

## More Than Income

*Providing income is no longer enough if you want to address the long-term retirement needs, according to Mark Simenstad, manager of the Thrivent Diversified Income Plus Fund. The fund invests in a mix of asset classes to provide income, downside protection, and capital appreciation. Employing a multi-manager strategy, the fund relies mainly on quantitative methods to assess the relative value between the various asset classes and to make allocations.*

**Q: What are the core beliefs behind your style of money management?**

**A:** We established the Thrivent Diversified Income Trust Fund with the idea to respond to the growing need for income streams that aren't just static but have the probability of growth. With this fund we aim to fulfill three needs of our shareholders, namely, to provide income, downside principal protection, and long-term capital appreciation.

We take a long-term view of about 20 years when we examine the probability for growth of capital because we consider the potential long-term needs for pre-retirees and retirees. We also run a high-yield mutual fund for investors who need pure income, but we recognize that the high-yield market alone cannot address the problem of long-term retirement income. To achieve that goal you need not only a pure credit portfolio, but also equity exposure.

So we studied a number of different asset classes and created a mix that we believe can satisfy these three goals. This mix is the result of our long-term quantitative work and our experience both in the mutual fund world and in the insurance business. These asset classes are high-yield bonds, which are the core for income generation, high dividend-paying stocks, and REITs, which is an asset class that has been growing dramatically over the past 10 years.

The overall philosophy is to use multiple sectors in the financial markets to generate income and long-term growth of the principal. We employ a multi-manager strategy (myself plus Paul Ocenasek, Kevin Brimmer and David Spangler) to focus on the individual sectors and drill down into the specifics of these three areas to find value.

**Q: How do you translate that philosophy into an investment strategy and process?**

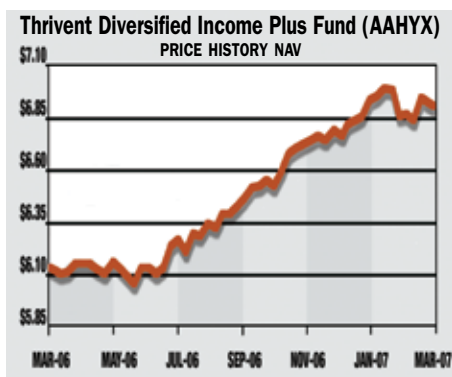
**A:** The process begins with the allocation of the portfolio in the three categories – high-yield bonds, REITs, and high dividend-paying stocks. The next step is allocating money to individual managers with expertise in the various sectors that we invest in, taking into account the expected returns of the various asset classes. This is a multi-manager portfolio and, similarly to our insurance accounts, we allocate capital to different managers to optimize the performance within their sectors.

The work of our quantitative research group generates a model portfolio that should achieve the three goals over a long period of time. But at any given point in time, we may tilt away from that static model by as much as 10%. For example, our model allocation to high-yield bonds is about 45%, but because we consider high-yield bonds



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**“We follow the three main categories—bonds, dividend-paying stocks, and REITs—and then look at the sub-sectors to evaluate which sectors offer the most attractive expected returns, both from the perspective of dividends and capital appreciation.”**



to be somewhat rich right now, our exposure is down to about 35%.

We may use other sectors, such as convertible bonds and preferred stocks, for a portion of the portfolio when we believe that the expected returns in those areas are more attractive. That's how we assess relative value - we start with our model allocation and then we put an overlay of the expected returns relative to risk. Comparing the yields of the various sectors remains a key part of the process, and to make our allocations, we compare the dividend yields of certain parts of the equity market with a high-yield bond, for example.

We may use our convertible bond capability when we want to have more downside protection in a certain situation. Part of our strategy is always to assess the value between the different parts of the capital structure that we can buy within a specific name. We might also have exposure to Master Limited Partnerships, which represent a sub-sector in the high dividend-paying stock arena. Another instrument that we use is preferred stocks.

