

The Unbeatable Power of Rising Annual Dividends

There are ways for the individual investor to make money in the securities markets. Buying value and holding long term while collecting dividends has been proven over and over again.

— Robert M. Sharp, author of *The Lore and Legends of Wall Street*

dividend:

n. a sum of money paid to shareholders of a corporation out of earnings

n. anything received as a bonus, reward, or in addition to or beyond what is expected (as in an extra or special dividend)

Most stock investors believe that price appreciation is the way to make the most money from equities, not dividends. The truth is, it's just the opposite.

In 1937 Lord John Maynard Keynes, the British economist remarked that, "In one of the greatest investment markets in the world, namely, New York, the influence of speculation is enormous. It is rare for an American to 'invest for income,' and he will not readily purchase an investment except in the hope of capital appreciation."

But John D. Rockefeller, the American industrialist, investor and philanthropist who founded Standard Oil in 1870 (now ExxonMobil) and the world's richest person ever (using today's dollars) said, "Do you know the only thing that gives me pleasure? It's to see my dividends coming in."

A lot of smart people (including many professional money managers) have opined for years that dividends don't matter, or at best matter little. To them it's really earnings growth and price appreciation that count.

Look at this table of the S&P 500's compounded annual growth rate (CAGR) from 1950 through 2000. You'll note that during all five periods ranging from 10 to 50 years, dividends comprised no less than 14% to as much as 31% of the annual total return.

	S&P 500 Annual Returns 1950-2000		
	CAGR	With Dividends	% Return from
Dividends			
1990-2000	14.9%	17.3%	14
1980-2000	12.0%	15.4%	22
1970-2000	9.3%	13.0%	29

1960-2000	8.1%	11.8%	31
1950-2000	8.7%	12.5%	30

Many advisors shun higher-yielding stocks for high-tax-bracket investors because they only focus on how much the government will take of that income. They ignore the historic total-return numbers and the fact that higher-yielding stocks generally go down less in a bear market. Thus, the overall return of the portfolio – dividends with appreciation – is almost always higher than from price appreciation alone.

Global markets analyst Mike Burnick sums it up this way, “Smart investing is about making money the old-fashioned way ... earning it. This includes buying undervalued blue-chip companies with attractive dividend yields. That’s one of the best investment strategies I know of.”

Cash dividends have accounted for roughly 40% of the total return on stocks dating all the way back to the inception of the S&P 500 at the end of 1925. Dividends were THE reason that stock returns were positive for the 10 years from the beginning of 1930 through the end of 1939, the period which encompassed the Great Depression.

Mark Skousen, author of *Investing in One Lesson*, has observed that investing exclusively in dividend-paying stocks will 1) help you avoid making big mistakes, 2) increase your chance of beating the market, and 3) typically provide you with less volatility than the overall market.

Way back in early 1989, it occurred to me that there must be a simple way to identify the highest-quality companies that make the most money over longer periods of time. I had one of those “ahas,” a blinding glimpse of the obvious. All I needed to do was to identify all U.S.-based companies with at least 10 years in a row of higher dividends and/or earnings per share. No one else was doing it, and still to this day no one else does.

Earnings have always been somewhat tricky to measure on the income statement because there is so much wiggle room on every line between and including the top (revenue) and the bottom (net income after taxes). But with dividends, there can be no tricks. Either a company pays a cash dividend or it doesn’t.

A dividend can maintain one of three directions – up, down or sideways. If it’s not going up every single year without fail, I’m not interested. By that simple rule of

thumb, I eliminate about 98% of all public U.S. companies. But that leaves more than 250, plenty in which to invest and make solid returns.

When I first came up with this concept, it took a research assistant and me 18 months to compile the original database, which at that time was about 425 companies. Way before the Internet, I trudged to the library virtually every day to pore through — one page at a time — roughly 5,000 *Standard & Poor's Fact Sheets* and more than 1,800 pages of *The Value Line Investment Survey*.

We wrote hundreds of letters asking for annual reports and other necessary information and talked with about the same number of companies as well. It was a mammoth effort but well worth the time and trouble because my experience had taught me that consistency -- as measured by long strings of rising earnings and dividends -- is a hallmark of above-average stock performance whether you're a buy-and-holder, market timer or combination of both.

We named and trademarked this exclusive universe *America's Finest Companies*®(AFCs). AFCs (about 2% of all publicly-traded U.S. based corporations) are the prime choice in American industry just as is prime beef, which is sold in only about 2% of America's finest restaurants. Interesting analogy, isn't it?

