***Ruminations*© – November 2009**
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Dividends Do Matter – A Lot

With investment-grade stocks, as measured by the Standard & Poor's 500, now providing a dividend yield of just two percent, dividends have become a diminished factor in the investment equation. Many investors, who focus mainly on price appreciation, don't seem to mind the low yield and the same disinterest shows up in corporations, which in aggregate have sharply reduced the proportion of earnings they pay out in dividends during the past fifteen years.

Yet dividends are important. As the consulting firm, Cambridge Associates, said in a September 2009 report, "Dividends have always been (and will always be) the main determinant of equity returns, as they are the primary method by which companies return profits to shareholders…The long-term record for dividends has been quite impressive. They have accounted for an average 39% of quarterly S&P 500 total returns since 1900." In fact, *all* the long-term outperformance of stocks versus bonds has come from dividend payments.

Over the years, stocks have appreciated in price exactly in line with the average annual 6% growth in earnings per share, and dividend yields have averaged 4.5% per year, making the annual total return 10.5%. So dividends are not just the frosting on the cake; they are the whole top layer of the cake.

Given that powerful evidence, why are dividend yields now less than half their long-term average? There are three reasons. First, stock valuations are higher than their historical norm. After the big market rebound of the past eight months, the S&P 500 is selling at twenty times estimated 2009 reported earnings, which are depressed by the continuing Great Recession. That multiple is 40% higher than the long-term average p/e ratio of 14.5. Higher prices mean lower yields.

Second, the extreme financial crisis and economic slump of the past two years did cause a large number of dividend cuts, far more than in the less-severe recessions of the past forty years. Not surprisingly, the biggest and most widespread reductions have come in the large financial sector, which accounted for over one-quarter of all the S&P 500's dividends in 2006.

Dividends & Earnings Reductions – S&P 500

	Current Recession	Average of Previous Post-1970 Recessions
Dividends	- 26%	- 10%
Earnings	- 47	- 36

Third, as I've said, many corporations radically changed their dividend payout policies starting in the mid-1990s, greatly reducing the proportion of earnings they pay to shareholders.

<u>Dividend Payout Ratio – S&P 500</u>
% of Earnings

1984-1994	50%
1995-1998	37
1999-2007	31
2008	57 *
2009	37

* Payout on depressed earnings that were 42% below 2007 earnings

Why did many managements (and their compliant directors) cut payout ratios so much? The answer is simple: an effort to jack up earnings per share by using large amounts of net profits to buy in outstanding shares. There are three ways to boost EPS: 1) achieve genuine business growth and control costs effectively, 2) stretch accounting rules to the limit to "dress up" earnings, and 3) repurchase shares.

All three became increasingly important to business executives in the mid-1990s as large stock option programs became their primary source of compensation, often three-quarters or more of their total paychecks. The shift from cash compensation to big stock awards was stimulated by passage of a federal law in 1993 limiting the corporate tax deductibility of cash salaries to $1 million. The goal was to hold executive compensation at "reasonable" levels, but in one of those classic unintended consequences, instead it unleashed a massive surge in stock option awards and total pay.

As a result, to maximize their personal benefit from their large share ownership, the Holy Grail for many executives became pushing up the price of their stock by engineering big gains in earnings per share. To help accomplish that, the mathematics of stock repurchases are a powerful tool. If a company reduces its shares outstanding by 10% and net profit remains unchanged, earnings per share on the reduced amount of stock become 11% greater. And a 20% share reduction boosts EPS by 25%.

As buybacks gained momentum, most of the current cash flow not used for capital expenditures and flatter dividends was employed for share repurchases. But by the early 2000s that wasn't enough for many managements, so they began to issue debt to pay for ever-larger repurchases. Interestingly, the prices of company shares were not a concern; in managements' eagerness to boot-strap earnings, the higher the stock market rose, the more shares they bought in. And these programs, which included purchases to offset new stock issued for option grants, began to far outpace dividend increases, as shown on the next page:

Annual Dividends & Share Repurchases
S&P 500 -- $ Billions

	Dividends	Share Repurchases	Repurchases % of Div's	S&P 500 Price
1998-2003 (average)	140	140	100%	1200
2004	170	210	124	1130
2005	200	320	160	1250
2006	220	440	200	1300
2007	250	595	232	1450
2008	265	295	111	1050
2009 (6 mos. annual rate)	200	110	55	900

So corporate executives acted just like dumb investors, buying more stock at higher prices – and then as their earnings and cash flow fell in the recession and fears about the stock market developed, they sharply reduced repurchases – just when stocks reached bargain-basement valuations. For example, in its 2008 fiscal year, Cisco cut its buybacks by two-thirds after its stock had fallen from an average price of 30 to an average of 20. For most companies doing repurchases, this has been a really sorry performance. It hurt shareowners by dissipating valuable cash resources, by leveraging up balance sheets, and by short-changing investors on dividends. And the unfortunate fact is that no definitive evidence has been developed, to my knowledge, to show that the buybacks produced any lasting boost to share prices. Whether the obvious lessons from this foolishness will be learned remains to be seen – although at the moment companies are spending much less and building their cash balances.

