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FEDERATED STRATEGIC VALUE (EQUITY INCOME)

STRATEGY NEWSLETTER

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Why We Own Telecom Stocks?

Dividend yields within the space are exceptionally attractive. AT&T (T) and Verizon (VZ) both have yields of 6.5%. The US Rural Local Exchange Carriers (RLECs), CenturyLink (CTL) and Windstream (WIN), are generating cash returns of 8.7% and 9.7% respectively. The leading global telecommunication vendors, Vodaphone and Telefonica, offer yields of 5.9% and 7.5%. Our Canadian holding, BCE, has an annual dividend worth 5.7% of the current purchase price. In contrast, the S&P 500 has a cash return of less than 2%. In as much as the components of long-term total return are dominated by the dividend, particularly the basic yield, the sector's absolute and relative return prospects are quite notable. Though only 3% of the S&P as currently constituted, telcos represent around 9% of the total dividend opportunity in the S&P 500. In a sideways moving market environment in which the dividend yield may well be all that you get, the telcos stand out.

The other significant component of total return is dividend growth, and despite the sector's high current yield, the dividends coming from the telcos are on the rise. AT&T and VZ have both raised their dividends within the past twelve months, and we expect a small increase from Verizon in September and AT&T in December. Despite a "flat dividend" model, CTL recently increased its distribution by 4%. Vodaphone has been raising its dividend steadily and is on track for another 5% increase in November. Telefonica has explicitly committed to a significant increase of its dividend payout ratio and its actual dividend from its current level of 1.15 euro to 1.75 euro. BCE has raised its dividend three times during the past eighteen months for a total increase of 19%, and it is expected to increase its distribution again this year.

Dividend yield is only relevant if the dividend is safe. While the recent and prospective increases discussed above speak volumes about the underlying financial condition of the companies paying them, it is worth reviewing the financial ability of these companies to support their payouts. These are companies operating in a mature sector; their reinvestment needs are modest so that they can support the 70-80% payout ratios of T, VZ and Telefonica. BCE is lower at 65% and Vodaphone is lower still at 53%. In the case of the landline-only RLECs (CTL and WIN) with substantial depreciation charges and minimal reinvestment needs, company management can payout essentially all of the profits. More useful than the simple payout measure, however, is the free cash flow pay out as this takes into account both capital expenditures and depreciation charges. Here the situation is even more accommodating. The dividends at VZ , T, Vodaphone, Telefonica, and BCE represent only about 50-70% of the free cash flow generated by those companies. That is, the companies can easily pay their dividends from the cash that they generate. The greatest difference in regard to the earnings payout and the free cash flow payout can be seen, however, in the RLECs, which have free cash flow payouts of just 50-60% compared to the 100% income payout.

Aren't these companies highly levered and isn't that a risk to their dividends? Yes, and no. Cash flow at these companies is quite steady and so they can handle debt more easily than cyclical companies. Verizon, AT&T, Vodaphone, Telefonica are all "A" rated companies. Granted that designation isn't as helpful as it used to be, but these are not companies on shaky ground. BCE is just one notch lower at BBB+. CenturyLink comes in at BBB-. Windstream is the only "high yield" name in the bunch with a BB rating. The major incumbents have debt coming due steadily, but will have no difficulty refinancing it. Indeed, one of the perverse benefits of the current environment of artificially low interest rates has been that high quality companies such as the telcos have been able to refinance their debt at low rates and reduce their debt service costs. The debt repayment schedule for the rural phone companies is not challenging. Windstream's next large tranche is due in 2013, CenturyLink's in 2016.

Further out in the future, the phone companies have substantial pension and retiree healthcare obligations, but to judge by the price of telco debt, the bond guys aren't much concerned about the condition of these companies. Verizon's and AT&T's 10-year debt is trading with a yield 150-200 basis points (1.5% to 2.0%) below that of the equity. That's the reverse of the usual situation in the low yielding US market where stocks trade with yields below that of the bonds. Not so in regard to the telcos. Even for the high yielding rurals, their debt is trading 2% below that of the equities.

