

APRIL | 2010

# THE IMPORTANCE OF DIVIDENDS

*Benefits Beyond Income*

EAGLE | Asset  
Management

Dividends historically have been a major source of stock-market returns over the long term. Standard & Poor's, for example, reported that dividends accounted for one-third of the monthly total return of the S&P 500 from 1926 to 2009<sup>1</sup>. Capital appreciation accounted for the rest, making a case that both sustainable dividend income and growth potential are essential to total returns.

<sup>1</sup>The S&P 500 did not actually have 500 stocks prior to 1957 and was known as the S&P 500 Composite Index. For simplicity's sake, we use the term "S&P 500" for all time periods.

Investors once primarily valued companies based on a stock's yield, before price/earnings multiples and other valuation metrics became popular. A stock with a higher yield was considered a better value. Today's investors know all too well the market's volatility and may consider dividend-paying stocks essential to the total return of a balanced portfolio. Dividend-yield-based strategies, which focus on income and capital appreciation, may be an ideal way to pursue more stable return patterns.

Interest in income-producing or dividend-paying stocks reflects a shift from the 1990s, when rapidly growing stocks dominated the market but generally paid no dividends. (A dividend is the amount of money, normally a portion of the profits, a corporation's board of directors decides to distribute to a class of shareholders.) A cash dividend helps gauge the company's financial health. Companies that pay dividends must have cash on hand to do so. Current investors may remember all too well the volatility of that market environment and now consider dividend-paying stocks essential to a balanced portfolio.

Despite recent market volatility amid global economic recovery, there are still many companies paying or even increasing their dividends. Consider that 43 of the companies in the S&P 500 – in 10 diverse sectors – were included in the S&P 500 Dividend Aristocrats Class of 2010, meaning they've increased their dividend payout for 25 consecutive years.

Today's economic environment may prove favorable for investors who want a growing stream of dividends to help beat inflation. Investors may demand higher dividends and corporations may respond by scaling back stock repurchases in favor of dividends. Investment managers who focus on solid dividend payers should do well in this environment.

Two decades ago, dividends accounted for 3.1 percent of the per-capita personal income in the United States then climbed to 5.6 percent in 2008, according to research by S&P. Income-seeking retirees, in particular, may be interested in dividend-paying stocks, especially since yields have ranged between 1.98 percent and 5 percent over the past 10 years. As more and more investors get back into the market, the importance of dividend income should increase.

Of course, all investors should carefully analyze the source of a company's cash, the company's management and the firm's payout history. A good place to start is cash. After all, that's what dividend investors seek: companies that generate extremely large free-cash flows. It is also important to ensure the company isn't paying out more than it can handle.

### **The importance of dividends**

As noted earlier, dividends historically have been a significant source of total stock-market returns. According to S&P, dividends have contributed 34 percent of the monthly total return on the broad

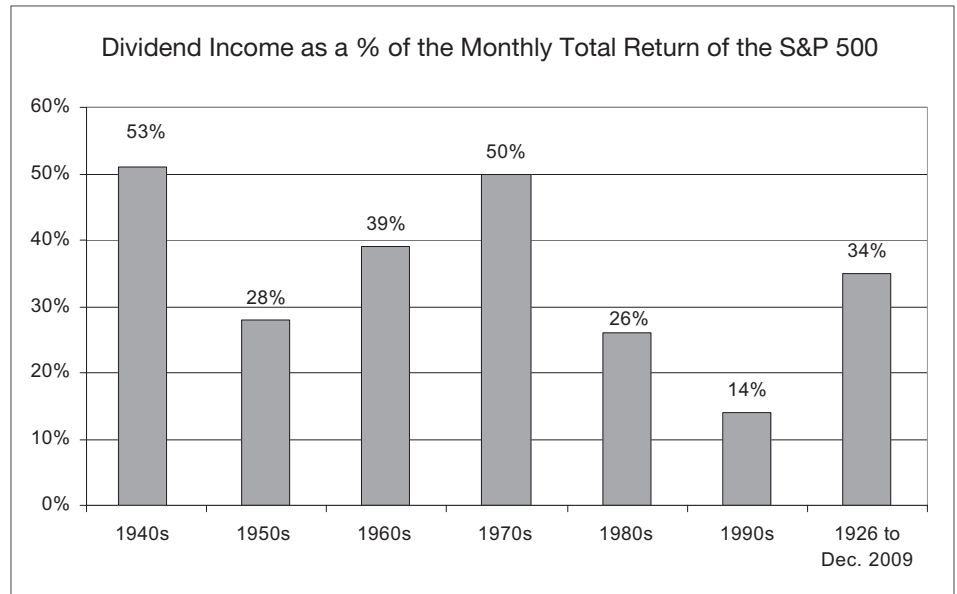
S&P index from 1926 through 2009. Capital gains have contributed the rest. Both are important to an investor's total return expectations.

