

Why We Favor Stocks over Mutual Funds

October 2012 Client Letter

For some time, we have been disillusioned with much of the mutual fund industry. Aggressive sales tactics, front-end sales loads, 12b-1 marketing fees, and high expense ratios practiced by many fund groups seem far from investor friendly. The sad reality is most mutual funds are not bought by investors, they are *sold* to



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investors. And the most popular funds are too often those that offer the greatest payout to brokers.

It should come as no surprise, then, that the nation's largest actively managed equity mutual fund is Growth Fund of America—a \$116-billion behemoth with a 5.75% front-end sales load and a 25-basis-point 12b-1 fee. With \$116 billion under management, the fund can only take a meaningful stake in about 100 U.S. stocks (without buying more than 5% of that company's shares). Any objective assessment of the Growth Fund of America would recognize that it could be nothing more than a closet index fund. It is just too big.



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Unfortunately, the promoters selling the fund aren't objective. The fund gets jammed into millions of accounts, requiring investors to fork over 5.75% of their assets up front, and then to pay an annual expense ratio for a fund that for all practical purposes is no different from the ultra-low-cost Vanguard 500 Index Fund.

To help our clients avoid the pitfalls of mutual fund investing, we buy only funds with no loads, no 12b-1 fees, and low expense ratios. But as our longtime clients can attest, our reliance on mutual funds has waned over the years. The problem is that successful no-load, low-expense-ratio funds often become too large and



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suffer from the same limitations as the Growth Fund of America. We would put the Dodge & Cox group, a family of funds we have used in the past, into this category.

Other low-fee, no-load fund groups have caved to the pressure to deliver strong short-term results and have decided to take a benchmark-centric approach to portfolio management. The *raison d'être* of this crowd is to beat the benchmark—at all costs. This is a perilous strategy. Consider the example of the Legg Mason Value Trust—a fund we've never liked. The Legg Mason Value Trust became popular after beating the S&P 500 for a record 15 consecutive



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years. But since the streak ended in 2005, the fund has trailed the S&P 500 by a cumulative 60 percentage points. That has turned its 20-year performance record from hero to has-been.

Our growing dissatisfaction with the mutual fund industry is one of the reasons we have decided to decrease the allocation to equity funds and increase the allocation to common stocks. We have recently begun shifting assets from equity funds and ETFs into our Retirement Compounders (RCs) equity portfolio. Funds and ETFs will continue to remain a component of equity portfolios, but now they will play only a supporting



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role.

A greater allocation to the RCs will enhance our dividend-focused strategy without sacrificing sector and geographical diversification. In many cases, the yield on the RCs is greater than the yield on the funds and ETFs we are selling. By example, one of the funds we have been selling is iShares Switzerland. iShares Switzerland pays a 2.6% dividend yield. The Swiss stocks we are buying in RCs portfolios have an average yield of 4.26%.

In conjunction with the increased allocation to the RCs, we are also expanding the number of stocks in RCs portfolios. We've long advised 32-stock portfolios. With a 32-



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stock portfolio, you achieve 90% of the diversification of owning all NYSE-listed stocks—or at least you used to. Our favored 32-stock portfolio target was based on studies of the U.S. stock market in a period when high-frequency trading and ETFs didn't play a dominant role in equity markets (that was only a few years ago). Over recent years, market structure has changed considerably.

High-frequency trading (HFT) now accounts for 70% of volume, and ETFs account for as much as two-thirds of all trading volume. The proliferation of HFT and ETFs has led to a near tripling in the average correlation among



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S&P 500 stocks. Increased correlation means that a 32-stock portfolio no longer provides as much diversification as it once did. To achieve maximum diversification today, a larger portfolio is necessary.

A larger stock portfolio also provides more opportunity for global diversification. Not long ago, an equity portfolio made up of strictly U.S. stocks provided ample diversification. Today, a properly diversified portfolio means a globally diversified portfolio. There are about 40,000 publicly traded companies of size in the world. Over 85% of those companies are domiciled outside of the United States. In the



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context of an investment universe that includes 40,000 stocks, a 32-stock portfolio can be limiting.

