RECORD LOW DIVIDEND YIELDS
IS IT A BANE OR A BLESSING?

By H. Bradlee Perry

Skyrocketing stock valuations and declining payout ratios have resulted in the lowest dividend yields in decades. The news for investors—mostly good.

Four, three, two, one—so runs the dividend yield countdown, in one of the most dramatic investment changes in history. Yes, as recently as 1990, the stocks in the Standard & Poor's 500 index provided a cash yield of 4%, but today it is only 1.4%, by far the lowest in recorded investment history.

For as long as there has been an active market for common stocks, dividends have been an important component of returns for their owners. In the modern investment era, the figures (from Chicago-based Ibbotson & Associates, which are based on the S&P 500) show that from 1926 to 1990 the 10.1% average annual rate of return consisted of 6.9% from price appreciation and 3.2% from cash dividends.

But there's been a major change in the 1990s. As corporate earnings growth has accelerated to 15% annually (more than double the long-term average of 7%), and stock prices have soared at an unprecedented 17.5% yearly pace, dividend increases have been minuscule—averaging only 4.5%.

This pattern has significant implications for investors—some positive and some negative. To understand the situation, it is necessary to analyze the two factors causing the plunge in yields: skyrocketing stock valuations and declining payout ratios.

SOARING STOCK VALUATIONS

While over the long term stock prices have increased in close parallel with earnings growth, there have been periods when prices have far outpaced rising earnings. The 1990s are the most extreme example of this, as can be seen in the price-earnings ratios in Figure 1. Note that at its current level of 25, the price-earnings ratio on the S&P 500 is higher than it has been in over 70 years, except for the depths of the Great Depression in the early 1930s, after stock prices had plummeted 90% and corporate earnings had collapsed 97%.

The unusually favorable economic conditions of recent years have produced the fastest-ever growth in corporate profits and this has generated tremendous investor optimism.

Much of that has been justified by the performance of the economy and American businesses. But now, with corporate profit margins far higher than they have ever been, with capital spending in real terms at the largest proportion of U.S. economic activity ever, and with excess capacity developing in a number of industries around the world (especially Asia), there are reasons to question whether—even with continued good economic conditions in the U.S.—corporate profit growth can maintain a rapid enough pace to keep investors as ebullient as they have been in the past three years.

The extremely favorable economic conditions of the 1990s have been described as the new "paradigm," a fancy word for pattern or model. However, with new paradigms in Japan and most of the other East Asian nations having sunk into oblivion recently, it is risky to assume that all the factors affecting American business and profits will remain indefinitely as favorable as they have been so far in the 1990s.

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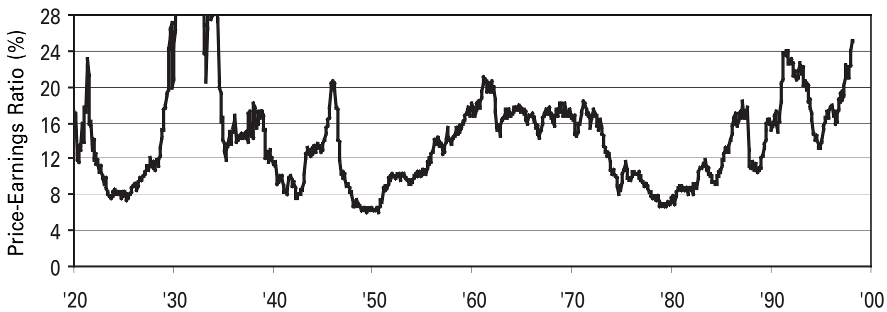
FIGURE 1.
S&P 500 PRICE-EARNINGS RATIOS: 1920-1998
(BASED ON CURRENT EARNINGS)



Source: Standard & Poor's

Be that as it may, the tremendous rise in stock valuations has been a key factor in driving dividend yields down to record lows, as shown in Figure 2. And even if companies were still paying out 47% of their earnings (which was the average from 1960 through 1995), the dividend yield on the S&P 500 at today's peak price-earnings ratio would be only 2.4%, lower than any level prior to 1996 (including the 2.9% yield at the top of the stock market in 1929, when the S&P's price-earnings ratio was 23).

DECLINING PAYOUT RATIOS

The current cash dividend on the S&P 500 represents a payout ratio of just 35% of reported earnings, the lowest ratio going all the way back to 1926 (see Figure 3). While the skimpy dividend decisions of managements and directors may have been influenced recently by the cut in the top capital gains tax rate from 28% to 20% (which makes a dollar of market appreciation worth much more to most taxable investors than a dollar of dividend income), another big reason payout ratios have dropped so much is that corporate executives (and to an increasing extent, directors) now have the great majority of their compensation tied to the performance of their company's stock.

