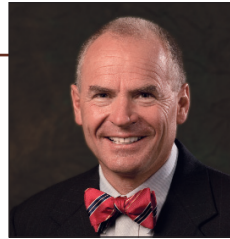


**ABOUT THIS SERIES:** This newsletter is one in a series about macro-economic topics that may affect investors in the coming decade. Fritz Meyer is a senior investment officer with A I M Advisors, Inc.

# Meyer Report

## on Dividends

Fritz Meyer



‘A crucial lesson for long-term investors ... is that the reinvestment of dividends matters—and it matters a lot.’

—Jeremy J. Siegel, *The Future for Investors*

### The case for dividends

During the soaring markets of the 1990s, many investors decided to forgo seemingly stodgy dividend-paying stocks in favor of high-flying tech stocks—the desire for heady growth overruled the prospect of steady income. I believe, however, that if your portfolio doesn’t include dividend-paying stocks, you might be missing out on potentially significant returns.

Dividend stocks are far from stodgy. By reinvesting the dividends that companies pay their shareholders, investors may boost their potential for higher overall returns over the long term.

Alternatively, for retired investors, taking dividends in cash can provide necessary income while still maintaining the potential for capital growth through share

price appreciation. That’s an important distinction from fixed-income investments—a popular choice for retired investors. Individual bonds offer income at a fixed rate, with no potential for higher income down the line. Additional income from bonds can be found through mutual funds that buy and sell the bonds in their portfolios, trading lower rate bonds for higher rate ones. But, the growth potential still may not be as high as that for equities.

So whatever your stage in life—a recent graduate, a recent retiree or somewhere in between—I believe a well-diversified portfolio that includes dividend-paying stocks may help you achieve your investment goals.

### The power of reinvesting

The benefits of reinvesting dividends can be seen in all economic climates—especially, perhaps, in bear markets, when dividends historically have helped cushion investors’ portfolios and accelerate returns.

According to Jeremy Siegel, author of *The Future for Investors*, “Long-term investors who reinvest their dividends will find that bear markets not only are easier on their portfolio, but also can enhance their wealth.”

How does this happen? Investors who consistently use their dividends to purchase new shares will end up buying more shares

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## Dividends 101

How do you determine the performance of a dividend-paying investment?

By using yield, a measure of return. It is usually an estimate of what a stock or fund would pay if its dividends continued at the same rate for the next year.

- For stocks, yield is the annual percentage of cash payouts for a share of stock.

- For mutual funds, yield calculates the income portion of a fund's performance, which consists of three components: capital appreciation/depreciation, capital gains and dividends.

### Determining yield:

$$\text{Yield} = \frac{\text{Annual dividends per (stock or mutual fund) share}}{\text{Price per share (stock or mutual fund)}}$$

### Example:

If Acme Co. pays a \$0.40 dividend quarterly, stockholders will receive \$1.60 in dividends annually for each share they own. If the share price is \$65, the yield is 2.5% annually.

$$\frac{\$1.60}{\$65} = 2.5\%$$

This may not seem significant, but it becomes a valuable return when the rate of appreciation in share price slows or stops.

If a stock price rises faster than a company's dividend, the dividend yield will fall:

$$\frac{\$1.60}{\$70} = 2.3\%$$

If a stock price falls relative to dividends, the dividend yield will rise:

$$\frac{\$1.60}{\$60} = 2.7\%$$

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in bear markets, when stock prices are lower and their dollars stretch farther. This can have two benefits:

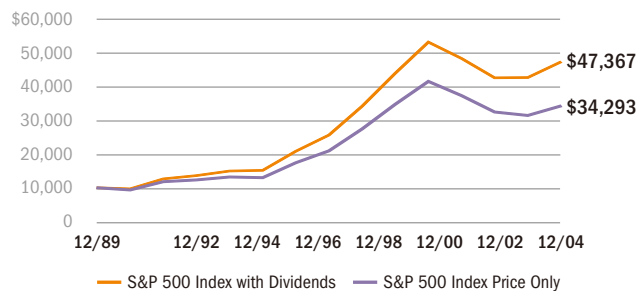
- The extra shares purchased in bear markets can help prevent an immediate decline in portfolio value.
- When the market recovers, those shares may have the potential to increase in value.

“Market cycles, although difficult on investors’ psyches, generate wealth for long-term stockholders,” Siegel maintains. “These gains come not through timing the market, but through the reinvestment of dividends.”

So while stock prices may fall, reinvested dividends can help soften the blow, providing a level of downside protection while allowing you to potentially benefit if the market moves higher. It should be noted that this strategy does not assure a profit and does not protect against loss in declining markets. In addition, since this strategy involves continuous investment in securities regardless of fluctuating price levels, an investor should consider his/her financial ability to continue purchases through periods of low price levels.

### How dividends have benefitted total returns

\$10,000 invested in the S&P 500 Index on Dec. 31, 1989, would have grown to \$34,293 by Dec. 31, 2004, if dividends were not reinvested. But if dividends were reinvested, that initial \$10,000 would have grown to \$47,367. Past performance is no guarantee of future results. An investor cannot invest directly in an index.



