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Uncovering Hidden Values

Rising dividends have power. But, their power is largely hidden because most people don't know where to look for it. Understood properly, the hidden qualities of rising dividends can afford investors an unobstructed view beyond today's fluctuating prices into the underlying values of an individual stock and the overall market. In this quarterly letter, we will identify some of these hidden qualities and how we use them for investment analysis and selection. Dividends are becoming a more familiar subject among investors, but judging from the articles we have read in the mainstream media, the public is still primarily interested in high dividend yield, with dividend growth running a distant second. It is natural that high dividend yield investing would get the most attention. It is easy to understand. The formula for current dividend yield is very straight forward:

$$\text{Current Dividend Yield} = \frac{\text{Current Dividend}}{\text{Current Price}}$$

For example, Bank of America (BAC) pays a dividend of \$2.00 and is selling at \$45.00 per share, producing a current dividend yield of 4.44%. Although a yield of 4.44% is attractive, particularly in a world where a 10-year US Treasury Bond yields just over 4.0%, our research shows conclusively that it is the combination of dividend yield and dividend growth that offers the greatest rewards. BAC is one of our favorite stocks, but we like it for important reasons beyond its current dividend yield. Indeed, if its current dividend yield were all we could expect over the next 10 years, we would buy the Treasury bond because it is backed by the full faith and credit of the US government, while BAC's dividend is not guaranteed and could be cut to zero next week without violating any laws.

Quality Door

It is important to remember that dividends are not a legal obligation; they are paid at the sole discretion of the board of directors of the company. That is why, even though we invest only in stocks that pay dividends, our investment selection process does not start by going through the "Dividend Door." That process starts through the "Quality Door." By this we mean that all of our potential portfolio holdings must possess solid creditworthiness before we will even look at them from a dividend perspective. Indeed, the first question we ask about companies we are considering is -- would we loan them money? We expect to own most of the companies we buy for many years. Over time, some sort of bad news inevitably hits all companies. We want to be sure that the companies we own can take these hits and continue on without coming apart. The idea that you can jump in and out of stocks and avoid the hits is widespread among investors today and is simply not true. We can cite countless examples of bad news that has hit a company without warning and severely tested the financial and management resources of the organization for years.

Most high-yield dividend stocks we see touted in the media can not pass the quality door. We think they are an accident waiting to happen. The companies are using high dividends just to keep investors happy, but they are essentially liquidating their companies by paying out more than they can afford. When the inevitable bad news comes, their high dividend will be the first thing to go.

If we were to reduce our investment selection process to one sentence it would be:

We seek to own companies with unquestioned financial strength that pay a generous dividend and promise superior dividend growth in the future.

The word dividend comes from the French word, *dividere*, meaning, to cut. Dividends are literally your “cut” of the company’s profits, and herein lies the first hidden value of rising dividend investing: In selected companies, dividends go up almost every year. Indeed, in the last 45 years, the cumulative dividends of the Dow Jones Industrial Average (DJIA) have risen 37 times and fallen only 8 times. Few people are aware just how stable the dividends of some major companies really are. Our research shows that for the DJIA, the steadily rising dividends have not only represented nearly 40% of the total investment return, they have also provided an important gauge for determining the value of the DJIA itself. We will elaborate on this idea later.

Yield at Cost

The current dividend yield of a stock whose dividend is stable is easily understood. You do not even need to know the formula because it is computed for you and shown in most financial publications for every stock. But, understanding the value of a rising dividend is much tougher, and techniques to assist you in doing so are almost totally absent in today’s media. One approach we use to uncover this hidden value is the concept of “Yield at Cost.” Yield at Cost is the current dividend divided by your original purchase price. Yield at Cost is quite revealing once you understand how to use it. Let us show a Yield at Cost analysis for BAC.

When you look at BAC in the paper or at an online financial page, it will look something like this:

| <u>Name</u> | <u>Price</u> | <u>High</u> | <u>Low</u> | <u>Volume</u> | <u>PE</u> | <u>Dividend</u> | <u>Yield</u> |
|-------------|--------------|-------------|------------|---------------|-----------|-----------------|--------------|
| BAC | 45 | 46.25 | 44.15 | 300,000 | 12 | 2.00 | 4.4 |

Most investors look only at price. Some might look at PE or yield, but almost no one will look at the most important data on the line, dividend. Let’s say you bought BAC ten years ago. Table I on the next page shows that in 1995 you would have paid \$14.53 per share for BAC. Dividing the current dividend of \$2.00 by your original purchase price, we find that your Yield at Cost is 13.77%. This is a remarkable cash on cash return, yet no financial publication in the world can show it to you, because it is yours and yours alone.

