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**For Important Disclosures, see pages 7-8.**

## Dividends Still Matter

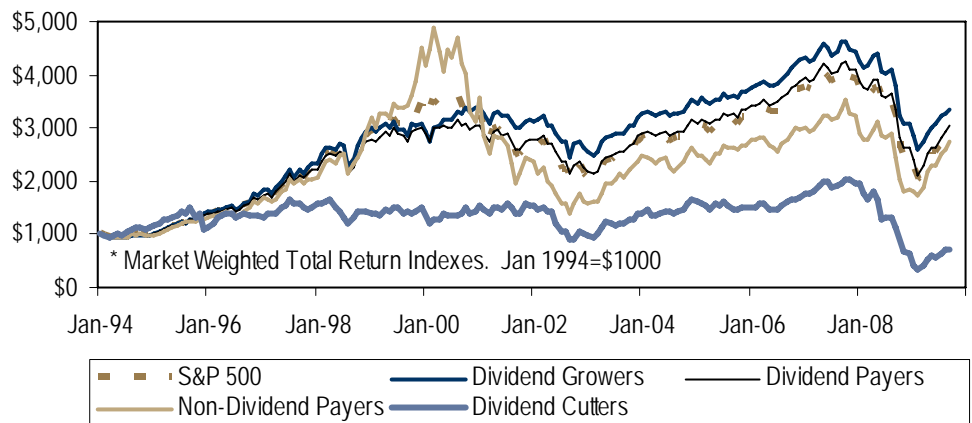
We all know that person who weaves in and out of traffic. Counter to the advice most of us received when we learned to drive (such as pick a lane and stay in it), the lure of weaving pulls at us. A lot of time the weaver does not get his reward. Speeding tickets or worse, or heaven forbid, arriving at the destination at the same time as the person who stays in one lane is a more frequent outcome than arriving early on a consistent basis. Studies show that to be the case, and experienced drivers understand this truth.

Dividend investing is the investing equivalent of “staying in one lane” compared to the weaver “trading the market.” While some trade successfully, most fail to accomplish what they set out to do. Yet the pull to trade remains.

Nevertheless, dividends—albeit not great cocktail party fodder—have been responsible for more than 70% of equity returns since 1900. Reinvested consistently, they are emblematic of the old saying “time in the market is more important than timing the market.”

We are poised to exit 2009 as the only decade since the 1930s where S&P 500 returns have not been positive. The market, as measured from 12/31/99 through 9/30/09 robbed investors of (3.32%) annually. The payment of dividends mitigated that decline to (1.56%). As the chart below shows, dividend payers—but especially dividend growers—have provided meaningfully better returns over the past 15 years.

Dividend Payers and Dividend Growers Outperform S&P 500 over the past 15 years



Source: RBC Capital Markets Quantitative Research

Do these trends signal a change for dividend investors post the Great Recession? If history is any guide, we will come through this economic downturn as we have in the past, and we believe the earnings power signalled by dividends offers a level of predictability and resiliency that investors, now more than ever, demand. Over the next few pages, we’ll be discussing:

- Historical performance of dividend-paying stocks
- What influences companies to pay a dividend
- Hallmarks of quality dividend-paying companies
- Debate on the implications of rising taxes and the possible impact on dividend decisions by corporations

## Corporations Remain Cautious Post the Great Recession

The strong market rebound this year belies the damage to the investing psyche afflicted by the financial crises over the past 18 months. A white paper recently published by the Economist Intelligence Unit and RBC Capital Markets titled “Raising Capital in a New Era” illustrates the degree of this pronounced shift in both investor and corporate sentiment:

- **Capital is king.** Business executives and financial institutions are more apt to stockpile capital, even if the cost of accessing capital is higher.
- **Old maxims are being questioned.** The survey also highlighted that more than half of the survey respondents are re-evaluating the “tenets of academic finance.” This is shaping how investment decisions are made.
- **Investor sentiment has shifted.** It was also noted that “investors [place a] stronger focus on financial strength and cash flow and a shift to a more defensive portfolio strategy.”
- **Respondents are cautious about the recovery.** According to this survey: “just 6% of respondents expect a sharp economic rebound in the next six months ... between one-third and one-half of respondents worldwide do not expect any up-tick for a year or longer...ten percent of respondents anticipate at least two years of economic weakness.”

