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- [Markets](#)
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SPEAKING OF DIVIDENDS

Spicy Payouts

Boomers' delights: growth stocks that yield 2%-5%

By **SHIRLEY A. LAZO**

ON APRIL 18, THIS SPACE WAS DEVOTED in large part to what Morgan Stanley's chief U.S. investment strategist, Henry H. McVey, called his "Brave New World thesis" -- that retiring baby boomers are shifting their investment focus toward income and that they'd particularly favor growth stocks with 1%-to-2% dividend yields. But now, he's determined that his theory didn't quite get the story right.

McVey noted that yields had deteriorated. In 1998, for example, retirees' equity investments "generated an average dividend yield of fully 2.6%, versus an average of just 0.8% among younger investors." So, they were hungry for fatter payouts.

However, McVey says that, after his report was published, some boomers and their financial advisers let him know that "the sweet spot for [his] Brave New World thesis is not the 1%-2% dividend-yielding stocks with double-digit earnings growth" that he highlighted in his April piece. Instead, he says in a new report, "these investors are willing to give up a little -- but not a lot -- on the growth front to get more of the proverbial bird in the hand earlier in the game." Thus, the sweet spot, from what he can tell, is "2%-5%-yielding stocks with 5%-15% earnings growth."

McVey says he was amazed at how hard it was to find a lot of stocks in this category, but he still managed to put together a basket of 20, which outperformed the S&P 500 by 4.6 percentage points this year, through late May. Sixty percent of the stocks are in just three industry groups: banks, capital goods, and pharmaceutical and biotech. In his view, they offer the prospect of market-level returns (roughly 13% over the next two years) but with less risk than the broad market. They are:

[Wachovia](#) (ticker: WB), [Wells Fargo](#) (WFC), [Washington Mutual](#) (WM), [Bank of America](#) (BAC), [Masco](#) (MAS), [General Electric](#) (GE), [3M](#) (MMM), [Emerson Electric](#) (EMR), [Harrah's Entertainment](#) (HET), [Kinder Morgan](#) (KMI), [Kellogg](#) (K), [Altria Group](#) (MO), [Procter & Gamble](#) (PG), [Eli Lilly](#) (LLY), [Abbott Laboratories](#) (ABT), [Pfizer](#) (PFE), [Wyeth](#) (WYE), [Genuine Parts](#) (GPC), [Edison International](#) (EIX) and [Exelon](#) (EXC).

McVey found that, "at times when there has been a sudden spike in market volatility, the volatility of this portfolio has typically remained muted." His conclusion: "These stocks offer most of the market's spice, but with significantly less heartburn."

ROBERT WILLENS, LEHMAN BROTHERS' managing director and tax-accounting expert, recently zeroed in on an Internal Revenue Service ruling that makes dividend income even more attractive, from a tax viewpoint, than originally thought.

This one, ruling 2005-31, lets a mutual fund with both domestic and

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foreign shareholders allocate all of its qualified dividend income to the domestic investors, whose dividends are taxed at a maximum rate of 15%. It had been believed that a portion of the qualified dividend had to be allocated to the foreign shareholders, who are ineligible for any such tax break.

Willens provides an example: Say, a mutual fund earned for the taxable year \$10,000 of qualified dividend income, \$10,000 of qualified interest income, \$5,000 of net short-term capital gains and \$5,000 of net long-term capital gains. The fund incurred \$10,000 of general and administrative expenses and distributed \$20,000 to its investors.

Shareholder A, a U.S. citizen, received a distribution amounting to \$20, as did Shareholder B, a nonresident alien. According to Willens, "the first step was to ascertain the maximum amounts the fund could designate as capital-gain dividends, qualified dividend income, short-term capital-gain dividends and interest-related dividends." Except for interest-related dividends (which had to be reduced by the allocable share of the fund's expenses; for this example, the final amount was calculated at \$6,000), it was the gross amount for each variety. The \$26,000 total of the maximum amounts exceeded the total amount distributed (\$20,000), but the IRS ruling concludes, nonetheless, that the fund "may designate each of the maximum amounts, even though the aggregate of such maximums exceeds the total distributions," says Willens.

The second part of the ruling holds that the U.S. shareholder and the nonresident alien "may apply different designations to their distributions." Accordingly, of the \$20 distributed to the American, \$10 consists of qualified dividend income, and \$5 is capital gains -- in each case taxed at the maximum rate of 15%. Only the remaining \$5 is treated as unqualified dividend income. For the nonresident alien shareholder, \$5 is a capital-gains dividend, \$6 is an interest-related dividend and \$5 constitutes a short-term capital-gain dividend. Willens explains, there is no withholding with respect to these elements of the distribution. Only the \$4 balance of the distribution was ordinary dividend income.

The message, says Willens, "is that a mutual fund need not apportion each variety of income to each of its shareholders in strict proportion to their relative shareholdings. Income that is tax-favored in the hands of one type of shareholder can be disproportionately allocated to such shareholder with the result that the aggregate taxes derived from mutual funds, thanks to the IRS's surprising concession, will be minimized."