DO DIVIDENDS STILL MATTER?

YES—AND HERE'S WHY

By Donald Cassidy

Even in the historically extraordinary market climate of the past several years, dividend actions have been strong predictors of stock-price action. In addition, dividend yields provide a cushion under prices when stocks go through their recurring sinking spells.

Do dividends still matter?

Much has been written about the "tax inefficiency" of mutual funds due to high dividend distributions. Some academics say companies should buy back their shares rather than pay or raise dividends. And corporate payout ratios (common dividends as a percentage of earnings per share) have declined.

What should the informed investor do—forget dividends, or pay some attention?

THE INCREDIBLE SHRINKING DIVIDEND

A bit of history will provide useful perspective. In the 1920s and 1930s, many investment professionals believed that dividends were an essential element in proving the value of a common stock, and indeed in differentiating speculative stocks from investment-grade stocks. In fact, owners of AT&T were treated better during the Great Depression than in recent years, as the company maintained its $9/share dividend rate throughout that economic siege.

Although the experience of very recent years would make one believe otherwise, dividend yield for a long time represented a significant, often majority, portion of total returns on common stocks. It was not until 1958 that the average yield on common stocks in the S&P 500 index fell below that of long-term U.S. Treasury bonds.

We now live in an age of high growth expectations, and we enjoyed a long bull market that ended in early 2000. During that time, we gradually came to expect ever lower dividend yields. The old rule of thumb that stocks should be sold when the dividend yield on major indexes falls below 3% is in disrepute, as it would have taken an investor out of the market in the middle 1990s.

As Table 1 illustrates, the past half century could be called the time of the incredible shrinking dividend yield. The table shows yields, as well as price-earnings ratios, at major market highs; yields, of course, have been higher in low markets. The key point of interest is the far-right column, which provides the history of common stock yields relative to bond yields over time. This ratio has shrunk by an incredible 90%. This does not mean that actual percentage yields on stocks have declined that much. Rather, three major forces have been at work:

- A decreasing percentage of public companies actually pay cash dividends;
- The components of major averages have changed to emphasize more growth-type companies, especially in technology, that pay out little or no cash; and
- Overall inflation and therefore interest rates have declined greatly in the past 20 years. Conservative and income-oriented investors view common stock yields as competing with those of bonds, so falling interest rates indirectly push up the prices of stocks.

Many studies by academics and brokerage researchers have shown that, over time, the tendency to pay dividends has been on the wane. Requirements

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TABLE 1. DIVIDEND YIELDS AT PAST MAJOR MARKET HIGHS

High Year	S&P 500 High P/E (X)	S&P 500 Low Dividend Yield (%)	Long-Term Treasury Yield (%)	Ratio: Dividend-to-Bond Yield (X)
1947	22.0	4.8	2.24	2.14
1956/7	14.0	3.6	3.26	1.10
1959	18.0	3.1	4.10	0.76
1962	22.0	2.9	3.95	0.73
1965	17.0	3.1	4.68	0.66
1969	17.0	3.1	6.22	0.50
1972	18.0	2.7	5.67	0.48
1976	12.0	3.6	7.87	0.46
1981	9.0	4.6	13.20	0.35
1987	21.0	2.7	8.76	0.30
1990	16.8	3.3	8.81	0.37
1993	21.3	2.7	6.46	0.42
1998Q2	29.7	1.4	5.81	0.24
2000 (March)	31.7	1.1	6.08	0.18

Source: "When the Dow Breaks," by Donald Cassidy; McGraw-Hill, 1999.

for heavy capital expenditures in a time of rapidly advancing technology are often given as a reason. Some corporate boards are also probably choosing share buybacks over the less tax-efficient route of paying or raising dividends.

As Table 2 shows, the share of NYSE-listed common stocks paying dividends has slipped by almost 10% in just the past five years; payout ratios among companies actually paying dividends have been slightly higher on balance and are influenced by earnings as the divisor. Thus it can be said that the dividend payers are becoming more of an elite corps among investors' potential choices.

DIVIDENDS AND VALUATIONS

A major valuation technique for assessing the theoretical value of common stocks is the dividend-discount model, enunciated by John Burr Williams in his 1938 textbook "Theory of Investment Value." In this model, the analyst estimates the future stream of annual dividends and discounts the sum to a present value by an appropriate interest rate. If the resulting discounted present value exceeds the present share price, the stock is judged to be a buy candidate. Clearly, dividends rule in this formulation. But what if a firm does not pay dividends? An alternate version of the model uses estimated future free cash flows per share. Those amounts represent a proxy for possible future dividends. Otherwise, they would be of little interest to an investor—except perhaps for estimating what an acquiring firm might pay for the company. So dividends do matter to serious professional investors (excluding momentum-chasing speculators).

