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Able, Willing, and Ready

In recent years, we have been talking about, writing about, and acting upon the hidden value we have discovered in owning companies who consistently raise their dividends. Our enthusiasm with growing dividends must be more than a little apparent. One client recently commented that we were becoming those “Dividend Guys.” If that is the perception, so be it. We know a good strategy when we see one, and we have been spreading the word. In recent months, we have had the opportunity to carry this message to hundreds of people, and in this process, we have been asked several times, “Why do I need you guys to invest in companies with high dividend yields?”

This is a logical question. In fact, Standard & Poor’s, Forbes, and Valueline all provide lists of the top dividend-paying companies. Our answer to this question is born from a journey that began over a decade ago. In the remainder of this letter, we would like to give you a glimpse of the journey we have taken that leads us to the conviction: **“So goes the dividend, so goes the stock.”**

It’s Not High Yield

Our dividend management style’s roots go back to 1992, when we first began using dividend-paying stocks to attempt to replace the great returns bonds provided during the 1980s. That first attempt, called the Equity Income Portfolio (EIP), focused on companies with high dividend yields. Living with EIP for a couple of years proved to be a far more volatile ride than we had expected. Unlike bond interest payments, corporations are not legally bound to pay dividends. They are not even morally bound to pay them, and they can start and stop dividend payments at any time. Unfortunately, we discovered that high dividend yields are often the result of falling prices that are predicting trouble for the company and its dividend. Thus, to begin the investment process with dividend yield is just like any other form of speculation. To assume that current yield is the starting point and dividends can only go higher from here is folly. In fact, it may well be the ending point where dividends are headed lower or going to be eliminated. Therefore, we concluded that high yield investing was very similar to junk bond investing and not what we were after.

The Quality Door

If dividend payments are not a legal obligation or even a promise, how could we make them real? We found that dividends started to become more dependable as we ran them through a series of filters that got first things first. Learning in the early 1990s that dividends may not be as real as they are often thought to be led us to convert the EIP to the Value & Income Portfolio, or VIP. VIP’s mission was to buy quality companies at good value with attractive dividend yields. VIP started the stock selection process through the “Quality Door” instead of through the “Dividend Door.” Starting our selection process by filtering for companies of excellent financial strength, which is where we still start today, begins to make the dividends something real, something that we can count on. To determine which companies had the highest probability of continuing to pay dividends, we identified criteria that sounded like the old saying,

“READY, WILLING, & ABLE” – but in reverse. The first criteria seeks to identify companies who are so financially strong that it virtually assures they will be **Able** to pay a dividend now and in the future.

At the Able stage, we are really analyzing companies as though we are going to loan them money instead of buying their stocks. Indeed, we use a company’s bond ratings as one of the considerations. This is also where we impose a minimum size limitation on companies. They must be large enough to have access to the capital markets. We do not want to invest in companies who depend entirely on their banks for additional capital, because this dramatically lowers their flexibility. By the end of the Able stage, we have reduced our universe from the 6,000 stocks that trade in the United States to approximately 500 with a high probability of continuing to pay their dividends.

Entering the world of dividends through the Quality Door allows us to leave behind the exhausting and ultimately futile exercise of trying to outguess millions of other investors as to what is hot and going to get hotter, or cool and on its way to cooler. Quality is a much easier characteristic to identify; it changes relatively infrequently, and always comes back into fashion.

After identifying the companies that are Able to pay uninterrupted dividends, we turn our attention to those companies that we believe are **WILLING** to pay those dividends in some relationship to their own success. At this stage of our analysis, we are looking at the company’s financial results and annual reports and listening to what their management says to determine their attitude toward their shareholders. This is one of the most satisfying parts of the analysis because we are really looking at the heart and soul of the company. We get there by asking these questions:

1. Are their public messages candid and balanced or full of hype?
2. Have they clearly and completely decided that shareholders are owners?
3. Do their dividends, over time, honestly represent the trends and financial health of the company?

The Willing stage, over the years, has become both easier and more difficult because dividend payouts have been falling and dividend cuts have become common. This has dramatically shrunk the number of companies we consider Willing, but it has also illuminated companies that have continued, or initiated, generous dividend policies that have been in lock-step with their own fortunes, even though they have had nothing to gain by it from the media or Wall Street. In the Willing stage, we also look at the length of time a company has paid a dividend and the consistency of their increases. We are particularly mindful of companies who have a stated dividend policy tied to their results. In our minds, a stated policy is very valuable, because if a company states they are going to follow some formula for dividends, they have entered the realm of a moral obligation. After the Willing stage, the 500 companies from the Able stage are reduced to approximately 150.

