

Dividend - Paying Stocks May Lead a Trend

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NEW YORK (AP) -- The emerging leadership of dividend-paying stocks has some market watchers spotting a broader trend: With earnings growth on the decline, there's renewed interest in what was once considered an old-fashioned investment.

Dividends -- regular payments to shareholders out of a company's retained earnings -- have long provided a boost to total return, and now analysts say they could help drive the stock market higher. Since stocks struck their mid-April lows, the best performers have been in sectors with the fastest dividend-per-share growth in recent years, said Jeff Kleintop, chief investment strategist for [PNC Financial Services Group](#) in Philadelphia. Those with weaker dividend-per-share growth have lagged.

"Back in the old days, people bought stock for the dividends," Kleintop said. "It's only been in the last couple decades people focused more on stocks going up than what they paid in dividends. And now that may finally be reversing."

The dividend revolution is most clear in the technology sector, where they've grown at a rate of 44 percent over the past two years. And, since April 20, these stocks have surged 9.5 percent, Kleintop said. Underscoring the trend was last year's decision by Microsoft Corp. to issue a special one-time dividend of \$3; the company has also doubled its regular quarterly dividend twice since it began paying it in March 2003.

"Tech is a sector that hasn't historically paid out much in dividends, but over the past several years it has substantially increased its dividend payout," Kleintop said. "If you look at the semiconductor industry, five years ago, only two of the top ten companies paid dividends. Now only two of the top ten don't."

"Historically, dividends have played a much more important role than they currently do, accounting for about 4 percentage points of the roughly 10 percent average annual return stocks have delivered since 1926. But their popularity waned during the bull market, and the average equity yield for the Standard & Poor's 500 struck an all-time low of 1.1 percent in 2000. The number of S&P companies offering dividends dropped from 470 in 1980 to just 351 in 2002. Now that number has climbed to 378, and the average yield is 1.9 percent.

The rate of payout has been on the rise, as well, said Rande Spiegelman, vice president of Financial Planning for the Schwab Center for Investment Research. In 2004, 1,745 dividend increases were announced, a 7.1 percent increase over 2003, a trend expected to continue this year.

Spiegelman attributes some of this to the tax act of May 2003, which lowered the rate for long-term capital gains and qualified dividends to 15 percent for investors above the ordinary tax bracket. Prior to that, dividends were taxed as ordinary income at rates as high as 35 percent.

"Instead of keeping less than two-thirds, you get to keep 85 percent of your dividend if you're in the highest bracket," Spiegelman said. "So now a tax-efficient 'bird in the hand' doesn't seem so old fashioned, does it?"

Why now, two years after the tax act was passed, are dividends taking the lead? It's partly because earnings growth was so strong, it eclipsed the importance of the humble dividend, Kleintop said. One of the reasons for the recent pullback in stocks was investors' concerns about earnings growth. They rose at a rate of 13 percent, year-over-year during the first quarter -- strong, but slower than in previous quarters. In contrast, dividends were up 17 percent. That marked the first time in the current business cycle dividends grew faster than earnings, Kleintop said.

Another factor is the rush to restructure compensation packages before the end of the year, when corporations will be required to start expensing stock options at fair value. A common alternative to options is to award restricted stock to executives. That brings the dividend issue home to corporate America's corner offices.

"The nice thing about dividends is they can't be restated, they can't be written off. The same can't be said of earnings," Kleintop said. "Here we have something that's growing faster and is of higher quality, and therefore it's more important to investors."

As an added benefit, companies with a history of maintaining and steadily increasing their dividends tend to have strong balance sheets and good cash flow.

On top of that, research suggests high-quality companies with both growth and yield characteristics are poised to produce market returns with meaningfully less risk. They're a safe place to seek shelter when volatility strikes, Henry H. McVey, [Morgan Stanley's](#) chief investment strategist, wrote in a recent note to clients. Such stocks offer "most of the market's 'spice' with significantly less heartburn," he said.

They've also performed well historically, according to Schwab. If you'd plunked \$10,000 into the dividend-paying stocks of the S&P on an equal-weighted basis in 1975, your investment would have grown to \$514,132 today, Spiegelman said. If you'd invested the same amount in the index's non-dividend paying stocks, you'd have just \$374,912.

The dividend paying stocks of the S&P have produced better returns in the short term as well, rising 18.4 percent in 2004, versus a 13.7 percent rise for non-dividend payers, on an equal-weighted basis.

"Dividend payers have outperformed non-dividend payers, but not only that, the record suggests dividend payers hold up better on a relative basis during periods of economic weakness," Spiegelman said. "Combine that with the fact that they're taxed at a preferential rate, and it makes a real solid case for dividend-paying stocks for a lot of folks."