### Income plus growth potential

But what if you don't fall under the category of “long-term” investor? What if your retirement is around the corner and you need your portfolio to start providing income? In this situation, dividend-paying stocks can still offer potential benefits.

Consider the strategy many older, income-oriented investors take with their portfolios: investing primarily—or totally—in fixed-income holdings such as bonds or certificates of deposit (CDs). These investments offer a steady stream of income, but they have a fixed rate of return—there is no potential for growth. Please note that CDs are insured by the Federal Deposit Insurance Corp., while securities such as stocks and bonds are not.

Conservative investors often choose fixed-income investments because of their relatively low level of investment risk. However, these investors may be underestimating another type of risk that they face—inflation. In other words, as time goes by and if inflation levels rise, the cash flow generated by fixed-income investments is ultimately worth less and less. Some type of growth potential may be necessary to combat the effects of inflation.

Chart Source: Lipper

Dividend-paying investments offer an equity alternative to bonds or CDs—which means income and growth potential.

- Stock dividends typically increase as a company’s profits increase. This could provide you with a growing stream of income.
- As with all equity investments, there’s the potential for a stock’s price to rise, increasing the value of your portfolio.

Considering that people are living longer today than previous generations, supplementing fixed-income investments with dividend-generating stocks may be a key to helping your retirement savings last as long as you do.

**More companies are paying dividends**

The choices for investors interested in dividend-paying stocks are increasing as more companies join the ranks of dividend-generators.

In 2003, Congress reduced the tax rate for stock dividends from a maximum of 38.6% to 15%, eliminating the preferential tax treatment of capital gains over dividends. As a result, many companies initiated regular dividend payments where, previously, none had existed.

Now, two years later, even more companies are sharing their profits in the form of dividends. According to Standard and Poor’s, 376 companies that make up the S&P 500 Index paid dividends last year, a 7% increase from 2002. Moreover, there were 269 dividend rate increases in 2004 for S&P 500 companies, up from 240 the previous year.

More companies sharing their wealth—and more dividend rate increases—mean more investment opportunities for you.

**Dividend-paying companies: A history of performance**

Siegel asserts that companies that pay dividends have a history of competitive performance. In *The Future for Investors*, he examined the returns of firms in the S&P 500 Index from its beginning in 1957 through 2003. He found that if an investor put \$1,000 into the S&P 500 at the end of December 1957, he would have achieved an annual return of 11.19% at the end of 2003. In comparison, a \$1,000 investment made in just the top 20% of S&P 500 companies with the highest dividend yields would have earned an annual return of 14.27%. Putting \$1,000 into the 20% of S&P 500 companies with the lowest dividend yields would have yielded an annual return under 10%.

Ned Davis Research Inc. also has found that the stock returns of companies with growing dividends have outpaced companies that don’t change their dividend payments, or don’t pay dividends at all. (See box at top right.)

Also, Siegel points out, dividend-paying companies send an important message to their shareholders—their earnings are real. This is especially important in the wake of Enron and other corporate scandals that shook the confidence of investors. Dividends are a “critical ingredient in generating trust between shareholders and management and confirming management’s statements about earnings,” he says.

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**Returns of S&P 500 Index Stocks**

1/31/72 to 12/31/04

	Annual gain	\$100 grows to
Dividend growers and initiators	10.7%	\$2,853
Dividend payers with no change in dividends	7.4	1,053
Dividend cutters or eliminators	5.4	566
Non-dividend paying stocks	4.4	412

**Chart Source:** Ned Davis Research  
Returns based on monthly equal-weighted geometric average of total returns of S&P 500 component stocks, with components reconstituted annually.

## Index Information

The S&P 500 Index is an unmanaged index considered representative of the U.S. stock market.

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### Finding dividend-paying stocks

Investors who want to add dividend-paying stocks to their portfolio can either research individual companies or invest in a mutual fund that focuses on this type of stock.

Portfolio managers of dividend-focused funds consider whether companies:

- Can sustain, or even increase, dividend payments in the future.
- Have management teams that know when to reinvest in their business and when to make distributions to shareholders.
- Have the potential to grow in value over the long term.

I believe that investors can benefit from the knowledge and analysis of professional portfolio managers who are focused on dividend-paying stocks.

### Talk to your financial advisor

Dividend-paying stocks may involve more risk than bonds and CDs, but they may be an important factor in prolonging the life of your retirement assets. Consult your financial advisor about how a mutual fund that focuses on dividend-paying stocks may fit into your diversified portfolio.

*Fritz Meyer is a senior investment officer with A I M Advisors, Inc. He regularly provides both economic and general market commentary for internal audiences and external broadcast and print media. He began his investment career in 1976. Mr. Meyer earned his master's degree in business from the Amos Tuck School at Dartmouth College. He earned his bachelor's degree from Dartmouth College with a distinction in economics.*

The opinions expressed by Fritz Meyer are subject to change at any time based on market and other conditions and offer no guarantee of future performance.

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