

Back in Style

Favorable tax changes combined with more conservative corporate accounting are awakening dividends, a slumbering giant.

By Brian McMahon

November 1, 2004- What was old once is new again, as often happens in the financial world. Dividends--dead and buried during the roaring bull market of the late 1990s--are becoming fashionable once more for both companies and investors.

Regulators and investors have initiated a campaign designed to reverse a decade of dishonest accounting practices and thoughtless acquisitions in corporate America, fueled by the naked pursuit of growth for growth's sake. And things have been changing.

Corporate accounting is becoming more conservative. Starting in 2006, for example, the issuance of stock options must be expensed. Firms can no longer omit employee compensation expenses in the form of stock options from their income statement in an attempt to make earnings look better than they really are. If the use of stock options lessens, then share repurchase activity to mask the accompanying dilution should also fall, leaving more cash available to pay dividends, shrink the number of shares outstanding, or both.

The tangible effects of these efforts are already evident. In the first half of 2004, firms reported average revenue growth in the mid-teens, and average earnings per share growth topped 20%.

The quality of earnings has also gotten better. For example, the S&P 500 earned an average of \$54.24 per share in 2003. The quality of that \$54.24 is better than the quality of the \$52.84 earned by the S&P 500 in 2000, when WorldCom, Enron, AOL, and others reported grossly inflated numbers. For 2004, analysts are expecting to see S&P per share earnings of around \$64, an increase of 18% over 2003. If this increase really does materialize, it will lead to better balance sheets, greater capital adequacy, higher levels of surplus cash--and the rediscovery of the dividend.

Along with an improving ability to pay dividends, we are beginning to see a renewed willingness on the part of companies to do so. Some notable firms have either significantly increased their dividends or initiated a dividend program.

For example, Citigroup announced in 2003 that in the future it would reallocate its surplus cash flow from 75% to share repurchases and 25% to dividends to 75% to dividends and 25% to share repurchases. Microsoft will pay a special dividend of \$30 billion in December, and it will direct another \$30 billion to repurchase shares in the coming years, as it curtails its employee share options program. Expect more companies to do likewise, particularly if expensing stock options is universally adopted.

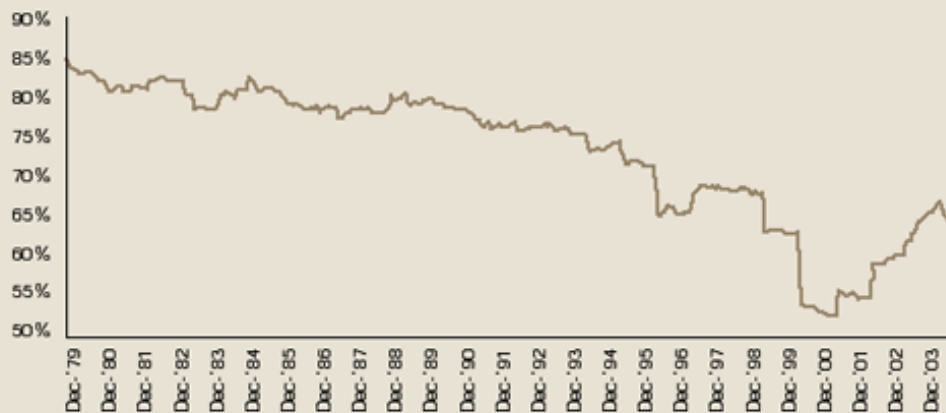
Through September, 243 of the S&P 500 firms increased their dividends this year. Only a handful of S&P 500 members reduced or suspended their dividends year-to-date. Analysts now estimate that the S&P 500 portfolio will pay a dividend of around \$22.50 in 2004, up some 29% from the \$17.38 paid in 2003. Yes, Microsoft's special dividend adds to the magnitude of the increase, but after all, cash is cash.

The Russell 1000 contains 1,000 public companies that are intended to be representative of big business in this country. As the chart below shows, at least 80% of these companies paid some

dividend between 1980 and 1993.

The Big Chill

Between 1998 and 2000, the number of companies in the Russell 1000 paying a dividend dropped to about 50%, from 700 to just over 500 firms.



Source: CSFB Quantitative and Equity Derivatives Strategy

Corporate propensity to pay any dividend weakened through the rest of the 1990s, however; as the decade waned, investors were demanding growth and were less concerned about dividends. Note the enormous shift between 1998 and 2000, when the number of firms in the Russell 1000 paying a dividend fell from 700 to just over 500 companies--around 50%--indicating investor and management preference for reinvesting retained earnings in growth initiatives. Dividends were also affected by repurchases of company stock, with surplus cash flow going to offset dilution created by employee stock option awards.

Now, though, the pendulum appears to be swinging back in the other direction. Today, 65% of Russell 1000 firms pay dividends.

As noted earlier, investors and corporate managements de-emphasized dividends during the last bull market in favor of "growth." But dividend-paying stocks aren't necessarily anti-growth. In fact, the capital discipline that's fostered by a management commitment to paying dividends appears to foster subsequent earnings growth over time.