When you think about it, a stock has value only because of one of three potential outcomes. First, the company could liquidate or be acquired. Second, the stream of dividends per share, discounted by a factor appropriate to both risk and the level of interest rates, implies a price serious investors will pay and demand. The third and only other reason to buy a stock is on speculation that others will readily pay a higher price in the future. If such an outcome is not based on an estimate of rising dividends or lower interest rates, this hope for price appreciation is reduced to the greater-fool theory. Thus, dividends do matter to the true investor (as opposed to a speculator).

A well-regarded book on the subject, "Dividends Don't Lie," by Geraldine Weiss and Janet Lowe, makes the case that value in blue-chip stocks is well-defined and reflected by growth in dividends. Earnings as reported are widely thought to be less than totally definitive. But a board of directors presumably knows what the true condition of a company is, so its dividend actions are quite meaningful. Rising dividends, flat dividends, and reductions tend to reflect the differentiated cash-generating abilities of various firms. Thus, one can argue, for the investor (again, as opposed to the trader or speculator), dividends indeed matter very much as indicators of corporate health. This is especially true in two areas that continue to provide the highest dividend yields among types of common stocks: REITs (real estate investment trusts) and utilities.

REITs AND UTILITIES

REITs are required by provisions of the IRS code to pay out a very high percentage (at least 90%) of their current earnings or else they will lose their tax-free conduit status. Thus, these firms are required to give concrete signals of their relative current prosperity on an annual basis. That information can be used by investors for both

TABLE 2. DIVIDEND PATTERNS AMONG NYSE-LISTED COMMON STOCKS

	Percent Paying Cash Divs. (%)	Average Payout Ratio (%)
1995	68.7	34.9
1996	68.5	34.5
1997	67.8	33.5
1998	65.6	37.7
1999	64.2	37.9
2000	62.7	36.3

selecting good companies and noting where questions are arising regarding others.

Utilities historically were more tightly regulated and protected from competition than is now true. Their businesses were likely to grow slowly but fairly steadily over time. Boards knew that their investors bought such shares mainly for income with some chance of gradual growth over time. Therefore, regular small increases in dividends were the norm. When such a pattern was broken, investors were thus notified that something had changed for the worse. Electric companies and telephone firms have seen the most disruption to this historical pattern of business stability. It is no accident that these have been most prone to dividend cuts and omissions. Water companies and local gas distributors are still quite stable because of the high (capital investment) barriers to entry for potential competitors (and actual grants of franchise exclusivity). These companies have been much more reliable in maintaining and raising dividends, and their stocks currently sell at fairly low yields to reflect resulting investor confidence. As much as investors are tempted by high yields, I have long advised that they immediately sell any utility that does not raise its dividends at the same pace as in prior years. Such changes in policy are high-likelihood indicators of looming business problems. (Evidence for this approach was given in my book, "Plugging Into Utilities;" 1993, McGraw-Hill, $24.95.)

PRICE FOLLOWS THE ACTION

If investment theory says that dividends determine the value of stocks, is this actually matched in real-market (i.e., price) experience?

Yes! Even in the historically extraordinary market climate of the past several years, dividend actions have been strong predictors of stock-price action. This is well-illustrated in Table 3.

Remember, 1998 through early 2000 was a time when growth-style money management won out by a considerable margin over the value-style approach, which puts more emphasis on dividend yield and lower price-earnings ratios. And yet in Table 3 we see a bias toward better stock performance among rising-dividend payers than among static payers or dividend decreasers, even in the final two years of the 'Nifty Nineties.' In 2000, when the growth bubble burst and the S&P 500 index lost a net of roughly 8%, the order of price performance by quintile among NYSE-listed dividend-paying commons was directly parallel to those stocks' average dividend-changing actions. While the order of price results was not perfect in the prior years, the direction of tilt was clearly the same as for their dividend changes. So we see that to investors who invest in dividend-paying common stocks, changes in dividends did indeed matter, even during this unusually growth-focused time window.

WINNING APPROACHES

What seems almost amazing in today's context with recent memories of an extended period of growth outrunning value is this: For the 20 years through and including 2000, an income orientation was the winner in 11 years and the growth approach in nine. This is apparent from comparing the returns of two long-lived Lipper fund indexes, those for Capital Appreciation funds compared to Equity Income funds. Besides the nearly equal score for winning years, what we see is an amazing, almost-constant annual alternation between the two in terms of the winning approach. That pattern failed only once in the 1980s and twice in the late 1990s, as shown in Table 4.

Unless the last half of 2001 brings a resurgence of confidence and therefore better performance in the growth area, it appears that we are now in another unusual string of two years in favor of one style. I would not advise "betting the farm" on perfectly annual reversals, but it is encouraging that there appears to be an internal correcting mechanism at work: When one style runs ahead, investors see the imbalance and soon revise their holdings to favor the lagging approach. While it might have been difficult to believe in early 2000, the data above also tend to support the well-established fact that over long periods, on average, value beats growth. So, it seems dividends do indeed matter.

While one might not be investing specifically for dividend income, that factor should not be overlooked in the portfolio construction and diversification process. When a bad market occurs (and history tells us that is about three years in 10), not surprisingly, the dividend payers provide a good cushion under stock prices. In 2000, for example, while the median price performance for NYSE companies paying dividends was a gain of 9.2%, those not sending holders any cash provided a median loss of 5.8%.