Looking at Table I, you will see that in 1995 BAC paid a dividend of \$.52, which produced a dividend yield of 3.58%. Over the last 10 years, however, the company has raised its dividend every year and today pays \$2.00, almost four times what it paid in 1995. Please note that BAC’s current yield, as would have been reported in the media, ranged between 2.25% and 4.44% (Column F). Your Yield at Cost, which Column G shows was rising every year, would have been completely hidden from you, unless you understood the concept. Let’s look at Table I to see other important features of dividend investing.

Table I*
Bank of America
Earnings and Dividends

| A | B | C | D | E | F | G |
|-----------------------|--------------------|--------------------|-----------------------|---------|---------------|--------------------------|
| Year | Earnings Per Share | Dividend Per Share | Dividend Payout Ratio | Price | Current Yield | Yield at Cost of \$14.53 |
| 1995 | \$1.76 | \$0.52 | 29.5% | \$14.53 | 3.58% | 3.58% |
| 1996 | \$1.96 | \$0.60 | 30.6% | \$20.87 | 2.88% | 4.13% |
| 1997 | \$2.09 | \$0.69 | 33.0% | \$30.61 | 2.25% | 4.75% |
| 1998 | \$1.82 | \$0.80 | 44.0% | \$33.83 | 2.36% | 5.51% |
| 1999 | \$2.34 | \$0.93 | 39.7% | \$32.09 | 2.88% | 6.40% |
| 2000 | \$2.36 | \$1.03 | 43.6% | \$24.22 | 4.25% | 7.09% |
| 2001 | \$2.47 | \$1.14 | 46.2% | \$28.64 | 3.98% | 7.85% |
| 2002 | \$2.95 | \$1.22 | 41.4% | \$33.81 | 3.61% | 8.40% |
| 2003 | \$3.57 | \$1.44 | 40.3% | \$37.76 | 3.81% | 9.91% |
| 2004 | \$3.69 | \$1.70 | 46.1% | \$42.62 | 3.99% | 11.70% |
| 2005 | \$4.20 | \$2.00 | 47.6% | \$45.00 | 4.44% | 13.77% |
| Average Annual Growth | 9.1% | 14.4% | | 12.0% | | |
| 10-Year Average | | | 39.4% | | 3.45% | |

If you are like most people, who look only at price, you wake up every morning saying, “Should I sell my BAC and take my profit, or should I wait for another day when it might be higher?” Our guess is that most price-only investors who bought BAC in 1995 had a very tough time holding the stock in the late 1990s. The stock went flat from 1997 through 2002 (Column E), at a time when the investment world became inebriated with tech stocks. Yet, even though BAC’s price was going nowhere, its dividend and underlying value was increasing by double digits every year. BAC’s dividend went from \$.69 in 1997 to a \$1.22 in 2002. That is nearly an 80% increase in cash distributions and the price hardly moved. That alone should have been a warning that something was amiss with the market’s valuation mechanism. In hindsight, it is now clear that during this time something other than valuation was driving stock prices. Understanding that your Yield at Cost was rising every year, may have given you enough incentive not to go chasing tech stocks that were trading at 200 and 300 times earnings.

As shown in columns B and C, BAC’s earnings and dividends have had average annual growth of 9.1% and 14.4%, respectively. This is excellent growth, particularly in dividends. Column D shows that BAC’s dividend payout has averaged 39.4% of earnings per share. Column D also shows that the dividend payout ratio has been rising significantly – with dividends representing about 30% of earnings ten years ago and about 50% today. This is graphic evidence of a board of directors that is able and willing to return to its shareholders a fair cut of the profits. Column E shows that BAC has experienced price growth of 12% per year, which is similar to dividend growth, as is often the case with rising dividend stocks.

There is much good information on Table I, but let us cite two points that tell us BAC’s prospects for the next ten years are as good as its results were for the last ten years.

1. Growing Earnings: It is not well understood that the US economy has been growing on average about 7% a year for the last 50 years. If you are a closet economist you will fuss and say that the economy has grown at only 3% a year. But both numbers are correct. The more widely accepted figure of 3% annual growth is adjusted for inflation, which has averaged 4% per year during this time, and measures real economic growth. But the 7% figure is also correct because it is the actual or gross rate of economic growth not adjusted for inflation. Since stock prices and other corporate financial data are not adjusted for inflation, an apples to apples comparison calls for us to use the 7% growth rate.

