

**“He is no wise man that will quit a certainty for an uncertainty” — Samuel Johnson, Essayist and Poet**

## Introduction

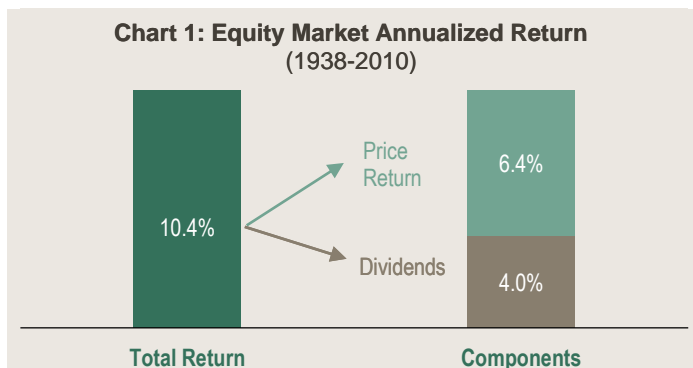
The ideal security for many investors, particularly retirees, is one that provides a stable source of income while offering the ability to grow the underlying capital. Our experience tells us that the two asset classes that exemplify these characteristics best are equities that pay high dividends and bonds that pay high coupons. The dividend and coupon income generated by these securities can help add a component of consistency to inherently volatile asset classes. Income strategies can be an effective solution for investors with medium/long-term time horizons and recurring cash flow requirements.

This paper will first walk us through the characteristics of dividend-paying equities. It will then walk us through the characteristics of high-coupon bonds. Finally, it will highlight the advantages that can be attained from combining these income-generating asset classes. The following three sections will comprise the paper:

- I. **Dividend Income and the Equity Market**
- II. **Coupon Income and the High Yield Bond Market**
- III. **Combining High Dividends and High Coupons**

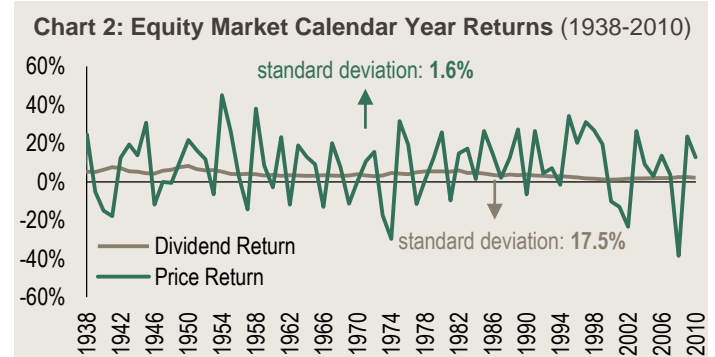
### I. Dividend Income and the Equity Market

We begin our discussion by dissecting the equity market's return going back to 1938, as represented by the S&P 500. We have data going back further but we wanted to exclude the Great Depression and its early recovery because the numbers are quite radical and skew the results. As depicted in Chart 1, the S&P has returned 10.4% per year in the 73-year period from 1938 through 2010, nearly 40% of which comes from dividend payments.

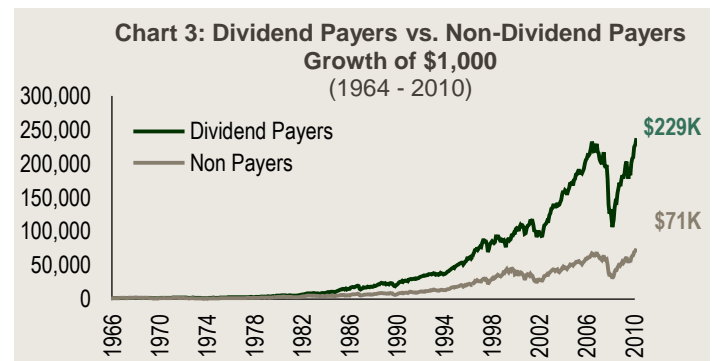


While dividends have comprised a considerable portion of the equity market's return over time, many investors view the historical consistency of the dividend payment as the primary advantage of investing in stocks. Dividends paid cannot be less than zero for an equity investor (most companies can issue new equity, which dilutes shareholders and has a similar effect, but they cannot actually require

