

## The Dividend Rediscovered

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Long before price/earnings multiples and other valuation metrics became popular, investors valued companies based on a stock's yield. A stock with a higher yield was a better value. Throughout the past few decades, investors largely ignored dividends and rewarded companies that retained capital in pursuit of higher growth rates. As expected, corporate management shifted capital allocation strategies to heed the desires of shareholders. The proportion of companies in the Russell 1000 Index that paid dividends fell from 90% in the early 1980s to only 55% in 2000. For the most part, retained capital was not well invested by corporate management. But now capital discipline is again in vogue, and the importance of dividends is being rediscovered — both by investors and corporate boards.

Most academic studies<sup>1</sup> confirm that the receipt and reinvestment of dividends has been the major source of stock market returns over the long term. Depending on which study one cites, from 40 to 70% of stock returns can be traced to dividends. When dividends have not dominated total returns, price/earnings (p/e) multiple expansion has most often been the driver of stock returns. Supported largely by low bond yields, current p/e multiples are well above long-term norms, and it may be prudent to assume that multiples are more likely to contract rather than expand from current levels. This takes us back to dividends as key creators of value.

Studies<sup>2</sup> have also confirmed that higher-yielding stocks have significantly outperformed lower-yield or no-yield stocks over the long term. Studies<sup>3</sup> also show that the companies that have paid higher dividends in the past have generated higher future earnings growth! It seems that most of this information was ignored or forgotten by investors and corporate management during the last bull market. But as investors search for attractive returns and corporate management seeks to reestablish credibility, these facts are again getting significant attention. Given that dividend yields recently dipped to all-time lows, a good deal of progress (in rising yields) should remain before we fully retrace the decade-long deviation away from the importance attributed to dividends. The S&P 500 Index's current dividend yield of 1.6% is not meaningfully higher than the 1.1% yield posted in 2000, and remains a far cry from the all-time record 8.7% posted in 1950. Note that even the average yield posted over the past 130 years is 4.6%. We may never make it back to those levels, but progress in that direction should be significant to stock investors.

Despite the currently low yield on the S&P 500, the backdrop remains favorable for investors who want or need a growing stream of dividends to keep pace with inflation. In fact, the dollar amount of dividends paid by the companies that comprise the S&P 500 Index increased in 83 of the last 100 years. Even from 1970 to 2002, a period during which dividends were significantly out of favor, actual dividend payments from the index increased at almost an 8% average per year. Importantly, dividends paid (by the companies that comprise the index) increased every year during that period except in 2000 and 2001. Dividend payment growth resumed in 2002 and 2003. We believe that growth in dividend payments is a long-running trend that will be supported in coming years by several factors. We have entered a period during which corporate ability to pay dividends is improving, underpinned by a firming economy. As revenue growth continues to improve, growth in earnings and cash flow follows suit. This leads to stronger balance sheets, greater capital adequacy, and higher levels of unrestricted cash.

Along with a strengthened ability to pay dividends is a renewed willingness to pay dividends on the part of corporate management. Many companies have used the improved cash flows prudently by returning excess cash to shareholders in the form of dividends, and payout ratios have risen over the past few years. Hundreds of companies have joined the party with some notable companies having either significantly increased their dividends (Citigroup (C) dividends increased 94% year-over-year), or initiated dividend payments for the first time, as in the case of Microsoft (MSFT).

For many, investing in dividend-paying stocks means buying stocks in the financial or utilities sectors. At first glance, this seems a logical place to start. However, investors may benefit from a portfolio that is more diversified across sectors. Financials and utilities, for example, account for only 27% and 7%, respectively, of all dividend payments made by U.S. corporations. Interestingly, consumer staples, healthcare, and industrial stocks each account for a higher proportion of dividend payments than do utilities. Furthermore, those three sectors averaged between 5% and 10%

dividend growth per annum from 1997 to 2002, while utilities averaged less than a 1% increase. See "Dividend Growth" below.

