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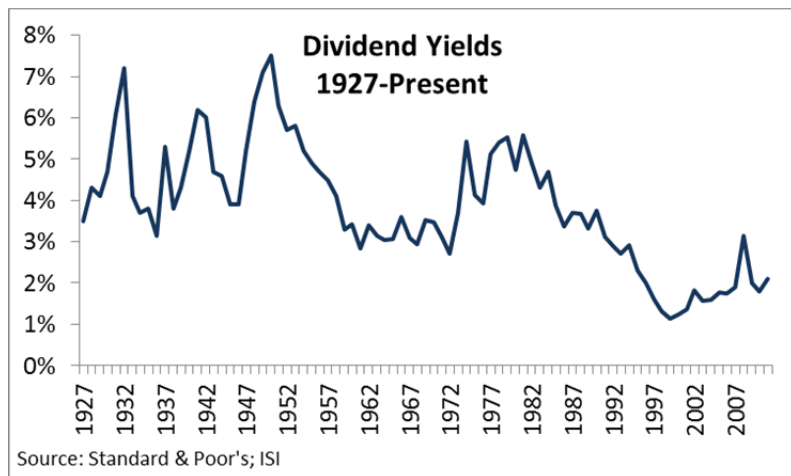
## Dividends – The Return Of The Good Old Days

February 2012

*“The only thing that gives me pleasure is to see my dividends coming in.” – John D. Rockefeller (1839-1937)*

According to Google Books, the use of the word “dividend” peaked in 1922, when the yield on the S&P 500 was 6.3%. At the same time the words “Charleston”, “flapper”, and “prohibition” also peaked in usage. In the mid-1950’s, as dividend yields hit 5.7%, “dividend” had a brief resurgence and the words twist, doody, and hydrogen were also common. In these two disparate decades, following two costly world wars, investors were much less interested in the uncertain potential gains from stock price movements, and much more focused on the certainty that dividend checks appearing in their mailbox provided. Dividends were how “gentlemen” received gains on their stock investments and therefore, their payment was expected by shareholders. Incidentally, the phrase “share repurchase” did not even enter the investing lexicon until the mid-1970’s. So for most of investing history, there was only one way to share company profits with shareholders: the payment of regular dividends. Dividend payments were thought to ensure capital discipline by management, and provide a valuation floor for the stock. Unfortunately, those good old days changed with the times, and companies found ways other than dividend payments to spend shareholder capital.

The dividend yield on the S&P averaged 5.4% during the first 50 years of the last century. However, since 1950, the market has averaged a 3.4% dividend yield, and since 1980, investors have received just 2.7% in yield. Even more troubling is the paltry 1.7% yield investors have received over the past 15 years. Corporate managements in recent times have hoarded cash on their balance sheets, and used it for other



purposes that were thought to increase shareholder value more than dividends, such as share repurchases, acquisitions, and global expansion. During this period, unfortunately, paying dividends became thought of as stodgy and old-fashioned. It was considered a silent admission that they could not

find a more productive use for the capital, so managements were forced to sheepishly hand it back to shareholders.

Meanwhile, since 1980, many things have changed. With more than \$1 trillion in cash sitting on corporate balance sheets today, corporate America is in terrific financial shape, with profit margins, productivity, and efficiency at historic levels. Corporate debt levels are also extremely low, with the borrowing window open at historically attractive low interest rates. In addition, the yield received on some alternatives to dividend paying stocks are extremely low. The 10-year government bond yields less than 2.0%, and the latest investing craze, gold, yields nothing. In today's world of slower global growth, managements are finding fewer avenues in which to grow revenue. Cash is piling up at a record pace and dividend payments are beginning to grow again. Total dividends paid out by S&P 500 companies have actually increased from \$196 billion in 2009 to \$241 billion in 2011. In 2012, projected dividend payments are expected to be a record \$275 billion. However, dividends are not growing at the same rate as cash, and the payout ratio, i.e. the portion of overall earnings that are paid out in dividends, now sits at an historic low. With personal tax rates on dividends at a very favorable 15% rate, we need more dividends!

