

Beyond Market Exposure

Dividend growth stocks may be the answer to prolonged low interest rates and increasing market volatility

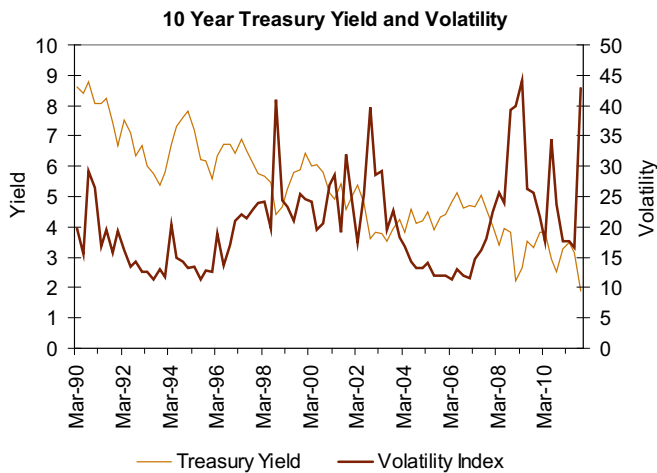


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Record Low Interest Rates, Persistent Underwriting Losses and a Highly Competitive Marketplace Have Many Investors Seeking Alternatives to Traditional Investment Strategies

Market volatility has increased, reflecting more severe and frequent peak-to-trough cycles in the equity markets, as shown in Figure 1. In addition, interest rates and bond yields remain at historic lows, and there is scant evidence they will rise soon. This environment presents challenges for even the most astute institutional investors, whether their portfolios utilize traditional, high quality fixed income or stand-alone equity strategies. It is clear that portfolio strategies must evolve with the markets to support institutional investors' broader goals and objectives.

Figure 1



Source: Bloomberg

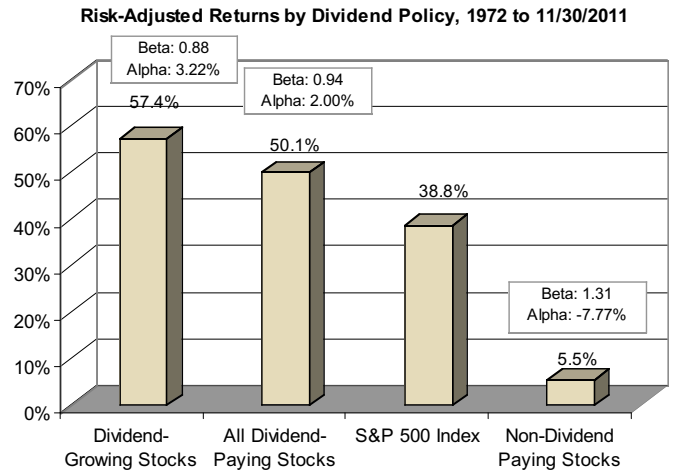
Strategies Focused on Dividend-Growing Stocks Reduce Risk, Enhance Income Predictability without Sacrificing Returns

Risk-adjusted performance

The return potential of *dividend-paying* stocks – those companies that pay dividends in any given year – is well established: They have provided attractive returns to investors for the past forty years.

However, *dividend-growing* stocks take this one step further. These companies have increased their dividends each year, and they have far outperformed dividend-paying companies, the S&P 500, and non-dividend paying stocks on both a relative and risk-adjusted return – the annualized returns divided by standard deviation – basis as illustrated in Figure 2. Dividend-growing stocks have lower standard deviations,

Figure 2



Source: Miles Capital and Ned Davis Research¹

and provide higher alpha – excess performance on a risk-adjusted basis – with lower beta or systematic risk over time.

Reasons for Reduction in Risk

Confidence and transparency

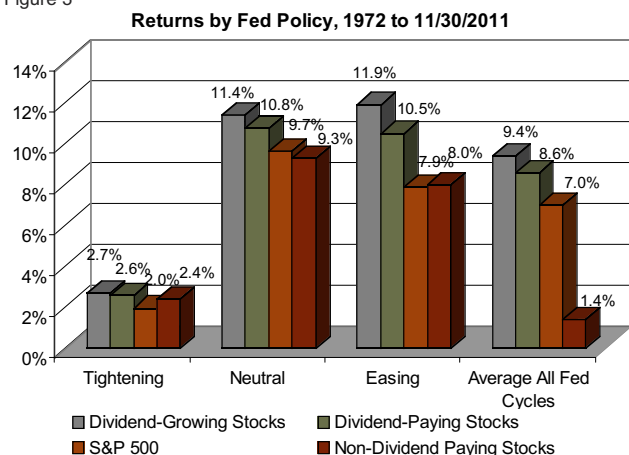
“In our experience, dividend-paying companies – and especially dividend growers – have historically proven to be higher quality companies. Dividend-paying companies tend to have far greater confidence in their business models, and therefore provide greater transparency. This ultimately allows for a more comprehensive understanding of the security’s appreciation potential. In addition, the paying of dividends demonstrates management’s confidence in the company’s stability, and certainty about the firm’s ability to generate cash flows and earnings growth,” says Allen Goody, Miles Capital’s Director of Equity Asset Management.