Back in the 1970s and well into the 1980s, managers' principal compensation came from salaries and cash bonuses. True, there were stock option programs then, but with the stock market as a whole making no net advance from 1965 through the middle of 1982, options were not very remunerative—except in a handful of superior companies. For the same reason, a great many executives and almost all directors also had only modest direct shareholdings in their companies.

That all changed with the development of the great bull market in the mid-1980s, and in the current decade compensation via stock options and ownership has reached a fever pitch. This is illustrated by a recent Wall Street Journal tabulation of the 1997 compensation of 326 chief executive officers, whose combined salary and cash bonus averaged $2 million. It shows that realized gains from stock options added 24% to those officers' total cash compensation last year and that unrealized gains on their outstanding options at the end of 1997 were equivalent to *nine times* that year's combined salary and bonus.

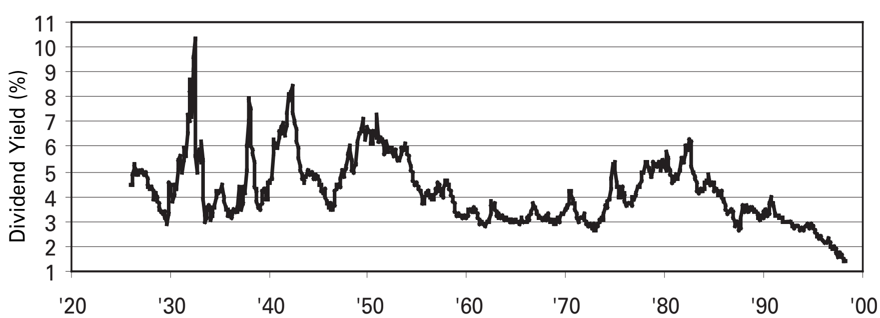
Those unrealized gains, of course, were not all achieved in 1997, but given the trend of the stock market, most of them arose in just the past three to four years. On that basis, even excluding these CEOs' gains on the sizable amounts of stock they own outright (coming mainly from previously exercised options), *over three-quarters* of all their compensation is coming from stock market appreciation.

Corporate directors also have much greater interest in stock price performance now, as more and more of their compensation has been switched from cash to stock.

Basically, this shift in the pattern of compensation has been constructive—because while one could argue with the huge size of options granted to some CEOs, clearly the interests of corporate officers and directors have become more closely aligned with those of all shareholders. This has given more impetus to managing businesses well and making their earnings grow faster.

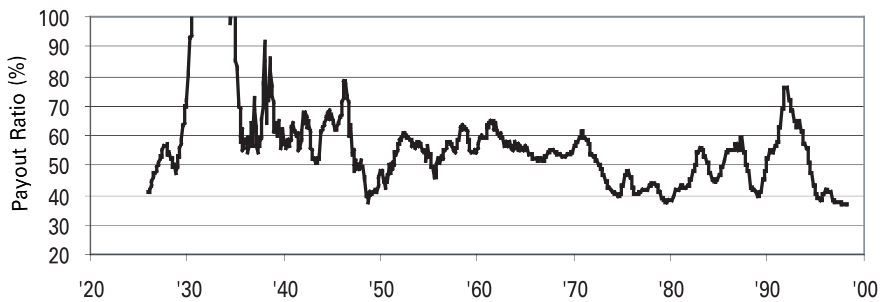
A negative aspect of this incentive is the pressure to make earnings look better than they really are, by pushing accounting to its allowable limits in a variety of ways. This includes taking periodic "restructuring write-offs" that make future earnings look better than they

FIGURE 2.
S&P 500 DIVIDEND YIELD: 1926-1998



Source: Standard & Poor's

FIGURE 3.
S&P 500 PAYOUT RATIO: 1926-1998



Source: Standard & Poor's

otherwise would, and by not charging against reported earnings the often-substantial cost of stock option programs. This only has to be disclosed in footnotes to the financial statements, which few investors read.

An extreme example of options' impact on overstating earnings is Microsoft. That company has disclosed that the grant of options on 28 million shares to its officers and employees last year would have reduced reported earnings per share by 23% if the cost of purchasing all the optioned shares on the open market had been charged against earnings. Most investors are unaware of such overstatement of profits, and those who are aware of it from poring over the footnotes tend to ignore the fact.

In addition to pushing the earnings accelerator to the floor, managements and directors have succeeded in boosting their stock prices more rapidly by large share repurchase programs. After the necessary reinvestment of profits in their businesses to finance growth, companies have used more of their free cash flow to buy in stock and proportionately much less to pay out in dividends.

Stock repurchases, when they are large enough to offset the issuance of new shares through option programs, enhance stock values by reducing the number of outstanding shares over which earnings are spread.

