

FINANCIAL ADVISOR

Revising The Rules Of Investing

The resurgence of dividends according to Peter Bernstein.

By Evan Simonoff

Once in an occasional generation, some phenomenon or event occurs that permanently changes some of the basic rules of investing. It happened in 1958 when, for the first time in the modern history of U.S. financial markets, the yield on stock dividends fell below the yield on bonds.

But most other changes prove to be transient, as the old cliché about the four most dangerous words about investing reminds us. When someone says, “It’s different this time,” it’s usually time to look out and run for cover.

But when that person happens to be Peter Bernstein, even the most jaded and cynical skeptics do a double take. A founder and longtime editor of *The Journal Of Portfolio Management* and his *Economics and Portfolio Management* newsletter, this self-described “social worker to the rich” has led a kaleidoscopic life as a financial advisor, money manager, author, scholar and always-perceptive student of investing.

So when in early 2003 he gave a speech entitled *Points of Inflection* that questioned if some underpinning tenets of portfolio management, such as the theory of efficient markets and buy-and-hold strategies might no longer work in the current environment, many financial professionals were shocked. Bernstein himself was stunned at their response. “I give talks all the time,” he notes, adding that they never caused these kinds of shock waves in the past.

An octogenarian who was pushed by his family to quit commercial banking and start working on Wall Street, where no one wanted to work in 1951, Bernstein’s five decades of experience provides him with a perspective few money managers possess. And he shows no signs of slowing down in his other activities. His book, *Against The Gods*, a history of risk, has sold 500,000 copies since its publication in 1997. He is now completing a history of the Erie Canal, which simultaneously opened America’s Midwestern industrial heartland while solidifying New York City’s place as the nation’s commercial and financial center.

In late May 2004, Bernstein addressed a group of financial advisors who gathered in Oak Brook, Ill., to attend a wealth management symposium sponsored by JP Morgan Fleming. Before turning to his main subject of the night, the dividend paradox, he recapped a few highlights from his provocative 2003 talk.

Essentially, the theme of the two-part talk was not that investors aren't in Kansas any more. His first point centered on the changing character of Wall Street research.

The abolition of the fixed 2% commissions on stock transactions that existed up until May Day 1975 meant that Wall Street research could no longer pay for itself, so that investment banking fees became the revenue source that paid analysts' salaries. Although most securities analysts became subservient to the investment bankers, a few like Jack Grubman became rainmakers on a big scale and put together huge telecom mergers. But the last factor Salomon Smith Barney used to calculate Grubman's eight-figure annual bonus was the quality of his investment research.

"Now that it's tainted, research will become more expensive, but it's going to be a lot better," Bernstein predicted.

The next subject he tackled was indexing. An early fan of indexing, he believes the increasing turnover in major indexes has reduced their reliability. "It changes too fast and no longer provides diversification," Bernstein declared.

Then it was on to problem No. 3, benchmarking or performance measurement. "Managers with skill suffer from being locked into style boxes," Bernstein argued. "It's extremely constraining and explains the exodus [of managers] from mutual funds to hedge funds."

It makes sense, after all, that if someone is a great small-cap manager, she ought to be able to find investment opportunities in other areas as well. Challenging the so-called style police, Bernstein said that managers with skill should be given as much opportunity to earn returns wherever possible. At the same time, he also remarked that cash was an underrated asset class. Just because it doesn't have a lot of appreciation potential doesn't mean it can't help investors control risk in times of uncertainty.

Moving to the final point recapping his 2003 talk, Bernstein remarked that "long-only is a silly way to manage money," adding that this view of investment management was declining. If a manager is able to spot market inefficiencies that result in undervalued securities, they should be able to identify overvalued ones as well. But if short-selling is legitimate, this student of investing seemed more skeptical about the fee structure of modern hedge funds, calling it only "a means of

compensation.”

At this juncture, Bernstein turned his attention to his main subject at the JP Morgan Fleming conference—dividends, the forgotten part of total return. For the first time in a long lifetime, dividends today are worth as much after taxes as capital gains. “This event has occurred and no one has noticed” beyond an occasional article, he argued.

Conditioned by their own experience, it’s little wonder dividends get no respect from today’s investors. Over the last 20 years, capital gains were not only taxed at favorable rates, but they also accounted for the lion’s share of total return.

The long-term picture is very different than the current climate, in which dividends still get no respect. Research from famed academic Jeremy Siegel examining stock price history back into the 19th century reveals that, of the 7% long-term real rate of return on stocks only 2.7%, or 39% of the total, came from capital gains.

Bernstein himself was just a babe on Wall Street when, during a powerful 1958 rally, stocks suddenly were yielding less than bonds. In 1929, stock yields came very close to falling below bond payouts, and then the market crashed.

