

April 15, 2004

Bees for Their Honey

In 1937 near the end of the worst bear market in US history, John Burr Williams, a thirty-five year old Harvard doctoral student in economics, made the following statement in his thesis:

“The investment value of a stock is the present worth of all future dividends to be paid upon it . . . discounted at the pure [riskless] interest rate demanded by the investor.”

Mr. Williams’s dissertation, entitled “The Theory of Investment Value,” did not immediately earn him his doctorate. That would not be forthcoming until 1940. Prior to his final oral exam, he sold the rights to his thesis to Harvard University Press, who published his dissertation as a book. It would seem only foolish greed could compel a doctoral student to sell his thesis before he had been granted the degree. Williams, however, who was already a successful Wall Street investor when he went back to Harvard, explained that he had returned to college to learn from the best minds possible what had caused the stock market crash of 1929 and the subsequent economic depression. Since he had come for the knowledge and not the degree and since his work was complete, he wanted to share his findings with the public as quickly as possible. What he did not say at the time, but would later admit, was that because of some of the views he had expressed in his thesis, he had become persona non-grata with key Harvard professors and was unlikely to have been awarded the degree anyway.

Blaming the Bureaucrats

His troubles with the dons of the school of economics were many but were centered in two areas: (1) Williams claimed that the correct method of determining the intrinsic value of a company was by calculating the present value of its future dividend payments, not earnings as was the universal belief at the time, and (2) he voiced great skepticism of the theories of John Maynard Keynes and the socialist programs of President Franklin Roosevelt, both of whom believed that government policies could lead to prosperity. Williams was convinced that the government’s “mismanagement” of the economy was partly responsible for the depression of the early 1930s.

Finally, in 1940, with the book drawing praise from important financial commentators, and his success as an investor gaining accolades, John Burr Williams went before the faculty to seek his doctorate. As expected, he was soundly criticized for publishing the thesis before he had obtained his doctorate, and his professors were irate that he did not embrace Keynes’s teachings. Oddly enough, however, they did not dispute his dividend-centric theory of investment value but questioned if a thesis studying the valuation of stocks was of enough significance to justify a doctorate in economics from Harvard. After a heated debate he was granted his doctorate.

The truth is often born of travail, matures under constant testing, and once acknowledged, is subject to twisting. That has certainly been the case with John Burr Williams’s theory. What had angered his Harvard professors, at first, caused Wall Street brokers to scoff. The majority of the wizards of Wall Street believed then, as they still do today, that earnings are the driver of stock prices and that dividends are only a by-product. Furthermore, intrinsic value has never commanded a big following on Wall Street, where trading and short-term speculation have long been the accepted modus operandi.

Blaming Wall Street

But, a closer reading of the book turned Wall Street's ridicule to anger. The ways of Wall Street were being blamed, at least partly, for the stock market crash. William's thesis stated the following:

"The wide changes in stock prices during the last eight years, when prices fell by 80% to 90% from their 1929 peaks only to recover much of their decline later, are a serious indictment of past practices in Investment Analysis [Wall Street]. Had there been any general agreement among analysts themselves concerning the proper criteria of *value*, [italics ours] such enormous fluctuations should not have occurred, because the long-run prospects for dividends have not, in fact, changed as much as prices have. Prices have been based too much on current earning power, too little on long-run dividend-paying power. Is not one cause of the past volatility of stocks a lack of a sound Theory of Investment Value? Since this volatility of stocks helps in turn to make the business cycle itself more severe, may not advances in Investment Analysis prove a real help in reducing the damage done by the cycle?"

Gradually, particularly among seasoned investment analysts and some academicians, Williams's theories gained credence. Arnold Bernhard, the founder of "The Value-Line Investment Survey," perhaps the most famous of all independent, investment research firms, quoted Williams in his 1959 book and echoed his concerns,

"Williams postulates that the value of a stock is the sum of all its future dividends discounted by the present interest rates. . . . Because there is no generally accepted standard of value, the market prices of stocks fluctuate far more widely than their true values. The wide fluctuations have in the past imposed a heavy burden on the general economy and undermined the faith of many people in the free market economy. The need, therefore, exists for rational and disciplined standards of value that cannot lead to the wildness of 1929 or 1949 or the present." [or 1995-2002]

Investing, Not Speculating

Bernhard was echoing Williams in pointing out the need for generally accepted criteria to value stocks. He also joined Williams in warning that the effect of not having such criteria resulted in excess stock market and economic volatility, which damaged investor confidence not only in the stock market but also in the free markets. Bernhard then boldly states,

"In our own experience, during periods of inflation as well as at other times, in this country and abroad, it has been found that dividend-paying ability is the final determinant of the price of a common stock. Whenever, over a period of years, the dividend, or the ability to pay dividends, went up, so too did the price of the stock. When the dividend-paying ability went down, so did the price of the stock, inflation or no inflation."