We believe investors may determine that dividend-paying stocks provide that “bird in the hand” as compensation for taking risk with their equity holdings.

## What Compels Companies to Pay Dividends?

Every company realizes its future success depends on the prudent choices made with its free cash flow. According to a classic study by Modigliani and Miller in 1961, in a perfectly efficient market and if there were no transaction costs, rational investors value dividends and capital gains equally, and corporations are not compelled to choose one over the other. Theory is one thing, but reality is another. As we noted above, recent market action has caused many investors to question long-held market assumptions. If capital is more difficult to come by, could dividends go away?

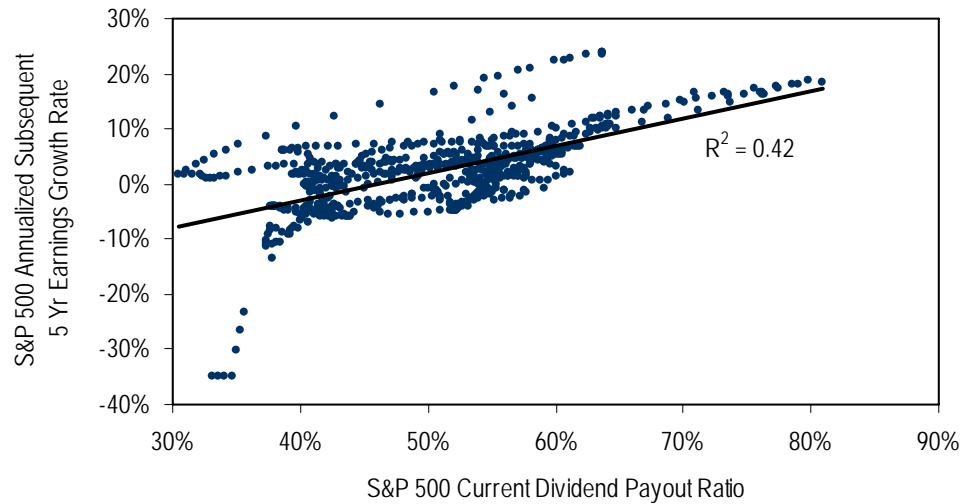
Quality dividend stocks have broadly lagged the market surge in 2009 since dividends paid on S&P 500 companies have been cut by nearly 25% on average, a level not seen since 1938. Overall payments rose 2.4% in 2008, the smallest increase since 2002. Yet dividend stocks preserved capital more effectively during the 2008 decline, similar to past volatile periods.

A study by Baker and Wurgler in 2003, *Appearing and Disappearing Dividends: the link to catering incentives*, provides additional perspective to their landmark study *A Catering Theory of Dividends* published in 2002. The report makes three important conclusions about dividend decisions:

- **Investors may have irrational or time-specific reasons for choosing dividends.** Retirees want dividends to supplement their income stream as global demographic trend favors dividend stocks to meet this need. Institutions often prefer dividend stocks and receive a dividend tax exclusion to hold them. In fact, many institutional investors have investment policies that require holding stocks that pay dividends.

- **Investors are willing to pay up for dividends.** The study showed that when all other variables were held constant, investors were willing to pay a premium for a dividend-paying stock compared to a comparable holding without a dividend.
- **Managers of firm capital actively “cater” to investor demands.** According to the Baker and Wurgler studies, when growth stocks are in vogue, fewer companies initiate dividends. This was particularly true during the late 1970s and late 1990s when the demand for growth stocks was high and stock repurchases and acquisitions were prevalent. Yet the premium for dividend payers persists. Market volatility, such as the recent recession and the bursting of the technology bubble in the early 2000s, has caused the premium paid for dividend-paying stocks to persist, in our view.

