

NOYES CAPITAL MANAGEMENT, LLC

Personal Financial Planning & Prudent Investment Management

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The Quest for Portfolio Income Continues

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The year 2011 represents a major inflection point for many Americans. The age demographics of the United States have reached a tipping point where the giant bulge of “baby boomers”, our most experienced workers, are heading for retirement and counting on pensions and health benefits that have not been provided for. Individually, they can no longer gamble with their life savings and must prepare for retirement. They have reached a point in life where sustainable income is more important than portfolio growth. This increased demand for income will be with us for a very long time.

Traditionally, investors believe that income comes exclusively from bonds. However, in today’s low interest rate environment, a traditional bond portfolio is unlikely to meet an investor’s income needs. Dividend income will be essential to meet future savings needs. I believe that high dividend stocks and dividend growth stocks should be a core component of an income generating portfolio.

Current Bond Market Outlook

Today’s low interest rate environment is very challenging for those investors needing income. The Federal Reserve has lowered interest rates to help the banking system but sacrificed the income needs of savers. This has created a wonderful three-year bond market rally which lowered yields on 10-year US treasuries from 5.4% to 2.4%. In most cases, your portfolio has enjoyed bond price appreciation. In my opinion, we are close to a turning point where bond yields may bottom out.

The US Federal Reserve is expected to start a process called “quantitative easing” where it is expected to buy up to \$1 trillion in bonds from the marketplace. This is expected to lower rates and stimulate the economy. Japan, the United Kingdom and possibly the European Union will follow similar policies. This additional global liquidity should lower interest rates and drive up equity prices in the short term.

In the long run, I believe that coordinated global monetary stimulus will create future inflation. Governments around the world need inflation to occur. They cannot pay off their debts any other way. There is no other solution to the budgetary problems faced by governments at all levels around the world. I believe that inflation will occur because governments need it to occur. Since bond values go down during inflation, I believe that a defensive bond strategy is warranted.

US Bond Market Opportunities

Current interest rates are the lowest I have seen in my lifetime. The only way to receive a reasonable yield is to either accept weaker credit or increase the maturity of your bond portfolio. The U.S. bond market is priced for a long term deflationary world. Current yields are:

<u>Bond Type</u>	<u>Yield</u>	<u>My Comments</u>
US Treasury 2yr Note	0.36%	Money market alternative
US Treasury 5yr Note	1.13%	No thanks
US Treasury 10 yr Notes	2.40%	No thanks
US Treasury 30 yr Bonds	3.80%	No thanks
US Ginnie Mae AAA Mort backed	3.50%	Maybe
NY, NJ Municipal bonds 10 yr	2.50%	dicey, budget problems
NY, NJ Municipal bonds 20 yr	4.50%	dicey, budget problems
Corporate bonds – A 5 year	2.5%	Best tradeoff
Corporate bonds – BBB 5year	3.0%	Still OK, but riskier
Corporate bonds - B 5 year	7.0%	No thanks.

Foreign Fixed Income Opportunities

We have realized excellent returns in mutual funds that invest in foreign fixed income opportunities. In addition, foreign bonds provide currency diversification and protection against a declining US dollar. The credit rating of foreign bonds ranges from high quality (Swiss, Australia, Canada) to weak credits (Greece, Pakistan, Iceland). Emerging market bonds (Brazil, Korea, India, etc) have an average credit rating of single A but a much higher yield than US bonds.

European Foreign bonds AA 5yr	1.50%	return is primarily currency related
Australian Bonds AAA 5yr	5.00%	high yield plus currency exposure
Emerging Market Bonds A 5yr	6.00%	high yield plus currency exposure

Alternatives to Bonds

Income equities are traditionally viewed as boring steady companies that provide the necessities of daily life. These would include:

- Telephone companies such as Verizon and AT&T
- Oil companies such as Exxon and Chevron
- Industrials such as MMM and DuPont
- Consumer goods franchises such as Coca Cola, Kimberly Clark and Kraft Foods
- Utilities such as Duke Energy and Con Edison
- Energy royalty trust MLP's such as Hugoton Energy Trust

- Pipeline MLP's such as Enterprise Product Partners or Kinder Morgan
- Mortgage backed MLP's such as Annaly Capital
- Preferred Stock
- Real Estate Investment Trusts (REIT)

These stocks all provide an income yield in excess of 3% to 7% and hopefully will provide additional price appreciation. In the event of inflation, many of these companies have the ability to raise prices and pass along a greater dividend. Income equities are more volatile than bonds because there is no fixed return of principal and less volatile than high risk stocks such as those in emerging markets and smaller companies.

When adding dividend income to a portfolio, we like to use a combination of individual stocks and dividend focused mutual funds in our portfolio designs. Examples include: American Funds Washington Mutual Fund (WMFFX), Vanguard Dividend Growth (VDIGX) and American Funds International Growth and Income (IGFFX).

The Balance Between Stocks and Bonds

I believe that valuations in the financial markets are compelling investors to move some money from bonds to dividend paying stocks. My portfolios are heavily weighted towards large cap equities, emerging markets and individual income equities. I have been very comfortable with foreign stocks but now believe that US large cap stocks provide the best value. I have not been this fully invested in stocks for several years. I would like to end with two recent quotes from Warren Buffett:

“I’m a huge bull on this country ... we won’t have a double dip recession. I see our businesses coming back almost across the board...” Warren Buffett - September 13, 2010

“It's quite clear that stocks are cheaper than bonds. I can't imagine anyone having bonds in their portfolio when they can own equities.” Warren Buffett - October 6, 2010

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