In addition, many academic studies confirm that reinvesting dividends has been a major source of stock-market returns — anywhere from 40 percent to 70 percent of returns can be traced to dividends — over the long term. As a result, many investors look to dividends as key creators of value.

Several studies also have shown that dividend-paying companies have significantly outperformed the market over time. Stocks that have paid higher dividends in the past also have generated higher future earnings growth. It seems in recent years, investors began to think dividend-paying firms were forgoing valuable growth options that could be financed with earnings instead of paying out dividends. Investors may have incorrectly assumed that dividend-paying companies tend to underperform non-payers in heated markets merely because these stocks are viewed as safer investments. This was true during the Internet- and technology-driven craze of the late '90s, but it hasn't held true for more normal market environments.

### Dividends in action

According to Jeremy Siegel's "The Future For Investors," dividends have been the overwhelming source of stockholder returns throughout time, and firms that have higher dividend yields have given better returns to investors. For example, from 1871 through 2003, 97 percent of the total after-inflation accumulation from stocks came from reinvesting dividends. Only 3 percent came from capital gains.



Growth in dividend payments seems to be a long-running trend. In fact, the dollar amount of dividends paid by the S&P 500 Index companies increased in 83 of the past 100 years. From 1970 to 2002, a period when dividends were significantly out of favor, actual dividend payments from the index increased at almost an 8 percent average each year. In addition, dividends paid by the companies in the index increased every year during that period except in 2000 and 2001, but dividend payment growth resumed in 2002 and 2003.

The S&P 500's current dividend yield of 1.9 percent (as of Dec. 31, 2009) remains a far cry from the all-time record 8.7 percent posted in 1950. But it has room to grow. The average yield over the past 130 years is 4.6 percent. We may never make it back to those levels, but progress in that direction could be significant to stock investors.

### Benefits of dividends

Dividend-focused strategies can bolster a portfolio in several ways: They provide more income than an S&P 500 Index fund, they may offer a tax break and they could help stabilize a portfolio because better-than-average dividends tend to soften market

downturns. Investors have benefited from higher dividend yields, which help to smooth market volatility. Dividends by definition are positive contributors and can cushion market corrections by offsetting price depreciation. Keep in mind, however, that a dividend must be substantial enough to offer meaningful cash returns or allow one to reinvest in additional shares of stock to truly soften a downturn.

A high dividend payout may be more important to investors because dividends provide a level of confidence in the company's financial well-being. After all, barring a corporate crisis, investors historically have been able to count on receiving the dividend check. It is important to keep in mind, however, that companies with a long-standing history of stable dividend payouts could be negatively affected by lowering or omitting dividend distributions. Conversely, these companies would be positively affected by increasing dividend payouts or making additional payouts. Companies without a history of paying dividends may also be viewed favorably when they declare new dividends or a special dividend. A company may announce a one-time special dividend to shareholders that is separate from the typical recurring dividend cycle, if any, for the company.

Investors looking to secure current income may also find dividends attractive. Many investors may view equity investments with an eye toward capital appreciation rather than a source of income. Historically, stocks have generated returns through both capital appreciation and income. But starting in the mid-1990s, there has been a focus on capital appreciation as the main contributor to return.