In applauding Williams's theory, however, Bernhard inserted a subtle twist to Williams's basic premise by adding the words, "the dividend, or the ability to pay dividends." By adding just these few words, he reentered the world of earnings and left behind the "dividends only" world that Williams had described as so important in determining long-term intrinsic value.

Warren Buffett, Chairman of Berkshire Hathaway and the most famous investor of modern times, makes a similar twist. He is famous for saying that investing is easy: "just buy wonderful companies at good to great prices." When asked to explain what good to great prices means, he credits John Burr Williams's formula for intrinsic value, but defines it with a different twist: "The value of any stock, bond, or business today is determined by the cash inflows and outflows - discounted at an appropriate interest rate - that can be expected to occur during the remaining life of the asset." Warren Buffett substitutes cash flow for dividends and Arnold Bernhard substitutes earnings. Neither Buffett nor Bernhard nor many of the thousands of others who have quoted John Burr Williams over the years is saying the same thing Williams said. Williams was speaking of dividends alone, not earnings, cash flow, or a combination of the two.

Williams went so far to keep dividends at the center of his methodology that he included in his book a chapter titled "A Chapter for Skeptics." There he explained that he was certainly aware that without earnings and cash flow there would be no dividends, but he steadfastly asserted that they mattered only if you owned the whole company.

Indeed, in what must be one of the most amazing paragraphs in the history of doctoral dissertations, he offered the following:

“Earnings are a means to an end, and the means should not be mistaken for the ends. In short, a stock is worth only *what you can get out of it.*” [Italics are the author’s.]

He then added the following poem:

“Even so, the old farmer said to his son:

A cow for her milk,
A hen for her eggs,
And a stock, by heck,
For its dividends.

An orchard for fruit
Bees for their honey,
And stocks, besides,
For their dividends.

The old man knew where milk and honey came from, but he made no such mistake as to tell his son to buy a cow for her cud or bees for their buzz.”

In saying dividends, not earnings, were the determining factor in calculating intrinsic value, Williams knew he was reversing the normal rule that every investor learns when they start investing in the markets. Williams answered this issue with the following statement,

“The apparent contradiction is easily answered, however, for we are discussing permanent investment, and not speculative trading, and dividends for years to come, not income for the moment only.”

DCM’s Journey to Intrinsic Value

As we explained in our October 2003 quarterly letter, we began using a dividend-oriented investment style in the early 1990s as a higher yielding alternative for our bond investors, who had experienced a precipitous fall in interest income during the prior years. At the time, we were not aware of John Burr Williams’s work, so we relied mostly on high-yielding, slow-growing companies because we did not have the capability to calculate the present values of lower-yielding, faster-growing companies. Later, after consulting with selected economics professors and hiring a person who had a degree in mathematical economics, we constructed our first multi-stage, dividend discount model of the type that Williams described. But, even with the more sophisticated models we could not produce reliable intrinsic values for companies who paid little or no dividends.

Since almost all technology companies and many other high growth companies paid no dividends, we joined so many before us and performed what we now see as a regrettable twist of Williams’s principles. We changed our model from a dividends-only model to what we called a Modified Cash Flow model. We described this model in our January 1997 quarterly letter. Even though this model had the high intentions of valuing the dividend-paying abilities of companies along the lines of Bernhard’s and Buffett’s models, because it required many manual calculations, we finally ended up with a model based on a standardized dividend payout for all companies. At first, we were delighted that our new valuation tool could calculate the intrinsic value of almost any company. But, as with many one-size-fits-all products, our model’s weaknesses soon appeared. As the market began its tremendous ascent in the late 1990s, we realized that, even among companies that were paying a generous dividend, few were paying at the level of our standardized projections, which were based on historical trends. We found ourselves making continual adjustments to try to re-calibrate our model to the widening gap between earnings growth and dividend growth.

Dividends had fallen out of favor among many corporations, who were opting for share buy-back plans, instead. Unfortunately, many companies were also taking massive write-offs. These write-offs were reported as one time events, but it was unmistakable that they lowered past years’ earnings, which meant that the numbers upon which our model was based often were not real.