It may be similar to how smart, ambitious young people without large inheritances tend to out-earn well educated trust babies. Firms with excess retained earnings can be too comfortable. They frequently make value-destroying acquisitions simply because they can afford to make mistakes. Corporate capital discipline is a good trait, of course, and often dividend programs contribute to capital discipline in operating businesses.

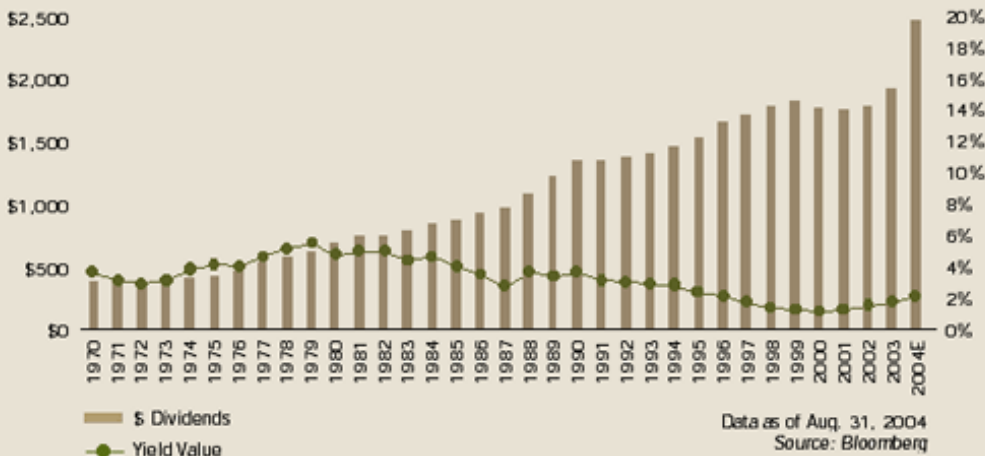
Disciplined dividend investing contributes to interesting income developments over time for far-sighted advisers and clients, too. For example, if a client invested \$10,000 in the S&P 500 in 1970, she earned \$336, about a 3.36% return. Let's say she maintained her investment for 33 years and spent her cash dividends every year. By 2003, her cash dividend would have grown to \$1,859, or a yield of 18.59% on her original investment, without reinvesting a dime. This year, with the S&P dividend expected to hit a minimum of \$22, her cash dividends could easily exceed \$2,200 from the original \$10,000 investment.

In "Opportunity Knocks" below, the first chart shows how the dollar dividend per unit of the S&P 500 has grown. Since the price of the index itself has increased (from less than 100 in 1970 to more than 1,000 today), the yield as a percentage of the current index price has decreased in recent decades. But it's important for advisers and clients to recognize that the absolute dollar amount of dividend paid has increased at a compound annual rate of around 5% per year for the last 34 years. If you plan ahead, you can plant a significant income tree for clients; like a beautiful hardwood, it will take some time to grow.

Opportunity Knocks

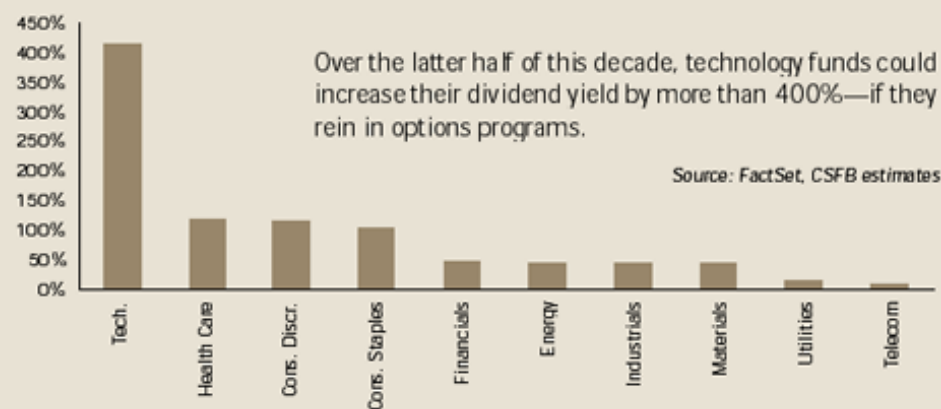
Clients and advisers should take a closer look at the benefits of dividend-paying equities.

AVERAGE YIELD VS. ANNUAL DIVIDENDS



Because the price of the S&P 500 has increased, the yield, as a percentage of the current index price, has dropped in recent decades. But the absolute dollar amount of dividend paid has increased at a compound annual rate of around 5% per year for the last 34 years.

THE SWEET SPOT?



So which type of firm is likely to pay better dividends in the coming years? On one end of the scale are the technology companies. They have the biggest potential to increase their dividends, but their markets become obsolete quickly, and too many of them continue to use stock option deals to compensate their employees. Chances are good that technology firms will never be big dividend payers, but they can get better if options programs are reined in.

Utilities sit at the opposite end of the scale. They historically have paid attractive dividends, but the dividends haven't grown in recent years. That trend seems set to continue if regulators suppress rate increase requests.

