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FUND FIEND

By IAN MCDONALD

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Latest Dividend-Fund Boom Could Be Boon for Investors

A boom in the number of dividend-focused stock funds sounds about as cool as a combover craze, but so be it.

More than a baker's dozen new funds designed to invest primarily in stocks of dividend-paying companies have either been filed with regulators or are fresh on the market this year, according to Chicago researcher Morningstar Inc.

Most dividend-focused stock funds (there were about 55 with "dividend" or "equity income" in their name before this year) were written off as passé during the heady 1990s, along with other conservative stock strategies like balanced funds that blend stock and bond investments.

But dividends provided a cushion in the bear market, and this year's dividend-tax cut has put hum-drum dividend-focused funds in vogue. More than $3.6 billion has gushed into equity-income funds so far this year, according to fund-tracker Lipper Inc. "Equity-income" includes most though not all dividend-focused funds.

Dividend-focused funds "will become a much bigger part of the funds market," says Randall Merk, president of Charles Schwab Investment Management Inc., which will launch the Schwab Dividend Equity Fund and sibling private managed accounts for high-net-worth investors in September.

A spate of fund launches with "ripped from the headlines" prescience smacks of the marketing gimmickry last seen during the tech-fund glut of the late 1990s. But a look at factors driving this dividend-fund boomlet shows why it's a strategy that might make sense for many of us.

The Beltway Boost: This year's much-ballyhooed tax cut on dividends, part of the Bush

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A CLOSER LOOK AT DIVIDENDS

Higher Dividends Don't Stir Investors: A slew of companies have raised their dividends since Bush's dividend-tax cut, but investors have yet to show more enthusiasm for dividend-paying firms.

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Test Your Knowledge

Who said that when investors choose sector funds, "...they have adopted the ultimate losers' strategy"?

A. Peter Lynch
B. Benjamin Graham
C. John Bogle
D. Alan Greenspan

See answer [below](#).

administration's larger tax-dicing package, makes dividends far more tax efficient for investors. From now through 2008, corporate dividends that you earn via stocks or stock mutual funds will be taxed at 15%, regardless of your income-tax rate. For many investors, this change more than halved their dividend taxes.

Competitive Yields: With interest rates so low, the after-tax yields of a number of stocks are pretty competitive with bond income taxed at your income-tax rate. An investor in the 35% tax bracket would get about the same after-tax yield from a bond yielding 4% and a diversified blend of stocks yielding 3%, for example. Nearly a quarter of the nation's large-cap stocks are paying dividends greater than 3%. Also, with many believing [we're entering a decade of single-digit returns from stocks](#), stocks that offer you a 2% or 3% dividend are tough to ignore.

Seeing Is Believing: Enron never paid dividends, and that's partly why rattled investors and market watchers are smitten with them now. Dividends provide some tangible evidence that a company's profits aren't an accountant's fantasy. While a company could fudge a dividend by borrowing money to pay a dividend to shareholders, it's hard to make that shell game last, as lenders ask why an allegedly profitable company keeps coming by with its hand out.

Everybody's Doing It: Now that dividends equal credibility, companies are boosting the former to get the latter -- in droves. So far this year, 171 companies in the S&P 500 have upped or initiated a dividend, compared with 113 at the same point last year, according to Standard & Poor's analyst Howard Silverblatt. More than three quarters of the index's financial stocks have raised their dividend rate in 2003. There's room for even more dividend growth, given the hope for a stronger economy and the fact that companies in the S&P 500 are only paying out a third of their earnings in dividends, on average. That's down from a 50% payout ratio 10 years ago.

Supply and Demand: Despite the recent stock-market rally and tech resurgence, many investors are more risk averse than they were before the three-year bear market.

A GUSH OF DIVIDEND FUNDS

A roster of 15 dividend-focused funds launched or filed so far this year.

AIM Diversified Dividend*

Cullen High Dividend Equity

Eaton Vance Tax-Advantaged Dividend Income**

Eaton Vance Tax-Managed Dividend Income

Federated Muni and Stock Advantage

First Trust Value Line Dividend**

Hartford Equity Income

ING Global Equity Dividend

Ivy Dividend Income

Neiman Enhanced Dividend

Nuveen Diversified Dividend and Income**

Phoenix Partner Select Growth & Dividend

Schwab Dividend Equity

Scudder Dividend Income

Sentinel Capital Markets Income

Source: SEC filings

* AIM Large Cap Core Equity prior to May 2

**Closed-end fund

"We get a sense of a real sea change," says Michael Mach, co-manager of the nascent Eaton Vance Tax-Managed Dividend Income Fund. "You can build a nice equity-income product with good income and people are interested."

Perhaps many will be. Fund marketers believe the ocean of Baby Boomers will swallow hard as they consider that their cracked nest eggs will have to last 20 to 30 years in retirement. For those who will need both current income and capital appreciation, dividend funds are a handy option.

There are caveats. For one, these tax cuts expire at the end of 2008, unless lawmakers renew them. And income-seeking investors need to remember that stocks usually offer a bumpier ride than bonds, even if they are historically more enriching over time.

Additionally, dividends aren't an automatic divining rod for finding great businesses or stunning returns. While dividend-paying stocks in the S&P 500 beat non-payers from 1980 through the start of this year, according to S&P data, non-payers tend to rise highest in bull runs. They're up 32% on average since Jan. 1, for example, compared with 14% for dividend payers.

If, despite these concerns, you're interested in adding a dividend-focused fund to your portfolio, you might be well served to look past the spate of shiny, new offerings.

Perhaps the only good thing about the fund industry's overwhelming glut of choices is that there's no need for you to sink money into any fund without a track record you can inspect. At a site like morningstar.com, you can screen for large-cap stock funds that have above-average yields, weathered the bear market well, and sport long manager tenure and low expenses.

Stress-tested options include the $8.2 billion American Mutual Fund, the $2.5 billion Vanguard Equity-Income Fund and the $11.4 billion T. Rowe Price Equity Income Fund. Each has made money over the past three years, topping the S&P 500 by more than ten percentage points annually on average.

As you might imagine, dividend-fund vets aren't too pleased with a glut of new competitors.

"You can't print what I think about it," jokes John Snyder, who has primarily invested in dividend-paying companies since he started running the John Hancock Sovereign Investors Fund 20 years ago.

Still, if firms are clogging their pipelines with humble, low-turnover funds focused on companies with a knack for churning out higher dividends, that's my kind of mania.

Janus Team Follows Boss Out the Door

When Sandy Rufenacht, well-regarded manager of the Janus High Yield Fund, left the Denver firm last month to start his own shop, he wasn't sure if his junk-bond team at Janus would join him.

Well, they did.

Analysts Craig McMullen and Adrian Shopp, as well as trader Mary Cooper, left Janus last month "by mutual agreement," the company confirms. Mr. Rufenacht's replacement, Michael Buchanan, is now hunting for new staffers while other fixed-income analysts and traders pitch in.

Mr. Buchanan, fresh off a meet-and-greet tour of top clients, plans to hire three junk-bond analysts and one trader soon.

"We view their departure as an opportunity to build an even stronger high-yield team," wrote Janus spokesman Blair Johnson in an e-mail.

The Answer Is…

The answer is C., Jack Bogle, who made the comment in a 2001 speech. Last Thursday Vanguard, the firm he founded, filed paperwork to launch, you guessed it, ten index-based sector funds. These funds carry a $250,000 minimum investment, which should discourage performance-chasing Main Street investors, but they'll also offer an exchange-traded class of shares. These shares will trade like stocks and have no minimum investment. The firm hopes to launch the funds in the fall.

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