For example, if a company earns a profit of $1 billion and has 200 million shares outstanding, its earnings per share are $5.00. Then if it buys in just 1% of its stock (2 million shares), its earnings per share become 1% greater ($5.05). And if over a few years it reacquires a net of 10% of its stock, the same $1 billion of earnings translates into $5.56 of earnings per share on the 180 million then outstanding, a gain of 11%.

Higher earnings per share typically mean higher stock prices, so the process is beneficial for all shareholders, including management and directors. The downside, of course, is that the more money devoted to stock repurchases, the less there is available for dividends. This is why the payout ratio on the S&P 500 has dropped so far and pushed yields way down.

What will happen to payout ratios in the future is uncertain. As long as the stock market keeps roaring ahead and investors are benefiting from further price appreciation, the odds are great that payout ratios will stay low, maybe even dropping a little more.

However, if the stock market enters a stagnant or negative period, there may be heavy pressure on boards of directors to "reward" their shareholders by opening up the dividend spigot—because it will be much harder to justify large share repurchases if they are not pushing stock prices up. Until then, though, investors will probably have to live with puny dividends.

LOW YIELDS: THE DOWNSIDE

For investors whose cash spending needs cannot be met from today's low dividend yields (and declining bond yields), the total return approach to spending is required. Here's one way this can work in a prudent manner. First, assume a $10 million portfolio with 65% allocated to stocks and 35% to bonds, with the current yields that are shown below:

	Income	
Market Value	**Yield**	**Cash**
$3.5 million	6.0%	$210,000
6.5 million	1.4	91,000
$10.0 million	3.0%	$301,000

In the first year, the investor can spend the income—$301,000. However, if he wants to keep spending this amount in real terms in future years and anticipates future inflation at the long-term historical average of about 3%, the capital in this portfolio must grow at 3% annually to produce 3% more income each year, if yields stay steady.

That means that the annual stock appreciation to be retained in the portfolio must start at $300,000 the first year and increase by 3% each year. However, if the stocks appreciate at the 7% long-term average of the S&P, that will produce $455,000 of increased market value on the $6.5 million starting value of the stock portfolio. Thus, $155,000 of the year's appreciation can be spent in addition to the "regular" income produced, raising the total cash take from the portfolio to $456,000, or slightly over 4.5% of its market value.

This is the approach, adjusted for changing yields on bonds and stocks and occasional changes in inflation

assumptions, that most endowment funds have been following successfully for a long time.

Recently, with the very slow growth of dividend income, a number of older individual investors have started to follow the same strategy. That is perfectly sensible as long as realistic inflation assumptions are used—and if people realize that they are going to live much longer than their parents, so they need to keep as much money as possible in equities in order to protect the purchasing power of their capital for many years ahead.

Some individuals, though, have a real problem with this approach: Those who get much or all of their cash income from trusts that are not permitted to pay out principal. The only way these people can offset extremely low dividend yields is to have their trustees reduce stock ratios and put more money into bonds (whose current yields are much higher). That can be prudent for people who are really well along in years (85–90 or older), but today's septuagenarians and early octogenarians need to keep relatively high stock ratios to protect against inflation. Many of these people will live at least 15 to 20 years longer, and even at 3%, inflation can erode their standard of living significantly if they don't own enough stocks.

Given the current problem trusts are having with low dividend yields (a problem that may or may not continue in the future), individuals and their attorneys who are drafting new trusts now (or are able to amend the terms of "living trusts" before they die) should consider provisions enabling modest annual withdrawals of principal in periods of very low investment yields—as long as such provisions do not create tax disadvantages.

CONCLUSION

Today's extremely low dividend yields are a direct consequence of the tremendous rise in stock prices that has occurred in the past few years. Somewhere along the line, when the market loses its upward momentum for a while, yields will rise—either because of lower stock prices or higher payout ratios, or a combination of the two. However, it will take major changes to get back even to the yield of 3% last seen in 1995. And 1990's yield of 4% seems a remote possibility at this point.

Cash dividends traditionally have been valued more highly than market appreciation because they are much more certain—"the bird in the hand." However, for the majority of taxable investors, cash dividends are worth a lot less in terms of spendable cash (being taxed at up to 40%, versus 20% for capital gains).

Years ago, high dividend yields were considered something of a cushion for stocks in a bear market. But that has not worked for a long time. In the 1987 crash, higher-yielding stocks such as oil and telephone issues fell almost as much as low-yielding stocks.

So, while dividends are still extremely important for older individual investors (and there will be many more of them when the Baby Boomers start to retire), generally speaking dividends matter less than they used to. This is fortunate, since the yields they produce have become so exceedingly low. ◆