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The Investor Class

Don't you just love it when the financial gurus and media are so stunned by news that they blab incessantly in ever widening circles until even your dog knows that they don't have a clue of what is really going on? The Bush administration's recent proposal to completely repeal taxes on dividends has created one of those glorious moments when you can look your dog straight in the eyes and ask him what he thinks the President's proposal will mean for stocks, bonds, and the economy. If old Fido just sits there with his tongue hanging out and makes no sound at all, wisdom will be served. This is because nobody knows what the plan will ultimately mean because there is little likelihood that the plan, in its present form, will be passed by Congress. It is an opening bid in a debate that will last for the next several months. As time goes on, the plan will take form in the normal give-and-take of the legislative process, and at that point its implications for the economy can be determined.

The one thing we believe we do know now is that dividend-paying stocks will be getting a tax break, and in our estimation, a year from now their share prices will be significantly higher. How much? This is our best guess. In our recent special letter called "The Rising Income Story," we offered our proof that dividend yields do, indeed, influence stock prices. Thus, the following logic should hold true: 50% of US dividend stocks are held outside of retirement and other tax deferred accounts. If the average US investor is in the 30% marginal tax rate, then the complete elimination of taxes on dividends should push dividend-paying stocks 15% higher (50% x 30%). But of course, even if the tax break on dividends is less than a complete repeal, it will still attract significant sums of money away from investments with less tax advantages. **We would not be surprised to see gains for dividend stocks in the 20%-30% range.**

This math is so simple it's probably no closer than your dog's guess, but the logic is valid. The big deal here, however, is this: The avoidance and deferral of taxes is a gigantic business in the United States. Just think of all of the investment vehicles that offer some form of tax deferral: annuities, mutual funds, tax exempt bonds, life insurance, retirement plans, and limited partnerships. We believe that if the current proposal to repeal taxes on dividends becomes law in its present form it will be the single biggest change in American tax law since the income tax was introduced by Abraham Lincoln to fund the Civil War.

The Dividend Bonus

As you know, we have been advocating dividend-paying stocks since we created the Rising Income Equity style of management in 1991. During the last year, we have done additional research and tried to clarify for you the benefits of owning companies who consistently raise their dividends. To us, the

President's proposal is just a bonus. His proposal to repeal taxes on dividends has now put dividends directly into the spotlight for all investors, and the learning curve of dividend investing will shorten dramatically. **We are happy that this is the case because we believe that the shortened learning curve will bring many new investors hunting for the stocks we already hold in your portfolios.**

Recognizing the "Investor Class"

We believe an important question is being lost in all the talk about the implications of the President's plan: Why -- why did he do it? The economic effects of the proposal will be analyzed ad nauseum on Wall Street. In Washington DC, however, the debate will take on tones of class warfare because a great percentage of the tax break will, indeed, fall to the wealthiest Americans. Is the President really paying off all of his and his dad's old blue-blood Yale buddies? Has he become Robin Hood's evil brother stealing from the poor and giving to the rich? If we thought the answer to these questions was yes, we would depart the capital markets at the next opening bell. We believe the administration is dealing with a problem that has much greater implications than a tax cut for the rich. We believe this proposal is really aimed at a very big part of the American population, the "investor class." Recent statistics suggest that nearly 70% of Americans own stocks of one form or another. The public interest group, Americans for Tax Reform, made the following observation:

"The recent federal midterm elections of 2002 demonstrated the growing electoral strength of investor class voters. National exit polling, for example, shows seven out of ten voters owned at least a 401(k) and approximately 60 percent of voters consider themselves "investor class voters." In fact, pollster Mark Penn reported to the Democratic Leadership Council this summer more voters now own stock (66 percent) than have a full time job (53 percent).

Clearly, the accelerating growth of the investor class voter is real. The investor class thinks differently, acts differently, and votes differently from non-self-identified investors. And they include not just the obvious wealthy and suburbanites one might have assumed, but now represent the investor next door. This changing demographic among a majority of voters has drastically restructured the political environment facing policymakers because investor class voters clearly understand the significant impact government tax, spending, and regulatory policies place on their standard of living.

At the same time, nearly \$7 trillion or over 40% of stockholder wealth has evaporated since stocks peaked in early 2000. Only one other period in American history has experienced a longer and more severe stock decline, which was the bear market following the 1929 stock market crash. This dramatic and sustained decline has significantly reduced investors' confidence, which is at its lowest level since the UBS Index of Investor Optimism was started six years ago."

