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Dear Client,

For investors who focus on dividends and interest, 2009 proved to be a challenging year. Last year was the worst year for dividend cuts in decades as companies looked to conserve cash amid a dreadful economy. At least 78 companies in the S&P 500 index either reduced or suspended their dividends, eliminating nearly \$50 billion in cash flow to investors.

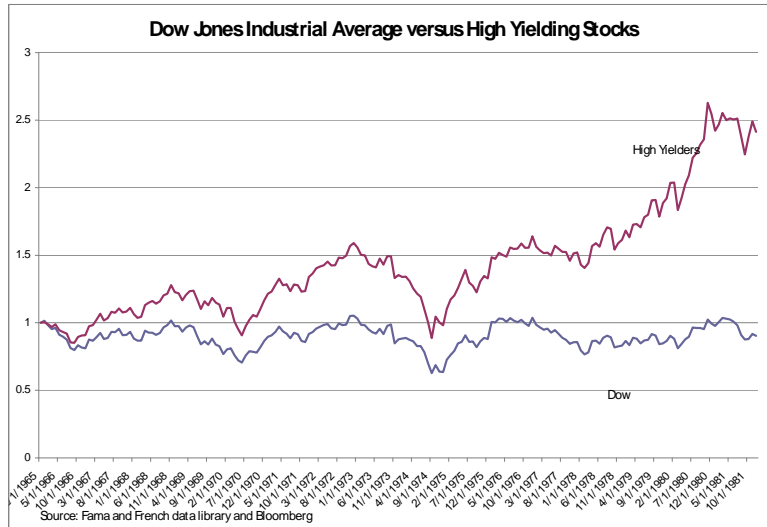
Fortunately, dividends and dividend increases are not completely dead. In fact, through our Retirement Compounders equity portfolio, we have been able to invest in companies that maintained or even raised their dividends in the past year. Companies that announced dividend increases in the fourth quarter of 2009 include Sunoco Logistics (yield 6.1%), Buckeye Partners (yield 6.4%), Unilever (yield 2.6%), Atmos Energy (yield 4.7%), American States Water (yield 3.1%), and Middlesex Water (yield 4.4%).

The Dow Jones Industrial Average ended 1981 at 875, 10% below its year-end 1965 value. During this difficult 16-year period, blue-chip stocks went nowhere. This was the ice age for stock prices. High and rising inflation and interest rates and big government were to blame—an environment not dissimilar to today's.

In *Fortune* magazine's January 18, 2010, issue, PIMCO founder Bill Gross offered the following investment strategy for the decade ahead, "Instead of a speculative Nasdaq stock at a 50 P/E, investors in the next 10 years should consider, say, an NYSE utilities stock that yields 5%. Focus on dividend income in terms of stocks, as opposed to growth and investment-grade income from bonds. You can generate a portfolio that yields 4% to 5% and that is in some fashion protected against inflation."

Savvy, conservative investors may be able to successfully navigate long dry spells in the stock market by placing an emphasis on cash flow in the form of stocks that pay higher dividends. The below chart compares the hypothetical growth of a \$10,000 investment in the Dow, ex dividends, to the growth of a \$10,000 investment in the highest-yielding U.S. stocks. The highest yielders are defined as the top-yielding quintile of U.S.-listed stocks. The portfolio of high yielders compounded at 6.4% annually over this 16-year period, compared to a loss on the Dow. For conservative investors and those approaching or in retirement, we believe investing for yield is a must.

"Diversification and patience built on a foundation of value and compound interest."



As always, past performance figures are no guarantee of future results. Also, from a performance standpoint, dividend payers will not always shine. During market rebounds, dividend payers will often lag nonpayers. There are several reasons for this. Nonpayers include riskier stocks, such as growth companies or high-tech firms that become popular once the prospects of a recession have passed. Additionally, these firms often plow earnings back into their businesses rather than passing them on to investors. Doing so can improve their earnings compared to companies that pay out dividends. In 2009, by example, technology was the best-performing sector, easily outperforming the dividend-heavy telecom and utility sectors.

Nonetheless, on a longer-term basis, dividend payers track well against nonpayers. Since 1972, according to Ned Davis Research Inc., companies that increased or started paying dividends have returned 9.5% yearly on average. In 19 of the past 30 years, S&P data shows payers' shares did better than nonpayers'.

Our investment strategy at Richard C. Young & Co., Ltd., emphasizes dividends and interest. In our continued quest to boost yield on our Retirement Compounders equity program, we have reduced or sold a number of our lower-yielding positions, including Hershey, Smuckers, McCormick, and Illinois Tool Works. We have used the proceeds to purchase a number of higher-yielding positions.

While we are able to tie down attractive yields through equity purchases, we are having a more challenging time with corporate bonds. The supply of high-yielding investment-grade corporate bonds with shorter maturities is thin. And, unlike the more speculative bond investor, we are uncomfortable reaching for yield by extending maturities.

In a January 19, 2010 article, *The WSJ* reported that, in the bond market, risk is taking a backseat as demand for high-yield credit sets a record: "Companies left for dead a year ago are now finding that investors are clamoring for their high-yield debt.... The latest demand seems all the more remarkable coming just over a year after the greatest financial panic in generations. The panic and a bleak economy helped pushed [sic] 11% of high-yield issuers into default in 2009." The article went on to note that, "the new debt is not going toward building new factories or

funding big acquisitions. Instead, these new deals are improving the companies' balance sheets by repaying existing debt and pushing back maturities. These overleveraged companies hope they can get more time to improve operations and benefit from an economic recovery. ”

Investors are eager for such new debt, in part because of economic policies emanating from Washington. With the Federal Reserve keeping interest rates near zero, yields on government debt have stayed low, forcing investors searching for decent returns to chase riskier paper, like junk.