Many strong companies that have previously shunned paying dividends may have to start yielding to shareholder demands and begin paying out more cash in the form of dividends. Companies like Apple, with \$98 billion of net cash, could initiate a 2% dividend payout using only about \$9 billion of that cash pile every year. And huge cash flow generators such as IBM, Microsoft, Oracle, and Intel could certainly increase their payouts and still remain in strong financial shape. The time honored maxim that "technology companies do not pay dividends" is slowly fading, as these high-return companies pile up cash and find internal investment opportunities less attractive than in years past. As a result, dividends in the Technology sector, which have begun to rise, will certainly continue rising in the coming years.

Could there be a sea change occurring now in the investors' view of dividends? Could this changing view make it advantageous for CEOs to initiate or increase dividends, and to not be seen as merely admitting to weakness or a lack of creativity in their business plan? Are dividends now a great way to send profits back to the business owners? We feel higher dividend yields will come as a result of three factors:

- 1) **Demand:** Investors are changing their perception of dividends. In this low yield environment, investors do not view dividends as just a nominal payout, but consider them a significant and necessary sharing in the profits of the companies in which they own stock. Corporate managements are hearing a louder call these days from investors for higher dividend payouts, and CEOs are starting to respond. So far in 2012, 61 S&P 500 companies have announced dividend increases and we expect there will be more to come. Managements listen to their largest shareholders, and these influential owners are demanding higher payouts.
- 2) **Visibility:** Companies survived the 2008-09 economic downturn by cutting costs, laying off workers, and doing more with less. Since those dark economic days, business growth has returned, with lower costs and higher margins. Managements have much greater visibility and

clarity in their future than they did three years ago. Confidence in future cash flows has returned, and corporate chiefs know that the worst is behind us. Increasing comfort with raising dividends is a reflection of that confidence.

- 3) **Cash:** Cash on corporate balance sheets is at a record high, but at the same time the yield on that cash is at a record low, and is even negative when inflation is factored in. The inefficiency of keeping cash on the balance sheet at negative returns, i.e. negative real yields, is loud and clear, and management is further diluting rates of return on their businesses by continuing to hoard cash for a rainy day that they have already experienced. Investors are not rewarding companies in the form of higher stock prices for keeping a pile of cash on the books that is earning nothing, so management will increasingly choose to pay it out to shareholders.

There are many stocks that have such great underlying business prospects and high dividend yields that they could be considered “*Fixed Income Stocks*”. Among them are many companies that have raised dividend payouts consistently over many years, and have such steady businesses and high returns on invested capital that they should be able to increase dividends consistently in the future. Some great examples include:

**Abbott Laboratories** (ABT, 3.5% yield): Strong cash flows from Abbott’s main drug Humira, which treats rheumatoid arthritis, as well as their vast portfolio of products, from vascular products to infant formula, should allow ABT to increase their dividend at their normal 10% yearly growth rate. A strong new product pipeline, solid earnings growth, and global market reach gives the underlying stock a good shot at share price appreciation as well.

**Emerson Electric Co.** (EMR, 3.1% yield): Emerson’s broad portfolio of high-quality industrial businesses have allowed it to gain a reputation for providing consistent returns to investors, both in dividend yield and stock appreciation from growth of the underlying business segments. Emerson has re-tooled the company over time to focus on higher margin, higher growth business areas around the globe, and the current earnings and cash flow growth is a testament to that focus. Emerson should be able to consistently grow the dividend over time, at their 5-year clip of 10% a year, and also make strong, sound acquisitions around the world, with great focus on emerging markets.

**Intel Corp.** (INTC, 3.1% yield): Intel’s 90%+ market share in the \$30 billion computer processor market leads to large free cash flows, while still allowing for an unmatched amount of capital to be deployed into research & development to help maintain industry domination. Intel has grown its dividend 15% a year over the last five years, and looks poised to continue to do so, with high barriers to entry in its core business, and a large pile of cash in the bank.

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Since 1962 the S&P dividend yield has averaged less than half of the 10 year Treasury note yield. Given the current low level of bond yields and the demand for higher dividend yields, the S&P dividend yield is

actually *higher* than the 10-year Treasury yield today. This margin may increase given the Fed’s promise to keep interest rates extremely low through 2014 and continued demand by investors for higher corporate dividend payouts. Since its founding in 1983, Westwood has consistently owned high-quality, cash flow generating companies on behalf of its clients. Market focus certainly changes over time, but as the market appetite for use of corporate cash comes full circle, and dividends come back in vogue, we believe strategies that invest in high quality dividend paying stocks will be quite attractive over the next few years. Hopefully, we can leave words like “flapper” and “doody” in the past where they belong.

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