

WHY DIVIDENDS MATTER

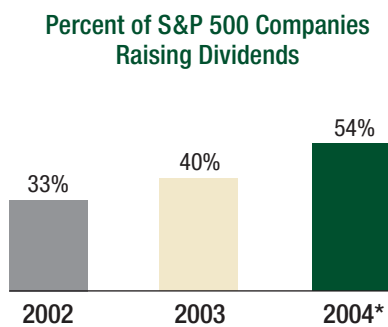
How profits are distributed to shareholders is a key indicator of a company's health—and a big factor in a stock investor's long-term wealth.



MICROSOFT'S JULY ANNOUNCEMENT OF ITS gargantuan onetime dividend payment confirmed a trend: Dividends are in vogue again on Wall Street. The percentage of companies in the S&P 500 raising dividends has been steadily increasing, up from 33% in 2002 to 54% in 2004 (*Display 1*). In addition, the percentage of these large companies establishing dividends for the first time is higher now than it has been in the previous five years. Yet many equity investors are unmoved: What use is an annual payout measured in cents per share? Isn't the appeal of stocks their potential for price appreciation? These investors might not care about dividends—but should you?

Display 1

The number of companies raising dividends has been steadily increasing



* Through August

Source: FactSet, Standard & Poor's, and Bernstein

The answer, in our view, is an emphatic yes. Not only have dividends been a main component of the stock market's long-term return over the years, but

they're also a critical indicator of a company's health, and thus can be a key factor in evaluating a company for investment. Our latest research suggests that right now in capital-markets history—fueled by recent changes in tax rates and a strong economy—dividends are hitting a sweet spot.

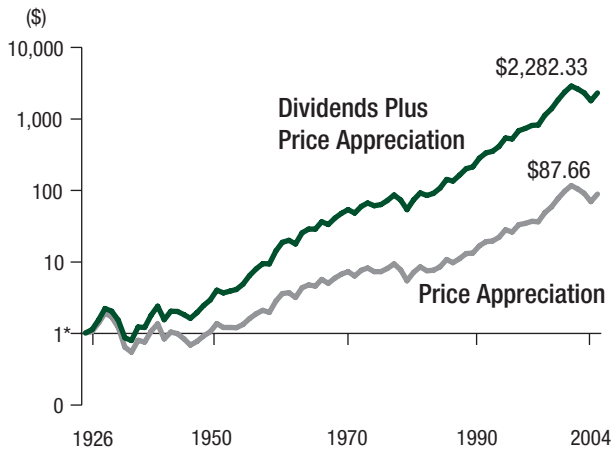
THE VALUE OF DIVIDENDS

Many equity investors raised on the bull markets of the 1980s and '90s ignore dividends and think of a stock's value simply in terms of its price—how much does it cost, how much can they sell it for in the future? In reality, investors should also focus on the fact that owning a share of stock entitles them to a share of the profits of a company. These profits can be reinvested in the business itself in hopes of providing higher profits in the future; they can be spent by the company to buy back its own shares, in which case they boost earnings per share since there are fewer shares outstanding than before; or they can be paid out as dividends, in which case they go straight into investors' pockets.

It should therefore come as no surprise that dividends have been a major component of growth in an investor's return over time. Remember, calculations of a stock's performance in a portfolio are based on total return, i.e., the annual price appreciation (or loss) plus dividends. Since 1926 (when reliable data were first available), dividends have accounted for 35% of stocks' total return. When you factor in the power of compounding, dividends can contribute impressively to the buildup of your nest egg. Consider this scenario: A dollar invested in 1926 in U.S. large-cap stocks would have grown to nearly \$2,300 today (*Display 2*). But take out the dividends (and

Display 2

Without dividends, the long-term value of stock investing would be phenomenally smaller



* Log scale
 Stocks are represented by Ibbotson data through 1974 and by the S&P 500 thereafter.
 Source: Compustat; Roger G. Ibbotson and Rex A. Siquefield, "Stocks, Bonds, Bills, and Inflation: Year-by-Year Historical Returns," University of Chicago Press *Journal of Business* (January 1976); and Bernstein

the effect of compounding on those reinvested dividends) and that same dollar would be worth a little less than \$88.*

Stock prices are predominantly an indication of how much investors think a company is worth at any given moment. So stock prices are volatile, as investors' expectations of the future are often whimsical in the short term. Just consider what happens to a stock's price when quarterly earnings are reported: It rises or falls based on investors' views of what future cash flows might be. But it is not a perfect relationship. Sometimes profits go up but the stock price stays depressed; sometimes there are no profits and prices go up. Dividends, however, are not based on investor perception; they're based on a company's actual operations and available cash—so they tend to change much less radically than stock prices. In fact, the volatility of dividend payouts has been a fraction of that of stocks (*Display 3*).