cash payments from equity investors). In aggregate, the dividend yield for the S&P 500 since 1938 has typically ranged from 2% to 6%. This is shown on Chart 2, which also superimposes the S&P 500's return from price appreciation (or depreciation) over the same period. Notice the greater consistency of the dark green line compared to the volatility of the grey line.



Charts 1 and 2 highlight the importance of dividends to the equity market's return as a whole, but they fail to distinguish between companies that pay a dividend and those that do not. This brings us to the next step in our discussion. Chart 3 highlights the total return of dividend paying stocks and the total return of non-dividend paying stocks as far back as we have reliable data. Over this 46-year period, dividend payers have outperformed by a considerable margin.



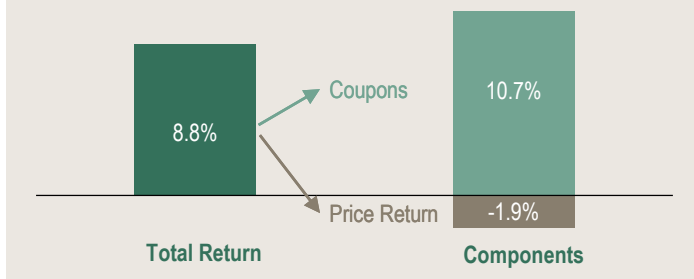
#### Dividends and the equity market—key takeaways:

- ▶ Dividends have comprised a meaningful portion of the equity market's return
- ▶ Dividends have been relatively consistent through time
- ▶ Dividend-paying companies have outperformed non-dividend paying companies

## II. Coupon Income and the High Yield Bond Market

First let's dissect the high yield market's return going back to 1987, similar to our analysis of equities in the previous section. We chose 1987 as the starting date because the inception of our proxy, the BofA Merrill Lynch Master II High Yield Index ("Master II"), was late 1986. As depicted in Chart 4, the Master II has returned 8.8% since 1987—more than 100% of this return is attributed to coupon income.

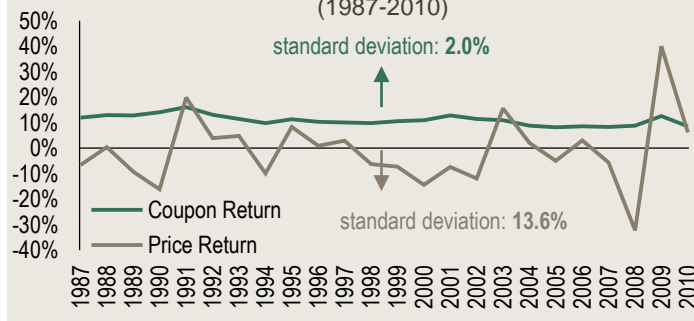
**Chart 4: High Yield Market Annualized Return (1987-2010)**



The negative price return over the long-term may not be intuitive or encouraging at first pass, but can be explained by the losses due to defaults. The high yield market's average default rate is about 4% and the average recovery rate on defaulted bonds is about 40% (recovery rate is the amount of par that the investor receives after the bankruptcy process). This implies an average loss rate of about 2.4% per year for the high yield market [4% \* (1-40%)]. Combine this loss amount with modest price appreciation for bonds that did not default and you have an average price return of -1.9% per year. Of course, the high coupons paid more than makes up for this price depreciation and effective active management can reduce the negative effects of high defaults and low recoveries.

Next let's review the volatility (or consistency) of the coupon component of the high yield market's return relative to its price return—again, similarly to what we did for dividends and equities in the previous section. Since 1987, the return from coupon income has generally ranged between 8% and 15%. Chart 5 breaks out the coupon component and the price component of the high yield market's total return going back to 1987.

