June 30, 2011

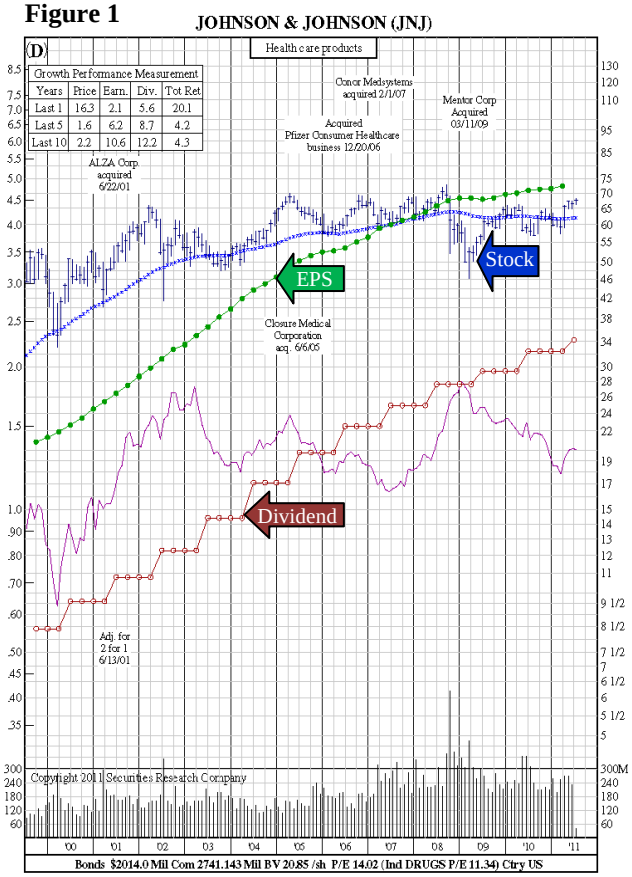
The Alchemy of Dividends

Over the long run, the dividend is the most important factor controlling shareholder value.
–Benjamin Graham

With the increase in average life expectancy during the past 25 years, and the current low interest rate environment, high dividend/cash returns have become increasingly important for both younger accumulators as well as mature, retired individuals. In the past two years a number of noted investors, including Warren Buffett, Bill Gross, and Ralph Wanger have suggested that historical S&P 500 investment returns of 9% will be much more difficult to attain in the future. Inflation remains a concern as well.

> According to Bloomberg, $100 saved by the end of 1988 was "worth" only $56 by the end of 2009. Investors may wish to take into account such changes as they estimate the potential returns of their portfolios, and consider incorporating inflation hedges into their investment strategy.[1]

Figure 1



Investors looking for higher yields and investment returns are faced with a problem: How does one invest in such an environment without increasing investment risk? Benjamin Graham, (1894-1976), the father of value investing, provides provocative insight: invest in strong, dividend paying companies.

Corporate dividends can act as a buffer against inflation. As many corporations have "pricing flexibility" they can increase prices to offset price increases of raw materials and production costs. This offset can be passed on to the investor as increased dividends. **This ability to transmute earning increases into cash dividend increases is the true form of alchemy**. Earnings are converted into the golden purchasing power of the cash dividend.

Figure 1 demonstrates the relationship between earnings and dividend growth of one of America's outstanding companies, Johnson & Johnson (JNJ). For the decade, earnings increased at 10.6% and dividends at 12.2% doubling about every 6 years. (Dividend per share JNJ Yr. 1999 $ .50 vs. Yr.2010 $2.28)

[1] Levine, Richard; Matthew Rubin and Tom Marthaler. *The Inflation Revival: Is it Time to Recalibrate Your Portfolio?* Neuberger Berman Group (June, 2011) https://www.nb.com/wealth/insights/inflation

During periods of financial crisis and prolonged economic slowdowns, such as the Great Depression and the recent Great Recession, dividends paid by solid companies are perhaps the best way to protecting purchasing power and cash flow. To paraphrase Warren Buffet at the 2010 annual Berkshire Hathaway meeting: during a depression the best thing is to own your own business. If not, then own businesses with good cash flow.

Over the long-term, studies have shown that companies which pay dividends have substantially outperformed non-dividend paying companies.

> The year 2009 was a good test of this, as it was the worst year for dividend cuts since Standard and Poor's started keeping tabs of this in the 1950's. Yet well-managed companies made it through this period without cutting their payouts. Some even managed to maintain their dividend increases.[2]

As Ben Graham noted the dividend is the most important factor controlling shareholder value. In more recent years, however, a combination of factors has reduced the number of dividend paying companies.

For nearly a century, until 1993, dividends drove shareholder returns.[3] During this extended period, corporations in the US paid out nearly half of their earnings to the shareholders. Tax policy and management/boardroom mentality were significant factors in the ongoing dividend payout level. Many corporations still had meaningful family ownership, family board members, and senior (family) executives with significant stock ownership. As major shareholders, they had a vested interest in the business and, a substantial portion of their personal income was derived from the company dividends.

In the 1980's, under the Reagan administration, significant federal tax reform took place, reducing the long-term capital gains and dividend tax rates from 28% to 20%. It is well known that tax policy plays a significant roll regarding investor's and management's behavior. With capital gains further reduced, in 2003, to 15%, and dividend payout rates reduced from 44% to 29%[4], dividends became less compelling to management.

A second and more subtle factor also changed the attitude of corporate dividend policy at the corporate management level. The decades from 1970-1990 witnessed a general transition from generational "family" management towards "professional" management. This transition fundamentally changed the relationship between a company and its management and the basis on which management evaluated personal interest.