DIVIDENDS AND TAXES

There has been considerable media attention lately on the tax efficiency

TABLE 3. ANNUAL NET PRICE CHANGES BY DIVIDEND-PAYING NYSE COMMON STOCKS

Type of Dividend Change by Quintile	Median Price Change by Quintile (%) 1998	1999	2000
I: Largest % Increases	–0.5	–3.6	12.7
II: Moderate % Increases	–0.3	–8.4	11.2
III: Small % Increase or No Change	–4.9	–10.8	9.2
IV: Zero or Small % Decreases	–9.9	–10.1	3.3
V: Largest % Decreases	–16.4	–6.3	–18.1

of mutual funds, including a recent new SEC regulation that prescribes a fund's disclosures of aftertax performance in prospectuses and advertising. Logically, of course, investors concerned about funds' tax consequences are sure to be sensitive to how their individual stock (and bond) holdings affect their current tax bills. Fortunately, for many there is a potential to manage that readily—assuming that one has tax-deferred or tax-free accounts in their direct control. Examples of these are 401(k) and 403(b) type plans, as well as Keogh/SEP, traditional IRA, and Roth IRA accounts. To gain the best tax result, one would want to shelter dividend (and interest) income by placing it in such accounts until it becomes necessary to draw down income or assets to live on in later years. Fortunately, this produces no conflict with the relative tax-rate treatments of income versus long-term capital gains: If you focus growth-type investments in taxable accounts (and refrain from heavy short-term trading), you will have a lower tax rate on growth-type income and a full rate on (non-Roth) dividend income in your deferred accounts. Arranging it the opposite way would be far less than optimal since long-term gains would be taxed at full marginal rates in deferred accounts upon their withdrawal, while dividends would be taxed both fully at high marginal rates and currently in your taxable personal account (whether or not currently needed for living expenses).

TABLE 4. ANNUAL RETURNS OF LIPPER CAPITAL APPRECIATION AND LIPPER EQUITY INCOME FUND INDEXES

	Capital Apprec. (%)	Equity Income (%)
1981	–2.6	**6.0**
1982	30.5	**30.9**
1983	**23.2**	22.5
1984	–6.1	**8.0**
1985	**29.4**	27.7
1986	15.8	**18.3**
1987	**2.0**	0.5
1988	12.9	**17.1**
1989	**28.3**	22.6
1990	–7.8	**–5.1**
1991	**37.6**	26.7
1992	7.6	**9.4**
1993	**15.8**	14.8
1994	–2.5	**–0.9**
1995	**31.6**	29.8
1996	15.0	**18.0**
1997	20.0	**27.2**
1998	**20.0**	11.8
1999	**39.7**	4.2
2000	–12.9	**7.5**
2001 (6 Mos)	–7.4	**–2.0**

Bd: Winning Strategy
Source: Lipper Inc.

DIVIDENDS DO MATTER

Though much of the late 1990s produced an overwhelmingly growth-oriented mindset in investing, long-term perspective reminds us that not all the available common stocks represent technology companies that eat rather than throw off cash. Some industries are perennial cash generators and therefore do tend to produce dividend income. In addition to the four utility areas mentioned earlier, and of course REITs, banks and major energy producing and distributing companies tend to pay decent dividends. Likewise, pharmaceutical and consumer-products companies are commonly dividend payers, although usually at lower ratios of dividends to earnings. So one can indeed construct a reasonably well-diversified equity portfolio that generates somewhat dependable dividend income. The income itself may not be of present use, but the yields provided will be a cushion under prices when stocks go through their recurring sinking spells.

We can also look forward, I believe, to a time not too far ahead when dividends may again become a more important part of overall equity returns—and when in fact they will be in more intense demand than today.

Demographic trends indicate that around 2007 or 2008 the baby boomers will begin retiring in such large numbers that we can reasonably assume their investment personalities will mellow toward a more cautious stance. Yet we are all well-educated to the need for owning equities rather than bonds alone as a hedge against inflation while we seek income for our retirement years.

Dividends, if acquired from successful companies with proven staying power, tend to grow over time, whereas bond interest rates are fixed for particular issues. And bond rates go up and down over time, meaning that an all-bond portfolio may yield less at some times than others: Ask your friends who retired in the early 1980s and assumed they would always earn 15% on Treasury bonds.

Thus, not only are dividends currently still an attractive item, they may well matter even more in the future. ✥

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- The Individual Investor's Guide to Dividend Reinvestment Plans can direct you to dividend-paying stocks that maintain reinvestment plans. Click on **Investor Resources** on the right-hand side of the home page.
- The Geraldine Weiss approach to selecting blue-chip stocks can be accessed through the **Stock Screens** area under Tools on the left-hand side of the home page. Read an explanation of the approach and view a list of stocks that currently pass the screen.
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