High Correlation Suggests Earnings Growth Drives Dividend Growth



Source: RBC Capital Markets, Robert D Arnott & Clifford S. Asness - AIMR 2003

- **Dividend Growth Tied to Earnings Growth.** As the above chart illustrates, dividend growth has strong correlation to earnings growth. While over the short term dividends may grow slower or faster than earnings based on “catering” demand for dividends or other opportunities for that capital (such as the reinvestment/repurchasing boom during the 1990s decade), over the long term, increase in dividend growth closely matches earnings growth. As a result, it is not surprising that with earnings growth poised to decline for the S&P 500 to 12.68% from 2008 to 2009, dividend income is expected to decline nearly 25%. While some of this is structural (i.e. a condition of TARP funding for financial institutions), it also reflects the reality of the economic environment and tough decisions facing corporations. With fewer investment opportunities available to corporations, combined with a higher cost of capital, a prudent use of capital may be to return it to shareholders. We could see payout ratios expand, similar to the period of 1982-1990.

Time Period	Trough	Annualized Dividend Growth	Annualized Earnings Growth
1976-1981	(1975)	8.56%	7.65%
1982-1990	(1991)	6.63%	5.16%
1992-2000	(1991)	3.08%	12.42%
2002-2007	(2001)	3.36%	7.12%
<b>1973-2008</b>		<b>5.20%</b>	<b>5.98%</b>

Source: Standard & Poor's – S&P 500 data

## Hallmarks of Quality Dividend-Paying Companies

Companies with long-term dividend track records are generally considered some of the best companies in the world. Studies show that the ability to pay a dividend through the thick and thin of the business cycle points to a better-than-average business model. This ability also generally points to above-average management teams. We've highlighted several factors we consider when evaluating dividend-paying stocks for inclusion on our lists:

- **A strong financial foundation.** A company able to successfully raise its dividend over time generally has financial flexibility, access to capital, and a stronger-than-average balance sheet, with total debt/capitalization below its peer group. Companies that qualify for inclusion in designations such as the S&P Dividend Aristocrats, which highlights firms that have raised their dividend in each of the past 25 years, historically have scored well in the firm's "quality" rating—85% of Aristocrats are ranked A- or higher compared to 46% of the S&P 500. S&P's quality rating scores companies based on the historical growth and stability of their earnings and dividends.
- **A demonstrated ability to grow shareholder value.** Shareholders should monitor the success with which companies make acquisitions or capital investments. It is critical these efforts contribute to a stable to rising ROIC. Frankly, one of the reasons we favor dividends is the challenge many companies face turning potential opportunity into financial reality. Corporate write-downs should be monitored for content and consistency, and corporate pay policies should be tied to long-term company objectives. A demonstrated ability to expertly shepherd a company and build long-term earnings growth is akin to carefully tending the golden goose that lays the dividend eggs.
- **A history of consistent dividend payments and, preferably, regular dividend increases.** As the discussion above illustrates, paying a dividend is a choice. The pace of growth in that dividend is directly related to the earnings growth of the company. We suggest monitoring the free cash flow yield on the shares because it points to cash flow that may be available in the future for dividends. We are also mindful of rising payout ratios since it may indicate earnings growth has slowed or there has been a misplaced corporate decision to pay the dividend instead of pursuing attractive acquisitions. Both are situations that could foreshadow a dividend decrease longer-term.

## Current Capital Gains and Dividend Tax Outlook

The fiscal and monetary spending decisions as a result of the financial crisis have caused many individuals to expect taxes to rise.

Congress passed a resolution authorizing the fiscal 2010 budget in April 2009. The resolution includes provisions directing the tax committee to draft legislation on tax provisions. The budget resolution includes the following items:

- **Current capital gains and dividend tax rates were extended through 2010.** Tax hikes were postponed to 2011 due to the weak economy.
- **For 2011, capital gains and dividend tax rates should rise for upper-income earners.** Rates for other brackets will stay the same. Specifically:
  - ✓ **For tax payers with taxable income of \$250,000 (married) and \$200,000 (single) and above:** Capital gains and dividend tax rates will rise to 20% from the current 15% level. We caution that these breakpoints should be used only as a guideline because some accountants believe this tax increase could

impact taxable income at slightly lower levels since the 28% tax bracket will be expanded. The upper two tax brackets will change (33% moves to 36% and 35% moves to 39.6% in 2011).

- ✓ **Taxpayers who fall into the 25% and 28% bracket** should continue to pay rates at 15% for capital gains and dividends.
- ✓ **Taxpayers who fall into the 10% and 15% bracket** should continue to see capital gains and dividends taxed at 0%.

We suggest you speak with a tax professional to verify this information prior to making tax-based investment decisions.