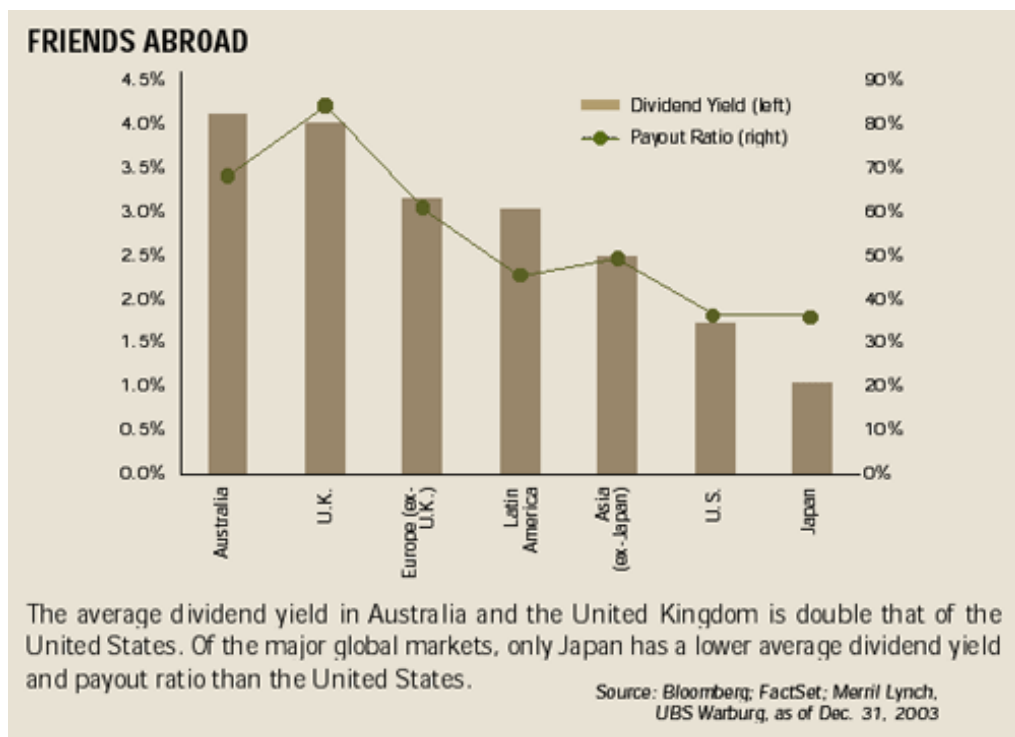
Other market sectors show the most room for dividend improvement down the line. Throughout the latter half of this decade, the dividend outlook for U.S. equities is improving. Revenues and earnings are growing, and payout ratios (dividend per share divided by earnings per share) are modest, relative to other markets around the world and to the U.S. historical market. The second chart above illustrates the potential for dividend increases by S&P sector, if all of the funds used to repurchase shares were redirected to dividend payments.

Still, most investors mistakenly think that investing in dividend-paying stocks means only buying stocks in the real estate investment trust (REIT) or utilities sectors. This may seem like a logical place to start, because historically stocks in these sectors have paid out the highest dividends.

For example, within the Russell 1000 index, 79% of the top 100 dividend payers are either REITs or utilities. And in the Russell 2000, 86% of top payers are either utilities or REITs.

Scrolling down *The Wall Street Journal* looking for the highest dividends isn't a winning strategy, however. It makes better long-term sense to assemble a diversified portfolio of growing businesses that pay interesting dividends today and that show the ability and a willingness to improve them in the future.

Foreign markets provide another element for dividend diversification. Since foreign firms tend not to hoard retained earnings as much as American firms and to share more earnings with shareholders, yields outside the United States are often better. For example, the average yields on stocks in European and Asian countries range from 3% to 4% (see chart below). Japan is about the only major country that doesn't have a higher average stock yield (1%) than the United States (1.6%).



Advisers should keep in mind that the 2003 federal tax reduction from 35% to 15% on qualifying dividend income includes international companies whose stocks trade on a U.S. market and international companies domiciled in countries with a tax treaty with the United States. There are currently 65 qualifying countries, representing most developed markets. On the other hand, dividends paid by REITs and master limited partnerships don't qualify for the 15% tax rate, since these entities don't pay tax at the enterprise level.

Mutual funds that own any dividend-paying companies received an additional yield boost from the tax act. Specifically, a mutual fund manager can reduce the tax liability on all non-qualifying income by allocating that income to cover fund expenses. Qualifying dividend income from portfolio investments is then allocated to the fund shareholder dividend stream. This preferential tax treatment may not last, of course, but it's the icing, not the cake.

American investors need income, particularly as the median age of citizens in this country continues to increase. Financial advisers and their clients are beginning to see dividend-paying equities as one way to meet these growing income needs.

Advisers often ask, "What exactly do my clients want to accomplish? How am I going to get them there?" A portfolio of equities that combines growth with dividends is part of the solution.

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