



[www.dcmol.com](http://www.dcmol.com)  
20 Northwest First Street  
Fifth Floor  
Evansville, IN 47708

Tel. 812.421.3211  
800.321.7442  
Fax 812.421.3214

## **The Rising Income Story**

### **The Power of Consistently Increasing Dividends**

The Pimco Total Return Bond Fund has become the largest mutual fund in the world, surpassing the famous Fidelity Magellan Fund and the Vanguard S&P Index fund, which had held the top two spots for many years. Managed by Bill Gross, the Pimco Bond Fund is now the new top dog in the investment world. Ironically, Mr. Gross has made a number of miscues in his investment strategy in the past year, and his fund has underperformed the benchmark for bond funds. But, as is so often the case, as an excellent self-promoter, Mr. Gross has become the guru de jour of the bond world. Bonds have been the asset class of choice as the bear market in stocks has worn on.

Mr. Gross does have a good long term track record, but his arriving at the top of the investment ladder in a year when he has performed poorly relative to his peers is just one more oddity in a season of oddities. The greatest oddity from an investment perspective, however, is not that a bond fund has risen to the top of the asset table, but that in the past year, the amount of money flowing into bond funds has overshadowed stock funds by a wide margin. History shows us this does not happen very often. History also shows us that when it has happened, it has been a sell signal for bond funds and a buy signal for stocks.

Bond funds pulled in huge amounts of cash in 1992, 1993, and 1998. In two of the cases, 1993 and 1998, within twelve months, bond prices had fallen sharply. In all three instances, stocks significantly outperformed bonds in the twelve months following the surge into bond funds. Indeed, evidence going back decades shows huge amounts of cash flowing into bond funds has signaled that things were about to change. Vanguard Mutual Funds, a bond fund distributor, has gone so far as to warn its investors of the track record of bond funds in the years after spikes in new money pouring into those funds. (You can read that report by going to their website, [www.vanguard.com](http://www.vanguard.com).) This seems quite logical. If an exorbitant amount of money pours into bonds, bond prices will be driven to peak levels and bond yields to extreme lows, which is the case today. These extremes have been produced by a flight to safety in the face of more terrorist attacks, a war with Iraq, and the grinding bear market in stocks. But, with bond yields at forty year lows, to bet that they would go lower would be to bet that the current situation will only get worse. We think that is a bad bet, as we will discuss later.

### **Looking Past Bonds**

We think there is another way to achieve safety of principal and income that promises to offer generous returns in the years ahead. We call that style of investing Rising Income Equity, or as we sometimes like to say, reading it backwards: Stocks whose Income is Rising.

The remainder of this presentation is about the benefits of investing in stocks with consistently increasing dividends, but a key feature of this style of investing is its ability to produce simple, bond-like valuations. As we have said in many previous letters, one of the main reasons the stock markets have lost their way is because valuing companies solely on the basis of earnings has proven

to be unreliable, especially when the quality of reported earnings is questionable. Valuing stocks on the basis of dividends is very similar to valuing a bond, which, as we shall show, is intuitive and reasonably straight forward. The Rising Income approach makes good common sense, has a long track record of success, and is quantifiable using nothing more than a calculator.

## **Stocks versus Bonds**

Let us head deeper into our discussion of Rising Income Stocks by looking more closely at bonds and some of the reasons for their current popularity. First of all, we like bonds. Bonds represent approximately 30% of our assets under management. But we see bonds as a part of an overall portfolio mix, not as the primary driver of capital growth as investors apparently believe today.

Bonds represent a loan. Because of this, bonds are considered by many a safer investment than stocks. They have a higher priority than stocks in the event a corporation must be liquidated, they have a fixed date of maturity, and they pay a fixed rate of interest.

Stocks represent ownership. They have no fixed date of maturity, and their dividend payments can change. Simplistically, much is known about the expected rate of return for a bond, and very little is known about the expected return of a typical stock. The odd thing to us, however, is that investors have been buying bonds issued by the very same companies whose stocks they have been selling. So bond fund investors appear to be saying that corporate America will survive enough to pay the interest on their loans, but future earnings and dividend growth is either unknowable or will slow dramatically in the years to come.