To improve diversification and better cover the global equity landscape, we are expanding the number of stocks in RCs portfolios. Since the correlation among stocks continues to fluctuate, we have decided to move away from a fixed number of positions and instead buy no fewer than 40 stocks.

Why We Are Buying Swisscom Stock

Some of the new names that we have been adding to portfolios recently include, among others, Swisscom, Bank of New



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York Mellon, UPS, and
Norfolk Southern.

Tracing its roots back to 1852, when the state-owned PTT (post, telegraph, and telephone) was founded, Swisscom is Switzerland's leading telecommunications provider. The company provides a full range of telecommunications products and services, including fixed-line telephone, mobile communications, broadband, and digital television. Swisscom became a publicly traded company in 1998, when the Swiss Confederation (the Swiss federal government) floated shares of the company. The Swiss Confederation remains Swisscom's largest



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shareholder, with a 57% stake in the company.

Today, Swisscom provides service to 6.1 million mobile customers and 1.7 million broadband customers. Swisscom boasts a 62% market share in mobile, 55% in broadband, and it is Switzerland's largest provider of digital television, with a market share of 25%.

Unlike many of the leading European telecommunications companies, Swisscom generates 80% of its revenue and all of its cash flow domestically. The focus on Switzerland helps insulate Swisscom from the recessionary conditions in much of Europe. The company does own



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Fastweb, an Italian broadband provider, but Fastweb accounts for only 20% of revenue, and a minor portion of Swisscom's value.

Swisscom is a shareholder-friendly company with a generous payout policy. The company aims to distribute half of its operating free cash flow to shareholders, with the goal of not paying a dividend that is lower than it was in the previous year. Its secondary goal is to return capital to shareholders through share buybacks. Swisscom shares offer an attractive dividend yield of 5.75%.

Why We Are



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Buying Bank of New York Stock

Bank of New York Mellon was founded in 1784 by Alexander Hamilton. Today, it is a leading global financial services company focused on helping clients manage and service financial assets. The bank operates in 36 countries and serves more than 100 markets. At year-end 2011, BNY Mellon had \$25.8 trillion in assets under custody and administration, and \$1.26 trillion in assets under management. The company also serviced nearly \$12 trillion in outstanding debt and processed global payments averaging \$1.5 trillion per day.



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BNY Mellon isn't like your typical bank, but it has been painted with the same brush by investors. Most banks generate the bulk of their earnings from interest income. Banks take in low-interest-rate deposits and lend at higher interest rates, pocketing the difference. But at BNY Mellon, almost 80% of revenue comes from fee-based businesses that are vital to the global financial system. BNY Mellon and its chief competitor, State Street, serve as the plumbing of the global financial system. It is instructive to note that BNY Mellon and State Street were two of the nine banks included in the first tranche of Troubled Asset Relief Program (TARP) investments, even though



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both banks were well capitalized at the time. The Treasury department clearly recognized the vital role that BNY Mellon and State Street play in the global financial system.

BNY Mellon is a dominant global financial services powerhouse with a solid balance sheet (the best-capitalized bank in the Fed's last round of stress tests) that generates almost 80% of revenue from fee-based businesses, but it doesn't get much respect from investors. The shares change hands at less than 11 times the value of BNY's depressed earnings. And unlike many companies in America today, BNY Mellon's profit margins aren't bordering on cyclical highs. Just the



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opposite, in fact. When the economy improves and interest rates eventually rise, BNY Mellon's margins should expand.

The stock also offers investors the potential for a big dividend hike. Currently, the bank is returning less than 25% of earnings to shareholders in the form of dividends. Prior to the financial crisis, a payout ratio of 40% was the norm. In a normalized economic environment, we look for a payout ratio near 40%. If BNY Mellon distributed 40% of earnings to shareholders today, the stock would yield 3.6%.

