automotive semiconductor supplier in the world, with 1.4 times the market share of its closest competitor. We believe the company's position in the $2.9 billion global auto semiconductor market provides NXP a long runway for attractive earnings growth, as the semiconductor content in automobiles is expected to expand significantly with the increasing proliferation of vehicle infotainment, keyless access systems and self-driving vehicle applications. Additionally, NXP is the technology and market leader in mobile Near Field Communication (NFC) semiconductors, which allow two electronic devices to exchange data remotely when in close proximity. Thus, NXP also stands to be a prime beneficiary of the growth in mobile payments, such as Apple Pay, and wearable technologies.

Calpine is the largest producer of natural-gas powered electricity in the United States. The company operates as a merchant generator, selling its power to utilities and other entities in electricity markets that have some form of wholesale market competition. Most of Calpine's assets are located California, Texas, and the Northeast and Mid-Atlantic regions, which are among the most attractive power markets. Calpine has one of the youngest, most efficient and cleanest power-generating fleets in the industry, which should favorably position the company to capitalize on sustained low natural-gas costs in the United States and the country's secular shift away from coal-fired electricity production. Despite its advantaged asset base, the market is valuing Calpine's collective generation fleet at a level well below the replacement cost of its plants. Temporary power pricing concerns in Calpine's wholesale markets are creating this dislocation in asset valuations. We believe the shares could appreciate considerably, however, when those short-term pressures subside and the true intrinsic value of Calpine's advantaged power-producing assets becomes more readily apparent.

We exited our positions in American Capital and Rackspace Hosting during the quarter.

American Capital is a publicly traded private equity firm and alternative asset manager. We originally invested in the company because it was trading at a significant discount to its net asset value (NAV). After pursuing several strategic initiatives to shrink that valuation gap, management agreed to sell the company to Ares Capital in a combined stock and cash transaction. Rather than assume the risk of a decline in Ares shares or termination of the deal prior to the closing date, we decided to exit our position in American Capital and reallocate the funds into other investments.

Rackspace is a managed hosting and cloud computing provider that also provides third-party support services for competing cloud platforms like Microsoft's Azure and Amazon's AWS. After years of takeover speculation by analysts and investors, Rackspace accepted a buyout offer from private equity firm Apollo Global Management. As a result, we sold our position in Rackspace to deploy the proceeds in other opportunities.

Equity Income

Stabilizing oil prices boost MLP returns

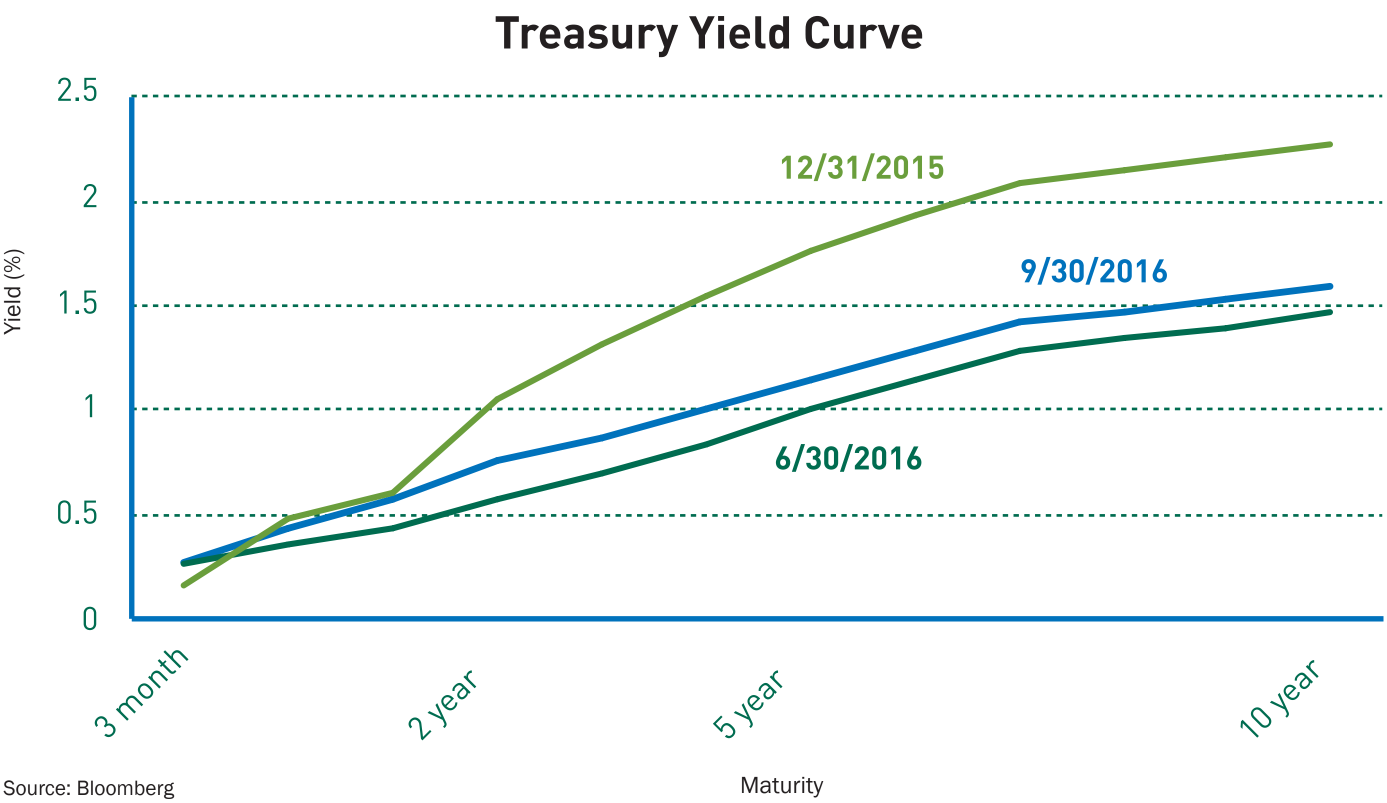
Income-producing equity investments, such as Mortgage Real Estate Investment Trusts (mREITs) and Master Limited Partnerships (MLPs), reported encouraging third-quarter returns. The Mortgage REIT Index posted a 5.1% increase in the quarter, extending its year-to-date return to an impressive 20.2%.

