A FOCUS ON GROWING DIVIDENDS AT REASONABLE VALUATIONS

FUND FACTS

T. ROWE PRICE DIVIDEND GROWTH

CATEGORY:
Growth & Income

PERFORMANCE: (thru 3/31/98)

	Fund	Category
1 Year	40.2	38.4
3 Years	30.0	26.5
5 Years	21.6	18.2

RISK: (relative to category)
Low

TOTAL ASSETS: (as of 4/98)
$1.4 billion

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Dividends may be getting less emphasis from corporate managements, but they are not forgotten, at least by investors. This month's special insert covers the growing number of companies that offer dividend reinvestment plans, a popular feature with investors.

A number of mutual funds also focus on dividend-paying companies. One such fund with a good track record is the T. Rowe Price Dividend Growth Fund, ranking among the top 25% in the growth and income category for the last five years (through March 31, 1998).

In late April, portfolio manager William J. Stromberg discussed the management of the fund with Maria Crawford Scott.

What is the investment philosophy of the Dividend Growth fund?

The philosophy is that companies that have a track record of, and the ability to continue, paying a rising stream of dividends will benefit shareholders over the long term, both in terms of capital appreciation and rising income. As a result, our strategy is to buy and hold those kinds of companies and to be able to pay out to our mutual fund shareholders a rising stream of income over time.

In addition, I tend to use a valuation-sensitive approach with an emphasis on the more reasonably valued part of the universe of dividend growth companies. Over time, this has tended to reduce the volatility of the fund a bit relative to what it might have been. Some shareholders may care about the volatility and others may not, but it is an important component.

What is your definition of "good growth" in dividends and earnings?

What we look for is double-digit growth in earnings and dividends, and in cash flow, too, not just earnings. Cash flow is really where the dividends come from, so I spend a lot of time looking at cash flow.

Also, we want to have a mix of companies, some that can grow faster and others that probably will wind up growing slower. I think of it as a spectrum of two axes: One axis is current yield—companies with high current yields tend to have slower dividend growth, but at the same time, you can buy them at lower valuations than companies that are growing very rapidly. The other axis is dividend growth—companies with low yields tend to have very fast dividend growth. I want to own stocks across the spectrum because styles go in and out of favor. Right now, "yield" is out-of-favor, and growth is in.

What is your primary screen?

We do all sorts of permutations on dividend growth. For instance, one of the screens is average annual growth in dividends over the last five and 10 years; another is consecutive years of dividend growth. We also screen for current yield, and past earnings and cash flow growth that at least matched the dividend growth, so that the dividends were supported by the growth in the underlying business, and the company wasn't stretching to do something they shouldn't be doing. I also throw in screens on valuations as well.

What do you look for to ensure the continuation of the dividend payments?

Number one, I look at the payout ratio—the percentage of earnings and cash flow they are actually paying out in the form of dividends.

Number two, we do a fair amount of work before we purchase the stock, trying to figure out how fast we think earnings and cash flow can grow in the next three years. We look at free cash flow a lot. Free cash flow is cash that is left after capital spending needs and things like that. We favor companies that generate more cash than they need because that cash is available for dividends and stock repurchases.

And finally, we tend to meet with most of the managements represented in the fund, and many of them will tell you flat out that they are going to keep the dividend growing in line with the earnings or that they want to lower their payout ratio and de-emphasize dividends.

What kind of valuation measures do you use?

We look at the whole spectrum of valuations from price-to-earnings to price-to-cash flow, although some work better than others depending on the industry. We also focus on something called relative dividend yield, and many stocks, particularly those that are consistent earnings growers, tend to have a dividend yield that maintains a regular band relative to the S&P 500's dividend yield, and they trade at similar relative yield levels over time. When those relative yield levels get out of whack—say a company's yield is unusually high for some reason—it is a signal that the stock may be oversold or significantly out-of-favor and would cause us to look at it a little bit more closely.

The fund is allowed to go into international stocks and you have some holdings overseas. Are the dividend policies different overseas, and are you finding better dividend growth over there?

Yes, dividend policies are different particularly in a couple of different markets overseas, in the UK and parts of Europe in particular, which is where our holdings are concentrated. They have a more pro-dividend culture, and we have found some terrific companies. Consequently, we hold 10%–12% internationally right now, and I guess we have gone as high as 15%, perhaps.

In terms of diversification, how does the fund compare with the S&P 500—are you more concentrated in particular industries because of the dividend approach?

Yes. Not all industries have companies that are active dividend payers. One place where we are conspicuously underweighted, have been and probably will be for many, many years, is technology. Technology companies are rapidly growing and opt not to pay dividends. There's about a handful that do have good dividend patterns, and we are focusing on them very hard and have invested in several of them. But technology is an area where we are likely to be underweighted for some time. Other than that, there are some areas where we are likely to be overweighted. For instance, one area is financial services where the current yields are attractive and we see the likelihood of significant dividend growth there. Another area is real estate investment trusts, which are not part of the S&P 500 right now, but where we get, I think, both high yields and very strong dividend growth.

What would cause you to sell a stock?

A couple of different things. One is if there is a change in the fundamentals for the worse. We are going to wind up owning stocks where things don't work out the way we had thought they would, and I found over time the best thing to do is to move on.

The second reason, which has been less fruitful over the last couple of years, is what I would call a quantum change in valuation. A great example right now of a stock that we've owned for a long time and made a lot of money in is Pfizer, the pharmaceutical company. When we bought it, it traded at 12, 13, 14 times earnings. And now it trades at 45 to 50 times earnings.

The maker of Viagra.

Yes, they are indeed. Pfizer is doing a fabulous job not just with Viagra but with other products as well. They have a whole suite of new products that are doing well. Since the multiple is now more than three times what it was when we purchased it, we have to ask ourselves: Do we still want to own this stock, and why? Where do we think it can go to and what happens if something goes wrong—is that multiple going to get cut in half?

So far, the right thing to do has been to let it run and keep it, but it's been a shrinking part of the portfolio because we're unwilling to purchase any more at these prices.

You mentioned the move among companies to de-emphasize dividends—why are managements favoring such a policy now?

The normal fallback for the reason they are de-emphasizing dividends is the changes in the tax code, which favor capital gains over dividends. The unspoken reason, which might be just as important, is the fact that many managements are compensated more and more with stock options. The value of those options goes up more with price appreciation than it does with dividends.

Do you think that the change in payout ratio policies is permanent?

I think there's been a long-term change in this direction, and eventually it will shift in a gradual sense back in the other direction. My sense is that if the market environment gets more difficult and price appreciation is less easy to come by, many managements will be more obligated to reward shareholders in the form of dividends.

I also think that once we get through the next recession, whenever it may come, and managements see that they are able to sustain their dividends, they will feel freer about raising dividends. Some companies worry about the sustainability of their current profit margins and want to see what happens when times get tougher.◆