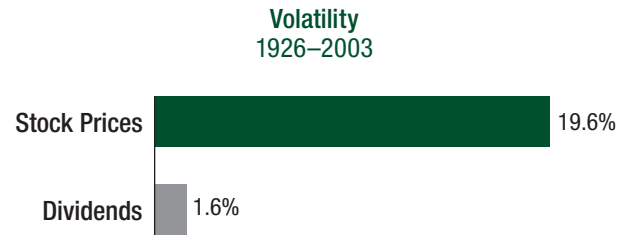
THE DIVIDEND AS INVESTING TOOL

Looking at a company's dividend-paying capability and its ability to increase its dividends over time provides useful information for investors.

* Of course, if you spent those dividends instead of reinvesting them, you'd have enjoyed lots of extra purchasing power over the years. That's why total return as calculated in percentage terms gives equal weight to dividends whether they're withdrawn or reinvested.

Display 3

Dividend payouts have been far less volatile than stock prices

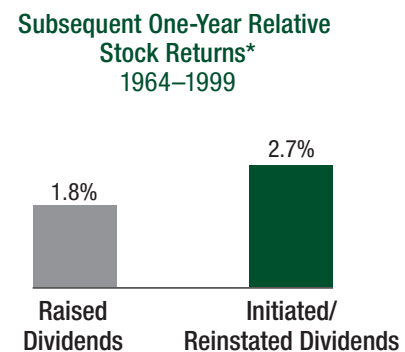


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Companies pay dividends after accounting for operating expenses and any expansion plans; when a company consistently has enough cash left over to reward investors, it's a likely indicator of good management and healthy cash flows. In fact, a research study we conducted showed that dividend-paying stocks generally outperformed non-payers over the years. In the year after large-cap companies raised their dividends, they outperformed their peers (based on total return) by an average of 1.8 percentage points (*Display 4*). Those that began paying dividends for the first time, or reinstated them after a lapse, outperformed their peers by 2.7 percentage points.

Display 4

On average, companies outperformed in the year after they raised, initiated, or reinstated dividends



* Universe of 1,500 largest U.S. stocks by market capitalization
 Source: Bernstein

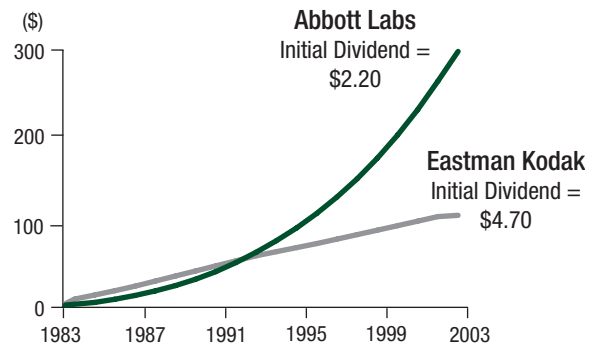
Although Kodak paid a higher dividend initially, Abbott ended up paying out dramatically more

So should you invest all your money in companies with high dividends? Not necessarily. For one thing, looking at the dividend alone doesn't tell you enough about a company. Generally speaking, younger companies don't pay dividends: They plow their profits back into the business. This isn't bad for investors if these companies can generate high returns on investment; Microsoft was able to do just that over the past two decades, producing massive returns for its investors without paying a single dividend. But rapid growth doesn't last forever. As a company grows and matures, management may see less opportunity for growth, less need to reinvest all of its earnings, and the wisdom in paying more of its earnings directly to shareholders. Both types of companies can be successful investments. The key is understanding what life-cycle stage a company is in—and whether it's using its earnings in the best interests of its shareholders.

Looking only at dividend yield—the dividend per share divided by the stock's price—is equally limited, as it relates solely to the current distribution to shareholders without any assurances about the future level of earnings and dividends, which may change significantly over time. Take the cases of Abbott Laboratories and Eastman Kodak.* In 1983, Abbott was yielding 2.2%, whereas Eastman Kodak was yielding 4.7%. That meant for every \$100 invested in Abbott, you received \$2.20 in dividends, versus \$4.70 with Kodak. Based on those statistics, Kodak was the clear winner—and its history as a steadily growing blue chip also provided a strong argument. But over the next 20 years, the company faced significant problems, while Abbott experienced phenomenal earnings growth. Driven by that growth, Abbott's dividends compounded by almost 15% annually, while Kodak's actually showed a decrease. The troubled camera company ended up paying far less in dividends per \$100 invested than Abbott: \$100 vs. \$300 over the entire 20-year period (*Display 5*).

Abbott's stock price largely followed these strong gains in earnings and dividends, providing an investor with an annualized total return of 17.4%. Meanwhile, Kodak investors received a meager 3.6% annual return. Although it had the bigger yield initially, Kodak could not grow or maintain this cash flow, resulting in a far less successful investment.