BAC is as close to being a nationwide banking operation as any financial institution we have in this country. If the US economy continues to expand at a gross rate of 7% per year, it is not a stretch of the imagination to predict that BAC will also grow earnings at least at 7% annually for the next decade.

2. Precedents for a Continued Rising Dividend: So, BAC has a bright future. That does not mean its dividends will keep pace with its earnings. How can we be sure that the company's board of directors will continue to give us our cut? The short answer is we don't know. We believe the best way to judge a company's likelihood of being fair to its shareholders is to look for precedents from its past. In this case, we mean dividend decisions they made when things were tough. There is a powerful precedent-setting action contained in Table I.

In 1998, BAC's earnings fell nearly 20% versus the prior year. Remarkably, BAC, showing their unquestioned financial strength, raised their dividend by nearly 14%. We see three good things to take from their actions:

- A. They correctly saw that the troubles of the time were temporary.
- B. They did not make a token dividend increase; they raised their dividend at the same rate as they had been doing prior to the earnings weakness.
- C. Their strategic actions prior to 1998 created a strong financial condition that allowed them to handle the rough spot with ease. (Thus, the importance of the "Quality Door.")

What about Price?

So far we have avoided much discussion of the "Price Door." The reason for this is that we believe there is a better way to achieve price growth than to try to ride the coat-tails of the next hot stock or industry. We have been saying for a long time that people agonize over current prices much more than they should. The average difference between the high and low of an individual stock in a typical year is nearly 25%. This volatility is just the nature of the beast, stocks go up and down. Sometimes there is a good reason; most times they just go up and down because speculators are hurling stocks back and forth among themselves for reasons known only to them. But, as we mentioned earlier, dividends are remarkably stable and consistent, and our research shows that in the long-term they are highly correlated to stock prices. Table II below has profound consequences for investors of all ages. We believe the data illustrate that there is another way of seeking price appreciation that is less volatile, more predictable, and yet, offers similar expected rates of return as does a price-only oriented investment strategy. Please study this table. In our judgment, it does more to de-mystify investing than anything we could write.

Table II*
Dow Jones Industrial Average
Total Dividend Return vs Total Return*

| | A | B | C | D | E | F | G |
|------------------------------|------------------------------|--------------|--------------|--------------|--------------|----------------|---------------------------|
| | Total Dividend Return | | | | | | |
| Decade | 1960s | 1970s | 1980s | 1990s | 2000s | Average | Standard Deviation |
| Dividend Growth | 5.8% | 4.3% | 7.6% | 5.4% | 5.6% | 5.7% | 1.2% |
| Dividend Yield | 3.5% | 4.6% | 4.8% | 2.6% | 2.0% | 3.5% | 1.2% |
| Total Dividend Return | 9.3% | 8.9% | 12.4% | 8.0% | 7.6% | 9.2% | 1.9% |
| | Total Return | | | | | | |
| Price Growth | 3.9% | 0.4% | 12.5% | 15.7% | 0.0% | 6.5% | 7.2% |
| Dividend Yield | 3.5% | 4.6% | 4.8% | 2.6% | 2.0% | 3.5% | 1.2% |
| Total Return | 7.4% | 5.0% | 17.3% | 18.3% | 2.0% | 10.0% | 7.4% |

At DCM, we often say that many of our companies' dividends are consistent and persistent. Just how consistent they are may surprise you. Earlier we said that the cumulative dividends of the DJIA have risen about 8 out of every 10 years. The upper half of Table II shows the DJIA's dividend growth and dividend yield over the last five decades. The chart vividly shows that dividend growth has been very consistent during this time. The five-decade average dividend growth of 5.7% has been accomplished with a remarkably small standard deviation (average volatility) of only 1.2%.

The table also compares the well-known concept of investment Total Return with our "Total Dividend Return." Total Return, the conventional way of looking at stock returns, is defined as price growth plus dividend yield. In our Total Dividend Return, we substitute dividend growth for price growth. Thus, Total Dividend Return is equal to dividend growth plus dividend yield. Total Dividend Return by decade for the DJIA has ranged from a low of 7.6% for the first half of the current decade, to a high of 12.4% for the decade of the 1980s. The five-decade average has been 9.2% (Column F), again with a miniscule standard deviation of 1.9%.

