In the first quarter of 2009 we reviewed the history of recovering markets and the performance of dividend-oriented stocks relative to the broad market in those recoveries. Our research made the periods during this past year, when low-quality stocks were bid up by investors, tolerable if not pleasant, for we found quite clearly that expectations for high-quality dividend stocks should not be set too high in the first stages of a market rebound. After the first stage, however, high-yield stocks (and by "high yield" we mean stocks in deciles 7–9 for yield in the stock universe) are clearly one of the key places to seek excess returns. Even during the tech-centric 1990s, dividend stocks provided excess returns above the market right up until the last few maniacal years of the decade, when the melt-up of tech stocks briefly caused their relative performance to dwarf all else in existence. (See the chart on page 2.)

Indeed, with the single anomalous exception induced by the 1999–2000 bubble, the longer the holding period after broad market declines, the greater the advantage of dividend stocks relative to the broad market. Looking at market progress after the bottoms of 1974, 1982, 1990, and 2003, deciles 7–9 of the broad market provided a cumulative average of about 17 percentage points above the broad market over three years, with cumulative excess returns of 34%, 31%, 3%, and 2%. Interestingly, in three of those four years high-yielding stocks failed to show any excess return in the first year (and were typically a bit behind), so the subsequent period cumulative returns were even more powerful.

In any event, past performance is no guarantee of future results (and how many have suffered for willful ignorance of that maxim!) so we don't want to be too married to historical expectations about the unfolding landscape from here, but it is indeed fortifying to us that after two quarters of eating some dust in 2009, the universe of quality (dividend-paying) companies became fully awake in the fourth quarter (ahead of schedule, if anything). When that very dust settled, each of our portfolio strategies—whether higher or lower yielding—proved thoroughly appealing on a relative basis for the full year as well.

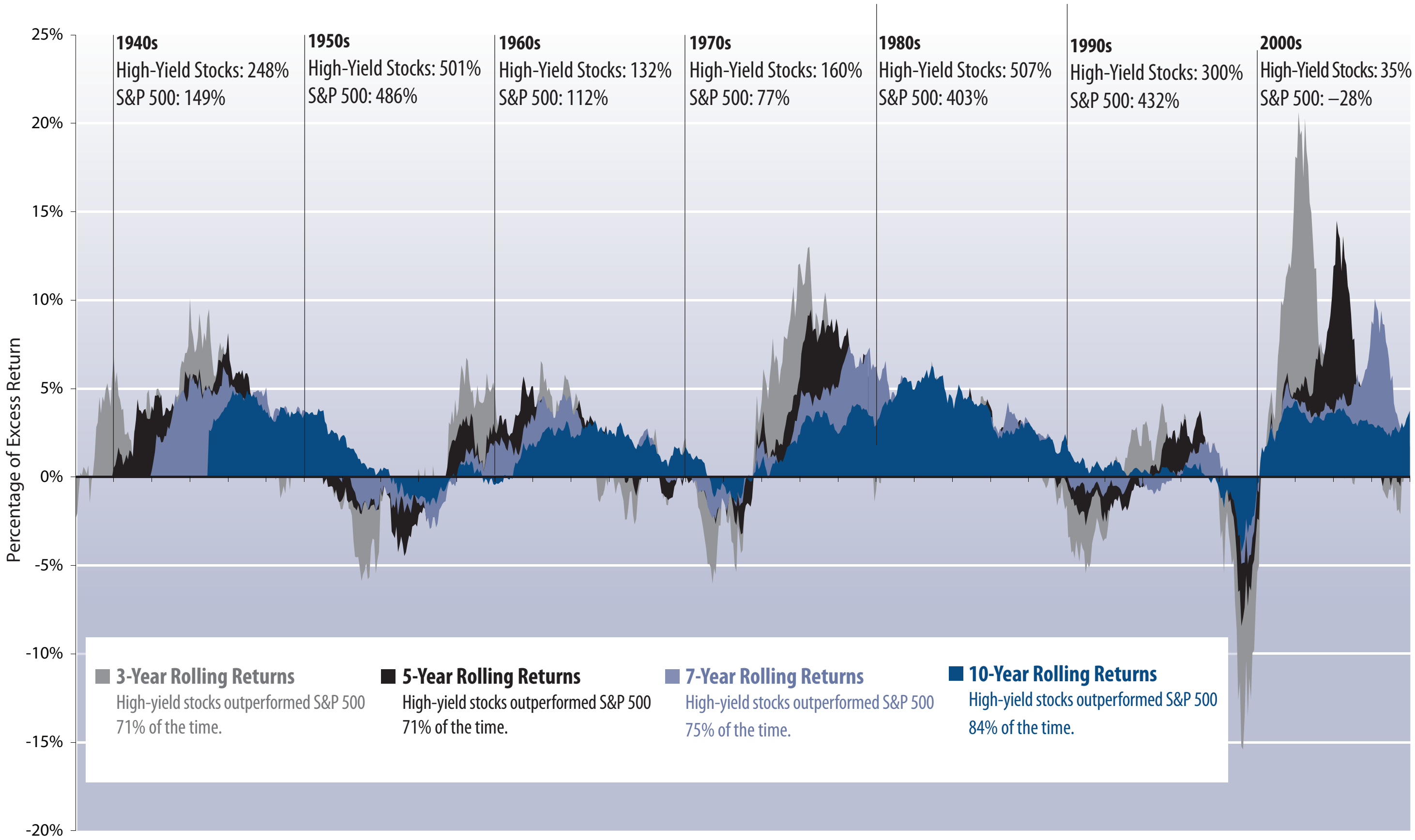
Can we expect more? We don't have a crystal ball, but clearly, based only on past market recoveries, the chances are good that we've entered the sweet spot for dividend-stock relative performance. Investors need to bear in mind, of course, that such thoughts are only based on probabilities derived from past history—which has a way of providing "twists" in each new incarnation of itself—and that such thoughts can also only really apply to relative performance. Still, when we survey the valuations of many of the stocks in our portfolios, we're comfortable as absolute investors both short and long term. Too, in terms of what we can learn from the available history of equities, dividend stocks outperform the average stock *most* of the time, not merely beginning in year two of a recovery.