As professional CEOs replaced family executives, *salaries and stock options*, rather than company dividends, became the bulk of executive pay. Executive (CEO) compensation in 1960 averaged approximately 50X that of the average work force vs. 350X by 2007. (Figure 2)

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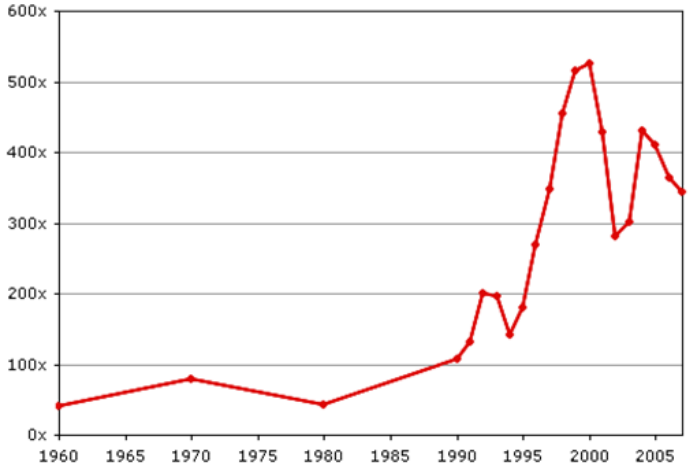
[2] Andersen, William. *Dividend Investing Today*, 2011.
http://www.andersen-capital.com/files/ACMDividend%20Investing%20Today2011.pdf

[3] Wanger, Ralph. *Dividends: Please Sir May I Have Some More*, Columbia Acorn Funds, (2007)
http://www.scribd.com/doc/31150411/Dividends-Please-Sir-May-I-Have-Some-More-012507-Ralph-Wanger

[4] Hough, Jack. *What Dividend Neglect Says About Stocks*, SmartyMoney.com (June 3, 2011)
http://www.smartmoney.com/invest/stocks/what-dividend-neglect-says-about-stocks-1306529341429

Figure 2: CEOs' pay as a multiple of the average worker's pay, 1960-2007

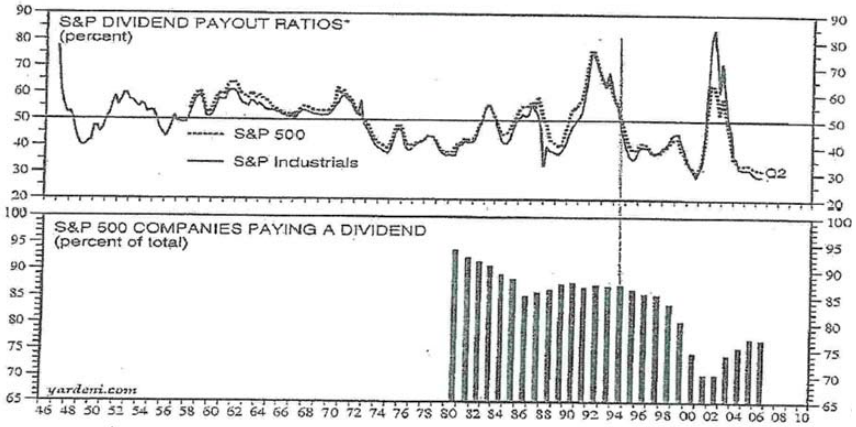


Source: *Executive Excess 2008*, the 15th Annual CEO Compensation Survey from the Institute for Policy Studies and United for a Fair Economy.

Additionally, their focus became much more performance oriented and short term in nature. During the bull market of the 1990's, many CEOs and Directors began to issue more stock options to themselves, taking advantage of both the bull market and the lower capital gains tax rates. Furthermore, by retaining corporate earnings for reinvestment, rather than distributing dividends, executives increased corporate earnings and stock prices, enhancing the worth of their stock options. The result is that, rather than the 50% historical dividend payout ratio, today's corporations pay a stipend of about 30%. (Figure 3)

Figure 3

The average dividend payout ratio (using reported earnings) dropped from 55% during the 1950s and 1960s to 44% during the 1970s, 43% during the 1980s, and 41% during the 1990s. The percentage of S&P 500 companies paying dividends increased from 70.2% in 2002 to 77.0% in 2006, about the same as in 2005.



* Four-quarter trailing dividends per share divided by four-quarter trailing reported earnings.
Source: Standard & Poor's Corporation and FactSet.

As a result, many investors and investment professionals have focused on growth for investment returns in the past three decades. But PIMCO's "new normal" of higher taxes, lower GDP growth, and higher monetary inflation, must, once again, shift the balance in favor of dividends.

Foreign companies have, on average, paid significantly higher dividends than domestic (US) companies. Global investing in strong, well managed, cash flowing companies, which pay high dividends, has become increasingly important. A number of well-managed foreign firms' have dividend yields between 6% and 9%. (The current yield of the S&P 500 is 1.9%)

Portfolio holdings in countries with a strong currency have the added benefit of hedging against a weaker currency, which may offset a potential future decline in the US dollar. For risk management, portfolio construction should consist of multi-country holdings as well as multi-sector holdings.

There are a very limited number of professionals with the skill set necessary to select the foreign countries, sectors, and companies in which to invest. They must identify those businesses:

- that have a high dividend yield,
- that will continue increasing dividend payout,
- that are high cash flow, lower risk, investments, and
- that have inflation protection characteristics.

As we allocate capital in this changing global economic environment, the wisdom of Benjamin Graham still is relevant. Shareholder value, expressed through higher dividends, is increasingly more important to many investors. Where appropriate, we will strive to utilize global managers and analysts who can identify and select global, shareholder friendly businesses, applying the alchemy of transmuting corporate earnings into meaningful cash dividends.

- Roger L. Johnson