## **What's Passed is Past**

With the benefit of hindsight, certainly, a 6% GE corporate bond looks like a better deal than the minus 35% return that GE's common stock has experienced this past year. The problem is using a rear view mirror to make investments has the same degree of success as it does in driving a car. Nada. The future performance of both stocks and bonds is in the future. Thus, the great majority of investors pouring money into bond funds are doing it for a completely irrational reason — because bond funds have done well over the past two years. Every investment brochure, performance report, and prospectus of any kind must include the sentence: "Past performance is no guarantee of future performance." This language is so prevalent on Wall Street, not because it is poetic, or a legal requirement. It is prevalent, because it has been proven over and over and over and over again to be true. The past is not the future, and we cannot invest in the past. We do not want to crush any illusions here, but we can only invest in the future.

Many investors will say they are piling into bond funds because the future is so uncertain. Earnings are so uncertain; the economy is so uncertain; the political landscape is so uncertain. Let's not kid around here. The future has always been uncertain. No one knows what will happen tomorrow, let alone 10 years from now. It might be good. It might be bad. More than likely it will be a little of both. The real uncertainty that is driving so many investors into bond funds is the bear market in stocks of the past two and a half years, not the future unknowns. People are projecting the recent past into the future.

## **Bonds are Contractual**

Bonds seemingly give investors some assurance of the future. The one big thing bonds have going for themselves is that they are easy to value. Most of the elements of a bond are, so to speak, contractual. As we said earlier, at regular intervals, bonds pay a fixed rate of interest to the investor. On a fixed date when the bond matures, the investors' principal will be returned to them.

Bonds are even uniformly priced; most bonds come to the market priced at par, \$1000 per bond. In essence, armed with all this contractual information, it is possible to compare the relative value of almost any bond to another.

The most elementary yield of a bond is the so-called Coupon Yield. This is simply the interest rate printed on the bond. While the Coupon Yield is vital, by itself, it is meaningless.

A more relevant return on bonds is called the Current Yield. This is computed by dividing the bond's annual income by the price we paid for it. The formula below shows the current yield of a bond.

$$\text{Current Yield} = \frac{\text{Annual Income}}{\text{Market Price}}$$

This is a kind of old fashioned formula that states: my rate of return is what I made divided by what I paid. For example, let's say we buy a General Electric bond for \$1000 and it pays \$60 in interest each year. The formula above indicates that the current yield of this bond is 6% (60 / 1000). Simple enough. Yet, we rarely pay the par price (\$1000) for a bond. Bonds move up and down in price to reflect the changes in prevailing interest rates. So, while the coupon payment and the maturity are contractual and fixed, the price of a bond fluctuates.

In order to determine the expected rate of return on a bond that we purchase for more or less than par (\$1000), we must make some additional calculations. Again using simple math, we can determine the internal rate of return for almost any bond, and thereby compare it to any other bond. These enhanced calculations result in the bond's Yield to Maturity (YTM). A YTM analysis calculates the present value of all future contractual interest and principal payments over the life of the bond. Of course today, computers make these calculations in an instant, and thus very few people actually know how to make a YTM calculation, but a basic understanding of the components of the YTM formula offer a template that we will later use to compute the relative valuation of a Rising Income stock. The YTM formula takes into consideration both income and capital gains or losses, resulting from bonds that mature at prices different from what was paid for them.

$$\text{Yield to Maturity} \square = \frac{\text{Annual Income} + \text{Prorated Annual Appreciation or Depreciation}}{\text{Average of the Purchase Price and Maturity Value}}$$

The Yield to Maturity is the annual income we receive plus the gain or loss in principal; all divided by the average cost of holding the bond. Using the average cost, instead of the purchase price, takes into account the time value of money and in actuality, approximates the present value of all future cash flows coming from the bond. Simply stated, we are going to divide all of the benefits we receive from the bond by our average cost to arrive at the net projected rate of return to maturity for that bond. To make this a little more clear, let us show you a calculation that is done thousands of times each day by computers and bond investors around the world.