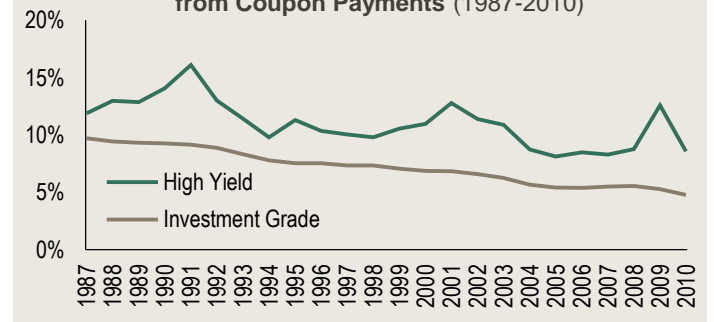
**Chart 5: High Yield Market Calendar Year Returns (1987-2010)**



Companies are contractually obligated to pay their stated coupon amount to creditors (creditors = investors). These companies can default by going bankrupt or missing their interest payments (coupons), but these payments cannot turn negative. In aggregate, coupon income has been fairly consistent through time as indicated in Chart 5 above.

Charts 4 and 5 highlight the importance of coupon income in the high yield market, but they do not address the investment grade market (bonds that the rating agencies rate as higher quality). The terms "high yield bond" and "high coupon paying bond" are essentially synonymous. Because these bonds encompass greater credit risk, the market requires extra compensation from lower rated bonds relative to investment grade bonds—this typically includes a higher coupon payment. Chart 6 compares the coupon return of the high yield market relative to the coupon return of the investment grade market from 1987 through 2010.

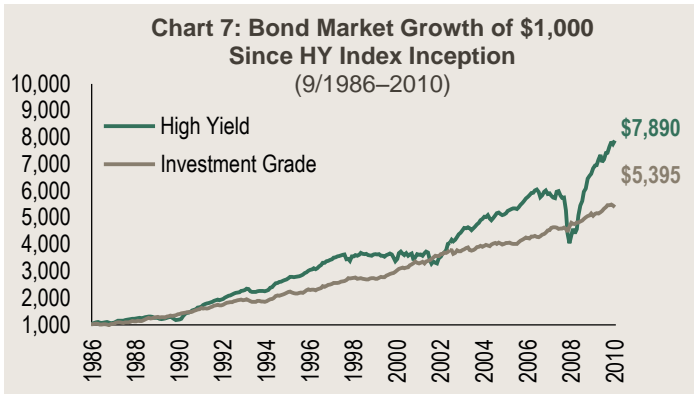
**Chart 6: Bond Market Return from Coupon Payments (1987-2010)**



As depicted in Chart 6, the coupon return from the high yield market is more volatile than the coupon return from the investment grade market—but high yield coupons have always exceeded investment grade coupons, at times, substantially.

Finally, let's compare the total return of high yield bonds to the total return of investment grade bonds. We have shown that high yield bonds have generated more coupon income than investment grade bonds, but we also showed that the price return of the high yield market has been slightly negative. Perhaps the price return of investment grade bonds was positive, which could result in comparable total returns. As it turns out, however, the price return of the investment grade bond market is about 0%, which means that the high yield market has outperformed in the long run (based on time period from Chart 4: 1987-2010).