Protection from interest-rate movement

The majority of current economic forecasts follow conventional expectations – that interest rates will eventually begin to rise as inflation expectations increase from today’s historic lows. As this investment environment emerges, portfolios heavily weighted to fixed income will be challenged on a total return basis. Traditionally, institutional investors have added equity securities as a proven hedge against rising inflation.

Dividend-growing stocks provide a superior hedge over traditional equity exposure as seen in Figure 3. They have historically outperformed dividend-paying stocks, the S&P 500 Index and non-dividend paying stocks in all interest rate environments, especially low interest rate environments.

Figure 3



Source: Miles Capital and Ned Davis Research¹

Active Analysis Identifies True Dividend Growers with Price Appreciation Potential

While the merits of a portfolio of dividend-paying stocks are well understood, it is extremely important not to underestimate the additional value of active management—especially of yield-focused strategies—and disciplined portfolio construction. Many strategies can easily identify stocks that pay attractive dividends. But a naïve approach that emphasizes yield alone will often lead to unintended outcomes or risks that may not be suitable given the volatile market environment. Among these are issuer quality, sector concentration, and capitalization biases.

Issuer quality

All high-dividend-paying stocks are not created equal. Some stocks become “high-yielding” due to earnings pressure or a challenged outlook, which causes the stock price to fall. A disciplined and thoughtful active portfolio construction process seeks to identify high quality dividend-growing companies that have earned their yield notwithstanding changing market dynamics and are more likely to have a reliable, positive growth outlook.

Diversification by sector

Passive strategies that prioritize yield may by default become more heavily weighted to three or four sectors which commonly pay higher dividends: consumer staples, financials, industrials, and utilities. But such sector concentrations can lead to dangerous overweights in the portfolio and result in a much higher risk profile than a broader market index.

Analysis of the top twenty dividend-focused ETFs by asset size shows that approximately 56% of the assets are invested in these four sectors.² Just 40% of the Russell 3000 Index is

comprised of these sectors, greatly enhancing the strength of its diversification. Actively managed strategies that proactively establish diversification parameters relative to a diversified benchmark greatly reduce sector concentration risk.

Diversification by capitalization

Many strategies, including 75% of the passively managed strategies analyzed above, seek to control risk by investing exclusively in larger-cap stocks.² Large-cap stocks are perceived to be more stable and therefore less risky than small-cap stocks. However, this bias falls short as it fails to consider the high quality nature of dividend-growing companies.

Small-cap dividend-growing companies demonstrate the same high quality characteristics, transparency, and consistency of cash flows as dividend-growing stocks across the other market capitalization structures.

Actively managed strategies, constructed by managers with capabilities across the capitalization spectrum, tend to deliver additional value over strategies focused solely on large-cap companies. As shown in Figure 4, the risk/return benefit of adding mid- and small-cap dividend-growing stocks to an investment portfolio does not result in increased volatility, but instead has the potential to enhance the portfolio’s total and risk-adjusted returns as well as the portfolio’s overall efficiency.

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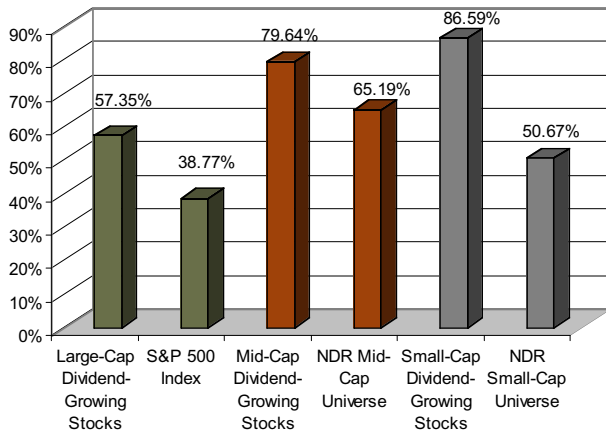
Prudent active management separates the much more promising dividend-growers from the dividend payers, generating more predictable income. It also increases the likelihood that the portfolio will take advantage of these significant nuances and avoid unintended concentrations, thereby increasing the portfolio’s return potential and lowering volatility.