However, that view may be changing. Many investors understand their portfolios may be a good source of retirement income that will eventually replace working income. Income-oriented investments are garnering renewed attention and dividend-paying

## Benefits of Dividends

### Attractive returns

---

- Historically stable businesses can afford to share profits with shareholders.

### Reduced volatility

---

- Companies that distribute reasonable dividends generally have exhibited lower stock-price volatility. They also tend to be more stable and mature.

### Boosts total returns

---

- Sustainable dividend income can be an important component of total return and can help protect against depreciation of a stock's price. In this way, dividends may soften the impact of stock-price declines on the overall value of a portfolio

### Diversification

---

- Dividend payers can be found across many sectors and industries and often have both value and growth characteristics.

### Yield

---

- Dividends provide income.

equities are seen as a critical component of many portfolios. Investors may be able to supplement their income by diversifying with dividend-based strategies.

Not only are dividends positive contributors to a portfolio, but they tend to be relatively stable over time. Stock market volatility can be partly attributed to speculation and market sentiment; while dividend income is less mutable. For example, from 1989 to September 2008, the standard deviation (a measure of volatility) of annual price returns was 13.96 percent. In contrast, the standard deviation of dividend return over the same time period was just 0.27 percent. The lower volatility means dividend income may be more stable across various market environments.

Companies with consistent dividend records historically have been more cautious and have tended

---

to be less volatile than non-dividend-paying stocks. Those companies often generate strong cash flow, are mature and do a good job of managing both risk and return. Many investment managers view dividends as a way to manage risk because dividend-paying companies typically have shown financial discipline and demonstrate the willingness and ability to increase dividends over time.

Investors also may want to include dividend-paying investments to help smooth the income stream from a fixed-income portfolio that may fluctuate as interest rates rise and fall. As long-term bond yields ebb and flow, investors relying on the interest from those portfolios see their incomes vacillate as well. As noted previously, dividends provide a source of income that may grow, consistently, over time. In addition, dividend-paying equities historically have generated income that has kept pace with inflation, an important factor for many investors.

Investors transitioning from accumulation to distribution are faced with the need to create an income stream that can keep pace with inflation over decades of retirement, often more than 30 years. Dividends can help fulfill that role. A dividend strategy can help bolster almost any portfolio.

### **Compounded dividend income**

Dividends are not just one-time gains. They often are paid quarterly and can regularly add cash to your portfolio, boosting performance. Dividends also allow you to purchase more shares of stock, growing your portfolio with reinvestments. That can result in significant increases over long periods of time. For example, \$1 invested in the broad S&P index on Jan. 1, 1930, would have grown to \$49 by the end of 2009. During the same period, with dividends reinvested, that same dollar would have yielded \$1,259.

As each quarterly dividend is paid, the shareholders

have incremental cash with which to purchase new shares. Like dollar-cost averaging, dividend reinvestment allows investors to take advantage of lower prices and purchase more shares. Of course, owning more shares will pay more dividends. Conversely, when prices are higher and prospective returns are lower, fewer shares are purchased. It is easy to see the power of dividends over time. Take a look at the payouts a company has made over the years. Create a spreadsheet that begins with the core position and cost basis, then calculate how a dividend-reinvestment plan would have helped accumulate additional shares over time. The power of dividends should become quite clear.

Even the smallest investor can take advantage of dividend-reinvestment plans, which can result in significant increases in value over long periods of time. While seemingly small, the compounding effect can be quite dramatic over the long term. Consider that the S&P 500 Index jumped from about 100 points to 1,250 points – more than a 1,000 percent increase – from 1980 through 2005. During that time, dividend payers outperformed non-payers by more than 2.6 percentage points per year. A \$10,000 investment in dividend-paying stocks in 1980 would have grown into nearly \$300,000: \$120,000 more than if that money had been invested in non-payers.

The compounding effect of dividend payouts can be quite dramatic over the long term. It simply takes patience, a long time horizon and quality companies. In “The Future for Investors,” Jeremy Siegel advocates a long-term dividend-reinvestment strategy based on research that showed dividend-paying stocks have historically outperformed non-dividend payers. The same can be said of today’s dividend payers. The S&P 500 Dividend Aristocrats have outperformed the S&P 500 and the S&P 500 Equal Weighted Index over the one-, three-, five-, 10- and 15-year periods ended Dec. 31, 2009.

