

Spotlight

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Finally, a Fresh Approach to Equity-Income Investing

Aston/River Road Dividend All Cap Value Fund* seeks appreciation and income in unexpected places

A volatile stock market and diminishing yields along the bond yield curve underscore the appeal of an investment vehicle that offers both current income and the potential for capital appreciation. While inflation can dramatically erode the real value of both principal and income for fixed-income investors, a properly structured equity-income strategy can provide a superior yield along with growth to help offset those corrosive effects.

Numerous research studies indicate that dividend-paying stocks as a group have historically delivered higher returns with lower volatility (as measured by standard deviation) over the long-term than non-dividend payers. Intuitively this makes sense since paying dividends requires a firm to produce real cash earnings. In other words, dividend-paying companies are typically sound financially, and paying a dividend provides a strong hint as to the health of the business. Although subject to change, the lowering of the top tax rate on qualified dividend income to 15% in 2003 also removed a significant disincentive to dividend investing by placing its tax rate on an equal footing with the capital gains rate.

Traditional equity-income strategies focus on blue-chip stocks that offer modest capital appreciation and yields. The rationale given for this approach is the lower risk tolerance and need for stability required by most equity-income investors. But it is also a reflection of the asset managers themselves, many of whom are large-value managers that view equity-income as a natural outgrowth of their core competency.

River Road Takes a Different Approach

River Road Asset Management is an investment shop that specializes in small- and mid-cap stocks and what it calls "Absolute Value" investing—a blend of the best aspects of traditional "deep" and "relative" value strategies. Headed by 35-year industry veteran James Shircliff, who is joined by comanagers Henry Sanders and Thomas Forsha on the equity-income strategy, the firm uses a bottom-up stock-picking process that emphasizes finding companies with predictable and sustainable business models. It's this background as a small-cap manager—informed by a philosophy of exploiting potential inefficiencies in this segment of the market—that drives their unique approach to dividend investing.

With the Aston/Dividend All Cap Value Fund, management scours a broad universe of securities for those with a minimum 3% dividend yield, a stable payout ratio, and five-years of positive dividend growth. They demand financial strength in terms of free cash flow and a healthy balance sheet to help ensure future yield and dividend growth. As value managers, they seek a minimum 15% discount to their estimate of a firm's absolute value. The team is also careful to monitor its top-down strategic sector allocation so as not to overload sectors with dividend-paying stocks that tend to move together, such as Financials and Utilities. They believe that this process, guided by its small- and mid-cap centric roots, offers a number of advantages over traditional large-value oriented equity-income approaches in terms of both capital appreciation and income.

Three-Tier Dynamic Diversification

Contrary to popular belief, a significant number of small- and mid-sized companies pay substantial dividends to shareholders. Indeed, more than 900 domestic firms with a market capitalization of less than

^{*} Effective 9/30/2008 the Fund's name changed from the Aston/River Road Dynamic Equity Income Fund

\$2 billion have a dividend yield of more than 2%—quadruple the number of similar yielding large-cap stocks (defined as those with market caps greater than \$10 billion). Like small-cap stocks in general, these firms are often overlooked by Wall Street, inefficiently priced, and tend to grow significantly faster than large-caps. Faster growth typically leads to not only greater capital appreciation, but in greater dividend growth as well.

That's not to say that large-caps aren't included in the River Road strategy. Large, dividend-paying companies have historically provided the high-quality stable growth and liquidity that equity-income investors seek. But large-caps comprise only one of three distinct portfolio components. Typically yielding between 2% and 4%, the stocks in this "Core" part of the portfolio make up roughly 25% to 50% of portfolio assets. Another 20% to 35% of assets are devoted to more growth-oriented small- and mid-cap stocks ("High Alpha") with targeted yields of 3% to 6% and the ability to provide greater upside potential through capital appreciation—from inefficient pricing and a potentially greater valuation



discount—as well as faster dividend growth. The remaining assets fall under the "High Yield" designation for those yielding more than 5%, and include non-traditional securities such as REITs, Income Depository Shares (IDS), Income Trusts and Limited Partnerships, and closed-end mutual funds. †

That breadth of diversification is unique for an equity-income approach, and further aids in minimizing volatility in an already defensive equity strategy. Instead of clustering around a bevy of the usual suspects, a plodding group of similar large-value stocks, the strategy seeks income from a variety of sources less likely to move in lockstep. As a recent example, instead of investing just in the common stock of traditional energy giants, the Fund placed assets in energy-related Master Limited Partnerships (MLPs) that offered double to triple the yield of the typical blue-chip energy stock. In addition, River Road endeavors to avoid the big mistakes that plague many asset managers by adhering to a strict rule against averaging down on losing positions.

Role in a Portfolio

River Road incorporates small-caps and alternative securities into their strategy because both offer potentially rich veins of growth and income often ignored by most equity-income investors. Those willing to think along with them outside the confines of the style box should consider its dedicated, go-anywhere equity-income mandate in broader terms. Instead of viewing equity-income as just another large-value or equity component to a portfolio, a strong case can be made for its employment on a strategic level as an income component. Indeed, many organizations, including Lipper, list equity-income strategies as a separate category. Used this way, investors can benefit from the Fund's unique approach to income and growth investing while not upsetting the overall style or market cap balance of an already diversified equity strategy.

¹ Source: River Road Asset Management, LLC and FactSet Research Systems, Inc.; data as of 5/12/2008.

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[†]Yield parameters set by the subadvisor are not fundamental policies of the Fund and are subject to change at any time. Also, small- and mid-cap stocks are considered riskier than large-cap stocks due to greater potential volatility and less liquidity.

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