



## **Bird in Hand Versus Bird in Bush** *Different Strategies for Different Economic Outlooks*

### **Implications of “Not so Bad” US recovery: Take the Bird in Hand**

A “not so bad” US economic environment will likely lead to underwhelming earnings growth for many domestic companies. Thus we do not think investors should expect, or pay, substantial premiums for earnings growth. Instead, we recommend a “bird in hand” approach in a not so bad economy.

We see current income as a bird in hand. Stocks that pay dividends now instead of offering a potentially attractive payoff down the road are likely to outperform, in our view. Furthermore, yields could grow meaningfully over time as companies increase their dividends. For example, a 3% dividend that increases by 10% per year would produce a nearly 5% dividend after five years, rising to nearly 8% after ten years (assuming the stock price holds steady). We are finding a number of stocks with current yields of 3% or greater that have a 10-year history of at least 10% annual dividend growth. *Past performance is no guarantee of future results. Dividends are not guaranteed and are subject to change or elimination.* There are even a few exchange-traded funds (ETFs) composed solely of these kinds of companies. Some of our favorites are listed below:

Exchange Traded Funds	<b>PowerShares Dividend Achievers Portfolio (PFM-NYSEArca-\$12.74)</b> <b>SPDR Dividend Aristocrat (SDY-NYSEArca-\$49.19)</b> <b>Vanguard Dividend Appreciation Fund (VIG-NYSEArca-\$47.36)</b>
<b>Altria (MO-N-\$21.99)</b>	6.6% yield 5-Year Dividend Per Share Growth Rate: 18%. Consecutive years of dividend payments: 29
<b>Automatic Data Processing (ADP-N-\$42.05)</b>	3.3%, Dividend Yield 5-Yr. Dividend Per Share Growth: 25% Consecutive years of dividend payments: 29
<b>Intel (INTC-NasdaqGS-\$21.71)</b>	3.1% yield 5-Year Dividend Per Share Growth Rate: 15% Consecutive years of dividend payments: 17
<b>Microchip (MCHP-NasdaqGS-\$31.52)</b>	4.6% yield 5-Year Dividend Per Share Growth: 23% Consecutive years of dividend payments: 7

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**Exchange Traded Funds (ETFs) are sold by prospectus. Please consider the investment objectives, risk, charges and expenses carefully before investing. The prospectus, which contains this and other information, can be obtained by calling your financial advisor. Read it carefully before you invest.**

In addition to countering a “not so bad” economic backdrop with a bird in hand, we believe there are other portfolio strategies an investor could utilize to increase the possibility of relative outperformance.

- 1. Lower exposure to domestically-oriented sectors.** In the “new normal” scenario, we think there will be fewer growth opportunities for companies that derive the majority of their revenue or earnings from the US economy. On the other hand, companies with significant international presence have the potential to offset slowing US business with better results overseas. According to Ned Davis Research, the four sectors with the lowest foreign pretax income exposure are:

Utilities	Telecommunications Services
Financials	Consumer Discretionary

- 2. Favor large-cap multinationals over small and mid-cap domestics.** Small and mid-cap companies have historically had a less global footprint and thus have been more reliant on domestic spending. Therefore, we anticipate small and mid-cap companies to be more exposed to “not so bad” economies and less exposed to “good” economies in the tri-polar world. We see evidence of this

in the latest surveys of CEO confidence. The Conference Board’s survey revealed that 72% of *large* company CEOs have optimistic 12-month outlooks while the NFIB<sup>1</sup> *small* business CEO survey reported the biggest drop in confidence since October 2008.

3. **We favor stocks with low expectations.** We expect that stocks will respond differently to new normal earnings that are likely over the coming years. We think expectations could be the distinguishing factor, and we believe that stocks are more likely to disappoint when expectations are high. Tables 1 and 2 list industries that we believe are the most and least at risk to a “not so bad” economic outlook, based on existing earnings expectations.

**Table 1: Most at Risk to Softening Economic Strength**

*Estimated earnings-per-share (EPS) growth significantly exceeds historical EPS growth*

Industry	Median Estimated EPS Growth (Fiscal Year 1 versus Fiscal Year 2)	Median 10-Year Historical EPS Growth
Auto & Auto Parts	38%	3%
Banks	14%	2%
Commercial & Professional Services	19%	9%
Consumer Durable & Apparel	14%	5%
Diversified Financials	19%	7%
Semiconductors*	20%	5%
Technology Hardware & Equipment*	17%	9%
Transportation	22%	10%

**Table 2: Least at risk to Softening Economic Strength**

*Estimated EPS growth in line with historical EPS growth*

Industry	Median Estimated EPS Growth (FY1 versus FY2)	Median 10-year Historical EPS Growth
Food, Beverage & Tobacco	9%	9%
Food & Staples Retail	11%	11%
Healthcare Equipment & Services	12%	16%
Household & Personal Products	10%	10%
Insurance	9%	13%
Pharmaceuticals & Biotechnology	12%	14%
Software & Services*	14%	12%

\* Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market. Past performance is no guarantee of future results.