“They’re all yield junkies, “ says Barry Ridings, the vice chairman of U.S. investment banking at Lazard Frères & Co. “Did everyone forget that 2008 happened? Talk about short-term memory loss on the part of the buyer.”

Our current bond strategy at Richard C. Young & Co., Ltd., is to avoid the more speculative end of the bond market. We are also avoiding longer maturities. Instead, we are staggering shorter maturities and creating more of a stepladder than a traditional ladder, which may include long-term bonds.

Our decision to avoid most long-term fixed-income securities is a primary reason for exiting our preferred securities positions. After 15 years of investing in preferreds, we are now completely out of that asset class.

As interest rates rise, bond prices decline. With rates so low today, we believe it’s just a matter of time before rates start their march upward. Once rate increases gain momentum, long-bond holders better look out. If, by example, rates rise 3%, then the value of a bond with a 15-year maturity will decline in price by approximately 35%. Given that preferreds are long-term securities, this is exactly the scenario they will most likely face when rates rise.

It’s hard to believe it was only 12 months ago that investors witnessed the collapse of Wall Street, a looming Depression, and a stock market spiraling downward. Today, those fears appear to be sidelined based on the stock market’s performance during the last three quarters of 2009. Why has the environment turned around so quickly? One reason is the stimulus being provided by ultra low interest rate policies in the U.S., Japan, Britain, and the euro zone.

By keeping rates low, central banks are encouraging investors to take their money out of cash and to buy riskier assets. The cheap money of today is the primary reason we are seeing asset prices rise. As *The Economist* explains, “When investors borrow money in order to buy assets, they push prices even higher. But this also makes markets vulnerable to sudden busts, as investors sell assets to pay their debts. The credit crunch of 2007–08 was the result of this process, with the debts greater and the price swings more violent than at any time in the past 30 years. Critics argue that central banks, by focusing on consumer- rather than asset-price inflation, have encouraged bubbles to grow by keeping interest rates too low. By intervening when markets fall, but doing little to curb them when they rise, they have offered investors a one-way bet.”

As long as the Fed continues its policy of low interest rates and easy money, the stock market may continue to be stimulated. We believe that the current combination of high asset prices, large fiscal deficits, and ultra-low interest rates is not a sustainable mix.

We are reacting to the current environment by placing an emphasis on short-term investment-grade bonds, high-quality dividend-paying stocks, a mix of foreign currencies, and natural resources, including natural gas and agriculture.

Have a good month, and, as always, please give us a call at 800-843-7273 if your financial situation has changed or if you have questions about your investment portfolio.

Warm regards,



Matthew A. Young

Quote of the Month: “Going out a few years, China is potentially a severe disappointment. A group of people who were communists in every aspect a few years ago is trying to drive the largest country in the world at the fastest rates in economic history. They are making unprecedentedly large and perhaps badly reviewed loans. They’ve been incredibly lucky. They are probably not as good as they seem to be. I think there is a nascent bubble in emerging markets.”

Jeremy Grantham, Chief Investment Strategist, Grantham, Mayo, Van Otterloo.

BlackRock: We’ve been purchasing both bonds and closed-end funds from BlackRock. BlackRock is one of the world’s largest diversified asset managers serving both institutional and retail investors. Especially attractive to us is the firm’s recent purchase of Barclays Global Investors, which owns the iShares family of exchange-traded funds (ETFs). ETFs, usually linked to an index or asset class, offer us a way of diversifying assets at a relatively low cost. With ETFs we can create precise asset allocation with currencies, commodities, and foreign economies.

Dividend Yield: When assembling stock portfolios, we are currently placing an emphasis on quality and increased cash flow. Recent trades in stock portfolios have been geared to boost overall yield. Sectors that lend themselves to higher payouts include utilities, pipelines, and consumer-product companies. Three recent purchases, from the energy sector, include Black Hills (yield 5.4%), Vectren (yield 5.7%), and Xcel (4.7%).

What a harried decade it has been for stock investors. **Chart 1** shows the S&P 500 from year-end 1999 to year-end 2009. Investors have been whipsawed over the last 10 years. We have seen two savage bear markets, with peak-to-trough declines of 50% and 56%. Even after the forceful rebound off of the March 2009 lows, the S&P 500 sits 23% below its yearend 1999 level. The 2000s were even worse for many foreign investors in U.S. stocks. **Chart 2** shows the S&P 500 in terms of Swiss francs. Swiss investors buying U.S. stocks over the last decade have been decimated, losing 47% of their wealth. European investors have also been clobbered. **Chart 3** shows that in terms of euros, the S&P 500 is down 46% since year-end 1999.

But the most depressing chart of all is **Chart 4**. Chart 4 shows the performance of the S&P 500 in terms of gold over the last decade. Gold is the only true hard currency in the world. In terms of gold, the S&P 500 is down 80% from its yearend 1999 level.

There is a lesson here for the Federal Reserve. You can't print your way to prosperity. Sustainable wealth is not created by slashing interest rates and debasing the dollar. Ultra-loose monetary policy is a short-term fix. You keep the bad actors in the system instead of allowing them to fail. The likely result is more severe problems down the road.

Has the Fed learned from its mistakes? It's doubtful. Chairman Bernanke has the monetary pedal pegged. The Fed is printing money, expanding bank reserves, and promising more of the same despite a recovery in most financial markets. A revamp of the Fed's monetary policy paradigm is much needed. If the Fed doesn't change its ways, it is not a matter of if, but when the next financial crisis strikes.

Jeremy Jones, CFA
Chief Investment Officer