What We Like



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About UPS Stock

The predecessor to UPS was founded in 1907 by Jim Casey, who borrowed \$100 from a friend to start his American Messenger Company in Seattle. In those days, most deliveries were made on foot, and the company would deliver just about anything, including trays of food from restaurants. Even in the face of stiff competition, the company took off by basing its business on the slogan “best service and lowest rates.”

Today, UPS is the world’s largest package delivery company and a leader in supply chain management. UPS provides air and ground services to



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customers in more than 220 countries. It has 2,773 operating facilities worldwide and 62,000 retail access points. The company's fleet of almost 99,000 vehicles delivered 4 billion packages and documents in 2011. On an average day, UPS completes 1.1 million pickups, and 7.7 million deliveries. UPS is currently in talks to acquire TNT Express. TNT operates 30,000 road vehicles, 46 freight airplanes, and 2,300 depots around the world. The deal would give UPS the largest market share in the EU among logistics and transportation companies.

Investing in



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Norfolk Southern

The history of Norfolk Southern railroad began in 1826 in Quincy, Massachusetts, where the Granite Railway Co. built the country's first commercial railroad. The Granite Railway was built to move granite blocks to the Bunker Hill monument in Boston. A year later, Southern Railway, another future component of Norfolk Southern, was chartered. On Christmas Day in 1830, Southern ran the nation's first scheduled passenger train. In 1838, a nine-mile link between Petersburg and City Point, Virginia, would become the foundation of the third major component of Norfolk and Western



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Railroad. Hundreds of mergers later, these three railroads and all the others would become Norfolk Southern.

Today Norfolk Southern crisscrosses the entire Eastern half of the United States, with rails travelling through the metropolises of the Mid-Atlantic States, the industrial heartlands of the Great Lakes region, and the agricultural hubs of the Deep South. Norfolk Southern operates 36,302 track miles and owns or leases 4,134 locomotives. Those engines pull the 87,715 freight cars owned or leased by Norfolk. Norfolk is the highest-yielding railroad in America with a current yield of 3.20%.

The goal of our RCs



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program is to provide clients with a professionally managed, globally diversified portfolio of high-dividend-paying stocks that have a history of dividend increases. Investing in companies with high dividends today and dividend growth tomorrow is a strategy that appeals to retired and soon-to-be-retired investors. High-dividend payers tend to reduce downside volatility in bear markets, and dividend growth helps keep pace with inflation.

We further bolster the RCs program by selecting companies with strong balance sheets, durable businesses, and sustainable competitive advantages (think



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businesses with high barriers to entry and strong brands).

Have a good month, and as always, please call us at (888) 456-5444 if your financial situation has changed or if you have questions about your investment portfolio.

Sincerely,



Matthew A. Young

President and Chief
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P.S. The Cato Institute's Chris Edwards has reported in the Fiscal Policy Report Card on America's Governors 2012 that four governors earned



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an A grade for their efforts to reform their states' taxes and spending. Those governors are Sam Brownback of Kansas, Rick Scott of Florida, Paul LePage of Maine, and Tom Corbett of Pennsylvania. These governors have all pursued and achieved tax cuts and relief measures, making their states more competitive for business and raising the standard of living for residents. Brownback told the Associated Press that he had lots of taxes to choose from when he came into office as governor. But he focused on corporate income taxes because he wanted to generate growth in the most efficient way by cutting taxes for small businesses. The Brownback plan lowered



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the state's income tax rate from 6.45% to 4.9% and eliminated taxes on 190,000 small businesses.

P.P.S. Due to an issue with our telephone service provider, Cox Communications, our Rhode Island office recently experienced several hours of interrupted telephone service. Please note that our Naples office uses a different service provider and should be available in this type of situation. The telephone numbers for both offices are (800) 843-7273 (Newport) and (888) 456-5444 (Naples). Also, when one of our offices is unavailable, we will update our website, www.younginvestments, with instructions for



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contacting us.

P.P.P.S. Enclosed in this month's letter is a reprint from *Barron's* magazine listing Richard C. Young & Co., Ltd., among the top independent financial advisors in the nation for 2012. We thought you would find this of interest.



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