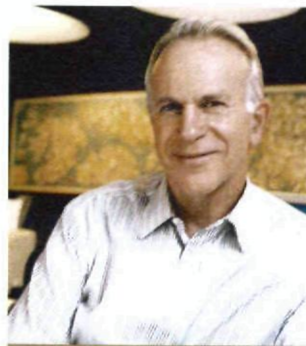
Why I ♥ DIVIDENDS

AMERICA'S businesses are awash in unprecedented pools of cash. The liquid assets of the 374 nonfinancial firms in Standard & Poor's 500-stock index totaled $633 billion at the end of last year. That's about $1.7 billion each, or fully 7% of their average market value. And what are corporations doing with all that dough? Much of it—*too* much, in my opinion—is being stashed under the mattress.



OPENING SHOT
by James K. Glassman

Money hoarders. Companies returned only 32% of earnings last year to their corporate owners (that is, you and me and other shareholders) in the form of dividends. That payout ratio is puny compared with the 50% average that prevailed from 1950 to 1989. And managers can no longer use onerous double taxation as an excuse for not bestowing some of the cash on the people who own their businesses.

Yes, dividends are still taxed twice. Corporations generally pay a 35% federal tax on profits, and shareholders pay a tax on the dividends those corporations distribute to them. But in 2003, Congress and the President agreed to slash the top dividend tax rate for shareholders from 35% to 15%; in May, the reduction was extended through 2010.

In 1980, all but 31 of the companies in the S&P 500 paid dividends. For the next 23 years, the number of non-dividend payers steadily increased. The tide turned in 2003, but at the end of last year 115 of the 500 still paid no dividend. Of those that did, three-fourths either increased or began a dividend in 2005. Some dividend hikes have been stunning. **Coca-Cola** (symbol KO), for instance, went from paying 72 cents a share in 2001 to $1.24 this year, and Wal-Mart Stores (WMT) went from 28 cents to 67 cents over the same period.

The average S&P 500 stock's yield (annual dividend payout divided by stock price) was just 1.1% in 2000. Today, the yield is 1.9%. Still, that's far below the average of 4.2% since 1926, as calculated by Ibbotson Associates. As recently as 1991, the S&P yielded 3.8%; in the early 1980s, yields averaged more than 5%.

> **"Dividends force managers to make the case for reinvestment. That's a very good thing."**

You may wonder why I am passionate on the subject of dividends. First, they make you richer. In a study earlier this year, Eaton Vance Corp. pointed out that "approximately 65% of the return on stocks has come from the compounding of reinvested dividends." Even before reinvestment, over the past 80 years dividends have represented about two-fifths of the annual return achieved by the average S&P 500 stock.

Second, dividends are the most revealing indicator of a company's success—better than earnings per share or return on equity. The economic textbooks say that the value of any firm depends on its flow of cash, not on any particular accounting entry. Without a dependable cash flow, a business can't pay a good dividend. Reducing or eliminating a dividend is a terrible embarrassment to managers and usually a long-term blow to a stock's price, so companies tend to raise payouts in a conservative fashion. They want to be sure they won't have to backtrack. In a world of financial hocus-pocus, the dividend is one figure you can rely on.

Four out of five executives surveyed by Eaton Vance said they think that a firm's dividend growth rate can give investors confidence in a company's projected long-term growth potential. It's true. Companies that raise their dividends consistently tend to outperform the market as a whole. For that reason, a wise strategy is to invest in companies that have increased their dividends over long periods. Such firms seem to have found a stable, profitable market niche—a "moat," or defensive perimeter, around their business that discourages competitors.

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Where to find 'em. Several exchange-traded funds (ETFs), mutual funds and closed-end funds now focus on these companies. **SPDR Dividend** (SDY), for example, is an ETF based on an index developed by Standard & Poor's called High Yield Dividend Aristocrats.

The index first identifies companies in the S&P Composite 1500 universe (which includes large-, mid- and small-cap companies) that have raised their dividends for at least 25 consecutive years. (At the end of last year, there were only 85.) The index then picks the 50 that have the highest dividend yields. Among these companies are ConAgra Foods (CAG), currently yielding 3.3%; Bank of America (BAC), 4.2%; and Vectren (VVC), an energy utility in Ohio and Indiana, 4.7%.