If the current market price for the GE 6% bond that matures in ten years is \$1,040 (for a \$1,000 bond), we can easily determine what our Yield to Maturity actually will be. The annual income will remain the same as above, \$60. However, since the bond will mature at \$1000, we will lose \$40 of our principal over the next ten years. If we prorate this loss over the ten years till maturity, we will lose \$4 (\$40 / 10 years) of principal every year. Why would we buy a bond upon which we will lose \$4 every year? The answer is simple. The net Yield to Maturity can still be quite attractive

compared to the prevailing interest rates on alternative investments. So, to complete the calculation for our GE bond

$$\text{Yield to Maturity } \square \quad \frac{\$60 \text{ Income} - \$4 \text{ Annual Depreciation}}{\$1020 \text{ Average Cost}} \quad \square \quad 5.4\%$$

Seems pretty simple to learn what we are getting when we buy a bond, doesn't it?

Wouldn't it be great if we could do the same sort of valuation for a stock? Glad you asked.

### Making Stocks Look Like Bonds

Unlike bonds, stocks with consistently increasing dividends have no fixed annual income or fixed date of maturity, but they do have something that, in our minds, makes up for both — a predictable, increasing stream of income. The world of dividend paying stocks is a unique corner of the investment world. As we have shown in our previous letters on dividend investing, there are companies with such a long record of consistently increasing their dividends that using regression analysis we can estimate with a high degree of confidence what their dividend will be in five years or more. Indeed, some companies actually provide projections of their future dividend growth. These consistent dividend payers open up a whole new way of analyzing a stock. They make it possible for us to actually evaluate a stock as though it were a bond. We cannot do this for all stocks because dividends are not a contractual obligation, but we can do it for companies who raise their dividends consistently year after year.

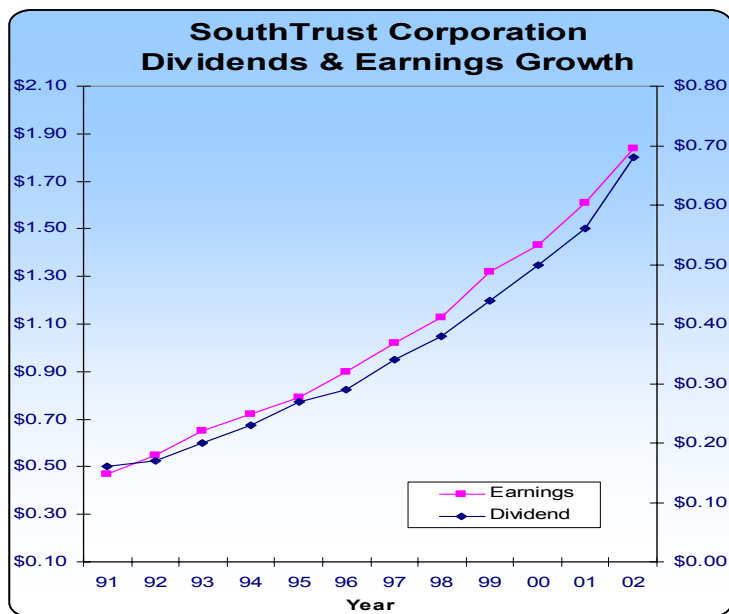
Since there is no maturity date for a stock, we never know when we will sell the stock or how much we will eventually be able to get for it. However, with companies that have increasing dividends, we can work backwards to provide a probable range of sales prices and thereby use a formula similar to the Yield to Maturity formula for bonds to determine a probable rate of return. For stocks we call this formula "Yield to Sale." The calculation we use to value rising dividend stocks uses the same principles as the yield to maturity calculation for bonds with a couple of small twists to accommodate for the differences between stocks and bonds.

$$\text{Yield to Sale } \square \quad \frac{\text{Current Dividend} + \text{Average Dividend Growth} + \text{Annualized Appreciation}}{\text{Average Cost}}$$

Just like our Yield to Maturity formula for a bond, our Yield to Sale calculation divides all of the benefits we receive from the stock by our average cost over the time we hold it. With companies paying increasing dividends, each year our return consists of three elements:

- 1) the current dividend,
- 2) the annual growth in that dividend, and
- 3) the net change in the market price of the stock.