If everything for the phone companies appears to be copacetic, why is the market pricing their equity such that the yields are so high? Keep in mind that the stock market isn't very good at focusing on the long-term. Human emotion and the overwhelming news flow that we receive everyday makes it hard for individual investors and many pros to make good long-term decisions. The telcos provide an excellent example of this myopia. Skittish investors see competition in the U.S. – from struggling Sprint-Nextel and all sorts of minor players—and

Source of dividend yields noted above: Bloomberg. Yields are as of May 10, 2010.

regulatory threats in Europe in the form of declining MTRs (mobile termination rates) that are pressuring revenue and profit growth in the industry. These are legitimate concerns. This is a mature industry and growth is slowing. Customers are dropping their landlines quickly and most of the adult population here and in Europe already have cell phones. After years of robust growth, this shift to maturity has some investors spooked.

What they don't see—in addition to the basic dividend yield which is so crucial to total return—is consolidation. It goes hand in hand with maturity. In Europe, essentially all the data points speak to consolidation, through outright mergers or through cooperative agreements that reduce expenses by getting rid of duplicative infrastructure and administrative expenses. In the US, the process is even clearer. Decades ago, we had "The Phone Company" with Lily Tomlin as our none-too-helpful operator. Now after a drawn out process of deregulation and fragmentation, we are well on our way back to having "The Phone Company," dominated by the duopoly of Verizon and AT&T. The remaining contenders, Deutsche Telekom's T-Mobile and especially Sprint-Nextel are struggling to find a strategic niche.

The small, pre-paid vendors at the low end will eventually be absorbed. As the consolidation proceeds, pressure on pricing will abate, and the companies can resume increasing profits at GDP+ levels. Given their current yields, we don't need to see earnings growth of more than 2-4%, reflected in dividend growth of the same amount, to justify our holdings. For the rural phone companies, consolidation is not part of the business plan, it is the business plan. Windstream and CenturyLink have emerged as the Verizon and AT&T of landline industry, consolidating the industry even as it shrinks.

Other near-term knocks on the phone companies may well end up benefitting them. One has been the troubles iPhone users have experienced on AT&T's network, especially in New York and SanFrancisco. Investors also chose to see the introduction of Skype, the internet phone service, on to mobile devices, as a defeat for the phone companies because it further cuts into their profitable voice business. Both challenges are real, but they are both near-term and will likely facilitate the return of usage based pricing. That is, for the first century or so of phone service, customers paid by the minute, by the amount of service that they consumed. For the last decade or so, all you can eat pricing has come to the fore. Fortunately for the phone companies, the iPhone and the likes of Skype make flat pricing products untenable. I don't expect to see Candice Bergen on TV anytime soon offering 10 cent per minute long distance plans for Sprint, but the return of usage-based pricing is inevitable. Instead of being for voice services, however, the usage based plans will be for data. Stream video all day long on your iPhone, and you can expect to pay more than your officemate who occasionally checks the weather.

Near-term puts and takes aside, on balance the telcos offer an exceptional proposition for investors with long-term horizons and a preference for cash returns.

- Daniel Peris

Past performance is no guarantee of future results.
Supplemental to the GIPS compliant composite.

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Schedule of Rates of Return and Statistics

Composite	**Strategic Value Managed Account Composite**
Index	**Changed 1/07 to Dow Jones Select Dividend from Russell Midcap Value Index**
Periods Ending	**3/31/2010**

	Returns (%)		
	Gross Composite Return	Index	Net Composite Return *(Assuming Maximum Fee)*
1st Qtr. 10	0.43	5.94	-0.32
1 Year	32.69	53.07	28.85
3 Years (Annlzd)	-8.74	-9.01	-11.46
5 Years (Annlzd)	1.56	0.70	-1.44
Oct 01-Mar 10 (Annlzd)	7.10	7.19	3.95