Another ETF, **PowerShares High-Yield Dividend Achievers** (PEY), has a portfolio consisting of 50 companies (among 11,000 listed firms) that have raised their dividends for at least the past ten years in a row. Holdings include Sara Lee (SLE), packaged foods, currently yielding 4.6%; Merck (MRK), pharmaceuticals, 4.4%; and Otter Tail (OTTR), plastics and health care, 4.3%. Overall, the PowerShares ETF currently yields 3.4%, and the SPDR fund, managed by State Street Global Advisors, yields 2.9%.

The largest of the rising-dividend ETFs, **iShares Dow Jones Select Dividend** (DVY), has a portfolio composed of more than 100 companies with a five-year payout ratio of no more than 60%, a flat to positive dividend growth rate and above-average yields. The fund is heavily invested in utilities, with holdings such as DTE Energy (DTE), which currently yields 5.1%, and banks, such as PNC Financial Services (PNC), currently yielding 3.2%.

All three of these ETFs have brief histories. But since its inception more than two decades ago, the Mergent Broad Dividend Achievers Index has whipped the market soundly (the PowerShares fund tracks the Mergent Dividend Achievers 50 Index, a subset of the broad index). An investment of $10,000 in the index in January 1983 would have grown to $211,447 by April 30, 2006, while $10,000 in the S&P 500 would have grown to only $166,728. A fourth ETF, **Vanguard Dividend Appreciation Vipers** (VIG), launched in April, carries the lowest expense ratio in the group at just 0.28%. The others are at or below a half-percentage point.

In contrast, the best of the managed mutual funds in the category—**Franklin Rising Dividend** (FRDPX), **Fidelity Dividend Growth** (FDGFX) and **T. Rowe Price Dividend Growth** (PRDGX)—have expense ratios of 1.1%, 0.66% and 0.75%, respectively. (Franklin charges a sales fee, to boot.) But on the plus side, these funds have lengthy and impressive track records. For instance, over the ten years to June 1, the Fidelity fund beat the S&P 500 by an average of 1.2 percentage points per year, and at lower risk levels.

Dividend-paying stocks not only produce attractive returns but also provide ballast in rough market seas. S&P research found that between 1926 and 2004, the price of an average stock rose 19% in years when the market as a whole was up and fell 15% in years when it went down. That's a lot of volatility. But dividend payers performed nearly as well in bad markets as they did in good ones: Yields averaged about 5% in up years and 4% in down years. Most stocks in rising-dividend indexes have proved less volatile than the market as a whole.

So why don't investors demand much higher dividends? Two reasons. First, they think companies that pay dividends are dull. The big money, they believe, is made when a stock's price shoots up, when in fact, slow and steady wins the investment race.

Second, Americans remain in the dark about taxes. Eaton Vance sponsored a survey that found that only one in six investors knew in late 2005 that the maximum dividend tax had been cut to 15% in 2003.

My guess, however, is that awareness of the tax advantage will grow and that dividends—and the companies that issue them liberally—will become more popular with investors. This demand will lift the prices of such stocks.

It's your money. After all, paying a sizable dividend is good corporate governance. The practice gives shareholders a significant say in what to do with a company's profits. When a company returns half of its earnings to its owners, those owners can spend the money, reinvest it in the stock or invest it elsewhere. Dividends force managers to make the case for reinvestment. That's a very good thing. Equally important, dividends prevent self-aggrandizing CEOs from building empires at the expense of shareholders. As Peter Lynch wrote in *One Up on Wall Street,* "Companies that don't pay dividends have a sorry history of blowing the money on a string of stupid diversifications." K

STOCKS Five favored dividend payers

Last year, Standard & Poor's launched an index comprising the 50 stocks with the highest yields among all companies in the S&P 1500 that have increased their dividends for 25 years in a row. In March, S&P listed 12 of the stocks it particularly favored—all of them ranked four or five stars. Glassman likes these five as well.

COMPANY	SYMBOL	SECTOR	PRICE-TO-EARNINGS RATIO*	YIELD
Coca-Cola	KO	Beverages	18	2.9%
Johnson & Johnson	JNJ	Pharmaceuticals	16	2.4
Procter & Gamble	PG	Consumer products	19	2.3
RPM International	RPM	Paints, sealants	12	3.5
U.S. Bancorp	USB	Financial	12	4.2

Data to June 19. *Based on earnings for the next 12 months.
SOURCES: Standard & Poor's, Yahoo.

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