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Dividends – A Perspective

A recent study by the London Business School and Credit Suisse Group disclosed that U.S. equities returned an average of six percent per annum since 1900, as adjusted for inflation. Take away dividends, however, and this annual gain drops to 1.7%: a return lower than that of long term Treasury bonds over the same period. The message here is that dividends really matter; and capturing them in a low cost, diversified manner is both important and rewarding for investors.

Laurence Booth, Finance Professor of the University of Toronto's Rotman School of Management, makes the point in this fashion: "Ultimately what you get out of investing in stocks is the cash flow from dividends." Graham and Dodd, in the sixth edition of their famous book, Security Analysis, also make this point very bluntly by stating, "The prime purpose of a business corporation is to pay dividends to its owners."

At Epoch Investment Partners, Inc., we believe that a broad definition of dividends can comprise any one of three separate elements: cash dividends, share repurchases, and corporate debt reductions that result when cash flow is deployed to reduce financial leverage.

The trick for investors is to discern whether a company's free cash flow is best utilized by paying a dividend or, alternatively, by reinvesting in internal projects or acquisitions. Under which scenario is the shareholder better off? The gating factor is the firm's cost of capital. If the firm can earn a return on the incremental cash flow available for investment that equals or exceeds the cost of raising a new dollar of capital, it should pursue those internal investment opportunities or make accretive acquisitions.[1] However, if a company is profitable and generates free cash flow but lacks reinvestment opportunities or acquisitions that would return more than their cost of capital, all or some of the company's free cash flow should be returned to shareholders via one of three dividend mechanisms: cash, share buybacks, or a reduction in financial leverage via a reduction in outstanding debt. This policy was recently reiterated by the CEO of Merck when he said his company would boost dividends or share buybacks in the event that

[1] This is the point of the famous "Gordon- Shapiro" growth model of 1959.

Merck's fast-growing cash position could not be profitably utilized through internal and external investments.[2] In effect, Merck's CEO is saying that if he has excess free cash flow, and if this capital is neither invested nor returned to shareholders, long term returns on capital will be sub-optimal.

Although companies are not required to pay dividends, nearly 75% of the firms comprising the S&P 500 do. That compares to only 40% for all common stock traded on the NYSE, AMEX, and NASDAQ combined. Moreover, in 2008, 45% of the dividend-paying firms on the S&P 500 raised their dividend, compared to only 21% for all listed U.S. companies. Even in today's difficult economic environment, Howard Silverblatt of S&P expects 200 companies within the S&P 500 to sweeten their cash dividend disbursements in 2009, albeit by a modest percentage.

However, given the rapidly declining state of the economy, the 40% estimate implied by Silverblatt may prove too optimistic. The risk that companies will cut, as opposed to increase, their dividend payments reflects nearly two years of bleak conditions in the finance sector and an expectation for at least another year of the same. GE, for example – which is really a finance company with industrial subsidiaries – has a dividend policy that seems to be on very uncertain ground. Nevertheless, because of the decline in market values, common shares of many companies with well-covered dividends have become even more attractive given the rise in their current yields. These firms often have leading market share positions in their industries, strong balance sheets, and capital sources from a variety of both internal and external sources.

Epoch expects dividends for the S&P 500 to fall in 2009 and this forecast applies to non U.S. companies as well. Although dividends for the S&P 500 and the MSCI indices may fall by as much as 15%-20% this year, current share prices for many firms' equities already reflect such a decline. This being said, however, it is certainly possible in this current economic environment to build portfolios with cash yields that will not experience declines of this magnitude.

In the Epoch Global Equity Shareholder Yield Fund, a Morningstar Five Star Fund[3], we have successfully avoided the pitfalls that have felled the financial sector[4], in which many of the aforementioned dividend cuts have taken place. This achievement alone would have resulted in strong performance for the Fund. However, through the careful implementation of proprietary data screens and extensive due diligence on the candidates considered for inclusion within the portfolio, we have provided substantial additional value.

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[2] Reuters 29.61-0.36

[3] The fund had the following ratings for the 1- and 3- year periods respectively: 68 and 57 out of 682 and 563 funds in the Morningstar World Stock Category. The Overall Morningstar Rating is based on risk-adjusted returns, derived from a weighted average of the one, three, five, and ten year (if applicable) Morningstar metrics.

[4] See our website www.eipny.com for our white papers on this topic over the past two and one half years.

What really makes this Fund successful is its emphasis on free cash flow metrics[5] rather than the traditional accounting metrics of Price-to-Book and Price-to Earnings. In our view, the difference between these two approaches is like the difference between astronomy and astrology: one is a legitimate science, while the other is a hodge-podge of speculations and superstitions. Unfortunately for some investment firms, this comparison has proved all too accurate in recent years.

By combining our definition of free cash flow with an understanding of the role of the cost of capital in making capital allocations, we have successfully identified a collection of companies that are most likely to increase shareholder value. And the key to this increase is the existence of prudent dividend payout policies in the forms of cash, share repurchases, and debt paydowns – our definition of shareholder yield.

[5] Our definition of free cash flow is cash available for distribution to shareholders after all planned capital expenditures and all cash taxes.