The investor class has swelled to historically high levels, but unless the stock market begins to offer positive rewards in some fashion, there is the very real probability that the investor class will begin to shrink as people forsake the securities markets and return to the "savings class." This group usually puts its money in bank CDs, passbook savings plans, guaranteed insurance contracts, and government savings bonds. This process would likely take several years to complete and potentially could keep a lid on stock gains for longer than we care to think about. Thus, under these circumstances, it has been our view that no matter who was sitting in the White House, a plan favorable to the investment class was inevitable. The only problem is that politicians have very few tools to affect the stock markets. The market is very smart and can see through lip-service when it knows that real doctoring is needed.

We believe the pro-investor proposal with the accent on dividends is just what the doctor ordered and offers good news in three ways:

- 1) It corrects the very real and unfair problem of taxing dividends twice;
- 2) It offers a tangible and immediate reward to the investor class to stick with stocks during these uncertain times; and
- 3) It helps all investors and corporations alike return to a greater appreciation of long-term ownership, as opposed to profiting entirely from capital gains.

Dividends' Contribution

Most people know that on a total return basis, stocks have generated an average annual return of approximately 11% since 1926. It is not well-known, however, that almost 40% of that gain has come from dividends. In essence, the "capital gains only" mentality that has formed as result of the roaring bull market of the last twenty years has led us away from a vital part of the tremendous engine of success that the stock markets have been down through history. Dividends have always mattered. A lot of people have been trying to tell us in recent years that dividends don't matter. We thought that they were wrong, and now we seem to have a crowd forming in our corner. **We at Donaldson Capital Management have been on a crusade to re-educate anyone who would listen to us that to ignore dividends is folly.** Indeed, we have tried to show, that by focusing on dividends at a time when the world was looking elsewhere, we could find bargains that were being overlooked by the capital gains crowd. That is the reason we have harped on this matter for so long and so often.

We have been in the investment business long enough to know without a doubt that the stock market yields wonderful blessings in the long run. Likewise, we have also gone through enough bad markets to realize, full well, that people can tolerate poor performances from stocks only so long before giving up on them. Unfortunately, investors tend to give up on stocks just before the market begins to shake off the ill effects of whatever was ailing it and starts on another multi-year upswing. We believe the administration's proposal buys time for investors while the economy and the markets work their way out of the bear market of the last three years.

The President's proposal has precipitated two important events that we believe will change the dynamics of the markets: (1) A tax break is now highly likely that will make holding stocks, let us repeat, holding stocks, more valuable, and (2) A linchpin has been inserted connecting public companies and investors to a long term relationship that is based on tangible and continuing rewards (a tax-advantaged dividend) and a more realistic way to measure the relative value of one company to the next.

A word of caution

Everywhere you look today, the financial media is hyping dividend-paying companies. As the likelihood increases that taxes on dividends will be eliminated or reduced, the noise will only grow louder. With this, the learning curve on dividend-paying companies will accelerate even further, and the advice on how to invest in dividend payers will become a torrent. Already, lists showing the highest yielding stocks, the fastest growing dividends, or the longest strings of dividends are hitting the financial pages. None of these approaches alone, however, will bring the kind of returns we have been preaching for the last year.

Two opportunities now exist: The first lies in what we have written on so extensively – companies that possess a combination of above average current yield and a long record of generous dividend growth.

The other comes from companies who have yet to break into the ranks of long-time dividend payers. This new tax law will give those companies with a shorter dividend history more reason to pursue a course of accelerating their dividend hikes. This group is, by far, the hardest to find and most difficult to value. Therefore, they may well offer the best total returns over the next few years. We have already taken positions in a few of these emerging dividend companies. Before long, we will issue a special report detailing how our major holdings are being selected in light of these strategies, and which companies are starting to respond to this new dividend-oriented environment.

Important Announcement

In July of 1999 we made the following insertion in our quarterly letter, "DCM will not accept new clients until further notice. Adding new clients takes time. We are choosing to spend our time on research, decision-making, and communicating with our existing clients." We did this for a very specific reason. Our performance in our various styles of investment management had been good enough that we were being inundated with requests for proposals to take on new clients. The only problem was as we interviewed these potential new clients we found over and over that they were not hiring us for who we were or what we believed in, but rather to get aboard the fast train to getting rich in the market. Because we were convinced the economy would slow and a mania had formed in technology we decided the best thing for us to do was to close our company to new clients and dedicated ourselves to the clients we already served. The only new accounts we have taken in the past three and a half years have been from our preferred list of brokers or the friends and family of existing clients.

Effective immediately, we are going to re-open our doors to new clients. We are convinced that our dividend approach will prosper in the years to come. We are also convinced that in the past three and a half years that we have added the necessary staff and technology to efficiently handle additional clients. Finally, we believe there is much reason to be optimistic about the stock market over the next few years.

Blessings,

Greg Donaldson Mike Hull