

THE POWER OF DIVIDENDS

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During the dotcom boom of the late 1990s, we were vehemently criticized on our position on looking for dividends. Conventional wisdom at the time was that we were in the “new economy” where earnings and cash flow didn’t matter, and stocks never fell. Who in their right mind would ever want to look for dividend yields when looking to invest? On one radio guest appearance I was actually deemed “*uncool*” by a typical dart throwing, internet-can-do-no-wrong stock analyst. After all, we were in the new economy: the rules had changed and companies that paid dividends were so yesterday.

Fast forward to 2006 and I couldn’t tell you where that new economy stock analyst is today, but if I were to guess I would probably say losing people money at some obscure hedge fund. On the other hand dividends are still here and making money for prudent and patient investors as they have been doing for over 100 years. Unfortunately many investors have still failed to grasp the concept of dividends and compounding interest.

A dividend is a cash payment from a company's earnings, announced by a company's board of directors and distributed among stockholders. In other words, dividends are an investor's share of a company's profits, given to him or her as a part-owner of the company. Aside from option strategies, dividends are the only way for investors to profit from ownership of stock without eliminating their stake in the company.

When a company earns profits from operations, management can do one of two things with the profits. It can choose to retain them which is essentially reinvesting them back into the company with the hopes of creating more profits and thus further stock appreciation. The other alternative is to distribute a portion of the profits to shareholders in the form of dividends (management can also opt to repurchase some of its own shares - a move that would also benefit shareholders. A company must keep growing at an above-average pace to justify reinvesting in itself rather than paying a dividend). Generally speaking, when a company's growth slows, its stock won't climb as much, and dividends will be necessary to keep shareholders around. This growth slowdown happens to virtually all companies after they attain a large market capitalization. A company will simply reach a size at which it no longer has the potential to grow at annual rates of 30-40% like a small cap, regardless of how much money is plowed back into it. At a certain point, the law of large numbers makes a large-cap company and outperforming growth rates which outperform the market an impossible combination.

The changes witnessed in Microsoft in the last few years are an excellent example of what can happen when a firm's growth levels off. In January 2003, Microsoft finally announced that it would pay a dividend: Microsoft had so much cash in the bank that it simply couldn't find enough worthwhile projects to invest in. The fact that Microsoft started to pay dividends did not signal that the company was weakening; it indicated that Microsoft had now become a huge company and had entered a new stage in its life cycle. When the management of a corporation decides to pay dividends it is indicating that profits are better off being distributed to the shareholders than being put back into the company.

Another incentive for a company to pay dividends is that a steadily increasing dividend payout is viewed as a strong indication of a company's continuing success. The great thing about dividends is that they can't be faked. They are paid or not paid, increased or not increased. This is often

not the case with earnings, which in some cases are nothing more than an accountant's best guess at a corporation's profitability. We have reported much too frequently over the years on companies that have essentially "cooked the books."

Wall Street analysts expected growth rates are also erratic. Wall Street analysts and the companies all too often make erroneous predictions that make stock prices rise so executive bonuses and investment banking deals can be completed. Earnings can be restated where shareholders take hits, however dividends cannot be taken back. The dividends you receive from your stocks are 100% yours.

The company's board of directors decides what percentage of earnings will be paid out to shareholders, and then puts the remaining profits back into the company. Although dividends are usually dispersed quarterly, it is important to remember that the company is not obligated to pay a dividend every single quarter. In fact, the company can stop paying a dividend at any time; however, this is rare, especially for a firm with a long history of dividend payments. If people were used to getting their quarterly dividends from a mature company, a sudden stop in payments to investors would be akin to corporate financial suicide, unless the decision to discontinue dividend payments was backed by some kind of strategy shift. For example: investing all retained earnings into expansion projects. For this reason, the board of directors will usually go to great lengths to keep paying at least the same dividend amount. Because public companies generally face adverse reactions from the marketplace if they discontinue or reduce their dividend payments, investors can be reasonably certain they will receive dividend income on a regular basis, for as long as they hold their shares. Therefore, investors tend to rely on dividends in much the same way that they rely on interest payments from corporate bonds and debentures.

Since they can be regarded as quasi-bonds, dividend-paying stocks tend to exhibit pricing characteristics that are moderately different from those of growth stocks. This is because they provide regular income, similar to a bond, but still provide investors with the potential to benefit from share price appreciation if the company does well. Investors looking for exposure to the growth potential of the equity market, combined with the safety of the moderately fixed income provided by dividends, should consider adding stocks with high dividend yields to their portfolio. A portfolio with dividend-paying stocks is likely to see less price volatility than a growth stock portfolio.

Corporations can't keep growing forever. When a company reaches a certain size and exhausts its growth potential, distributing dividends is often the best way for management to ensure shareholders receive a return from the company's earnings. A dividend announcement may be a sign that a company's growth has slowed, but it is also evidence of a sustainable capacity to make money. This sustainable income will likely produce some price stability when paid out regularly as dividends. Best of all, the cash in your hand is proof that the earnings are really there, and you can reinvest or spend them as you see fit.