Bernstein’s older partners warned that the move was transitory and “couldn’t last.” In the end, things really did turn out to be different that time. “The move was dramatic, it wasn’t just a few basis points,” Bernstein recalled. “Then the notion of growth took hold. This was a way to participate in the amazing growth engine of the U.S. economy.”

Shortly after the market’s seminal move in 1958 came the go-go years of the 1960s, followed by the Nifty Fifty period in the early 1970s. Growth investing was where the action was and, despite several sustained value rallies, it dominated equity investing for the last third of the last century.

“Young people don’t remember when dividends really mattered,” Bernstein observed. “When I started in this business [in 1951], people lived on their dividends.”

A larger question that cuts to the heart of American corporate finance is whether free cash flow should be reinvested or paid out as dividends. “Management says they need the money,” Bernstein noted sardonically. But the former U.S. Army captain who spent part of World War II serving in the Office Of Strategic Services (the Central Intelligence Agency’s predecessor organization), admits to being stumped in figuring out what they spend it on.

True, companies may use earnings to repair balance sheets or to fund future acquisitions. “The cost of retained earnings capital appears to be

near zero because managements can use it for anything they want,” Bernstein told the audience at the JP Morgan Fleming meeting. If he’s right, then the return on retained earnings capital also would approximate zero.

It certainly is true that many companies have only a few really good ideas that cost surprisingly little, and lots of mediocre projects that get expensive fast. Take Microsoft, the model Information Age business. Twenty-five years ago Microsoft paid consultants \$10,000 to create the DOS operating system, which gave it a huge competitive advantage over all other PC software makers. These days it will spend tens or hundreds of millions to produce a marginally better spell-check program.

Then there is the managed earnings issue. Anyone who read *Barbarians At The Gate* was stunned learning about KKR’s Henry Kravis meeting with the head of the Nabisco unit of RJR Nabisco. The executive told Kravis his biggest challenge was coming up with ways to spend about \$400 million to depress earnings, so RJR Nabisco could give shareholders nice smooth 15% annual earnings growth. That’s a different kind of burn rate than the one that Internet companies made famous at the turn of the millennium, but it’s squandering capital nonetheless.

Bernstein cited the 1980s swashbuckler, Boone Pickens, who urged companies to borrow and leverage up their balance sheet because the cost of capital “is real.” Debt, as Michael Milken and other junk bond aficionados proclaimed in that era, forced corporate managements to discipline their operations.

And any constraint that forces businesses to accept a higher hurdle rate for capital spending projects inevitably improves the rate of return on invested capital. This is the underlying thesis of a bold prediction Bernstein made that night in Oak Brook. “Companies with higher [dividend] payout ratios will have higher earnings growth rates in the next five years,” he said. “The evidence is very powerful.” In fact, he noted that Cliff Asness and Robert Arnott won the Graham and Dodd award for an article in the *Financial Analysts Journal* proving that lower payout ratios lead to lower earnings growth rates.

Two companies Bernstein cited that have displayed impressive growth despite their size and generous payouts are GE and IBM. GE’s payout ratio has averaged 40% for decades and it raised the payout in the 1990s. In the 1950s, IBM managed to pay out more than 20% of net income and grow at 20% even though its business was extremely capital intensive, because it leased its computers instead of selling them. By 1981, its dividend amounted to 81% of its 1956 share price.

Searching for an answer to the dividend paradox almost certainly finds its origins with the growth stock boom that started in the late 1950s and

1960s. Bernstein quotes his wife, Barbara, as saying that today's generation doesn't respect dividends for the same reason many people no longer prefer fresh-squeezed orange juice—because they're only familiar with the frozen kind. "Shareholders prefer that companies use earnings to lift share prices rather than pay dividends," Bernstein said.

That's all very nice, but he reminded attendees at the JP Morgan Fleming dinner that companies can't use earnings to raise share prices. In fact, no one can make the market do anything on a sustained basis. It marches to the beat of its own drummer. Bernstein recalled that between 1955 and 1961, earnings for the Standard & Poor's 500 Index fell 12% while the index rose 59%. Fast forward to the 1969 to 1974 period, and earnings rose 54% while the index slipped 26%.

What a 20-year bull market has caused this generation of investors to forget is that, in Bernstein's view, the difference in risk between dividends and capital gains is enormous. "Dividends are known, and earnings per share are not known," he remarked, with a eulogy for Arthur Andersen. "What you see [with earnings] is not necessarily what you get."

Bernstein argued that this explains why John Burr Williams created his famous valuation model, the dividend discount model, around dividends rather than earnings. Between 1871 and the late 1950s, dividend yields typically fluctuated between 4% and 6%. In 1949, the S&P 500 yielded 6%; during the next eight years, when earnings rose 80%, the yield still stood at 4.4%. Going back a long way in time, Bernstein said it's hard to find a sustained bull market that began with the S&P yielding less than 4%.