Let's use a real live example to show you how this works. That example is Southtrust Corporation.

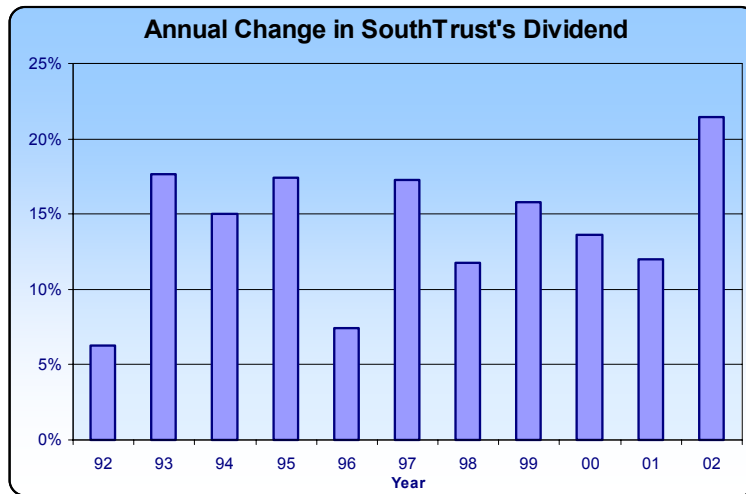


**Graph 1**

Southtrust is a bank headquartered in Birmingham, Alabama with 700 branches spread across the Southeast and Texas. Its shares currently sell for \$24.61 and pay a dividend of \$0.68. They have increased their dividend every year for 31 years in a row. Not just paid a dividend for 31 years but increased it every year for 31 years. To increase their dividend every year, a company has to be increasing their earnings at a steady pace. That further means they have to be in a business that is repeatable, sustainable, and consistent.

Banks are very good candidates for this. People and businesses need the services of banks in good times and in bad. Graph 1 demonstrates that Southtrust has been able to grow its earnings and its dividends in good economic times and in bad. They have done it in times of high interest rates and in times of low interest rates. Most of the companies capable of consistently increasing their dividends operate in industries that have "moats" around their businesses. They may not be monopolies, but their businesses are insulated from competition and environmental factors by regulations, high barriers to entry, or consistent demand for the goods and services they offer. The companies also possess one other critically important characteristic: These companies have demonstrated a commitment to their shareholders through a dividend that is growing with their business.

Graph 2 shows, Southtrust's dividends have increased at about 15% each year over the last 15 years.



**Graph 2**

Not many companies can maintain this kind of growth but there are many good companies who do continue to increase their dividends every year. For our example, we are going to assume that Southtrust continues its record of dividend increases but only increases them by 10% annually over the next ten years. That would make the dividend ten years from now \$1.60 per share. (See Table 1, below.) In the first year we own Southtrust, we get a dividend of \$.68. That dividend will be \$.92 higher by the 10th year ( $1.60 - .68$ ). On average, the dividend will be \$.46 ( $.92 / 2$ ) higher each year than it was when we started. That type of growing dividend sounds great, but what if this dividend from Southtrust and the increases in it each year are the only benefit we get? What if the stock price never goes up? In that case, there would be no price appreciation and the average cost would be just what we paid for the stock.

	<b>Current Dividend</b> + <b>Average Dividend Growth</b> + <b>ZERO + Appreciation</b>
<b>Yield to Sale</b>	<input type="checkbox"/> $\frac{\text{-----}}{\text{The Original Purchase Price}}$
	$(\$1.60 - \$.68)$
<b>Yield to Sale</b>	<input type="checkbox"/> $\frac{0.68 + 2 + 0}{\$24.61}$ <input type="checkbox"/> <b>4.6%</b>

This tells us the net Yield to Sale of our investment in Southtrust (with no increase in its price) is 4.6%, which is dramatically better than Southtrust's current yield of 2.8%, also better than T-Bills, CDs, or 10-Year Treasuries. Does this mean that we can buy and sell a stock at the same price over a ten-year period of time and still make 4.6% on our money? Absolutely.