**Q: Would you explain your strategy for each specific asset class?**

**A:** In the high-yield sector, the decision-making process involves constant analysis of current yield for various quality sectors relative to their historical yield. About half of the portfolio is currently allocated to BB-rated bonds because with spreads tight, you are not paid well for the risk in CCC-rated bonds, which are like quasi-equities.

In investment grade bonds, we consider a whole range of securities. Our long-term static allocation to high-grade bonds is only 5%, but right now our exposure is about 10% because we believe that higher-quality bonds are better value. To ensure that we generate enough yield, we may also invest in hybrid and mortgage-backed securities. The new hybrid securities are almost like preferred stocks. They fit well with the portfolio and provide diversification while generating higher yields. The main difference is that they are very low in the capital structure, much like a deeply subordinated bond.

Our equity exposure is driven almost entirely by top-down quantitative screens on high dividend-paying stocks. Different from many bottom-up equity portfolios, we use a fundamental review on the companies only after we screen them quantitatively. Instead, we use multi-factor screens to find the highest dividend-paying opportunities. Screening criteria include a market cap of at least \$1 billion and a payout ratio of no more than 95%. Basically, we look for companies that don't pay more than they earn and that exhibit dividend growth over time. The other screens aim to ensure that the portfolio has growth elements, so we screen for growth in sales and earnings to avoid being stuck with companies with negative growth rates.

For the high dividend paying stock portfolio, we start by screening The Mergent Dividend Achievers Index. This index is made up of companies with significantly higher dividend yields than the S&P 500. For example, right now our average yield in high-dividend paying stocks is about 4%, while in the S&P 500, it is about 1.7%.

On the REIT side, we also run screens for dividend-paying capability, but with a different twist. We are aware of the sectors within the REIT universe, and we make sure to achieve balance between apartments, office, and retail properties. We consider the long-term return and the volatility of the market, which has grown rapidly in a rela-

tively short period of time. Right now the REIT market looks fully valued to us, and we maintain half the weighting of our model allocation. We're never going to exit entirely the REIT market but the near-term analysis doesn't support a large exposure.

The REIT part of the portfolio has a dividend yield of about 5% and has been quite successful in the past year. Those stocks attract private equity investors because they generate a lot of excess cash. We have been fortunate to have big positions in companies that have been bought out, although we aren't specifically looking for buyouts. However, our screening mechanisms might be similar to the screening mechanisms of some of the buyout firms.

**Q: What would your strategy be for companies like General Motors, which may be paying high dividends despite the fact that its core business is in trouble?**

**A:** GM wouldn't have passed the screens because it is not growing and its dividend payout ratio is over 95%. That would be enough to eliminate that stock. Although our process is quantitatively driven, we have a research group that ensures that the names pass certain fundamental tests as well.

**Q: Would you illustrate your process with some examples in each asset class?**

**A:** A good example on the bond side would be Rogers Communications, the Canadian company. We found the industry to be compelling, with attractive fundamentals, and good valuation. We found the BB-rated credit of Rogers to fit our portfolio due to its compelling yield for the lower risk credit profile of the company. There was also significant potential as an upgrade candidate.

A similar name is Coventry Health Care, which is also in a very stable industry. We believe that Coventry, which currently has a BB credit, can actually become investment grade. Given our current outlook and the search for higher quality, both of those

names satisfy our research criteria. In an uncertain economy, they represent good stable businesses with the potential to be upgraded.

On the equity side, our top three holdings are Progress Energy, Altria, and Kinder-Morgan. Although they are in three different industries - utilities, consumer products, and energy - all of them have good payout capabilities. These companies first passed our quantitative dividend screening process. From a fundamental standpoint, Altria generates prodigious cash and has a dividend yield of over 4%. It is a very stable business with a long history of increasing dividends. It recently spun off Kraft Foods and is in a bullet-proof industry environment right now. Since the company fits all of our criteria, it makes up about 4% of our equity allocation.