Miles Capital All-Cap Equity Income Delivers Strong Solution

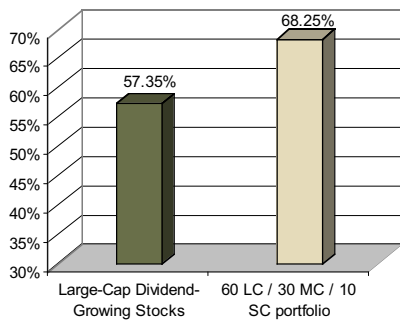
Consider then the actively managed All-Cap Equity Income strategy from Miles Capital.

Miles Capital has a tenured history of meeting client needs and expectations with dividend-oriented strategies. The Miles Capital All-Cap Equity Income strategy employs an active management process that provides strong and thoughtful

Figure 4
Risk-Adjusted Returns by Dividend Policy, 1981 to 11/30/2011



All-Cap Strategy Risk-Adjusted Return, 1981 to 11/30/2011



Source: Miles Capital and Ned Davis Research¹

portfolio design, targeted at minimizing risk while enhancing yield and capital appreciation potential.

The strategy incorporates the power of true high quality dividend-growing securities, establishes guidelines to guard against naïve concentrations resulting from yield mining, and utilizes our expertise to take full advantage of the risk/return enhancements provided by investing in the full market capitalization structure.

Disciplined equity selection process provides strong foundation

At Miles Capital, we believe that buying high quality stocks, trading at a reasonable valuation at a time when the market is also appreciating them is the key to generating long-term excess returns.

Our proprietary equity selection process identifies securities with strong characteristics for producing alpha through the application of both quantitative screens and fundamental analysis. The combination of these methods results in a consistent, repeatable process capable of delivering excess returns over a full market cycle. More importantly, our experience and results in multiple capitalization structures, including

large- and small-cap, demonstrate that the all-weather nature of our process is applicable to different investment styles.

All-Cap Equity Income strategy provides core portfolio characteristics and enhanced yield

For the All-Cap Equity Income strategy, we begin with a universe of securities that have a history of paying dividends, from which we filter roughly 150 dividend-growing stocks by applying quantitative measures. Using fundamental analyses, we then narrow the list to 40 or 50 stocks across the capitalization structure that are well positioned to provide alpha. The process builds from the bottom up, with sector parameters to avoid unintended overweights to sectors such as financials, which can be biased toward yield without the complementary reduction in volatility. Strategy objectives:

- Yield exceeding the Russell 3000 Index yield plus 1.5%
- Dynamic diversification across sectors
- Broad market capitalization diversification (60% large-cap, 30% mid-cap, 10% small-cap)
- Total return net of fees exceeding the Russell 3000 Index over full market cycles

The strategy targets holdings of 45 to 55 stocks, with turnover between 50% and 75%, and maintains sector diversification.

Respected experience provides confidence

Miles Capital is an independent institutional asset manager with three decades of experience providing outcome-oriented investment solutions for clients. We manage both fixed income and equity strategies totaling nearly \$4 billion in assets. Clients include insurance companies, foundations, endowments and other institutional investors.

We take great pride in the client focus that our independence affords us. It allows us to align our interests with those of our clients and tailor solutions to meet their specific, distinct needs.

Appropriateness of Miles Capital All-Cap Equity Income

As a core investment portfolio, this strategy has the capability to both support business growth and backstop possible underwriting losses – an important consideration given the extensive losses realized by many insurers in 2011. In addition, the strategy's risk/return profile will likely reduce risk within current equity allocations without sacrificing total return potential.

Just as importantly for many of our institutional clients, the Miles Capital All-Cap Equity Income strategy serves as a complement to fixed income investing. It enhances the level of predictability of investment income and possesses the potential to reduce portfolio risk.

We're now offering our expertise across the market capitalization structure and experience with dividend-focused strategies to you.

To learn more about the power of dividend-growing stocks and our active management equity process, contact us today.

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² Analysis by Miles Capital. Categorization and asset sizes of dividend-focused ETFs provided by ETFdatabase.com. All other data analyzed from ETF Fact Sheets as of 9/30/11.