

Much ado about nothing, and other tales of tissue.

We're often asked how we manage our portfolios differently from other managers. Yes, you have heard us talk about the combination of high yield and dividend growth. Yes, you understand that dividends dominate the components of total return, which sounds very important indeed. Yes, it all looks quite good, but sometimes you just want to ask "What's it all mean?"

So, let me offer up a simple story from the stock market that highlights what we do and how it differs from many if not most managers. As you know, we are dull people and have a preference for dull investments. Those investments—slow-growing providers of everyday necessities—tend to be in mature companies that have excess profits and can afford to return a good portion of them to shareholders in the form of cash. That may seem an heretical notion on Wall Street, actually sending out a check to the client, but it's what we like to see and we are not going to apologize for it. These types of companies are generally looked down upon by Wall Street. They are not part of the IPO scene, are usually not as volatile and commission-generating as "hot" stocks, and more often than not are absent from the M&A market. They simply grow their business at a modest and generally consistent rate and pay us, as owners, our fair share in cash.

The Kimberly-Clark Corporation is a good example. Boring does not even begin to describe Kimberly. This is a company that makes Kleenex tissue, Scott and Cottonelle toilet paper, Huggies and Little Swimmers Diapers, and Kotex and Poise products for women. And some of you now - and more of you later - will be familiar with another of their brands, Depend. Say no more. Go out to dinner or stay in a hotel and you'll see more dull Kimberly products in the restrooms and kitchens. Should you have to visit a doctor or the hospital, you will find a large and growing number of Kimberly products there—gloves, gowns, masks, booties, scrubs, and the ever-attractive hair-nets, etc.

Kimberly sells its products across the globe and about half of its sales come from outside the U.S. Sales have been growing at a compound annual growth rate of 4.9% for the past five years. Operating profit has risen at a rate of 3.4% in the same period. Net income per share is up the same 4.9% as sales. Booooooring..... Dividend growth in the same period is a positive 8% as the company's payout ratio has risen

modestly from 45% to 55%. And, Kimberly has paid a dividend continuously since 1930 and raised it every year since 1972.

Now Kimberly is a business and is subject to all sorts of volatility. Input costs, primarily pulp and energy, can move around a lot. Competition with Procter & Gamble, Georgia-Pacific, and SCA in Europe can affect near-term results. And Kimberly has some chinks in its armor, most notably its European business. But when all is said and done, it's a well-established, stable business with clear if modest growth prospects. Around 50 percent of the profits come back to investors in the form of a check.

Despite its clear attributes, Kimberly is viewed by the stock market as a lesser company---not a "grower"—and therefore trades at a relatively low valuation. That low price and the high dividend, currently \$2.64 on an annual basis or \$0.66 per quarter, translates into a very attractive 4% yield—twice that of the broader U.S. market. Combine that with the quality of the payment—only representing a little more than half of net income and a little less than half of free cash flow (Cash Flow from Operations minus Capital Expenditures)—and dividend growth prospects of 5-7% over the next five years, the cash return profile would seem pretty attractive.

Not to Wall Street. Wall Street wants action, wants M&A, wants lots of turnover. Kimberly offers none of these. Instead, on February 23, 2010, the Board of Directors at Kimberly raised the dividend by 10%, and thereby signaled their assessment of the company's fundamental strength and outlook. Unlike earnings or guidance, a dividend can't be faked.

One week after the company raised its cash distribution by 10%, a leading Wall Street brokerage lowered its rating on the shares of Kimberly-Clark to Sell from Neutral. The reasoning was simple: the risks of near-term, negative revisions to "consensus" earnings estimates—a key prop in Wall Street's internal theatre of the absurd—due to rising pulp costs. The brokerage lowered its 12-month "target price"—another of the props—from \$63 to \$60. At the time, the shares were trading at \$61. Two weeks later, the same brokerage added Kimberly to its Conviction Sell list, a gathering place for the worst of the worst, at least in the

eyes of that brokerage. The brokerage once again lowered its estimates for the near-in years and adjusted its target price down a whopping 5% to \$57. The shares were still trading at that time at \$60. The brokerage's reasoning was all near-term in focus, and its recommendation included buying April 2010 "puts" on the stock.

So on one hand, a company raises its cash payment to company owners by 10%. On the other hand, a Wall Street brokerage that makes money from trading stocks recommends that investors sell their shares out of concern that the price may drop all of 5%. It's no surprise that we'll go with the increased cash payment and ignore the near-term noise. We run a business and the purpose of that business is to generate high and rising cash distributions for our clients. We're not here to support the trading activity of a Wall Street brokerage.

How'd things work out? On July 25, 2010, four months after rating Kimberly a Conviction Sell, the brokerage reversed course and removed the shares from that penalty box. The analyst wrote that the near-term, negative earnings pressures had not materialized. Instead, the company had benefitted from "strong cost productivity and better cash flow." He raised his earnings estimates and target price back to where they had been before the brokerage recommended selling the shares. It makes your head spin.

While on the Conviction Sell list, the KMB shares rose 6.6% versus a decline for the S&P 500 Index of 3.5%, a difference of 10% in just four months. Even against a benchmark of peers, the S&P 500 Consumer Staples Index, the KMB shares outperformed by 6% in the same period.

Longer term, the same is true: the tortoise whips the hare and does so handily. Over a 10-year period, Kimberly beats the market by 5.3% per year. Over a 20-year period, the advantage is 1.7% per year. For 30 years, the difference is just shy of 4.0% per year.

So how are we different? We focus on the long-term determinants of value—the dividend and dividend growth and do our best to ignore the near-term, turnover-for-turnover's-sake advice of Wall Street.

— Daniel Peris

*Past performance is no guarantee of future results.
Supplemental to the full GIPS report.*

All data from Bloomberg, Federated Investors, and Kimberly Clark, 2010.

²Goldman Sachs report dated March 1, 2010. Subsequent reports dated March 16, 2010, July 18, 2010 and July 25, 2010 respectively.

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