When I first started publishing my *America's Finest Companies*® investment directory, now in its 18th year, there was little evidence about investing in companies that pay dividends versus those that don't. Now more and more research seems to be literally popping out of the woodwork to support my case.

Higher Payouts = Higher Returns

My money management clients have outperformed the market averages with below-average risk simply because we focus on quality dividend-paying stocks with above-average yields. Study after study has proved beyond the shadow of anyone's doubt that this is a long-term moneymaker. Plus, it's easy to understand and implement.

In March 2003 *AIMR Digest* carried a sophisticated article that originally appeared in *The Financial Analysts Journal* titled "Surprise! Higher Dividends = Higher Earnings Growth," by Robert D. Arnott (former global-equity strategist for Salomon Brothers) and hedge-fund manager Clifford S. Asness that studied the payout ratio (percentage of earnings paid as dividends) and its relationship to

subsequent earnings growth stretching back for 130 years, with particular emphasis on the post-WWII era.

They proved that higher dividend-payout ratios predicted faster earnings growth over the ensuing 10 years. The top 25% of S&P 500 stocks with highest payouts enjoyed average inflation-adjusted earnings growth of 4.2% per year. Conversely, the lowest 25% reported profits shrinking by 0.4% per year. Even over the top 10-year period, earnings growth was never higher than 3.2% annually.

Jack Hough in *SmartMoney* observed, “An old adage holds that investors in dividend stocks are being ‘paid to wait for the stock to appreciate.’ Academic research suggests they may not have to wait very long. Dividends, it turns out, can actually forecast earnings growth. And earnings growth, of course, drives stock gains.”

“Arnott and Asness came up with two possible explanations for their findings. One holds that since managers hate cutting dividends, high payout ratios suggest extraordinary confidence in future earnings. Another says that high payout ratios prevent ‘empire building.’ That’s the well-documented tendency of managers with too much cash on their hands to waste it on ill-advised acquisitions.” Continually paying and increasing dividends forces CEOs and managers to excel. The famous Hollywood actor Edward G. Robinson once opined: “Live beyond your means; then you’re forced to work hard, you have to succeed.”

The March 2003 issue of *Worth* magazine said, on page 23, that “investing in stocks with rising dividends is a prescription for growth, not just income. *Worth* observed, “While many investors like... cash payouts for safety and income, [money manager Donald Taylor’s] attraction stems largely from the discipline they impose. Companies with long records of mostly uninterrupted dividend growth tend to think carefully about how they allocate capital. They are much more likely to grow and prosper than companies that try to fuel growth by reinvesting a large portion of retained earnings, which often end up being wasted on slow-growth businesses, poorly thought-out projects or ill-fated acquisitions.” Said another way, lots of cash can easily burn huge holes in corporate pockets. History proves it.

Charles E. Babin of State Street Global Advisors, author of the 1999 business book, *Investing Secrets of the Masters*, observes, “There’s a school of thought that says dividends are strictly for old fogies and tax-exempt entities, and that smart investors should think only about capital gains. I don’t subscribe. I think dividends do matter and that paying attention to them will improve your odds of getting capital gains.

“The key is to find stocks that consistently raise dividends year after year. Dividend hikes are the kind of news that feeds appreciation.” Laurence H. Sloan, the man who founded Standard & Poor’s, noted way back in 1931, “An unbeatable combination is a stock with a hefty payout and an ability to keep raising it.” *America’s Finest Companies*® is chock full of them, more than 20 dozen from which to pick. Exactly 100 paid a higher yearly cash dividend for at least 30 years through the end of 2008. Many have already increased the payout for 2009.

Regardless of what anyone says, **dividends do matter**. The Dow Jones industrial average (DJIA) of just 30 stocks began with 12 in 1896 at the level of 42. In 2007 it passed 14,000 for the first time, but that’s without dividends. With dividends reinvested, the DJIA would have already busted through 1,000,000. Wow!

Money magazine said, “The very fact that a company pays and regularly increases a dividend is a sign that the top managers lean toward traditional ideas of sound financial management – they believe in returning a growing stream of cash to shareholders and aren’t betting every cent they can borrow on future expansion. Stocks with the fastest dividend growth tend to have the biggest gains.”

