HAMLIN
CAPITAL MANAGEMENT, LLC

September 2012

Fresh Squeezed Orange Juice Served Here

A Short Treatise on Dividend Stocks

Vivian Pan, Ph.D., CFA

Contact Information:
Mark Stitzer
640 Fifth Avenue, 6th Floor
NY, NY 10019
Tel: 212.752.8777
Fax: 212.752.5698

In the aftermath of the 2008 financial crisis, the US Federal Reserve implemented an unprecedented easy money policy to stimulate the economy and to improve employment. The ancillary outcome of this ultra-low rate monetary policy is that dividend paying stocks have regained their popularity, a phenomena that hasn't been seen in quite a few decades if not more. Retirees, savers and conservative investors are seeking dividends in lieu of low coupon fixed income securities. As lone wolves in this asset class over the recent decades, we are delighted that enthusiasm has returned to our investment style. Here we provide a brief history of dividend paying stocks. We will pay particular attention to the 15 year post-WWII period during which time the US financial situation most resemble the current environment.

Why differentiate "dividend paying" stocks?

Are dividend paying stocks fundamentally different from stocks in general? Yes, mainly because not all stocks pay dividends (66% of all publicly traded companies do not pay dividends). Many companies do not share profits with shareholders in the form of cash payments. Those that do, pay out a portion of their net income to owners and retain the balance for reinvestment back into their enterprises.

Starting in the latter half of the 20th century it was widely promoted that dividend paying companies are mature companies whose growth may be limited. As the argument goes, companies pay out because they cannot find useful projects to reinvest in. In our view, this is simply not true. Many companies, whose dividend paying history goes back to the turn of the 20th century and even to the 19th century, have successfully grown their enterprises well into the 21st century, all the while having paid somewhere around 50% of earnings and increased their dividends per share along the way. In the words of the esteemed Peter Bernstein[1]:

> *In the years before 1990, the S&P500 companies as a whole managed to pay out dividends and still record high earnings growth rates. The pay-out ratio exceeded 50% in every year of the 1960s, the decade when growth became the dominant theme in equity investing. Dividends were so popular in those days that there was a significant inverse correlation between pay-out ratios and dividend yields. And tax differentials seem to have been no obstacle to the demand for dividends: from 1953 to the early 1980s, the top federal income tax bracket was 70% as against only 25% on long-term capital gains.*

We would go as far as saying that the mature company misnomer has not served investors well. A good dividend paying stock portfolio tends to experience less turnover, hence less trading, relative to a non-paying portfolio; and has outperformed non-payers over time, i.e. dividend aristocrats' performance[2].

Who cared about a stock dividend and its yield?

We remind readers that stocks are shareholders' claims on a company's assets after all the creditors have been satisfied. Dividends paid on stocks are at the discretion of management and are not contractual. For

---

[1] Bernstein, Peter L., March/April 2005, Dividends and the Frozen Orange Juice Syndrome, *Financial Analyst Journal*, Vol. 61, No. 2, pp. 25-30.

[2] The S&P500 Dividend Aristocrats are companies within the S&P500 that have followed a policy of increasing dividends every year for at least 25 consecutive years.

much of the 19th and 20th centuries, stocks that did not pay dividends were considered speculations. While prudent investors may have owned dividend stocks in the first half of the 20th century, the legal fiduciary standard of care was not codified until the American Law Institute's restatement of Trusts in 1959. This restatement permitted institutional fiduciaries to purchase dividend paying stocks (under the "prudent man rule") without exculpatory clauses in their investment contracts.

Institutional and large private investors favored regular dividend paying stocks as an indicator of investment prudence under the 'prudent man' fiduciary standard of care. It was also argued that companies paid dividends to attract credible investors. Pre-1959, investors bought stocks only if they yielded higher than bonds because of the dividend's subordination to bond interest. Stock prices routinely adjusted to the income yield of bonds so that dividend yields were always higher than Treasury yields. The relationship was highly predictable, investors bought stocks when dividend yields were higher than bond yields, and reacted conversely when bond yields exceeded dividend yields. This went on for exactly two decades after 1939.

In 1959 something else unexpected happened. Stock market dividend yields fell below the bond yield[3]. Many bewildered investors believed the yield crossover to be a transient phenomenon where the reversion to the norm would soon be restored. It was unthinkable to many that stock yields could stay below bond yields for very long. Anyone who survived the Great Depression clung to this view as dogma, so they waited to get back into the stock market. They waited and they waited, and they would have had to wait fifty years by that criteria.

The emergence of Modern Portfolio Theory[4] (MPT) in the 1960s ushered in a new investment paradigm for investors. Rather than treating investments based on individual merits, MPT allowed all investments as long as they played an appropriate role in achieving the risk/return objectives of the total portfolio. Conveniently, attrition or mortality cleared the bench of stock market crash veterans who favored dividend paying stocks. A new generation of Wall Street professionals with short investment memories dominated the market place. With two bull market decades to rest on, dividends were on their way to obsolescence. Who needs income when capital appreciation rules? Relying on MPT and later the "prudent investor rule[5]", professional investors no longer had to evaluate investments on their individual qualities. Investment prudence rested on the covariance of asset classes and their place in the whole portfolio, and in short time the dividend bias in investing languished.