	Gross Historical Returns (%)					Net Historical Returns (%)					Index Historical Returns (%)				
	Q1	Q2	Q3	Q4	Annual/ YTD	Q1	Q2	Q3	Q4	Annual/ YTD	Q1	Q2	Q3	Q4	Annual/ YTD
2001	N/A	N/A	N/A	9.05	N/A	N/A	N/A	N/A	8.26	N/A	N/A	N/A	N/A	12.03	N/A
2002	9.59	-0.89	-11.92	5.15	0.59	8.79	-1.64	-12.61	4.38	-2.39	7.89	-4.68	-17.95	7.06	-9.66
2003	-5.21	16.35	5.33	10.95	28.90	-5.93	15.52	4.55	10.15	25.16	-4.06	17.89	5.94	15.22	38.06
2004	6.18	-2.83	3.85	9.67	17.52	5.40	-3.57	3.08	8.88	14.08	5.35	1.73	1.74	13.46	23.71
2005	-0.21	5.23	2.97	-1.12	6.92	-0.96	4.46	2.21	-1.86	3.77	0.78	4.70	5.35	1.34	12.64
2006	7.52	1.88	9.20	9.49	30.97	6.74	1.12	8.41	8.69	27.18	7.62	-0.56	3.53	8.50	20.22
2007	1.32	0.32	-1.52	-4.65	-4.55	0.57	-0.43	-2.26	-5.38	-7.39	2.29	1.85	-2.98	-6.17	-5.16
2008	-8.08	-8.90	0.33	-13.46	-27.29	-8.78	-9.60	-0.42	-14.14	-29.50	-8.61	-14.00	11.27	-21.07	-30.97
2009	-16.36	10.22	10.49	8.49	10.50	-17.03	9.42	9.69	7.70	7.25	-23.09	13.71	18.24	7.46	11.13
2010	0.43	N/A	N/A	N/A	0.43	-0.32	N/A	N/A	N/A	-0.32	5.94	N/A	N/A	N/A	5.94

	# of Accts @ Quarter End				Composite Assets ($ mil)				Dispersion*				
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Annual
2001	N/A	N/A	N/A	2	N/A	N/A	N/A	0.39	N/A	N/A	N/A	N/A	N/A
2002	4	6	12	36	1.09	1.30	1.75	6.89	N/A	0.02	0.09	0.16	0.03
2003	88	166	379	692	21.93	43.74	92.44	191.90	0.56	0.40	0.43	0.44	1.20
2004	1,090	1,526	1,896	2,298	307.09	395.51	492.52	612.32	0.26	0.21	0.10	0.10	0.60
2005	3,010	3,648	4,348	4,653	754.30	909.04	1,057.27	1,015.62	0.10	0.10	0.11	0.32	0.39
2006	5,352	5,810	6,461	7,326	1,266.28	1,350.56	1,620.92	1,889.83	0.14	0.22	0.24	0.15	0.42
2007	8,771	10,277	10,878	9,420	2,137.70	2,430.54	2,484.51	1,979.62	0.20	0.19	0.21	0.24	0.38
2008	9,810	9,358	8,679	7,774	1,910.45	1,655.26	1,517.32	1,221.51	0.29	0.21	0.57	0.57	0.67
2009	7,928	7,597	7,334	6,970	1,074.70	1,206.84	1,312.46	1,400.99	0.33	0.19	0.18	0.19	0.47
2010	6,760	N/A	N/A	N/A	1,398.8	N/A	N/A	N/A	0.10	N/A	N/A	N/A	N/A

	Firm Assets ($bil)**				Carve Outs as % of Composite Assets			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
2001	145.6	159.9	162.5	176.5	N/A	N/A	N/A	N/A
2002	175.4	182.8	179.8	193.1	N/A	N/A	N/A	N/A
2003	193.3	199.3	190.4	193.9	N/A	N/A	N/A	N/A
2004	190.4	180.8	174.2	177.0	N/A	N/A	N/A	N/A
2005	177.0	202.5	204.5	210.9	N/A	N/A	N/A	N/A
2006	215.1	208.0	213.1	227.2	N/A	N/A	N/A	N/A
2007	246.0	254.5	276.3	294.9	0.00%	0.00%	0.00%	0.00%
2008	331.2	326.8	338.2	403.2	0.00%	0.00%	0.00%	0.00%
2009	404.5	397.2	387.8	384.8	0.00%	0.00%	0.00%	0.00%
2010	345.6	N/A	N/A	N/A	0.00%	0.00%	0.00%	0.00%

Standard deviation is calculated using gross returns. Standard deviation is not applicable ("N/A") for any period if fewer than five accounts are in the composite for that period (see footnotes 6 and 7).