On the REIT side, our top three holdings are Hospitality Properties Trust, Simon Property Group, and Vornado Realty Trust. Again, they represent three different areas in the REIT space, so that allocation provides diversification. Hospitality Properties is in the hotel business, Simon Property works predominantly on the retail market, while Vornado is focused on the office space. They are large companies that offer reasonable dividend yields and dividend growth.

**Q: What are the most important elements of the portfolio construction process?**

**A:** As a result of the screening process, it tends to be a relatively concentrated portfolio. Right now we have about 85 high dividend-paying stocks. The REIT portfolio only has about 60 to 65 names because the REIT market tends to be more homogenous.

Our long-term model allocation is 45% in fixed income and 55% in equity. On the bond side, that 45% exposure consists of 40% in high-yield and 5% in investment grade bonds. On the equity side, our model allocation is 23% in REITs and 32% in high dividend paying stocks.


We first follow the three main categories – bonds, dividend-paying stocks, and REITs - and then look at the sub-sectors to evaluate which one offers the most attractive expected returns, both from the perspective of dividends and capital appreciation. The question of the least downside risk is also important, especially in the current environment, when everything looks a little elevated.

Then we go through an allocation to each of the main areas for positioning that gives us the best risk/reward profile depending on the current market outlook. So the portfolio construction process represents constant calculation of the yield of the asset class and comparison on a statistical basis.

Finally, it involves judgment in terms of our overweights and underweights. The degree of the overweights is dictated by how rich a certain sector is compared to another sector or to its historical performance.

**Q: What kind of risks do you look at and how do you monitor and control them?**

**A:** We're fully aware that when you screen for high dividend-paying stocks, you will naturally lean towards certain sectors, such as financials and utilities. For risk control purposes, we optimize the portfolio to make sure that the leaning doesn't get too extreme. For example, when some of our financial stocks run up quite a bit and we were getting too heavy in financials, we pared those back and consciously sought for diversification in other industries.

Long-term risk management is most important since one of our portfolio goals is long-term capital appreciation. Our quant group runs an analysis, which shows the probability for the portfolio to achieve capital appreciation over a 20-year period. We try to keep that number at about 70% to 75%, and if we deviate too much from our static model, that probability drops. 

## Thrivent Diversified Income Plus Fund

Symbol	<b>AAHYX</b>
Website	<a href="http://www.thrivent.com">www.thrivent.com</a>
Address	Thrivent Financial for Lutherans, 625 Fourth Avenue South Minneapolis, MN 55415
Tel. No.	800-847-4836
Inception	01/08/97

PORTFOLIO	
Total Net Assets*	\$176.9
Avg Mkt Cap (\$ Weighted)*	\$28,300
Average Price/Earnings Ratio	19.32
Average Price/Book Ratio	1.91
Turnover Ratio	170%

INVESTMENT INFORMATION	
New Investment	Open
Min Initial Investment	\$1,000
Min Subsequent Investment	\$50
Min Initial IRA Investment	\$500

RISK (AGAINST S&P 500 - 3 YEAR)	
Alpha	0.44
Beta	0.28
R-Squared	0.26
Ann. Std Deviation	3.80
Sharpe Ratio	1.29

RETURNS VS. S&P 500 DIVIDEND ARISTOCRATS INDEX		
	AAHYX	Index
1 Year (Cum.)	13.17%	13.46%
3 Year (Ann.)	8.46%	11.27%
5 Year (Ann.)	10.00%	8.54%

RETURNS VS. LEHMAN BROTHERS AGGREGATE BOND INDEX		
	AAHYX	Index
1 Year (Cum.)	13.17%	6.59%
3 Year (Ann.)	8.46%	3.31%
5 Year (Ann.)	10.00%	5.35%

FEES AND EXPENSES	
Max Sales Charge - Front	4.50%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee*	0.00%
Total Expense Ratio	0.95%

PORTFOLIO MANAGER	
Mark Simenstad	2006
Paul Ocenasek	2006
Kevin Brimmer	2007
David Spangler	2007

\*millions

Data through: 03/31/07

Source: Company Documents; Lipper

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