**Implications of Strong Emerging Markets: Wait for the “Bird in the Bush”**

Foregoing immediate gratification for what hopefully turns into more significant gratification down the road is a strategy investors should only be willing to subscribe to if the probability of that payoff is reasonably high. Therefore, when it comes to the emerging world, we recommend employing a “bird in the bush” strategy. We consider “birds in the bushes” to be those companies positioned in front of the potential tidal wave of demand that is likely to occur if emerging economies live up to expectations. In our opinion, foregoing current income and certainty for the promise of superior growth and returns in the future is a worthwhile bet when it comes to the emerging markets, even if it entails paying a slight premium.

In our view, potential “birds in the bushes” include the following:

**Companies Exposed to the Emerging Market Consumer:** What happens when nearly a billion people move from farms to cities and become aspiring middle-class consumers? They do the same thing we do -- they buy carpet, appliances, clothes, jewelry, and electronics. We think companies that sell these products or services will have a meaningful tailwind for the foreseeable future. Industries that we believe are well-positioned for emerging market growth include the following:

1. **Fast Food -- McDonalds (MCD-N-\$70.87) and Yum! Brands (YUM-N-\$42.14):** According to Bernstein Research, Chinese hamburger consumption has the potential to increase 20-fold if Chinese consumers becomes just one-tenth as hamburger-crazy as their US peers.
2. **Everyday “Necessities” -- Clorox (CLX-N-\$65.75) and Philip Morris International (PM-N-\$51.19):** Soda, cleaning supplies, and cigarettes are often the first items purchased by citizens of the emerging world, because they are affordable, widely available, and well advertised.

<sup>1</sup> National Federation of Independent Business

3. **Aspirational Products -- Tiffany's (TIF-N-\$42.09), Nike (NKE-N-\$73.22) and Apple (AAPL-N-\$259.28):** Those who view the wealthy citizenship of the emerging world as an insignificant percentage of the population need to remember that "If you are one in a million in China, there are 1,000 people just like you." In other words, while small in percentage, the number of Chinese that can afford western goods is steadily increasing.

**Companies Helping Emerging Markets Build Infrastructure:** We are still bullish, albeit slightly less so, on infrastructure-related companies. Our waning enthusiasm stems from several formidable headwinds that will likely confront infrastructure companies. First, unlike 16-18 months ago when recession was imminent, we do not believe infrastructure companies have sufficiently discounted a slowing US economy and possible double-dip recession in several European countries. A second headwind is policy. The infrastructure industry appears to have become a preferred control-point for policymakers wishing to speed up or slow down their economies. With many emerging market policymakers sensitive to the risks of an overheating economy, we worry that future policy objectives may run counter to the growth objectives of the infrastructure industry. Thus, we are hesitant to get too excited about pure-play infrastructure companies in industries like Metals & Mining or Building Materials.

**Preference for quasi-infrastructure over pure-play:** We do see an opportunity in quasi-infrastructure companies, such as those producing efficiency tools for the manufacturing industry. We think China will be actively trying to reduce manufacturing costs in coming years. The country became the global leader in cheap manufacturing by riding a wave of low-cost laborers migrating from fields to factories. That wave has begun to mature and with it, worker unrest and wages have begun to rise. We anticipate China adopting western efficiency practices over the coming years in order to defend its leadership position, which should create growing demand for technology goods and services. Enterprise Resource Planning (ERP) and Supply Chain Management are just a sampling of technology solutions that have helped revolutionize manufacturing across the western world. These systems have allowed companies to cut costs, hire fewer people, and deliver higher quality products. We expect many of these practices to be increasingly adopted across the emerging world as low-cost labor becomes less cheap. We are attracted to Technology leaders and smaller software and networking companies, such as **Intel (INTC-NasdaqGS-\$21.71)**, **Cisco (CSCO-NasdaqGS-\$23.61)** and **International Business Machines (IBM-N-\$128.41)**, as well as smaller software and networking companies like those prevalent in the **PowerShares Dynamic Software Portfolio (PSJ-NYSEArca-\$22.19)** and **PowerShares Dynamic Networking Portfolio (PXQ-NYSEArca-\$21.14)**.

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