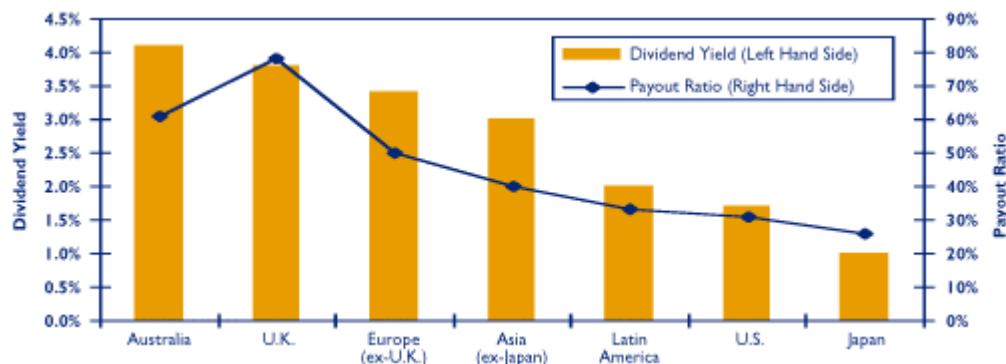
### Dividend Growth Comes from Unexpected Sources

	<b>1997-2002 Median Dividend/Share Growth</b>	<b>Current Yield</b>
Financials	10.7%	2.17%
Health Care	10.6%	1.39%
Consumer Staples	7.6%	1.92%
Industrials	5.4%	1.87%
Consumer Discretionary	5.2%	0.93%
S&P 500 Index	4.9%	1.68%
Energy	2.3%	2.57%
Telecom	1.3%	3.10%
Utilities	0.7%	3.80%
Technology	0.4%	0.36%
Materials	0.2%	2.58%

Source: FactSet

Sectors can and do vary over time.

Investors may also benefit from investing in a portfolio that is more diversified through international investments. For example, Japan is about the only major country in the world whose average stock does not show a higher yield than those in the U.S. (Japan's stocks average about 1.0% yield versus 1.6% for those of the U.S.) In contrast, the average yields on stocks in European and Asian countries range between 3% and 4%. Despite the trends of the American markets, investor demands for capital discipline — and growth of revenue and earnings — have remained in place outside the U.S. See the chart below.



Source: Baseline.

Investing in dividend-paying stocks outside the U.S. received a boost with the recent passage of Federal tax reductions on qualifying dividend income. Qualifying dividend income sources include international companies whose stocks trade on a U.S. market; international companies domiciled in countries that have a tax treaty with the United States (There are currently 65 qualifying countries, representing most developed markets); and most U.S. corporations (notable exceptions include real estate investment trusts and partnerships).

Mutual funds that generate both qualifying and non-qualifying income carry a meaningful structural benefit. A mutual fund is permitted to offset non-qualifying income with fund expenses, leaving a smaller proportion of non-qualifying income to be paid out to shareholders, along with the qualifying income. Offsetting the non-qualifying income has the effect of lowering the tax bill. Importantly, this tax-advantaged structure cannot be replicated by an individual who invests in a portfolio of individual stocks, or in a separate account.

Through the many beneficial factors that have come to a confluence over the past few years, dividends are beginning to gain their rightful share of attention. The better capital discipline imposed upon corporate managers — which

should lead to higher earnings growth and higher stock returns over the long term — means that all stock investors should benefit, whether directly or indirectly, from the rediscovery of the dividend.

1. Robert Arnott, First Quadrant, "Dividends and the Three Dwarfs"
2. CSFB Equity Quantitative Strategy, "Analyze Those Dividends," December 16, 2002  
Smith Barney and Frank Russell Company, Portfolio Strategist, July 3, 2003  
"Dividends: Be Careful What You Screen For"  
"The 'D' Word"  
Smith Barney, Quantitative Strategy, "Historical Performance of Dividend Yield Strategies," January 31, 2003.  
ING Financial Markets, Equity Markets Strategy, "Dividends = Outperformance" January 13, 2003.
3. Robert Arnott and Clifford Asness, January/February 2003 Financial Analysts Journal "Surprise! Higher Dividends = Higher Earnings Growth"  
Arnott and Asness, "Does Dividend Policy Foretell Earnings Growth?" December 2001.

The views expressed by the Associate Portfolio Manager reflects his professional opinion and should not be considered buy or sell recommendations. These views are subject to change.

There may be special risk considerations associated with international investing, including fluctuating exchange rates, government regulations and differences in liquidity, which may affect the volatility of the fund.

The S&P 500 Index is an unmanaged index of common stocks that's generally considered representative of the U.S. Market.

Russell 1000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization.

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