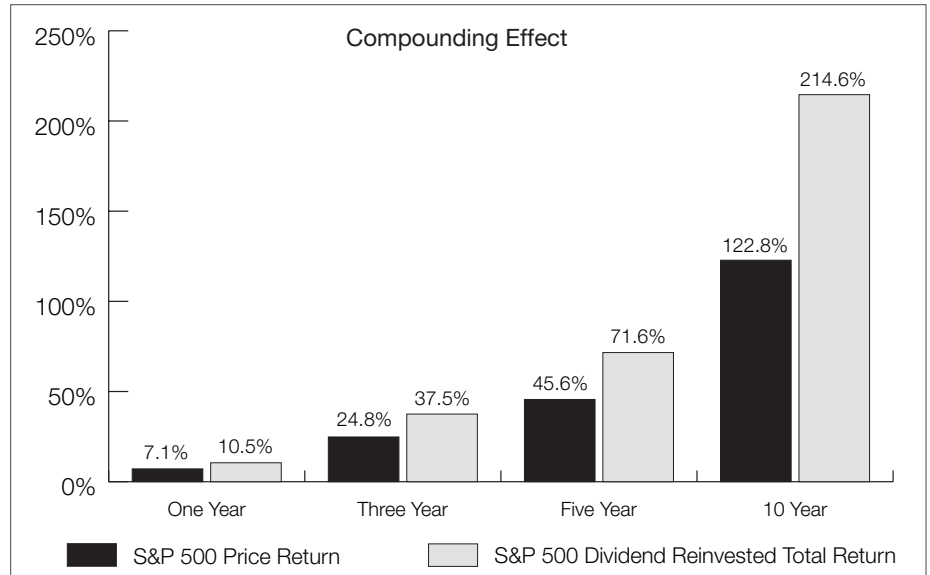
Not only did the S&P 500 Dividend Aristocrats outperform historically, they did so with lower volatility over the long term, as measured by standard deviation. Investors may be able to improve their odds by focusing on quality companies that have long-term competitive advantages and high returns on capital and equity, at a fair price.

Bottom line: Reinvest those dividends and allow the power of compounding to work in your portfolio. Dividends do take time to accumulate and grow. It may be several years before the true benefits of dividends become evident. However, that patience does eventually pay off.

### Sector diversification and risks

Equity investors increasingly recognize the value of dividend income, but it is important not to ignore potential sector risk. This is where a professional money manager may help. Financial companies and utilities have been known to consistently pay dividends, but a portfolio heavily invested in just two sectors is vulnerable to sector-specific and interest-rate risks. Professional money managers recognize that dividend payers can be found across a broad spectrum of industries. For example, in 2009, dividend payers could be found across all sectors, including consumer discretionary, consumer staples, healthcare and industrials. Investors may benefit from a portfolio that is more diversified across sectors.

You can also find dividend payers among real estate investment trusts (REITs), large integrated oil companies and cigarette manufacturers. It seems important, then, that investors ensure their portfolios are diversified across sectors.



### In conclusion

Capital discipline seems to be in vogue again, and the importance of dividends is being “rediscovered” both by individual investors and professional investment managers. Income-oriented portfolio managers view sustainable, stable and increasing dividends as an indicator of the company’s prospects, and individual investors recognize that a reliable dividend track record may be a sign of corporate stability and maturity. Corporate ability to pay dividends has improved, thanks to record levels of cash on corporate balance sheets. And many companies have returned that excess cash to shareholders as dividends.

We are not suggesting that investors focus solely on dividend-paying stocks and ignore other investment options, but it may be a good time to consider this seemingly under-appreciated segment of the market.

Source: S&P Indices Research Insight, January 2010, S&P 500 Dividend Aristocrats. E1442 6/10 exp. 6/11



EAGLE | Asset  
Management

880 Carillon Parkway | St. Petersburg, FL 33716 | 800.237.3101 | 727.573.2453 | eagleasset.com