That brings us to the **READY** stage. The surprise here is we are not looking for companies that are ready to blast off, or ready to turn a new leaf. In the Ready stage, we are searching among the great Able and Willing companies for those that can stay that way. But, immediately we run into a problem. These kinds of companies cannot hide, so the market generally prices them at premiums appropriate to their success. We have developed a valuation model that enables us to determine the value of each of our companies based entirely on its current dividend and our projection of its dividend growth. We can go back in time to see how the market has valued the stock in various interest rate and growth environments. We have found that these kinds of companies seldom get dirt cheap, but if for some reason, they get crossways with a Wall Street analyst, or miss an earnings estimate, we can often buy them at 70 to 80 cents on the dollar.

The biggest problem we have in this stage is keeping an eye on companies whose stock becomes overvalued, sometimes dramatically so. As you can imagine, we are very slow to sell a great company who has made it through all of the hurdles we have placed before it. Our research, however, shows that

a company that gets overvalued and stays overvalued beyond a year to eighteen months, usually has sub-par performance for the next two to three years. Obviously, we are also on the alert for great dividend-paying companies we own whose fortunes may be diminishing. When a company begins to descend from greatness to mediocrity, the markets are not kind. The losses can take years to work themselves out, and usually dividend growth slows dramatically, or ceases.

Rising Income Equity

By 1995, one of the other hidden virtues of companies that continue to increase their dividends became apparent in the Value & Income Portfolio. Research revealed a relationship that we called in a series of letters at that time “So Goes the Dividend, So Goes the Market, So Goes the Stock.” Simply put, we have found nothing over the years, among dividend-paying companies, that correlates more closely to price growth than dividend growth. So, following that discovery, we changed VIP’s name to today’s Rising Income Equity style of management.

To answer the question that began this discussion, the Rising Income Equity style of management is far better than any static list of pure dividend payers. It is much, much more than picking companies with high dividend yields. First, we pass companies through the Quality Door, where we examine their financial strength and their ability to pay dividends. Then, we look to the heart and soul of the company to get an understanding of their willingness to pay those dividends. That is followed by developing a valuation for the company that we like to think of as how ready they are to sustain their track record of increasing dividends. As you can see, this is an ever-changing process. We have not only changed companies as their prospects ebbed and flowed, but we even changed the name of our management style along the way to reflect the truths we were discovering.

Dividend Growth

As we have demonstrated several times in letters and presentations over the last two years, a company who regularly increases its dividend becomes increasingly more valuable to its shareholders. And, sooner or later, that increased value shows up in the price of the company’s stock. This understanding has led us to apply essentially the same strategy to our Blue Chip Growth portfolio. This brings us to another question we have heard often lately. **Many of you who own a Blue Chip Growth portfolio have asked us whether we are advocating that everyone shift to a “dividends only” approach. Our answer is yes, and no.**

Yes, recent studies show and we believe that a dividend-oriented investment strategy is the right way to go, especially now that dividends and capital gains are taxed at the same rate.

But, no, we are not advocating that everyone shift to Rising Income Equity. While Blue Chip Growth’s primary focus is on companies with above average, long-term earnings growth, dividends have always played an important role in the selection criteria.

Companies in both styles must pass the same, strict financial strength and market capitalization hurdles, as well as exhibit leadership characteristics in their respective industries. The table below shows the current vital statistics for each portfolio.

	Current Dividend Yield	Projected Dividend Growth	Implied Rate of Return	Current Price/Earnings
Rising Income Equity	3.5%	8.9%	12.4%	13.9
Blue Chip Growth	2.1%	12.5%	14.6%	17.3

The statistics are very revealing and explain the subtle but very significant differences between the styles. Rising Income's current dividend yield, at 3.5%, is approximately 70% more than Blue Chip Growth's 2.1%. By contrast, Blue Chip Growth's projected dividend growth is nearly 30% greater than Rising Income's. Combining current yield with dividend growth results in what is called the implied rate of return. The implied rate of return for Blue Chip Growth, at 14.6%, is almost 20% higher than Rising Income's 12.4%. If we stopped here, we would have to conclude that Blue Chip Growth is the better choice for projected long-term growth. However, the final column, Price to Earnings ratio, brings us back to a standstill between the two styles. While the implied rate of return of Blue Chip Growth is approximately 20% higher than Rising Income's, its P/E ratio is also about 20% higher than that of Rising Income's. Paying this much more for the expected return effectively neutralizes Blue Chip Growth's higher projected gains.

Before the reduction in taxes on dividends, the comparison was not so favorable to Rising Income Equity. Dividends were taxed at nearly twice the rate of capital gains, and because dividends are a big part of Rising Income Equity's projected rate of return, prior to this year, the math almost always has favored Blue Chip Growth over Rising Income Equity. Today, however, that is not the case. Mathematically, the two styles are almost at a flatfooted draw, and that is also our subjective view of their relative long-term prospects.

The Ride

There is one big difference between the two styles, however: the ride. The table below shows the median volatility of each style of management relative to the S&P 500 Index since 1995.