The bottom half of Table II shows the more conventional components of Total Return, as well as volatility. For the last five decades, the DJIA has averaged an annual total return of 10%, as shown in Column F. This has consisted of 6.5% average price growth and 3.5% average dividend yield (Column F). It is eye opening that Total Dividend Return, 9.2%, and Total Return for the DJIA, 10.0%, have been

so similar. Investors could have ignored the news of recessions, wars, oil shocks, assassinations, and tech bubbles. They could have dropped their subscriptions to the Wall Street Journal and pulled the plug on the talking heads on CNBC. They could have breathed easier each time a crisis of any kind came along; indeed, they could have dramatically reduced the time they invested in keeping up with the Dow Joneses. Instead, they could have watched just two things, the dividend growth and the dividend yield of the DJIA.

These two pieces of very consistent data predicted over 90% of the rate of return of the index. But, of equal importance, they did so with 75% less volatility than the DJIA itself. The standard deviation of the Total Dividend Return as shown in Column G has been only 1.9% on an average return of 9.2%. This is in sharp contrast to the 7.4% standard deviation of the DJIA on its 10% average annual return.

Our theory holds that in the long-run, the price growth of a stock will be highly correlated with its dividend growth, if dividend growth is consistent. Thus, its Total Return will also be highly correlated to its Total Dividend Return because dividend yield is common to both formulas. The reasons for the high correlations are simple. If a company is consistently giving its shareholders their fair cut of the profits, it should show up in the stock price. The stock market is a pricing machine. The more transparent a company is with their dividend policy, the more accurately the market will price their stock.

A Prediction

Since 1960, the companies in the DJIA have paid an average of near 50% of their earnings in dividends. Table III shows that in the five years since the turn of the century, the dividend payout ratio has slipped to an average of 39%, with it standing at only 35% today. We believe the dividend payout ratio will return to its historical average of 50% by the end of the current decade.

We expect this for three reasons: 1) Back on Table I we saw that Bank of America has increased its payout ratio from 30% to near 50% over the last decade. BAC and many other banks' stock prices went flat as the tech rally of the late 1990s took hold. In response to flat stock prices, which in the case of BAC we saw lasted for five years, most major banks began ramping up their dividends as a way to maintain shareholder approval and loyalty. 2) In Table II we saw that dividend growth for the DJIA was remarkably consistent for all decades except the 1980s, where growth was much higher. Our research into that occurrence reveals that the outsized gains were mainly in 1987 and 1988 in the aftermath of the stock market crash of late 1987. Again, it looks to us as though dividends were ramped up to regain shareholder confidence. 3) Table II also shows the fallout of the tech wreck. Thus far in the new century, stock prices have been flat. The total rate of return since 2000 has come entirely from the dividend. We think the current situation will be resolved in the same way as the other two by companies again ramping up dividends to mollify their shareholders.

Table III*

| Dow Jones Industrial Average Dividend Payout Ratio | | | | | | |
|---|--------------|--------------|--------------|--------------|--------------|----------------|
| 1960s | 1970s | 1980s | 1990s | 2000s | Today | Average |
| 60.0% | 47.0% | 54.0% | 47.0% | 39.0% | 35% | 50.0% |

Dividend payouts trending back toward 50% will mean that over the next five years or so, dividends on the DJIA and other Blue Chip indices should grow near 10% per year. If this prediction comes true, we believe stock prices over the remainder of the decade will surprise to the upside.

We believe viewing the stock market or an individual stock from a dividend perspective is the right approach for most people. In this letter, we hope that we have convinced you that dividends not only contribute directly to investment returns because they are real money, but they also have predictive powers for stock price growth. In addition, because they are so much more stable than prices, they can give us a more honest appraisal of values, and we can make decisions accordingly.

A look at the ups and downs of the DJIA over the last five decades shows plenty of both, but in all cases, down markets and flat markets have ultimately been resolved with another up-leg that has taken stocks to new highs. To bet that this won't happen again is just simply a bad bet in our minds. Keeping close tabs on dividends and the very real progress we predict there assures us that values will continue to rise, and history concretely shows that prices eventually follow values. In our judgment, just like BAC's flat performance of the late 1990s came to an end with the help of higher dividend payments, so too will the recent flat performance of the DJIA.

Blessings,

Greg Donaldson

Mike Hull

*All data shown here is taken from sources believed to be reliable. DCM cannot guarantee their accuracy. Data may not total correctly due to rounding.