According to Standard & Poor’s, “Investing in stocks that pay dividends is like betting on the tortoise in Aesop’s fable. Even though the hare is faster, slow and steady wins the race. Most investors who try their hands at hot stocks only get burned. Dividends, on the other hand, are real. They represent a tangible return to you, the shareholder. Dividends are money in the bank. For as long as anyone can remember, investors have intuitively understood that dividend-paying stocks provide a higher degree of price stability than non-dividend-paying issues [particularly in a severe market drop like now].”

Peter Lynch, the renowned money manager adds to that, “The dividend is such an important factor in the success of many stocks that you could hardly go wrong by making an entire portfolio of companies that have raised their dividends for 10 or 20 years in a row.”

The centerpiece of my new book from John Wiley & Sons, *Double Your Money in America’s Finest Companies*®: *The Unbeatable Power of Rising Dividends*, is that companies with a long string of rising annual dividends outperform the stock market in both good times and bad, including the Great Depression. Not only that, dividend growth in these companies historically has been able to keep up even with high inflation such as the 9.8% annual rate during the 1970s, the highest in more

than a century. They can protect against both deflation and inflation and every other fluctuation in between.

Today, few people are talking about growing inflation, which I believe is going to be a serious threat over the ensuing years. But the twin topics of deflation and depression are in the headlines almost every day.

In 1929 at the market's peak, the Dow 30 industrials reached the then all-time high of 381.1. Dividends paid that year amounted to \$12.80 for a yield of 3.4%. As stocks plunged to their ultimate 1932 low of 41.2, dividends plunged as well. They dropped to \$11.10 in 1930, to \$8.40 in 1931 and on down to \$3.40 in 1932, which happened to be the bottom. However, dividends never got back to the 1929 level until 1949, 20 years later.

Contrast that miserable performance in both stock prices and dividends to some of the America's Finest Companies® today that existed then under the same name. We found about 24 in an old stock-chart book covering the period between 1924 and 1935 and featuring 774 companies.

Abbott Labs just happens to be the first stock in the booklet. The stock price peaked in 1929 around 47 and ultimately fell to 17. The dividend was \$1.50 in 1929. By 1935 it had doubled to \$3.00, and the stock price shot up as high as 130.

Next in the booklet came AT&T(T). The company paid an annual dividend of \$9.00 right on through the depression as if the depression didn't exist. Yes, the stock price collapsed and only partially recovered by 1935, but if you could get by on the income of your portfolio, as lots of people did, there was no problem with T.

Following AT&T was Archer-Daniels-Midland. The stock peaked in 1928 at 56, fell to 8 in 1932 and got back to 52 in 1935, a wild ride but with almost no principal loss over the six years. Meanwhile, dividends dropped from their high of \$3.00 in 1927-28 to \$0.75 in 1931 and then rose to \$2.00 by 1935.

There were few outright dividend disasters I could find, at least among the America's Finest of that day. Kimberly-Clark's was one of those as they paid no dividend in either 1933 or 1934. Procter & Gamble, on the other hand, fared far better.

Caterpillar's dividend was \$1.65 in 1927. By 1935 it was at \$2.00. Coca-Cola's dividend rose from \$4.50 in 1929 to \$9.25 six years later. The stock had almost doubled its 1929 peak into 1935.

IBM's dividend was 50% higher in 1932 than in 1927. Pittsburgh Plate & Glass (now PPG Industries) had the stock price about 30% higher in 1935 than at 1929's top. The dividend was \$3.00 in 1929. In 1935 it was \$2.90. Sherwin Williams' dividend declined from \$4.125 in 1929, hit \$1.00 in 1933 and scrambled back to \$3.50 by 1935. The stock price in 1935 was 25% above 1929's peak.

Walgreen didn't start a dividend until 1933 when it began with \$1.00. Two years later it had jumped to \$1.30.

Whereas dividends for the market overall collapsed during the Great Depression and took two decades just to recover to where they'd been, that was not true for the America's Finest Companies® of that day. By our reckoning, their dividends dropped only some 30% from 1928-29 to their 1932-34 troughs. Most then went on to higher and higher payouts.

If we are truly in another depression today (the facts do not bear that out), America's Finest Companies® ought to continue to shine, even in such a horrible environment.

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He is the author of six books on investing, including *Double Your Money in America's Finest Companies®: The Unbeatable Moneymaking Power of Rising Dividends* from John Wiley & Sons.

He also writes *Statons E-Money Digest* for individual investors and publishes the *America's Finest Companies®* investment directory every July.