DCM Investment Styles vs S&P 500 Index

Investment Style	% of UP markets	% of DOWN Markets
Blue Chip Growth	106%	91%
Rising Income Equity	82%	49%

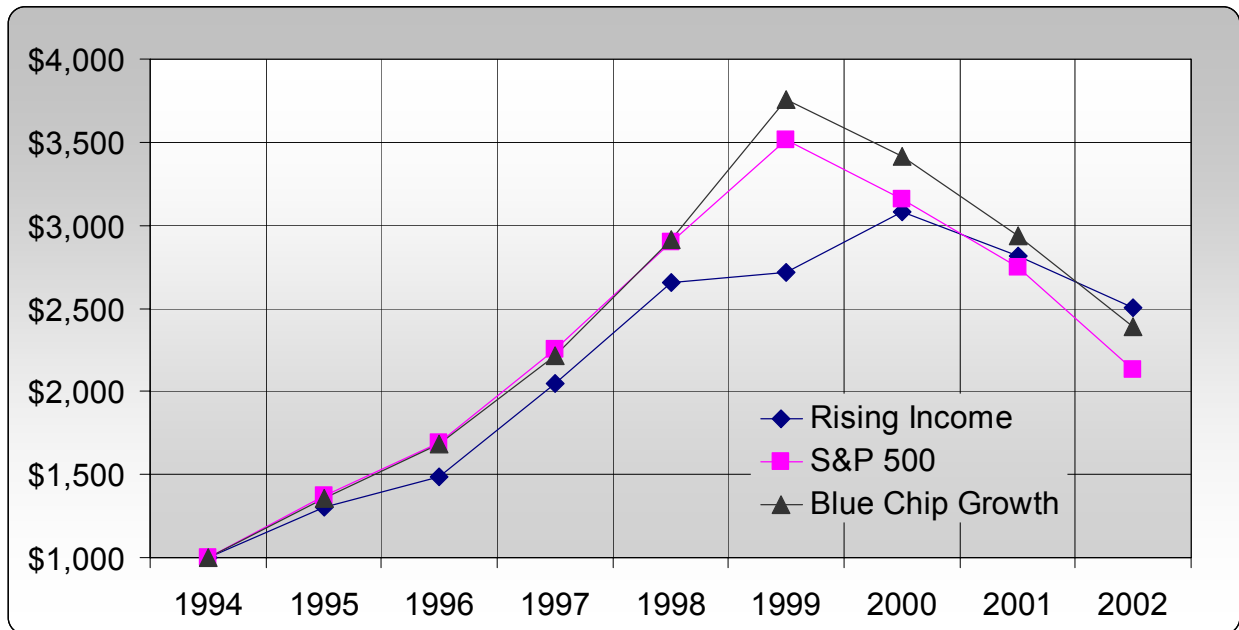
Blue Chip Growth has been solid, outperforming the S&P by 6% in up markets and by 9% in down markets, and it has about the same volatility as the market.

Rising Income Equity's ride is very different. In up markets it has achieved slightly less than the S&P at 82% of the gains, but in down markets its median descent has been only 49% of that of the S&P Index. In short, Rising Income has a narrower band of volatility than Blue Chip Growth or the S&P. It does not go as high or as low as stocks in general. If stocks never went down, Blue Chip growth would be the horse to ride because it can run with the best of them, but Rising Income Equity ends up with a prominent place on the track because it's a mudder. It runs better in bad weather.

Just glancing at the numbers, it would seem that Blue Chip Growth has been the star performer and should have handily whipped Rising Income and the S&P over the last 8 years. Indeed, Blue Chip Growth has beaten the S&P during this time by about 2% per year, but it has been outpaced by Rising Income Equity. Rising Income has led the S&P by almost 3% per year since December of 1994 and almost entirely because of its significantly better performance in the bear market of the past three years.

The chart below shows the cumulative total return of our Rising Income Equity and Blue Chip Growth model portfolios and the S&P Index. You will note that just as the aforementioned table showed, Blue Chip Growth has consistently beaten the S&P, while Rising Income has operated

DCM Investment Styles vs S&P 500 Index



more independently of the market. Indeed, the most surprising thing the chart reveals is that Rising Income Equity was actually up in 2000, while the S&P and Blue Chip Growth were down. Then in 2001 and 2002, when the market was down sharply, Rising Income Equity's fall was far more muted, leaving it as the best performing portfolio of the three for the eight-year period.

The First Door

As a result of the tax break and countless articles in the media, dividends have received heightened interest among investors. We have lived in the dividend world for years, and we know how far off the mark investors can get by just looking at dividends. We have shared our journey of discovery through the world of dividends because, judging from the questions and comments we get in our travels, many investors are heading down the wrong path by chasing high dividend yields. Whether they know it or not, high yield is just another term for high risk and certainly not the place where most investors think that dividend investing is leading them.

We hope this letter makes very clear what our strategies are for Rising Income Equity and Blue Chip Growth. They are dividend-oriented, but first, they are QUALITY-oriented. It's okay if people call us the "Dividend Guys," but we want our clients to know that Quality is the first door we open.

Blessings,

Greg Donaldson Mike Hull