One reason for the bad decisions made by companies on share repurchases is a widespread misunderstanding – among corporate executives and most investors – about the true benefit of dividends, not only in their large contribution to total investment returns, but also internally in companies' financial management.

Dividends are both a report card and a source of fiscal discipline. If a company performs well and earns high profits, it can afford to pay substantial dividends to reward its owners. Winners can pay generous dividends, laggards can't. Moreover, if dividends represent the first priority for use of profits, as they do in a truly responsible company, the remaining cash flow from operations must be handled wisely – either being retained to strengthen the company's finances, or being invested in new facilities that will earn a return equal to, or more than, that on the firm's existing assets.

But companies that pay low dividends, or none at all, often find that their flood of retained earnings is burning a hole in their pockets, and they tend to make inferior investments as they press to put their excess cash to work. There are countless examples of this undisciplined, empire-building folly. Motorola is a case in point.

Started as a successful producer of automobile radios in the 1930s, Motorola evolved logically into television sets and two-way radio communications equipment for fire and police departments, and taxi fleets after World War II. Then the transistor was invented and the company eagerly entered the semiconductor field in the 1960s. It lacked the technical capabilities of the two pioneers there, Texas Instruments and Intel, but Motorola was paying out only one-quarter of its earnings in dividends, so it had plenty of money to pour into the enticing new growth market.

To make a long story short, Motorola never could quite make the grade in semiconductors, and many years and many billions of dollars later, it finally bailed out of the business in 2004. Now, owned by a private equity firm, that operation still is barely staying afloat.

Meanwhile, Motorola spent far less money using its very good radio skills to build lasting strength in the burgeoning cell phone market. So after brief initial success there, it's now a struggling also-ran. The net result is that the company has evolved from an early leader in electronics to one of the walking dead – with its operations deeply in the red and its stock down 85% from the high of ten years ago. Now shareholders are praying that the latest in a long line of new CEOs can somehow revive the company from its collapse due to lack of financial discipline.

The lesson from Motorola and countless other underachievers is clear. Much of the time acquisitions and investments in new businesses are far less profitable than a hitherto-successful company's existing activities. Therefore, shareholders will benefit much more by receiving a greater proportion of *their* profits in cash dividends. Then, they can either spend the money or reinvest it in other successful companies that don't dribble away retained earnings in marginal ventures.

So where will corporate dividends go from here? A change back to former payout ratios will only occur if many investors make a concerted effort to persuade managements that boosting payouts would be beneficial to everyone. But there's a big barrier to such a switch. Today the bulk of stocks, some two-thirds, is owned by institutional investors who generally have a very short-term focus and who don't care whether stocks have good dividend yields or not as long as their prices rise, they hope, in the near future. And where institutions, like endowments, need current income they're happy to spend some principal. Many individual investors want higher dividend payouts but they have little means of expressing their views forcefully as a group.

Therefore, the bulk of investors are just going along with managements' wishes, and the realistic expectation is that low dividend payout ratios and yields will continue indefinitely. As demonstrated, this is bad for overall investment returns; so how does the alert investor cope with the problem? The only way is to concentrate on companies that do have sensible dividend policies. The following table, published by Hanson Investment Management (based on data from Ned Davis Research) shows the great advantage of owning good dividend payers:

Average Annual Return: 1/31/72 – 9/30/07

Dividend Growers & Initiators	10.9%
Dividend Payers with No Change in Dividend	8.9
Dividend Cutters or Eliminators	3.9
Non-Dividend-Paying Stocks	2.5

Two things stand out in these numbers. First, even paying flat dividends has produced pretty good returns. So dividends per se are a positive factor, even if they don't grow. Second, the old theory that rapidly growing businesses with apparent needs to retain all their earnings to finance growth can be good investments, is put in question by the last line. The returns from non-dividend payers in aggregate have been awful. And the data in the table are corroborated by a 2003 study by Robert

Arnott and Clifford Asness showing that companies with high dividend payouts typically experience a higher level of future earnings growth than firms with low payouts.

So that's where to put your money. Corporate generosity in dividends does pay off. With overall dividend yields now two and a half percentage points below their long-term average, future total returns from stocks in aggregate are certain to be lower than in the past. So the old advice from the noted bank robber Willie Sutton makes great sense, "Go where the money is." That is, the remaining good dividend payers, those with decent yields and the ones that raise their payments every year, or those that may initiate them in the future.

We are happy to be able to provide you with Ruminations. Please be aware that while Mr. Perry is a member of our Advisory Board, he is not an employee and his opinions are his own and not necessarily those of Marble Harbor Investment Counsel, LLC.

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