Cumulative Dividends Earned On a \$100 Investment



Source: Compustat and Bernstein

STOCK BUYBACKS: THE OTHER "DIVIDEND"

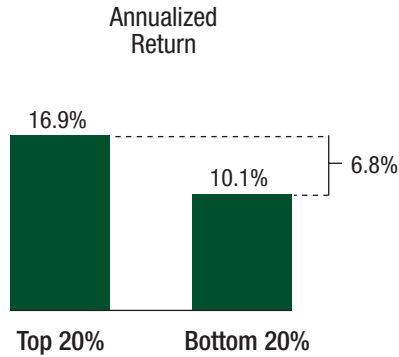
Dividends are not the only way a company can use its cash flow to reward investors: Companies can return money to shareholders through stock repurchases, and such buybacks have become increasingly popular. In fact, the percentage of earnings going toward stock repurchases among companies in the S&P 500 has climbed to almost 30% today from 16% 10 years ago. By looking at the amount of money paid out as dividends combined with the amount used to repurchase stock, investors can gain a more complete picture of how a company is using its cash flow. We divided the large-cap universe of stocks into five groups, based on the total amount of cash used to pay dividends plus repurchases (net of share issuance) relative to the stock's value (*Display 6*). We found that the group with the highest ranking (the top 20%) outperformed those with the lowest ranking (the bottom 20%) by nearly seven percentage points per year.

Paying dividends and repurchasing shares are, on average, each positive signs, but when a company does both, it's a very strong indication of good health. After all, how *much* a company is able to distribute to its shareholders is more important than *how* it does so.

* The specific securities described here are mentioned for illustrative purposes only and do not necessarily represent those purchased or sold in any particular portfolio. It should not be assumed that such investments were or will be profitable.

Companies that paid out more of their earnings to shareholders outperformed those that paid the least

**Companies Ranked by Shareholder Payout*
(Dividend Payments Plus Net Repurchases)
1972–2003**



* Universe of 1,500 largest U.S. stocks by market capitalization
Source: Bernstein

TODAY'S ENVIRONMENT IS IDEAL FOR DIVIDENDS

The recent renaissance in dividends has been prompted by three factors: a new focus on companies' business fundamentals, born of the reported-

earnings scandals of the late 1990s; the 2003 reduction in the dividend tax rate, from 39.5% to 15%, so that most dividends are no longer taxed more heavily than capital gains; and the current strong economy, which is improving corporate profits and cash flow.

This last point bears elaboration. Just one year into the economic recovery, corporate profit margins are at a 30-year high. Free cash flow is also at a record, at some 2½ times the peak of the early 1990s. As of summer 2004, corporations across the economic spectrum were enjoying some \$1.2 trillion in profits. By our analysis, S&P 500 companies, after retaining enough earnings for 6% growth, have enough cash left over on average to provide *double* the current dividend payout. Whether that payout actually comes in the form of dividends or stock buybacks is secondary. The point is that even as American corporations are investing more in building their core businesses, there's still plenty of room for them to return more cash to shareholders. ■

For more on corporate earnings, see "How Research Can Pierce the Veil of Accounting Practices" on our website, www.bernstein.com.

NOTE ON THE WEALTH FORECASTING ANALYSIS:

A number of the articles in *The Bernstein Journal* make use of our Wealth Forecasting Analysis, a proprietary modeling tool designed to assist investors in a range of key decisions including setting their long-term allocations of financial assets. The Wealth Forecasting Analysis consists of a four-step process: (1) Client-Profile Input: the client's asset allocation, income, expenses, cash withdrawals, tax rate, risk-tolerance level, goals, and other factors; (2) Client Scenarios: in effect, questions the client would like guidance on, which may touch on issues such as when to retire, what his cash-flow stream is likely to be, whether his portfolio can beat inflation long term, and how different asset allocations might affect his long-term security; (3) The Capital-Markets Engine: a model that uses our proprietary research and historical data to create a vast range of market returns, which takes into account the linkages within and among the capital markets (not Bernstein portfolios), as well as their unpredictability; and finally, (4) A Probability Distribution of Outcomes: Based on the assets invested pursuant to the stated asset allocation, 90% of the estimated range of returns and asset values the client could expect to experience are represented in a graphic output. We focus on the 10th, 50th, and 90th percentiles to understand the range of outcomes representing upside, median, and downside cases. However, outcomes outside this range are expected to occur 10% of the time; thus, the range does not establish the boundaries for all outcomes. Except where otherwise indicated, asset class assumptions are based on the following: Stocks are represented by the S&P 500, with an assumed compounding rate of 8.2%; growth stocks by the S&P/Barra Growth Index, 8.2%; value stocks by the S&P 500/Barra Value Index, 8.2%; developed foreign stocks by the MSCI EAFE Index (countries weighted by market capitalization), 8.5%; emerging markets stocks by the MSCI Emerging Markets Index, 7.5%; bonds by AA-rated diversified municipals with seven-year maturity, 3.5%. A "fully diversified" portfolio comprises 60/40 stocks/bonds, with the stock component 70/25/5 U.S./developed foreign/emerging markets, and the U.S. component 50/50 growth/value. Expected market returns on bonds are derived by taking into account yield and other criteria. An important assumption is that stocks will, over time, outperform long bonds by a reasonable amount, although this is by no means a certainty. Moreover, actual future results may not meet Bernstein's estimates of the range of market returns, as these results are subject to a variety of economic, market, and other variables. Accordingly, the analysis should not be construed as a promise of actual future results, the actual range of future results, or the actual probability that these results will be realized.