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**March 31, 2006**

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# Dividends—Here They Come

At Epoch Investment Partners, our investment philosophy is designed to address the changing drivers of equity returns. In today's markets, dividends are among the most significant of these changing drivers. This paper will address why dividends have emerged as an important source of equity returns, and what this means for the informed investor.

The change in total return for any equity index can be defined as follows: dividend yield plus earnings growth plus P/E expansion. Dividends, therefore, have always been a contributor to overall equity returns. However, from 1980 through 2000, their contribution was relatively minor. During this 20-year period, P/E expansion and earnings growth accounted for over 80 percent of the return in the stock market, as indicated in Figure 1.

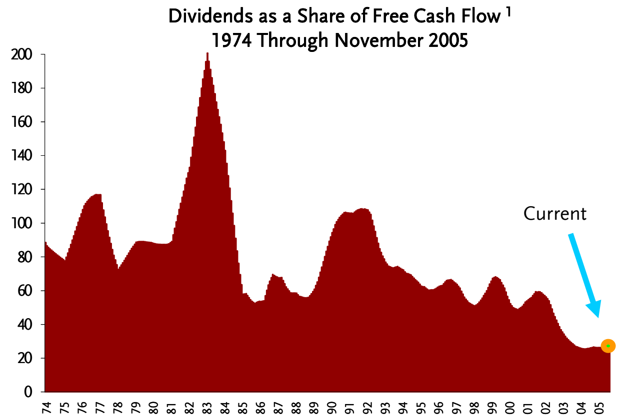
**Figure 1 – Total Return for Equities 1980-2000**

| | |
|---|---|
| P/E Expansion | 7.6% |
| Earnings Growth | 6.4% |
| Dividend Yield | 3.6% |
| Annualized Return | 17.6% |

Today, this equation is changing, largely due to rising interest rates. When interest rates fall, P/E ratios rise and vice versa. Since June of 2003, interest rates have been more likely to rise than fall and, hence, P/E ratios are more likely to fall than rise. As a result, earnings growth and dividend yield have become the dominant drivers of future equity returns. Specifically, dividends – in the form of cash, stock buybacks, or debt paydowns – will soon comprise nearly half of the total return expected from equities, up from 20% for the period 1980-2000.

Figure 2 provides further evidence that dividends are poised to play an increasingly meaningful role in total equity returns.

**Figure 2**




Source: Corporate Reports, Empirical Research Partners Analysis.

This graph shows the relationship between cash dividends and free cash flow levels for U.S. corporations over the past 30 years. The dividend-to-free-cash-flow ratio is currently at a 30 year low. In other words, the capability to increase dividends has never been better than it is today. In our view, this justifies an investment perspective that places a growing importance on the role of dividends in a company's free cash flow deployment strategy.

In order to fully consider this dividend-oriented investment perspective, one must ask whether firms will actually pay higher dividends just because they have the capability to do so. In our view, the answer is yes.

First of all, dividend payouts have become a de facto protection mechanism against the takeover aspirations of private equity investors. In many cases, dividends are the best possible use of free cash flow. If a dollar of free cash flow cannot be put to work by a company at the same or higher rate of return currently being earned on the capital employed in the business, then that incremental dollar should be returned to the shareholder through dividends. This can take the form of cash, stock buybacks, or debt paydowns. If a company's current management team fails to make efficient use of its assets in this manner, there are other management teams who will do it for them. These "other" management teams are private equity investors, who have recently amassed billions of dollars specifically earmarked for the takeover of companies that do not use their cash, working capital, and other assets wisely. These private equity investors will use the target company's cash – cash that might have been used for dividends – to reduce the cost of acquisition. As a result, the company's decision to retain cash instead of returning it to shareholders became part of the impetus behind the private equity takeover. With less cash on the books, and more free cash put to use through dividends, the company might not have been acquired. For this reason, we believe that today's robust private equity market provides a clear incentive for the intelligent use of a company's free cash flow by its management.

Today's changing corporate compensation system is another compelling reason for management teams to increase dividends. Options were a popular compensation strategy for many years, particularly from 1980 through 2000, but their popularity is currently on the decline. For example, both Citicorp and Exxon have eliminated their option plans. Options were attractive during the years when falling interest rates created huge windfall for corporate executives, and options themselves never had to be expensed in the income statement. Today, however, due to changes in accounting principles, options must be expensed and interest rates are much more likely to rise than fall from the levels reached in recent years.

This is the reasoning behind the emergence of Restricted Stocks Units (RSUs). Generally speaking, RSUs are exactly like the shares of a company available for public purchase, but they are awarded to a firm's employees and often have vesting restrictions and occasionally sales restrictions. However, if the firm pays a dividend, RSU shareholders, including members of the company's management team, receive that cash in the same way that general shareholders do. This cash is taxed at a rate of 15%, which is lower than the rate applicable to bonuses.

Therefore, RSUs represent a compensation-related incentive for companies to pay dividends that did not exist previously. For example, suppose you ran a firm with options struck at $45, a market price of $40 and you had excess cash of $5 per share on your balance sheet. Paying a special dividend of $5 could leave you $10, rather than $5, from realizing your option value. Therefore, the bias to retain cash, if it indeed existed at all, has disappeared with the arrival of RSUs. Pay a dividend and all shareholders receive the benefit, including management.

At Epoch, we believe that dividends are an integral component of the current investment landscape. Any investment strategy that hopes to fully address today's changing market dynamics needs to take dividends into account. For this reason, we have created both the CI Global Dividend Advantage Fund for Canadian investors and the Epoch Global Equity Shareholder Yield Fund; funds designed to capture dividends in the form of cash, stock buybacks, or debt paydowns. We believe we have identified a global set of companies that are likely to allocate much of their free cash flow to these three dividend-related applications.

In fact, we have already seen evidence that supports our focus on dividend yield. Cash dividends rose over 11% in 2005 for the S&P 500. Share buybacks (worth $350 billion) exceeded cash dividends paid in 2005 by nearly 75%. In 2004, shares repurchased equaled $250 billion. Buybacks totaled 61% of reported earnings for the S&P 500 in the fourth quarter of 2005, and cash dividends were 32% of reported fourth quarter earnings.

In our view, dividend yield shows every sign of being a powerful and enduring trend. For this reason, the investment professionals at Epoch have designed funds that will help our clients capture the growing importance of dividends as a driver of total return.