What are the implications of this thesis? If the current 1.7% S&P yield hardly provides a springboard to a new bull market, the new tax equilibrium between dividends and capital gains raises the risk premium for equities, as TIAA-CREF's research director Martin Leibowitz has described in an article in last September's *Financial Analysts Journal*. Leibowitz also noted that since taxes on interest income remain at old levels, it gives equities yet another advantage.

Ever since the bubble burst in March 2000, many financial commentators have engaged in a great deal of hand-wringing about how the equity investing culture engendered over the last two decades has pushed price/earnings multiples up and simultaneously pushed the equity risk premium down. As Bernstein explained in the May 15 edition of his newsletter, the new tax rate on dividends causes the tradeoff between stocks and bonds to tilt even further in equities' favor. If interest rates rise, as is universally anticipated, the equity risk premium should climb concomitantly since it is one component of the risk premium. "Changes this radical should ignite a big shift in investor preferences," Bernstein wrote to subscribers.

All these cross currents can challenge even the best investment minds. Equities remain richly valued even after spending the last four years going sideways at best. Yet bonds, in the words of Morgan Stanley strategist Byron Wien, resemble the Nasdaq at 5,000. Bernstein acknowledged what many other savants have predicted; that it's quite likely we're in for a period of lower returns from financial assets.

J. Michael Martin, principal of Financial Advantage in Columbia, Md., and a former contributor to Financial Advisor (before he was overwhelmed by the growth of his practice), believes it's a time for advisors to try hard not to lose clients' money. Some of his clients are starting to complain about \$150,000 cash balances in their accounts, a trend that partially validates the strategy for him. Bernstein himself remarked that cash, like dividends, gets less respect than it may deserve.

A former director of equity research at T. Rowe Price & Associates, Martin suspects that nominal ten-year returns for equities probably are about 7%, and near 6% for corporate bonds, with inflation at 3.0% or 3.5%. "But you'll probably have to put up with some minus-20% years with stocks," he says. "If the yields on corporate bonds were 6% and the yields on stocks were at 4%, I'd take stocks because they can grow the dividends."

How much companies will raise dividends remains the big wild card. Brian McMahon, president and chief investment officer of Thornburg Investment Management in Santa Fe, N.M., believes there is a lot of room on the upside.

It's a sign of the times that McMahon, who spent most of his career managing and supervising fixed-income portfolios, now is looking for dividend-paying stocks for the company's Income Builder fund. To paraphrase Willie Sutton, if someone is seeking income today, they have to go where the income is. And where it has room to grow.

The sector that McMahon has weighted most heavily is energy. He believes the world's two largest energy companies, ExxonMobil and British Petroleum, which currently yield 2.5% and 3.1%, respectively, have the ability to increase their dividends by 50% as long as the price of oil stays above \$30 a barrel.

Additionally, he thinks that companies like ExxonMobil, which has directed free cash flow into share repurchases in recent years, are reconsidering channeling the funds into higher dividends. To some extent, that is already happening. As Bernstein noted at the JP Morgan Fleming meeting, dividends in 2004 are up 8%, compared with an average of 4% annually between 1990 and 1999.

Evidence produced by McMahon reveals that not only are dividend payout ratios relatively low by historical standards but so is the

percentage of companies paying dividends. The payout ratio of companies in the S&P 500 remains near a 60-year low, at below 40%, while only 60% of the companies in the Russell 1000 paid any dividend at the end of 2002.

So energy companies aren't the only ones with upside potential for payouts. In fact, evidence compiled by Thornburg finds several industries offer far greater prospects for dividend growth including technology, health care, financials and consumer staples.

So what could derail a renewed focus on dividends and equities as income investments? As Bernstein mentioned, dividends have no constituency. If the Democrats were to regain control of the White House and/or Congress and seek to shrink the unprecedented budget deficits, raising taxes back to their former levels might make an inviting target.

But there are reasons why they might not. Even after the reduction to a 15% tax rate, the United States is the only major industrialized nation to impose double taxation on dividends, creating inequities for American shareholders. While it's difficult to imagine bureaucrats at the World Trade Organization or the European Union complaining about the inequities imposed on American investors, more economists are examining it.

Even before lower dividends became law, some corporate managements indicated that with growth prospects less buoyant than in the '80s and '90s, higher payouts were a real possibility. Of equal importance is an embryonic constituency that could materialize for dividends—baby boomers approaching and entering retirement. More Americans than ever are invested in equities, and if the dividend component of total return rises while the capital gains component declines, even these oblivious investors might awaken to the attraction of equities as income vehicles. Unlike bonds with fixed coupons, dividends can provide a measure of safety from the corrosive effects of inflation.