The Old Farmer's Poem

At the beginning of 2000 with reported earnings becoming more volatile and unreliable and stocks increasing in volatility, we realized that we had come face to face with the essence of the old farmer's poem. Through a subtle and innocent twist we were now in danger of investing in the "bees for their buzz," instead of the "bees for their honey." Williams believed that earnings are a "best guess" but subject to change, while dividends are real money consciously and publicly distributed to shareholders and not subject to recall. This was now becoming real to us in a way we had never known before. Dividends, of course, can change, but since boards of directors do not like to admit they made a mistake, they reduce dividends only as a last resort, whereas write-offs impacting past earnings had become common.

In short order, we decided that we would return to a dividends-only model for all stocks in our portfolios that paid dividends, and we would use the standardized payout model only for companies that did not pay a dividend. We also decided to cut back in stocks that paid little or no dividends as a percentage of our portfolios. Additionally, we cut back on dividend-paying companies that our model indicated were significantly overvalued.

This shift back to the actual dividends in our models enabled us to determine intrinsic values with much more confidence. This helped immensely in more accurately valuing companies that were paying dividends. As we mentioned earlier, however, the number of dividend-paying companies had been declining for nearly 20 years, and, thus, the universe of potential companies for inclusion in our portfolios was shrinking. At first, we were concerned that this dividends-only approach was too narrowly focused and short-changed the non dividend-paying, high growth stocks. But, as the bear market took hold and stocks began a slide that would last until early in 2003, the narrowing of our focus turned out to be a blessing. This was because, during the bear market, dividend-paying stocks performed so much better than non-dividend paying stocks.

Over the last three years we have continued to cut back on companies that pay little or no dividends, and, as we announced in 2003, we will no longer buy companies that do not pay a dividend. Thankfully, dividends are making a strong comeback. Standard & Poors recently announced that 16.5% of the companies in their universe raised dividends in the first quarter. This is the highest percentage of increases in many years.

Williams's Lament

If John Burr Williams were alive today, he would, undoubtedly be saying the same things about the market's volatility during the past eight years, as he stated in his thesis about the market's in the 1930s. During the last eight years, the Dow Jones Industrial average exploded from 6500 to over 11,000, then fell to nearly 7,000 and rose again in early 2004 to 10,700. This incredible volatility has shaken the confidence of many investors and had some role in the recession of 2001 and the slow rate of job growth as the economy has begun to gain strength. What Williams observed about the 1929 – 1937 market still applies today,

"Such enormous fluctuations should not have occurred, because the long-run prospects for dividends have not, in fact, changed as much as prices have. Prices have been based too much on current earning power, too little on long-run dividend-paying power."

Here is the proof of his words. The annual total return of the Dow Jones Industrial Average over the past eight years was approximately 11%, but no single year's return was anywhere near the average. In the four years when stocks rose, the smallest increase was almost 19%. The average of the four positive years was near 25%. The average of the three negative years was almost -9%. For the statisticians among you, the standard deviation during this period was 18%. Remarkably the volatility of the market in the past eight years has been slightly less than the 80-year average standard deviation of almost 20%. By contrast, what we call the dividends-only return (dividend yield plus dividend growth) during the last eight years has averaged 10%, or just slightly less than the total returns from stocks. The volatility, however, has been dramatically different. There were no years in which dividend yield plus dividend growth was negative. During the past eight years, the standard deviation of dividend yield plus dividend growth for the 30 companies in the Dow Jones Industrial Average was just over 4%.

We have completed research that shows, just as Williams theorized and Bernhard described, there is a high correlation between dividend growth and price growth among companies who return a good portion of their earnings to shareholders in the form of dividends. With this in mind, we believe the following is the bottom line for

the value of dividend investing. Viewing the Dow Jones from a purely dividend-centric methodology, we would have expected to have made 10% per year over the past eight years. That turned out to be very close to the DJIA's actual rate of return of 11%. The volatility of the dividend-centric returns, however, was dramatically different. At only a 4% standard deviation, the dividends-only approach was 78% less volatile than the standard deviation of the market itself. Or put another way, we achieved 90% of the market's return, with only 22% of the volatility or risk.

You may be saying that it is impossible to invest only in dividends because prices are always associated with stocks. Our argument is this: In the long run, prices follow dividends, thus if you have a way of assuring that today's price for a particular stock is reasonable in relation to interest rates, (We believe we have this in Williams's formulae.) then, there is a high probability that the growth rate of the price of the stock over the next ten years will be similar to the growth rate of the dividend.

For a moment, assume we are correct. What does it mean? To us it means that we can target rates of return in the 8%-12% for high quality, dividend stocks, as opposed to the 3%-6% interest rates currently available from bonds. The difference in these returns is so wide that it forces one to look closer at this approach. Indeed, the greater risk may be in not considering it. We will discuss this more in an upcoming special letter on our proprietary intrinsic value models.

Blessings,

Greg Donaldson

Mike Hull