Starting in the 1970's many companies opted to divert free cash flow away from dividends since it was no longer necessary to attract credible investors with generous income. A forty year secular trend of decreasing dividend pay-outs ensued. The reallocation of profits to CAPEX, small and large scale acquisitions, debt reduction, and share repurchases culminated in declining cash pay-outs from an average of 58% (of reported earnings) over the past 86 years to the current 31%.

---

[3] It has not, however, been demonstrated that the crossover was somehow related to institutional fiduciaries bias toward buying more dividend-paying stocks.

[4] Markowitz, H.M., 1959, Portfolio Selection: Efficient Diversification of Investments, New York: John Wiley & Sons.

[5] The Uniform Prudent Investor Act adopted by American Law Institute's Third Restatement of Trusts, 1992.

Today, after a lost decade in the stock market, at least two if not three generations have been deprived of the benefits of dividend-based investing. Peter and Barbara Bernstein termed it the 'frozen orange juice syndrome' – a metaphor of those who have only tasted frozen orange juice and do not appreciate what they are missing in the real thing. In 2005, he writes:

> *It is the taxable investors who are the real mystery. Maybe one day soon the word will reach them that dividends have been enriched by an income tax of only 15%. If and when that day arrives, they will launch a whole new generation of investors who, at long last, will disdain frozen orange juice.*

In this era of low bond yields the day of appreciating the dividend has finally returned. We are hopeful that investors who now have tasted fresh squeezed orange juice will make the additional effort to learn about the fundamental qualities of dividend paying companies that make for successful investing.

Revisiting the past

The present day rekindled fondness for dividend stock investing maybe more than serendipity. Recall that in the era after the Great Depression and WWII, the US was mired in similar circumstances as today with high government debt, and prolific public fiscal deficits. War funding led to massive government debt/GDP of 121% (today 100%). In response the Fed pursued financial repression[6] policies by limiting the long-term Treasury rate at 2.5% from 1945 until March 1951. By imposing ultra-low nominal interest rates the policy ensured that the US government's interest cost remained affordably low in order to ease the burden of servicing its debt. But there is an important consequence to consider. Ultra-low interest rates below the rate of inflation causes negative real rates which is a type of 'taxation' on savers as it erodes their wealth in real (inflation-adjusted) terms. With our present day Federal Reserve quantitative easing levers in play, Carmen Reinhart[7] makes a case that in the aftermath of the 2008 crisis the policies of financial repression have returned. The fear today is that the Fed's 300% expansion of the monetary base may ignite future inflation when this spare fuel will turn into rapid credit creation as economic growth picks up.

While history seldom repeats itself precisely, we see the economic and stock market similarities to our current condition as striking. How did events turn out back in the forties and fifties? As the US economy recovered post WWII under low interest rates, corporate earnings began to rise but not all equities participated equally in the ascendance. Although earnings were rising, P/E multiples contracted from January 1945 through 1950 (the period of financial repression). During this period of rising corporate earnings, fourth highest dividend paying quintile of stocks[8] (Q4) outperformed quintile one dividend paying stocks (the lowest yield quintile) by a wide margin, +81% in nominal returns. Recall in the last passage, many if not most investors pre-1959 were Great Depression battle-conditioned to prefer dividend paying stocks with yields higher than bonds. Perhaps then Q4's outperformance was driven by investors'

6 Financial repression – a term used to refer to policies relating to the coordinated actions of the government, the central bank and the financial sector.

7 Financial Repression Has Come Back to Stay: Carmen M. Reinhart, *Bloomberg News*, March 11, 2012.

8 Kenneth French, Portfolios on Dividend Yield, Value-weighted data set.

bias for less speculative assets and their desire for higher income, similar to today's savers chasing yield. Alternatively, it could be that the market was responding to investors who anticipated inflation-driven earnings and dividend growth potential from companies with higher dividends.

Inflation did rise during the period of financial repression. From 1945 through 1950 CPI increased 39% over this six-year period. Bondholders' real total returns in Fed-suppressed low coupon long-term Treasury bonds were -15.6% over this period[9]; a rational cause for concern for present day unsuspecting savers piling into Treasuries if history is any guide. Meanwhile quintile four dividend paying equities rewarded investors with impressive +95% returns and the stock market as measured by the S&P500 returned +56%, both in real terms.