***Firm assets for 2Q98, 1Q99, 2Q99 and 4Q04 have been revised from figures previously reported. These revisions have been deemed insignificant.*

The composite was created in December, 2001. Federated Investors has managed portfolios in this investment style since July, 1997. The benchmark was changed to the Dow Jones Select Dividend Index which proved to be more representative of the current strategy. This composite is comprised of all domestic portfolios investing in stocks that management believes will provide lower volatility in falling equity market environments, yet will provide some potential for participation in rising markets. Eligible portfolios are managed with wide latitude to choose the sectors and securities to fulfill the mandate, but generally utilize a relatively large amount of utilities and other high-dividend paying equity-like securities, including REITs. Within eligible portfolios, securities are selected based on a fundamental assessment of the quality of the company's business, including a search for market leading companies with strong finances whose stocks appear attractive on our valuation models. Separate accounts eligible for this composite generally have a minimum of $100,000 at the time of opening and are a part of an asset-based pricing program. Wrap fee accounts make up 100% of this composite for all time periods. Net returns reflect the deduction of the maximum annual wrap fee of 3.00%. Wrap fee accounts pay a fee based on a percentage of assets under management that covers investment management, trading, portfolio monitoring, consulting services, and in some cases, custodial services. Gross returns are shown as additional information and are stated net of any direct transaction costs, if any.

See Notes to the Schedule of Rates of Return and Statistics.

Notes to the Schedule of Rates of Return and Statistics:

1. *Federated Investors is a global, independent, multi-strategy investment management firm with offices in Pittsburgh, New York, Boston, London, and Frankfurt. For GIPS purposes, Federated Investors is defined to include the assets of registered investment companies, separate (or private) accounts, managed accounts (including wrap accounts) and commingled or collective trusts that are advised or sub-advised by the following subsidiaries: Federated Advisory Services Co.; Federated Equity Management Co. of PA; Federated Investment Counseling; Federated Investment Management Co.; Federated Global Investment Management Corp.; International Management Limited; Passport Research, Ltd.; MDT Advisers; Federated Securities Corp.; effective December 2008 (the date of acquisition) the institutional assets of Clover Capital, and effective September 2009 (the date the assets were brought into compliance) the SMA/Wrap assets of Clover Capital. The assets of the Capital Preservation Fund (a Guaranteed Investment Contract vehicle) are excluded from the defined firm as these are not market value based investments.*

2. *Federated Investors has prepared and presented this report in compliance with the Global Investment Performance Standards ("GIPS®"). For the period January 1, 1992, through present, the firm claims compliance. Federated's effective date of compliance is January 1992. Federated Investors has been independently verified for the period January 1992 through the most recent verification period. A copy of the verification report is available upon request. All of the numbers presented reflect a consistent application of the disclosed composite criteria and processes over the time period from January 1, 1992, to present.*

3. *Interest income is recognized on an accrual basis. All portfolio assets include dividends recognized on accrual basis.*

4. *All market values and performance information are valued in base currency.*

5. *With the exception of the Clover Capital composites, annual composite dispersion is measured and presented using the asset weighted standard deviation of the returns of all of the portfolios included in the composite over the entire year. Quarterly dispersion is measured using all portfolios included in the composite for that quarter. With regard to Clover Capital composites, annual dispersion is measured using the equal weighted standard deviation of the returns of all the portfolios included in the composite over the entire year.*

6. *Composite dispersion does not measure the risk of the product presented, it simply measures the return variance among portfolios managed in a similar fashion. This variance can be affected by variations in cash flow or specific client parameters among the portfolios comprising the composites, as well as by Federated's execution of strategy across accounts.*

7. *The composites may include the equity or fixed segments of balanced separate accounts, when appropriate. In such a case, cash for balanced accounts is allocated to/redeemed from the appropriate segment on a pro rata basis using the portfolio's allocation position in place at the time of the cash flow.*

8. *Performance results are presented gross and net of management fees. Effective October 1, 2009, net of fee performance for institutional composites is calculated monthly by reducing the gross composite return by the highest institutional management fee. For the period July 1, 1992 through September 30, 2009, net of fee performance was calculated monthly by reducing the gross composite return by the highest actual fee of any account in the composite for that month, regardless of investment vehicle. Prior to this, the maximum management fee charged for the period July 1, 1992 through September 30, 1992 was used to calculate net of fee performance back to inception of the composite. With regard to a composite which may reflect the performance of the Clover Capital portfolio management team, net of fee performance is calculated monthly using the actual net return for all portfolios in the composite. Further fee information can be obtained from Federated's respective Forms ADV, Part II, Schedule F.*

9. *Additional information regarding the policies for calculating and reporting returns, as well as a complete list and description of the firm's composites is available upon request.*

10. *Past performance is not indicative of future results.*

11. *See disclosures on the Schedule of Rates of Return and Statistics Reports for additional information.*