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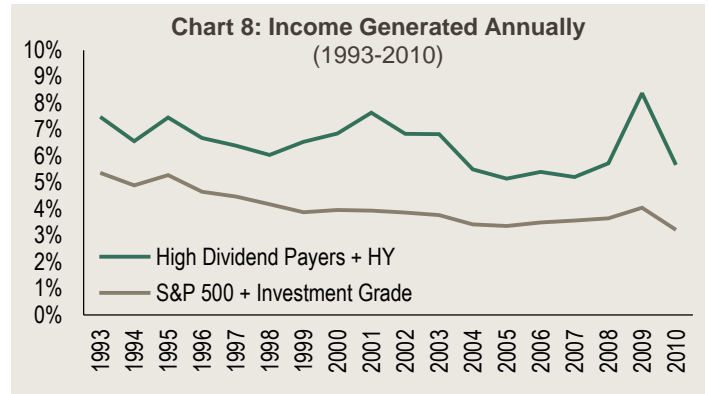
**Coupon income and the high yield market—key takeaways:**

- ▶ Coupon income has comprised all of the high yield market's return
- ▶ Coupon income has been relatively stable through time
- ▶ High yield coupon income has exceeded investment grade coupon income
- ▶ High yield bonds have outperformed investment grade bonds

**III. Combining High Dividends with High Coupons**

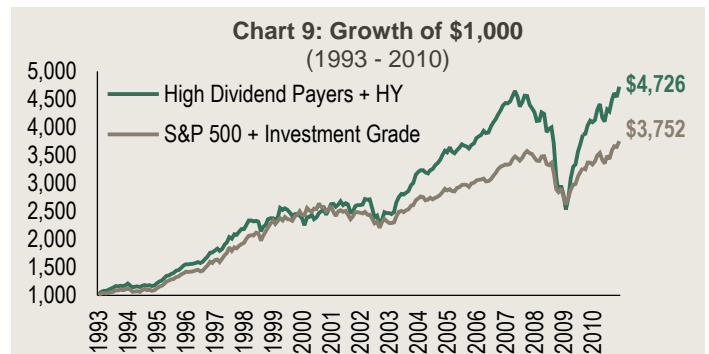
Now that we have highlighted the potential advantages of high dividend paying equities and high coupon paying bonds, we should evaluate the combination of the two asset classes. So far we have evaluated dividend paying equities and non-dividend paying equities for comparison purposes. Practically speaking, however, an investor that is considering a high dividend strategy should compare stocks that pay a *high* dividend, not just *any* dividend (e.g. \$0.01/share). Also, the stock market as a whole is the practical benchmark, not just non-dividend paying stocks (i.e. few rational investors implement a non-dividend strategy). Consequently, the analysis in this section uses a different proxy to better represent high dividend paying stocks. We began with the Russell 1000 Value because value stocks tend to pay higher dividends than growth stocks. Next, we isolated only the highest dividend payers by detaching the top 40% ranked by dividend yield. This methodology ensures that we are including companies that pay higher than average dividends. We have reliable data going back to 1993. We will compare this universe to the S&P 500 and we will continue to use the same proxies for high yield and investment grade bonds.

Chart 8 highlights the amount of income generated per year using a 50/50 combination of high dividend paying stocks/high yield bonds (dark green line). We compare this to the amount of income generated per year using a 50/50 combination of S&P 500/investment grade bonds (grey line).



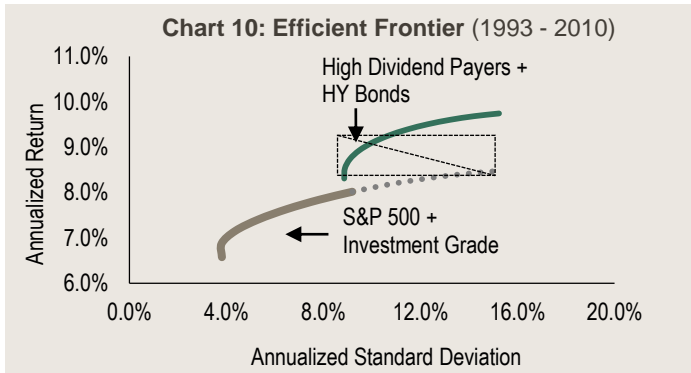
As depicted in Chart 8, the 50/50 combination of high dividend paying stocks/high yield bonds has generated average income of 6.5% per year; in its best year it generated 8.4% and in its worst year it generated 5.1%. This compares to the 50/50 combination of S&P 500/investment grade bonds, which has generated average income of 4.1% per year; in its best year it generated 5.4% and in its worst year it generated 3.2%.