We believe, however, that Southtrust's price will go up over the next ten years. The table below offers a very strong argument that Southtrust's stock price will be much higher in ten years if they

increase their dividends 10% annually (much slower than their current pace). The reason is found at the end of column 4.

### Southtrust Projected Dividends, Yields, and Prices

(1)	(2)	(3)	(4)	(5)	(6)
Year	Dividend	Current Price	Yield on Original Cost	Worst Case: Price Implied by 4.0% Yield	Likely Case: Price Implied by 2.8% Yield
1	0.68	24.61	2.8%	17.00	24.29
2	0.75	24.61	3.0%	18.70	26.71
3	0.82	24.61	3.3%	20.57	29.39
4	0.91	24.61	3.7%	22.63	32.32
5	1.00	24.61	4.0%	24.89	35.56
6	1.10	24.61	4.5%	27.38	39.11
7	1.20	24.61	4.9%	30.12	43.02
8	1.33	24.61	5.4%	33.13	47.33
9	1.46	24.61	5.9%	36.44	52.06
10	1.60	24.61	6.5%	40.09	57.26

**Table 1**

In year ten, as indicated earlier, Southtrust will be paying a dividend of 1.60. Holding the market price constant at the original purchase price shows that Southtrust would be yielding 6.5% in year ten ( $1.60 \div 24.61$ ). In the last twelve years, Southtrust has never yielded more than 3.8%. The only time Southtrust would have come close to yielding this much might have been in the 1979 – 81 period, a time of run-away inflation. Barring another experience like that, we would not expect Southtrust to yield more than 4%.

Column 5 shows what we would consider to be a worst-case scenario for Southtrust over the next ten years. That column reflects the prices at which the annual dividend would yield 4%. As you can see, a 4% yield in ten years would produce a share price of \$40.09. Let's use our Yield to Sale formula to compute the expected rate of return for Southtrust in this worst case scenario. As before, we have a beginning annual dividend of .68 and an average dividend growth of .46 plus an annual capital gain of \$1.55 (40.09 minus 24.61 divided by 10). All of those benefits get divided by our average cost of \$32.35 (the average of our 24.61 purchase price and our 40.09 selling price) to produce a Net Yield to Sale of 8.3%. Not bad for a "worst case."

Let's try a scenario where the current dividend yield of 2.8% doesn't change from where it is now, which by the way, is a little above Southtrust's average yield over the last ten years. In this conservative scenario, the price grows to \$57.26 in year ten. Plugging the numbers into the Yield to Sale formula, we get a projected net annual return of 10.8%, about what stocks have returned on average over the last 80 years.

$$\text{Yield to Sale} \quad \square \quad \frac{0.68 + .46 + 3.27}{40.94} \quad \square \quad 10.8\%$$

Can we have any assurance that the assumptions we are making here are reasonable? Based upon history, we think so. Table 2, below, shows Southtrust's actual dividends and prices over the last twelve years. First, note in Columns 3 & 5 that the dividend grew consistently over time. Second, notice how Southtrust's price (Column 2) moved so that the current yield (Column 4) stayed in a range of 1.6% to 3.8%.

### Southtrust Historic Dividends, Yields, and Prices

(1)	(2)	(3)	(4)	(5)	(6)	(7)
Year	Year End Price	Dividend	Dividend Yield	Dividend Growth Rate	Following Year's CPI	% Price Change
1991	5.54	0.16	2.9%		2.7%	
1992	5.61	0.17	3.0%	6.3%	2.5%	1.3%
1993	6.33	0.20	3.2%	17.6%	3.3%	12.8%
1994	6.00	0.23	3.8%	15.0%	2.8%	-5.2%
1995	8.54	0.27	3.2%	17.4%	2.9%	42.3%
1996	11.63	0.29	2.5%	7.4%	2.3%	36.2%
1997	21.15	0.34	1.6%	17.2%	1.6%	81.9%
1998	18.47	0.38	2.1%	11.8%	2.2%	-12.7%
1999	18.91	0.44	2.3%	15.8%	3.5%	2.4%
2000	20.34	0.50	2.5%	13.6%	1.6%	7.6%
2001	24.67	0.56	2.3%	12.0%	2.0%	21.3%
2002	24.61	0.68	2.8%	21.4%	-	-0.2%