The Alerian MLP Index increased 1.1% during the third quarter, pushing its total return up to 15.9% YTD. MLPs continue to recover from their 2015 swoon, and we believe the potential for significant upside remains. There are several positive catalysts in the midstream energy space that we expect to serve as tailwinds for these companies in the coming quarters. First, as oil prices have stabilized, sentiment surrounding the sector has started to improve. Second, increased demand for natural gas (the most important but often-ignored commodity component for MLPs) pushed natural-gas prices to a 20-month high in September. Finally, we think the low-teens total return outlook for MLPs remains compelling with the sector's stable dividend yield (7.3%) and sustained annual distribution growth (5%-7%).

Fixed Income

Interest rates rise slightly as investors gain confidence post-Brexit

Interest rates in the United States rose moderately off of their lows in the third quarter, as investors began to move from the post-Brexit safety trade. Yields on the 10-Year U.S. Treasury bond rose to about 1.6%, but still are over half a percent lower than where they began the year.



Source: Bloomberg

Alternatives

Hedge funds rise along with equities

Hedge Fund performance picked up during the third quarter alongside rising equity markets. During the quarter, market leadership rotated from high dividend securities in the utility and telecom sectors – two sectors of little interest to most equity long/short managers who prefer more complicated investments – to technology and financials. In conjunction with this sector rotation, results for equity long/short managers improved. Distressed and event-driven managers posted the strongest results during the quarter as credit spreads continued to tighten. While presidential election and rising interest-rate fears continue to weigh on the market, the U.S. and global economies appear to be on better footing, and credit investments have rebounded dramatically since markets hit their February lows. As investment performance is expected to broaden across industry sectors and individual positions, we anticipate that all active managers will perform better, particularly hedge funds.

Economic growth and low interest rates continue to support the **Real Estate** market. While high-end single and multifamily housing have seen some recent weakness (especially in New York and other gateway cities), rents for most residential properties are rising with the improving employment picture. While the pace hasn't been as fast as real estate owners would like, office market rents have risen for 22 consecutive quarters, according to real estate research firm Reis. Retail properties continue to hold steady in coastal markets, which show the lowest vacancy rates and highest rent growth. Properties located in the industrial heartland are generally more dependent on the local economy. With interest rates expected to stay low, owning real estate appears attractive.

Private Equity activity is taking a little bit of a respite so far in 2016. According to private equity data aggregator PitchBook, the median private equity deal size dropped 23%, new fundraising activity slowed 28% and exit activity declined 36% year-over-year during the third quarter, although no single event caused this slowdown. While economic and political uncertainty and concern about lofty valuation levels undoubtedly played a small role, the more likely explanation is that the market could not keep pace with the prior year's torrid activity levels. Because many large private equity managers are expected to come back to market in 2017 with new funds, we expect activity to rebound accordingly.

Emergency Contact

As a reminder, our website (www.cedhill.com) has an "Emergency" link under the Contact Us tab. In the event of an interruption to normal business operations at our office, this link will redirect users to a Web page that will provide updates and alternative phone numbers for communications with clients and interested parties. In such an event, updates will be provided continually until operations are fully restored to normal.

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