Beyond looking at history, we constantly want to revisit the basic premise of our dividend-oriented investment, and take comfort in the principles that have guided us through wars, recessions, terrorism, natural disasters, rising interest rates and falling, easy money, and most recently, a precipitous meltdown of the financial system. Withal, we're still here and still collecting our dividends. We think that the consistent results are built on a simple foundation: We are not looking for "exposure" to market indices; we are looking for good investments.

When dividends are a part of your investment portfolio, you are an income investor. And we strongly believe income isn't just a part of the investment equation, it is integral to it. When an investment produces income, which is a real return (not a promise), and which is always positive, that income can be spent, or re-invested in more stock. Over time one share with re-invested income becomes two, and then three, and then four, world without end. And if the income increases, over time the value of the instrument producing that income—the equity interest—should increase commensurately (all other things being equal). This "internal compounding" is a powerful force whether an investor re-invests the income or not, and it persists no matter whether the market is rising or falling. Hidden in the forest of everyday debate, discussion, and stargazing, too many investors lose sight of this fundamental compounding process as they become mesmerized by the ups and downs of the averages and the next great story.

The dynamics of income investing are easier to understand when comparing the process to owning rental property (everyone knows that's income investing!). Like dividend stock investors, rental property investors are buying a stream of cash flow, and paying a certain multiple for it. The income stock investor is not only buying the stream of cash flow, he or she is also *collecting* it, something like a landlord—a concrete moment that's very important in this world that has increasingly become a huckster's paradise. So we can think of a company and its cash flows as similar to a rental building and its cash flows.

ROLLING EXCESS CUMULATIVE RETURNS OF HIGH-YIELD STOCKS VS S&P 500 (1936–2008)*



*This chart presents a review of relative past performance for high-dividend-yield equities in relation to S&P 500 and should not be considered indicative or representative of future performance for either high-yield stocks in general or any of the investment strategies managed by Miller/Howard Investments. Returns for both high-yield stocks and S&P 500 are total returns. "High Yield Stocks" in this study comprise deciles 7 to 9 from the data set created by Eugene Fama and Kenneth French called "Portfolios Formed on Dividend Yield," in which they separate stocks into deciles based on their dividend yield. Their file was created by CMPT DP RETS using the 200901 CRSP database. We have utilized the value-weighted returns for this study. They compute D/P (in percent) breakpoints at the end of each June. We include dividend deciles 7 to 9 because we feel that profile most accurately reflects the composition (solely based on dividend yield) of stocks Miller/Howard Investments is most likely to utilize. More specifically, these companies have a dividend yield that is in the range of slightly better than market average to near the top decile. We omit the highest decile because many distressed stocks and outliers are commonly found in the tenth dividend yield decile.

You'd pay a certain price for a rental building based on the amount of cash it generates, cash that gets paid *to you*. You might look at some other features to determine your price as well: Is the income secure? Are there chances to increase the cash flow? Is the property well located and competitive in its segment? Is it protected from competitors in some way? Is it in the path of development? What are the chances that the owner might benefit from some additional source of value, such as mineral rights or re-zoning, or technological changes, such as the need for more cellular broadcast points? For the rental property investor the issues are the same as for the dividend stock investor: What is the security of the income? What are the chances for increasing income? Are there additional sources of potential value?

Like rental property owners, dividend stock owners need to keep a strong eye on the long term, where asset values can increase as income increases. And if asset values don't increase for a period—which can happen to both rental property and income stock investors—at least there is still the cash flow to provide positive returns (and to meet spending needs without having to sell assets). But income investors in the stock market have an edge: There are many more opportunities or different sources for income than just rents, the liquidity of the investment is much stronger—a situation that isn't working out as expected can be exchanged for another, and best of all, you don't have to go up on the roof with a pot of tar! You have an entire army of managers and workers all striving, when the world is working as it should, to increase your cash flow, the income that's actually paid to you, and the ultimate value of the asset producing the income.

To us, this seems like a much saner strategy than trying to jump from trade to trade, and that's why we do what we do. In the end, excellence in execution of the strategy makes a substantial difference. Focus and experience are required. But without a clearly defined strategy that offers both common sense and historical confirmation, investors are just dangling at the whim of daily market forces and emotions. M/H

The views and opinions expressed are those of the manager at the time of publication, and may change over time. All investments involve risk, including the possible loss of principal.

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