**Table 2**

It may seem like backward thinking to suggest that Southtrust's price is in large part a function of its dividend yield. That is like saying that the price adjusts to keep the dividend yield within certain limits. Conventional thinking says the price moves in its own world and the dividend yield just falls wherever it may. We believe, however, when it comes to Rising Income Stocks, that they do indeed work backwards. Notice in Table 2 how Southtrust's dividend yield (Column 4) at yearend tracks with inflation, as measured by the following year's Consumer Price Index (Column 6). Each time the dividend appears to be losing its connection to inflation, the market adjusts Southtrust's yield by moving the stock price dramatically higher or lower. The relationship between dividend yields and inflation appears consistent over time, but we know the nature of that relationship will vary from company to company and industry to industry. We can never know a full year in advance what inflation will be, but we can know, as it is reported quarter by quarter, how inflation is trending. This gives us a glimpse of how closely a company's dividend yield is tracking inflation.

## **But ... there's more**

There is another relationship between dividends and prices that is equally or more significant. Between 1991 and 2002, Southtrust's dividend grew by 4.3 times (from 16 cents to 68 cents). During that same time, its stock price grew by 4.4 times (from 5.54 to 24.61). This almost seems as though we picked this example because it works so well. We did not. We see time and time again among Rising Dividend stocks that price growth is highly correlated to dividend growth. Not necessarily on a quarter by quarter basis, or even on an annual basis, but in the long run, we cannot find a consistent dividend paying company where price and dividend growth did not eventually converge.

Any time we invest, we invest with the expectation that we will get cash in return at some point. If we are counting only on the price of the stock to be our reward, we are bound to be disappointed, especially if we are looking for that return to come in the short-term. But, if we are investing in a company that is always raising its dividends, that company is treating us like a real partner. We are constantly being rewarded for investing with them, and the rewards are getting better over time. These continually increasing cash rewards – dividends – make this investment more valuable, and our research convinces us that this will ultimately drive the share price higher.

There are no gimmicks here. The companies that produce these types of returns are less risky than the average company in the S&P 500 and more consistent in their earnings and dividend payouts than the average company in the Dow Jones 30 Industrials. We invest Rising Income Equity portfolios in companies that are well run businesses, operate in environments that are predictable, repeatable, and sustainable, and pay a consistently growing dividend.

Filling a portfolio with Rising Income Equity companies is not a buy and hold strategy. It is a "Buy and Sleep Well" strategy. Our job at DCM is to constantly make sure that the best of the companies with increasing dividends are in our Rising Income Equity portfolios. We do sell these companies from time to time. When something happens to alter the chance that any of the companies in the Rising Income Equity Portfolio will reduce or stop increasing their dividend, we replace them with a company that gives us more confidence of an increasing dividend stream. As long as we see increasing dividends, we can have every expectation of returns like those calculated here without the worry that the company will meet or beat their next quarterly earnings projection.

We have been collecting articles on dividends for some time, and their numbers have been growing exponentially as dividend-paying stocks have been outperforming non-dividend-paying stocks in this bear market. In none of these articles have we seen the concept we are describing here discussed. We can only assume that this idea is so new, or so old, that many of today's experts have failed to look this deep into the dynamics of rising dividends. When they get around to it, there is no way that Southtrust will be trading for \$24.61.

While the Rising Income Equity style of management is one focusing purely on dividends, we have begun adding companies that have growing dividends to our Blue Chip Growth portfolios as well. While our Rising Income stocks may have higher yields, our Blue Chip Growth companies will likely be raising their dividends at faster rates.

If this concept appeals to you, we would be more than happy to talk about how to make it work for you.

Blessings,

Greg Donaldson      Mike Hull