



DIVIDENDS

Despite the exceptional contribution to investment returns historically provided by dividends, it has been many years since we have heard as much about the subject as we have recently. Proposals for a relief from the double taxation of dividends are only bringing us back to what has always been a critical element of an investor's total return.

Historically, dividends were seen as proof of a company's profits, as a source of income to "capitalists," which we all become when we retire, and investors knew that you could not fake a dividend check. It either bounced or it cleared! As Alan Greenspan said recently, "Prior to the past several decades, earnings forecasts were not nearly as important a factor in assessing the value of corporations. Instead investors tended to value stocks on the basis of their dividend yields."

Market historians will tell you that in the 19th century, companies paid out virtually all of their earnings in dividends. It was proof positive that their reported earnings were real, not an unimportant consideration in the era of the robber barons and market panics. A recent study calculates that during the entire 20th century, fully 61% of the U.S. stock market's 6.7% annual return came from dividends.

into 2000, dividends became less and less important and recent S&P 500 yields have fallen to as low as 1.4% last year while payout ratios fell to less than 35%.

The portion of returns coming from dividends has varied significantly over the past seven decades. During periods of modest total returns from stocks—such as the 1930s, ‘40s, ‘60s and ‘70s, dividends provided most of the returns. Excluding the 1930s, when dividends provided all of the market’s returns, dividend yields averaged roughly 4% and payment ratios were above 100% some years. During these decades, dividends provided over two-thirds of the total return on consumer stocks. We may have returned to a decade of moderate returns in the 2000s after the strongest two decades of market returns in history. If this is true, dividends may provide a significant part of the total return on common stocks for years to come. Not a pleasant thought after what we’ve become used to, but worth considering carefully.

If a new emphasis on dividends means dividend-paying stocks will be outperformers, will total returns necessarily lag long-term averages? We cannot say, of course, but it may surprise you that over the thirty years from 1970 to 2000, dividend-paying stocks outperformed non-dividend paying stocks. How about over the past twenty years, an era of extraordinary market returns due to an extended period of disinflation and prosperity, a period when technology stocks soared to unprecedented heights (and record weightings

During decades when the stock market soared—the 1950s, ‘80s and ‘90s—dividends accounted for just 34% of total return. Dividends became less and less important to investors over the past two decades, a period of extraordinarily high total returns, for a variety of reasons. High returns on “growth” stocks were one of them. Taxes were certainly another. Those of us who have been in the business long enough will remember that the first \$400 of dividend income was tax-exempt to individual investors prior to the removal of that exclusion by the Tax Act of 1986. Since then, dividends have been taxed at the taxpayer’s ordinary rate, 38.6% currently in the top bracket. This gave companies a rationale for dropping payment ratios above 50% historically to roughly 33% today, depending on one’s definition of earnings.

The use of cash flow changed during the 1990s to a clear priority list, as follows:

- (1) Capital spending. Not just maintenance and improved efficiency of existing capacity but all too often the addition of new capacity as well. Adding capacity at what turned out to be peak demand often created depressed industry conditions for years during and after recessions.
- (2) Acquisitions. Strategic or fill-in acquisitions were the bread and butter of many growth companies in the past decade. Some of these were actually the primary

failures from the perspective of the shareholders of the acquiring company. They enhanced the ego of CEOs when shareholders would have been better served by having that excess cash returned to them in the form of a dividend check.

- (3) Share buybacks. The argument for buybacks is that shares purchased in the open market enhanced earnings per share via share count reduction and at the same time supported the share price. In reality, by the late 1990s, many of these share repurchases were used to simply provide for stock options exercised by management with little or no net reduction in shares outstanding. Even worse, companies became less sensitive to what they paid for their own stock, as they were forced to continue to buy by increasing exercise of options. In retrospect, the stocks of many companies doing the largest share buybacks in the late 1990s were poor uses of corporate cash. The stocks are selling at much lower levels today. Again, the investment bankers who worked the buyback orders encouraged this activity.
- (4) And finally, Dividends. Almost as a residual for many companies, dividends were reduced to an afterthought for many of the companies seeking “growth stock” status. Clearly, in the environment of the ‘90s, dividends were equated with a lack of imagination by management—stodgy, boring and definitely not an indication of growth.

Fortunately for some investors, not all companies felt this way. Some were able to grow

What form might dividend tax relief take and what is the potential impact on the Federal budget and, more importantly for us, as investors? Most observers agree that the likely initial proposal would be the complete elimination of taxes on dividends at a cost of about \$25 billion to Federal revenues in 2003 and \$350 billion over ten years. If this is deemed too expensive, politically, the Administration may favor the total elimination of double-taxation of dividends but later “settle for” one of several compromises. One alternative would be to create a lower tax rate on dividend income, such as that applied to long-term capital gains. This would bring the two forms of gain closer to equality but, like lower capital gains rates, would help the affluent (who tend to hold more stocks) significantly more than the average taxpayer.

A second compromise would be some minimum dollar amount of dividend income exempted from individual income taxes, probably \$1,000 to \$3,000. Some 62% of all taxable dividend income goes to households earning over \$100,000, as this could be seen as a more populist solution. For those with incomes of \$50,000 to \$100,000, average dividend income is \$1,500, but this would likely change with a limit of \$3,000 of tax-exempt income. Stocks would likely become a more preferred investment vehicle if their income was at least partially tax-exempt, given their potential for income growth as well as appreciation.

neglected portion of stockholders' returns. The discussion has publicized statistics about market returns which are probably news to many investors and has raised questions about recent uses of cash by corporations. Investors have also been reminded from the Enrons that consistent, and preferably growing, dividend payments are a reflection of accounting integrity. Companies like Microsoft will find it more difficult to justify sitting on a cash hoard. Let's hope that the adoption of these tax relief proposals becomes a reality and leads to a prosperous 2003.

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