### Rising Dividend Taxes Likely Result in a Muted Effect on Dividend Decisions

Despite the changing tax environment for dividends, in general we believe the impact on dividend-paying stocks will be muted for a variety of reasons, highlighted below:

- **Individuals hold about 30% of stock.** Close to 70% of stock is controlled by pension plans, mutual funds, and other financial intermediaries, based on 2006 data. This is a significant shift from just after WWII, when nearly 90% of stocks were held by individual investors.

A study published by the Center for Economic Policy Research (CEPR) concludes, as “ownership shares have migrated from wealthy households to untaxed private pension plans, further manipulation of capital income taxation of stock is increasingly less relevant.”

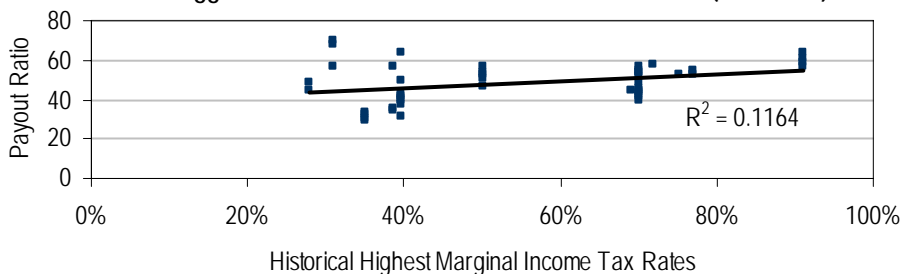
While higher taxes may impact the demand for dividends at the margin, corporations take many factors into consideration when setting dividend policy.

Although a short-term impact on investor demand for dividends cannot be ruled out, we also note the reversion to dividend tax rates prior to 2003 has been a topic of conversation for investors almost since the start of the 2008 election cycle, and intentions by the current administration have been well-telegraphed.

- **Economic cycle and business model drive dividend policy.** We tend to highlight the traditionally defensive sectors of the market when we talk about stable and growing dividends: consumer staples, healthcare, utilities, and telecom services.

These sectors have lagged cyclical stocks in the recent market rally, and at the present time are trading closer to the low end of their historic valuation ranges. We do not view these as impaired business models, but their steady earnings performance is not attractive in a recovery phase of the economic cycle.

Low Correlation Suggests Tax Rates Don't Drive Dividend Decisions (1960-2008)



Source: RBC Capital Markets, S&P, Internal Revenue Service

Decisions corporations make when considering dividend payments include many more variables than the tax rate paid by individual investors. Our prior commentary highlights the key role earnings growth plays in determining dividend growth.

- **The economic impact debate rages.** The potential impact on the economy depends on the source you cite.

According to analysis done by the conservative Heritage Foundation, allowing the 2001 and 2003 tax cuts to expire could increase total tax revenues from \$2.3 trillion in 2010 to \$4.2 trillion in 2019, an average of \$200 billion annually. The Heritage Foundation argues for a cut in spending, targeting the historic 20% level of GDP higher taxes.

The traditionally liberal Tax Policy Center takes a slightly different perspective, arguing that the lower tax rate had only a minimal impact on economic growth. In the case of capital gains, they note that according to their studies, “roughly half of capital gains represent profits on the sale of corporate stock...about half of these profits are never taxed at the corporate level because of various tax breaks that benefit corporations.”

The Center also advocates a stronger focus on the “tax avoidance gap,” of the \$300 billion or so of tax dollars that are still owed, the IRS intends to collect through voluntary late payments or increased enforcement actions. The Center also believes increased focus should be on investors and corporations that engage in “favored activities” that allow some to pay less than others despite the same income.

It appears the only consistency is the disagreement over the fairness of the tax code and the adherence to entrenched points of view on fiscal policy.

Higher tax rates often encourage individual investors to find ways to minimize their tax payments. It is often argued that low capital gains rates stimulate the demand for tax shelters that promise to convert earned income to capital gains. As in times past, we believe dividends will mightily withstand the risk of higher tax rates.

In general, we believe the value of dividends will continue to shine as investors look for ways to stay on that steady “same-lane” investment path. The demographic shift, in our view, is also a powerful driver of dividend demand as investors look to supplement their cash flows as they approach retirement.

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			Count	%
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