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What Investors Need to Know About the Fed

*Individuals can benefit from a basic understanding of how the central bank operates, explains asset manager and [Fed Friday](#) organizer **Hank Mulvihill**, who discusses some [ETFs](#) and large caps he likes these days.*

Kate Stalter: Today, we're welcoming back the very first guest here on the Daily Guru from back in July of last year, Hank Mulvihill of [Mulvihill Asset Management](#).

Hank, one of your themes in 2011 was high-quality dividend payers, and those turned out to be an area that investors did flock to in the second half of the year, with some blue chips rallying to all-time highs. So what's your take on that particular asset class in 2012?

Hank Mulvihill: I think that that trend will continue unabated. I think the momentum is clearly there.

Yes, some of the names have gotten puffed up a bit, but I look at things through the lens of what the Federal Reserve is doing, and I've got to interject that as long as they staple the overnight rate to the floor—and they've made it clear that that will be the situation until the middle of 2013, another 18-odd months from now—worldwide rates are drawn to that number like magnets.

Therefore, any entity such as dividend-paying stocks, that is likely to increase its yield, will attract investment. I said it a year ago, I said it during our interview in the summertime, and I think it's certainly going to be true for 2012.

Kate Stalter: A lot of advisors I talk to mention that fixed income is not as attractive an investment, in many cases. Do you agree with that assessment?

Hank Mulvihill: I do, because everything I just said argues in favor of fixed income, in that rates worldwide will trend down during 2012, because of the actions of the Fed.

That's the most powerful thing in global finance. When the Fed sets the marker, all yields get drawn to it—just the way it is.

So, yes, fixed income will limp along and return a little bit of positive, I believe, return during this year. But my gosh, the threat is extreme. Here's a quote I didn't give you in the middle of the year, but I'm going to give it to you now: Right now, the trade in fixed income is as overbalanced and overweighted as the trade in technology stocks was in 1999.

So am I a fan of fixed income? You can hide there for a while longer, but I bet the market starts to price in some actions long before the middle of 2013. So I think that...and I'll talk some more during this talk about why I believe stocks are a much better place to be.

Kate Stalter: I wanted to also follow up with you on something we talked about a few months ago, which is ETFs as dividend payers, as well as some of these master limited partnerships in the pipeline industry, for example. Is that safety trade getting crowded, or does that have some room to run still?

Hank Mulvihill: Well, it'll still run as long as you stay with the exchange traded dividend funds that focus on high-quality dividend payers. I believe that the differentiation will start to set in even more there.

And by that, if you really want to do the work, fine, but I guess you could say, I love that **Dow Jones Select Dividend Index** ([DVY](#)), I've always loved it. And it has a somewhat smaller version of itself and it's called **iShares High Dividend Equity Fund** ([HDV](#)).

That [latter] one is a little bit, I'd call it—and I don't want to offend either camp—but I'd say it focuses on a little bit higher quality names, vs. the top 100 that are in the DVY. They both are really good ETFs for trying to hit the market I'm talking about.

Kate Stalter: What about some growth names? How are you looking at that particular area of equity investing these days?

Hank Mulvihill: You and I have joshed a little bit about this offline, but I'll go ahead and say it for the record. I'm focused on the one growth sector that every investor should try to find a way to get into—and I'm making a joke here.

The growth sector otherwise known as [Apple \(AAPL\)](#). Which is so big by market capitalization, it can't go into the Dow, so it's most entertaining. It really is a sector and a force all of its own, and I think that nothing's going to stop it this year.

I wouldn't be surprised to see a dramatic price increase there, and probably [Google \(GOOG\)](#) as well. So, those are gigantic, mega-cap growth names, but I really don't see what's going to impede them.

Kate Stalter: Any other of the large-cap, liquid growth names that you might be looking at these days? I know a lot of them did have a rough end to 2011, and Apple and Google are a couple that did seem to be the survivors there.

Hank Mulvihill: Well, yeah, and I'm not just doing a survivor bias here. I think that each of those entities...look at them. Certainly Apple, I think, is the largest company on Planet Earth at this point, the largest publicly traded company. Google must be in the top 12. I mean, these are incredible entities, and both of them with no debt and astounding amounts of cash.

It's a little bit difficult in my position as an RIA to drop much down below these mega-caps. If I start talking about specific exciting ones then that can be construed as individual investment advice, so I need to be a little careful about that.

Kate Stalter: Let's talk, then, about the Federal Reserve. I know that's one of your favorite topics. You're a Fed watcher; in fact, you created the Fed Friday event to provide some insight into their policies. What Fed actions should individual investments be conscious of these days?

Hank Mulvihill: Well, the No. 1 thing that I think that they'll probably do sometime during the year is either reduce or eliminate the interest that they are paying to the banks.

In the incredible insanity of American finance, the Federal Reserve—which is not a branch of the US Government, sorry listeners who don't believe that, but it's true—anyway, the Fed creates money out of nothing. That's true.

Then they, believe it or not, give it to the banks, which then lend it to the Federal Government. The banks book the spread. That's what happens.

I know it seems completely incredible, but that is how things work in the United States. And, by the way, the Fed is currently purchasing 60% of the bonds issued by the US Government when the bonds come to be rolled every month, or week, I should say. Without their action, the US Government would have ceased to exist a long time ago. So I'm happy the Fed is there.

But carrying on a little further, the actions of the Fed that the investors should watch, the other piece that's happening is: The banks get all the free money they want from the Fed. They don't lend it all to the US Government. They lend some of it right back to the Federal Reserve, which pays them interest, remember, on the money that was just created out of nothing and given to the banks for no interest.

Now, they get to put that same money back at the Fed and receive interest on it. I'm not making this up. It's so unbelievable, and that amount is probably in the \$800 billion number that's sitting owned by banks on deposit at the Fed and not being pushed out into the economy, which is where it's supposed to go.

So, if the Fed is serious about trying to ignite some fundamental lending activity and support for the economy, they will reduce that risk-free rate of return and force the banks to move that capital.

Kate Stalter: Let's drill down a little bit, then. For individual investors who are hearing this, anything in particular they need to know about their portfolio, in light of what you're saying here, Hank?

Hank Mulvihill: Sure. Focus on quality yield. For those who do their own research, look for increasing free cash flow. I keep pounding the table.

If you lock me in a room and give me one metric, it's going to be free cash. That eliminates all kinds of problems. A company that's building up more cash than it knows what to do with from operations. They have more flexibility. Investors will be rewarded from those names.

Kate, if you could just let me launch a little bit about a topic that is ever more true now than it was six or eight months ago: The overweighting in bonds has turned stocks into so desirable—yield-bearing stocks with good free cash and reasonable debt levels, if any, are just so overwhelmingly attractive right now. I mean, historically, hugely attractive.

There's only been one time since 1956 that the yield on the S&P exceeded that of the ten-year Treasury. I'm sorry, two times. One time since the last time was 1956, and it's currently the case as we speak.

Yes, that yield is being depressed by the Fed buying longer-term bonds, I give you that, but even add back in the half point. Take us from wherever we are, 1.9%, 2%, to 2.5% to 3%, stocks are still extraordinarily competitive to bonds.

Kate Stalter: This seems like it ties back in to what you were saying a little bit earlier, regarding some of these high-quality dividend payers.

Hank Mulvihill: Absolutely. And I don't think we'll see any threat to the taxation of dividends either, so you're still picking up a nice benefit there on the long-term capital gains rate.

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