Next, let's add in price appreciation/depreciation for these two combinations so that we can evaluate the total return, not just the income portion. As shown in the Chart 9, the 50/50 combination of high dividend paying equities and high yield bonds has outperformed the 50/50 combination of S&P 500/investment grade bonds—by a considerable margin.



We've shown that the combination of high dividend payers and high yield bonds has generated more income and provided a higher total return (with income reinvested) relative to the combination of the broad equity market and investment grade bonds—but what about risk? Perhaps the superior income and performance is a function of taking much greater risk. In Chart 10 we have plotted the efficient frontiers of both asset class combinations to evaluate each risk/return profile.

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As it turns out, dividend-paying equities have exhibited similar volatility to the broad equity market with a higher return. High yield bonds have produced a higher return than investment grade bonds; however, they have also exhibited more volatility. This effect is evident in Chart 10, where certain combinations S&P 500/investment grade bonds have a lower standard deviation than the high dividend/high yield combination—albeit with less return. As you move up the risk spectrum (from left to right), certain combinations of S&P 500/investment grade bonds become suboptimal as defined by modern portfolio theory (i.e. less return for the same risk). In other words, if an investor’s objective is to earn a return of 8% or more, these data suggest that the combination of the S&P 500/investment grade bonds is not a rational option.

The conclusion is that to generate more income and better total returns, an investor will assume additional risk—there is not a free lunch. For investors with a medium to long term time horizon and a need for regular cash flows, however, this risk may be viewed as acceptable.

**Combining high dividends with high coupons—key takeaways:**

- ▶ Annual income can be improved
- ▶ Total return can be improved
- ▶ Additional risk will be assumed

**III. Wrap-Up**

We have shown that combining stocks that pay high dividends and bonds that pay high coupons can result in a portfolio that generates fairly consistent income while offering the potential for price appreciation. The income has historically provided a level of consistency to inherently volatile asset classes. These characteristics may be appealing to certain investors, particularly retirees looking for stable income sources while growing/preserving their capital.

We invite you to learn more about this idea and the Hotchkis & Wiley Capital Income Fund – a portfolio of dividend paying stocks and high yield bonds offering monthly income to investors. Please contact us at 800-796-5606.

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All references to the Equity Market based on S&P 500 Index; High Yield market based on BofA Merrill Lynch U.S. High Yield Master II Index; Investment Grade based on BofA Merrill Lynch U.S. Corporate, Government & Mortgage Index; High Dividend Payers based on Russell 1000 Value Index top 2 quintile dividend-yield stocks.

Chart data sources: 1-2, 6-7: Bloomberg; 3: Largest 1,500 stocks by mkt cap (Empirical Research); 4-5: Bloomberg, CSFB, JPMorgan; 8-10: Bloomberg, FactSet, JPMorgan

Growth stocks typically are more volatile than value stocks; however, value stocks have a lower expected growth rate in earnings and sales. Standard Deviation is a statistical measure of the historical volatility of a mutual fund or portfolio, usually

computed using 36 monthly returns. Default Rate is the number of defaulted issuers divided by total number of issuers. The S&P 500 Index consists of 500 stocks chosen for market size, liquidity and industry group representation. It is a market-value weighted index with each stock's weight to its market value. The Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The BofA ML U.S. High Yield Master II Index tracks the performance of below investment grade, but not in default, U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market, and includes issues with a credit rating of BBB or below, as rated by Moody's and S&P. The BofA ML U.S. Corporate, Government & Mortgage Index is a broad-based measure of the total rate of return performance of the U.S. investment grade bond markets. **Diversification does not assure a profit nor protect against loss in a declining market.**

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