Nucor Will Benefit the Most From U.S. Steel-Import Tariffs, Investors Say

Bloomberg Personal Finance

Tue, 19 Mar 2002, 1:33am EST

Milk Cows Make Blue-Ribbon Picks

When companies increase their dividends, share price often follows

By Jonathan Heller Bloomberg Personal Finance

In rampaging bull markets, like that of the mid-'90s, stock- pickers covet companies promising steep earnings growth. When the bears take over, as they did in 2000 and 2001, investors seek the security of regular dividend payments. Is it possible to find one set of stocks able to both catch the wave of up markets and stay afloat in down ones? Our quest to answer this question led us to "dividend growth" companies: those that not only increase their payouts to shareholders year after year but do so at a rapid rate.

Such companies obviously provide some dividend income. But how about capital appreciation potential? "Dividends and dividend growth are the real-life signal that a company...is experiencing real growth," says Lowell Miller, president of Miller Howard Investments, in his book The Single Best Investment (Adams Media). "A company can tell you about its earnings, but there is always a certain 'flexibility.' There is no flexibility when it comes to paying and increasing dividends. The company must have the cash to pay you."

The theory tests out well. Searching the Bloomberg database, we found 44 companies with market capitalizations of $500 million or more that had raised their dividends in each of the five years through December 31, 2001, and whose dividend growth over that period was at least 20 percent compounded annually. During those five years, which spanned both bull and bear markets, the 44 stocks generated an average annual return of 22.15 percent. We also identified 39 companies that grew their dividends in that period by between 15 and 20 percent. These stocks returned 20.81 percent. By comparison, the S&P 500, Nasdaq Composite, and S&P 400 MidCap Indexes returned 10.69, 8.95, and 16.09 percent, respectively. "A dividend-growth strategy can keep you out of trouble, and it leads you generally to some pretty high-quality situations," Thomas Huber, manager of T. Rowe Price's Dividend Growth Fund, told Bloomberg News in January.

The trick is to find companies that will generate strong dividend growth well into the future. But while identifying past growth is not difficult, predicting increases to come is a different story. That requires "art," according to Donald Taylor, co-manager of the $400 million Franklin Rising Dividends Fund, one of the few that focus on dividend growth.

"Clearly, in a narrow sense, the historical record matters," says Taylor, whose fund returned 11.01 percent annually for the five- year period ending last December. "But only to the extent that it helps you predict what the future performance will be. If you look at a historical pattern over a long enough time, you have some greater degree of confidence that the pattern will continue going forward. But it doesn't have to."

For Miller, the key is an ability to generate "reliable and repeating sales with moderate increases." In addition, he looks for a "growth kicker," which he defines as a "standout subsidiary or division than can help build extra growth in a controlled and evolutionary way." Another factor is management that demonstrates regard for its shareholders through actions such as share buybacks and a willingness to increase dividends. Miller also tries to identify companies whose strong performance in the past is likely to be "enhanced in the future by visible economic trends."

On a fundamental level, you want to see growing earnings, which enable companies to increase their dividends, and low debt in relation to equity, since high levels of indebtedness can threaten

future cash flow. Similarly, the company should have a low payout ratio--that is, the percentage of earnings disbursed in dividends should be relatively small, leaving room for growth.

For our stock screen, we specified a minimum market cap of $1 billion and a compound annual dividend growth rate of at least 15 percent over the past 5 and 10 years. Companies also must have increased their dividends each year during those periods. To eliminate those whose growth has recently slowed significantly, we required compound annual dividend growth in the double digits for the past three- and one-year periods. Lastly, to assure a legitimate level of income relative to price, we prescribed a minimum dividend yield--share price divided into annual dividend per share--of 0.5 percent.

Sustainability of dividend growth is crucial. While this can't be guaranteed, low payout ratios and increasing earnings create the necessary conditions. To that end, we specified that payout ratios be below 50 percent and that the estimated price-to-earnings ratios for the next fiscal year be below current ones. Finally, we required debt-to-equity ratios of less than 50 percent. The flexibility of earnings reporting often leaves investors on unstable ground. Dividend growth is not only less susceptible to manipulation but also has delivered above-market returns to investors.

Jonathan Heller, CFA, is senior markets editor for Bloomberg Personal Finance.

#<18602># -0- (CRL) Mar/14/2002 21:47 GMT

©2002 Bloomberg L.P. All rights reserved. Terms of Service, Privacy Policy and Trademarks.