In early 1951 the Fed lifted the cap on government interest rates and allowed market forces to dictate Treasury yields. Bond yields did rise, but more interestingly, so did stock P/E ratios. From 1951 through 1959, the improvement in public debt deleveraging back to historical average levels in debt/GDP alongside relatively tamer inflation (+17%) reinforced a stock bull market that began in 1949. High yield (Q4) stocks' real returns of +263% kept pace with the S&P500's +279% from 1951 through 1959 as the broader market experienced both rising earnings and P/E expansion. Inflation adjusted bond returns continued to disappoint within the secular bear bond market with -15%. Equity returns blew away bond returns by +294%.

Back to the present

Savers and pensioners are once again looking to dividend paying equities to augment income generation. So much about dividend equities has been written lately as though dividend investing is a novel approach. When we look back on the past eight decades, with the exception of the 1990's, investors who plowed the fertile soils of quintile four would have outperformed the S&P500 in each decade[10] (Figure 1). And even during the 1990's, Q4's underperformance was a manageable 2.6% annualized and absolute returns were very respectable.

So the question of the day is – "Is there a bubble in dividend equities or will dividend equities track the post-WWII trend?" The answer lies in "which dividend equities?" There are certainly pockets of frothiness in our view, but equity valuations within the broad universe of dividend stocks are not all the same. The astute investor will be able to reap the rewards by identifying dividend paying companies whose stocks are priced well below their potential dividend growth opportunities[11]. And that is the sweet taste of fresh squeezed OJ served here!

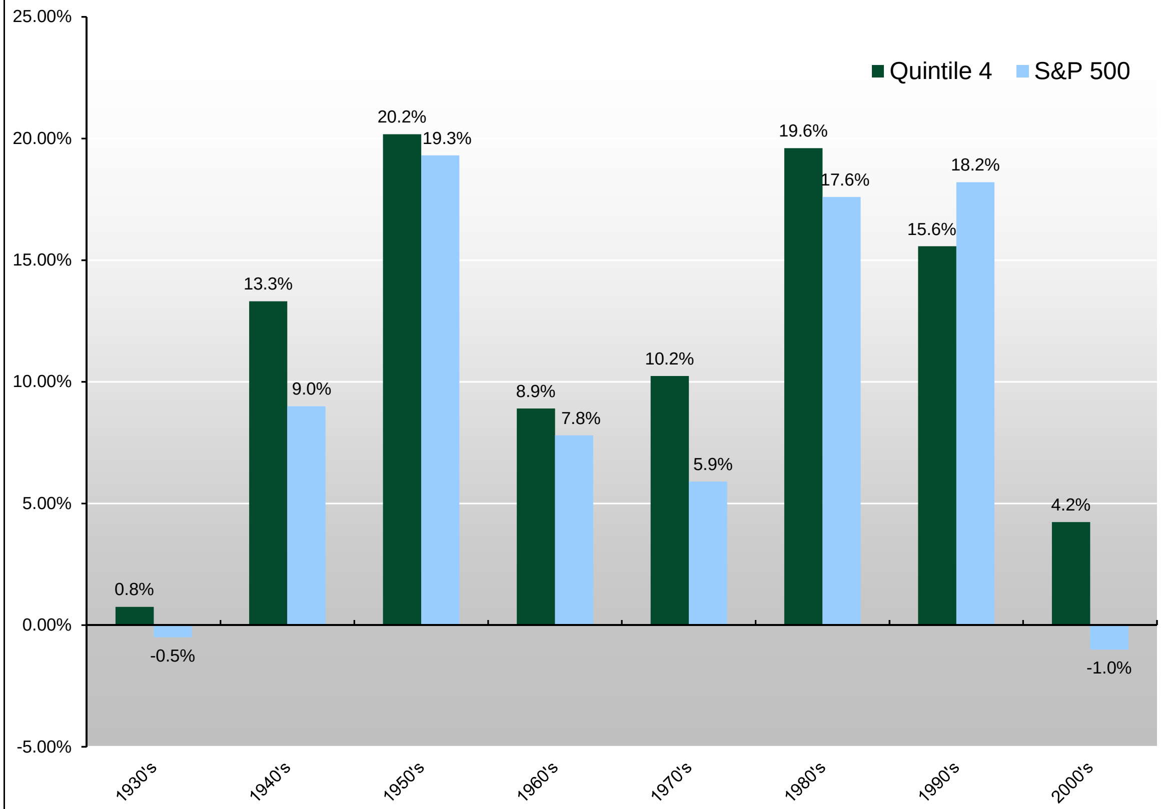
---

[9] Bond data source: Ibbotson SBBI 1926-1976 data from Government Bond File at the Center for Research in Security Prices at the University of Chicago, Graduate School of Business. Long-term bond data refers to 20-year term bonds.

[10] Dividend paying stocks have outperformed non-paying stocks even when tax rates on dividends were much higher than today.

[11] Hamlin's Dividend Investing 2.0 available at www.hamlincm.com

Figure 1: Annualized Total Return of Quintile 4 vs. S&P 500 by Decade



Source: Hamlin Capital Management; Kenneth French: Portfolios Formed on Dividend Yield