

Analyst Commentary

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Federated Investors, Inc. Federated Equity Income

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We recently had a conference call with Walter Bean and Daniel Peris, Portfolio Managers for the Federated Equity Income strategy to get an update on the strategy. After a respectable 2008, when on a relative basis, the strategy outperformed its benchmark (the Russell 3000 Value Index), the strategy has underperformed this year. This dividend-oriented strategy has a bias toward higher-quality, large-cap multinational companies. Unfortunately during this year's ongoing low-quality, high-beta rally, the strategy has struggled. Also hurting relative to its approach has been the fact that small caps have beaten large caps and low-yielding securities have outperformed high-yielding securities.

However, the main detractor from the strategy's relative performance has been the strategy's concentrated portfolio with no exposure to some of the best performing sectors in the Index since the beginning of the market rally in early March. Due to the strategy's focus on high-quality dividend-paying securities, the strategy has historically been void certain sectors – e.g. information technology. However, due to the turbulent markets in 2008 and the team's ongoing conservative outlook, the strategy's existing approach of having no exposure to financials and almost no exposure to consumer discretionary has been very detrimental to relative performance. In addition, while the strategy's consumer staple holdings have firmly outperformed the broad sector, the portfolio's significant above-benchmark exposure (30% vs. 5%) contributed to relative underperformance.

Although the strategy is facing significant headwind, Mr. Bean and Mr. Peris stated that they feel very comfortable on how the portfolio is constructed. Due to the strategy's focus on preservation of capital, they have constructed a portfolio that they believe should experience excellent downside protection if the broad market experiences a difficult environment. Portfolio turnover over the last few months has been kept to a minimum after encountering high turnover in 2008 and early 2009. Mr. Bean stated that they are not chasing the rally, instead adhering to the strategy's dividend-focused discipline. They continue to focus on fundamental, bottom-up research to determine which securities get added to the portfolio. Attributes monitored include earnings quality, strong balance sheet, cash flow generation, real earning generation, capacity utilization, capital expenditures, and managerial tendency to pay dividends. Overall the primary focus is on a firm's balance sheet since they do not fully trust companies' income statements. As a result, they are not significantly invested in cyclical companies that will be early beneficiaries from a strong economic recovery. Overall, the team is more cautious and careful versus 12-18 months ago.

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There are some sectors in which Mr. Bean and Mr. Peris are currently void as they do not have any interest. Although the strategy has a significant overweight in consumer staples, Mr. Bean stated they are still very committed to the sector as a source of secure and growing dividends. They added the sole industrial conglomerate holding to provide additional diversification within the portfolio. Mr. Bean stated that they continue to like 9 out of the 10 sectors. Last year they took shelter in 6 out of the 10 sectors. Now that the broad market has stabilized, the team is open to diversifying and they could end up potentially investing in all 10 sectors over the next few years. The strategy is currently close to its maximum foreign portfolio allocation of 30%. According to Mr. Bean that allocation could decline in the foreseeable future, since more attractive domestic options are presenting themselves through the screening process.

Federated is looking at potentially one or two technology companies that they might add to the strategy if the portfolio managers can increase their confidence in management's view regarding dividends and dividend growth without an enormous economic recovery. Mr. Bean stated that within technology, the industry is moving toward his dividend-oriented way of thinking, as many industry participants enter a more mature phase. He acknowledged that over the last 10-15 years the paradigm of total return has changed, turning back toward a dividend focus, which should benefit the strategy over time.

Although the strategy has gone through a difficult period, Manager Strategy continues to have high conviction in the team and the process. The strategy continues to generate a dividend yield north of 5% and more recently focused on adding solid large-capitalized blue chip companies that previously would not have met its valuation requirements. While this strategy will likely continue to lag if the low-quality, high-beta led rally continues, the portfolio should be well positioned as the focus returns to quality and cash flow. We reiterate our Recommended rating.

Investing in foreign securities presents certain risks not associated with domestic investments, such as currency inflation, political and economic instability, and different accounting standards. This may result in greater share price volatility.

Dividends are not guaranteed and are subject to change or elimination.

Past performance is not indicative of future results. The investment return and principal value will fluctuate, and shares, when sold, may be worth more or less than their original cost.

*The **Russell 3000 Value Index** measures the performance of the broad value segment of the U.S. equity universe. It includes those Russell 3000 companies with lower price-to-book ratios and lower forecasted growth values.*

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