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## The Dividend Gains New Respect

By VIRGINIA MUNGER KAHN

**D**ividends may be out of fashion, but companies that consistently raise their dividends often make excellent long-term investments, money managers and securities analysts say.

"In recent months, we've been stressing that dividend yield has been underappreciated," said Richard Bernstein, chief United States strategist at Merrill Lynch ([news/quote](#)). "In an environment of lower returns, dividends will play a major role."

In the 1990's, when stock returns averaged 18.2 percent a year, dividends provided just 2.9 percentage points of that. The remainder came from capital appreciation. Over the long term, though, dividends have provided 4.7 percentage points, or more than 40 percent of the market's average annual return of 11 percent since 1926.

Dividend-paying stocks have done particularly well recently. In 2000 and 2001, stocks in the Standard & Poor's 500-stock index that distributed dividends climbed a cumulative 10.2 percent, compared with a decline of 15 percent for those that did not.

Investing in dividend-paying stocks has been "a brilliant strategy in hindsight," said Stephen R. Petersen, manager of the Fidelity Equity-Income and Fidelity Puritan funds. Income streams from dividends cushion falling prices in bear markets.

Consistent dividend payers also have strong long-term records, according to a recent study by Standard & Poor's, analyzing 47 stocks it now recommends that have consistently increased dividends in the last 10 years. It found that they outperformed the S. & P. 500 from 1991 to 2001, rising fourfold, versus threefold for the index.

Moreover, as of mid-December, dividends on these stocks were providing investors with a yield of 8.6 percent, based on their average purchase price in 1991.

"What this tells you is that solid companies with policies of increasing dividends do well both in terms of a return on your money and capital appreciation," said Arnold Kaufman, editor of The Outlook, an S. & P. newsletter. "These are not stodgy high-yielding investments. These are for people with longer time horizons who can wait for the dividend to increase."

Seventy percent of the stocks in the S. & P. 500 now pay dividends, down from 87 percent in 1991 and 94 percent in 1980; the average yield is now 1.5 percent. So why have dividends fallen out of favor? There are several reasons. Companies contend that they can put their money to better use by reinvesting in their own businesses or buying back their stock than by paying the money out to shareholders. Moreover, dividend cash is taxed as both corporate profit and as ordinary income to the investor.

But in a time when investors are questioning the quality of corporate earnings and prospects for stock-price gains, dividend-paying stocks have new respect. "These companies are providing investors with immediate rewards," Mr. Kaufman said.

Such stocks may also attract investors who expect an economic recovery but are unwilling to take on much risk.

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"These tend to be pretty durable businesses, which leads to less volatility," said Thomas J. Huber, manager of T. Rowe Price Dividend Growth, one of the relatively few funds specializing in such stocks.

UNLIKE strategies that appeal to investors who need current income, investing in companies with increasing dividends makes sense for investors who will be retiring in 10 or 15 years. By holding these stocks in a retirement account, investors can defer taxes, said Steven E. Norwitz, a vice president at T. Rowe Price Associates. By the time investors start drawing income from these stocks, the return on the original cost can be very attractive.

For example, investors who bought Johnson & Johnson ([news/quote](#)) in 1981 at \$2.32 a share on a split-adjusted basis would have a yield on their original investment of 30 percent based on a dividend of 70 cents a share in 2001. Investors who bought Schering-Plough ([news/quote](#)) 20 years ago would have a 70 percent yield on their original stake. The yield on an investment 20 years ago in the S.& P. 500 would be 14.4 percent, according to T. Rowe Price.

Stocks with rising dividends also tend to provide more diversification than stocks bought solely for high current yield, which are concentrated among electric utilities and real estate investment trusts.

One of Mr. Huber's favorite stocks is Philip Morris ([news/quote](#)), which has a 32-year record of enhanced dividends despite the burden of antitobacco litigation. The stock now yields 4.4 percent, and earnings are expected to grow about 10 percent a year over the next three to five years. Mr. Huber also likes Citigroup ([news/quote](#)), which, with its Travelers unit, has consistently raised its dividend since 1986.

Mark D. Luftig, manager of the Strong Dividend Income fund, also looks for companies with a history of increasing dividends. "It's a big positive to us," he said. "It indicates how management feels about future earnings and cash flow."

He recommends TECO Energy, a Florida power company that has increased its dividend to \$1.37 a share from 90 cents in the last 10 years. The stock now yields 5.6 percent, and earnings are expected to grow 6 percent more a year in the next three to five years. Another favorite is Washington Mutual ([news/quote](#)), the big savings bank, which has raised its dividend at a 17 percent annual compound rate over the last decade.

But not all mutual funds whose names imply a dividend growth approach actually follow such a strategy. The Fidelity Dividend Growth fund, for example, tends to follow a course based on growth of earnings rather than one focused on dividends, said Scott Cooley, a Morningstar analyst.

Charles Mangum, manager of Fidelity Dividend Growth, said he uses dividends to screen companies' financial health and their "ability to finance future growth."

Sue Stevens, director for financial planning at Morningstar and founder of Stevens Portfolio Design in Deerfield, Ill., favors individual stocks over funds, partly for greater control over tax liability.

STILL, investing in dividend-conscious companies requires some homework. "Just because a company pays a dividend doesn't mean it's a good investment," Mr. Petersen of Fidelity said.

Dividends can always be cut or eliminated if a company runs into trouble. Last July, both Xerox ([news/quote](#)) and Corning ([news/quote](#)) suspended dividends after paying them without interruption for more than 50 years.

High yields on stocks can be a sign of distress, just as high yields on bonds indicate increased risk. A high stock yield may indicate that lower earnings are depressing the stock price. The stock of Puget Energy ([news/quote](#)) now has an 8.9 percent dividend yield, "a sign the dividend is in jeopardy," Mr. Luftig said.

Moreover, high-dividend stocks are most likely to be left behind when a bull market roars and investors look for companies that can raise earnings rapidly. The "Dogs of the Dow" strategy, which involves buying the highest-yielding stocks in the Dow Jones industrial average, badly underperformed the market during the boom years of 1997 to 1999.

Mr. Luftig, for one, is willing to take the dividend risk. "Frankly, at this point," he said, "I'd rather take a chance of being left behind, while I collect my dividends and settle for modest price appreciation."