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Should Corporate Dividends Matter to Investors? Part I

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Summary of Discussion

Many studies of U.S. stock returns suggest that over the long term, more than 50% of total return comes from the receipt of dividend payments and the growth in these payments. So the short answer to the title's question is "Yes." From SKBA's perspective, this observation nevertheless begs these further questions:

1. Why do companies establish, sustain and grow their dividend payments?
2. What do dividend payments imply about a company's earning power compared to its reported EPS?
3. What causes a company to cut its dividend?
4. Under what circumstances and market environments do dividend-paying companies offer desirable investment returns?

In Part I of this report, we will discuss the first three questions regarding corporate dividend policies and investor preferences. In Part II to follow, we will look at question 4, the return opportunities available in dividend-paying companies, with a wide-ranging discussion of when they perform well and poorly.

From SKBA's philosophical perspective (based on our decades of observation and practice), let's answer the first question, "Why do companies establish, sustain and raise their dividend payments?"

- Dividends represent one of the primary ways companies deliver value to their shareholders. The dividend "promise" is a reflection of a company's long-term success and sound finances.
- The dividend level is set based on the view of management and the board of directors of the company's sustainable earning power and cash flows over an economic cycle.
- An increase in the dividend rate sends a "signal" that a company's believes earning power has risen.
- The ability to sustain its dividend rate (or even raise it) during periods of economic stress also signals that the earnings decline is likely to be temporary and not impair the company's financial strength.

In the following pages, we discuss the following conclusions:

- Established dividend policies are often useful proxies for the earning power of companies.
- Corporate reports of operating and/or pro-forma earnings often overstate underlying earning power due to the recurrence of supposedly "non-recurring" charges and the failure to expense options.
- Much of the decline in the dividend payout ratio of the S&P 500 is the result of the substitution of non-dividend payers for dividend-payers in the index and of the severity of the "Great Recession."
- While payout ratios change with the cyclical volatility of corporate earnings, the average payout ratio of dividend-payers in the index has repeatedly returned to the 40-45% range on more normal earnings, suggesting that managements view earning power as more stable than reported earnings.

In summary, dividends are primarily based on company earning power, not simply reported EPS.

Part I – Discussion of Corporate Dividend Policies as a Signal Regarding Earning Power

While the above perspectives on why a company pays dividends are timeless in terms of basic motivations, other factors can and have had an impact on these motivations over shorter periods of time. One cannot start a discussion of the decision to pay dividends and the impact dividends have on stock returns without first understanding the impact that tax rates have on the preference for receiving returns in the form of capital gains or dividend payments. Figure 1 below highlights a few key changes in tax rates over the last 27 years.

Figure 1: Federal Marginal Effective Tax Rates on Capital Gains Compared to Dividend Income

- *1986* - Long-term capital gains tax rate and top marginal tax rate on ordinary/dividend income both set at 28% (from 50% on ordinary income and 20% on capital gains).
- *1997* - Long-term capital gains tax rate lowered to 20% while top marginal tax bracket on ordinary/dividend income increased to 39.6%.
- *2003* - Long-term capital gains and dividend income tax rates both lowered to 15%.
- *2013* - Long-term capital gains tax rate and dividend income tax rate both increased to 20% (plus 3.6% Affordable Care Act added tax on both types of income).

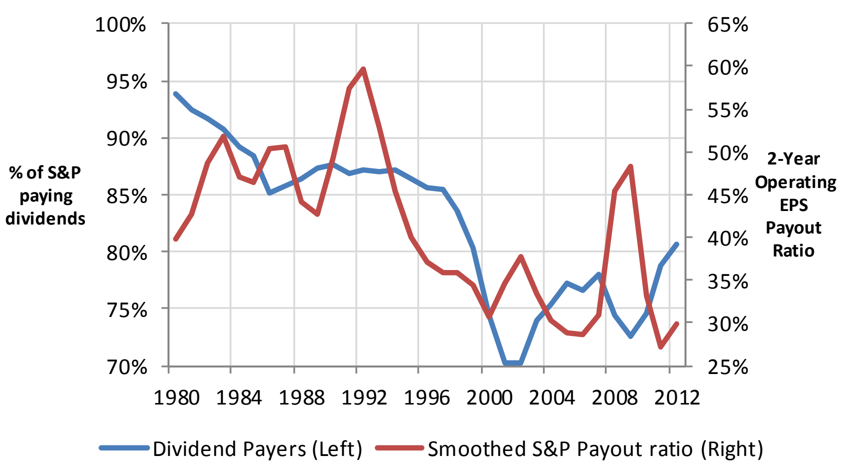
Typically, when the taxation on an economic activity or income increases, you get less of that activity. If you lower taxation or subsidize an economic activity or income, you get more of it (the activity or income). While investors are not indifferent to the source of their receipt of stock returns in the form of capital gains or dividends, when the marginal tax rates are made equal, there is no particular tax advantage that favors non-dividend payers over dividend-payers. Large shifts in tax rates on capital gains and dividends relative to one another, however, can have a significant impact on preferences. The huge change in relative taxation in 1997 (raising it on dividends and lowering it on capital gains) caused a shift in investors' preference for receiving their return from stock ownership in the form of capital gains rather than dividends. Furthermore, corporations are not insensitive to the efficiency in their use of cash flow, and they too experienced a preference shift toward using cash flow to buy back stock rather than initiate or grow dividends. The massive underperformance in the latter part of the 1990s of "value" stocks (of which many were dividend payers) relative to "growth" stocks is in part explained by this shift in taxation, and the supposed "paradigm shift" to permanently higher real economic growth (which did not last).

The opposite result occurred in 2003 as, while taxation on both capital gain and dividend income fell, the tax rate on dividend income was cut by more than 60%! While the initial impact of the huge reduction in taxation on capital was to "lift all boats in the rising tide" of the stock market, the longer term impact was to restore the incentive of corporations to initiate and grow dividend payments. It also created a preference shift in investors towards owning dividend-paying companies again.

In contrast, the recent increase in tax rates on both capital gains and dividend income should not, by itself, trigger any preference shifts by corporations or investors. While non-taxable investors (such as pension funds) might be thought to be indifferent to the source of stock market return, evidence still suggests that non-taxable investors respond to these actions by corporations and by taxable investors with similar actions of their own. Yet the impact of taxation is only the beginning of the story.

What does the dividend payout history of the S&P 500 tell us about earning power? It is commonly perceived that dividend payout ratios for S&P 500 companies have fallen. Although this has been the case since the beginning of the 1990s, most of this change is due to the decline in the number of companies that pay dividends. 30 years ago, nearly 95% of S&P 500 companies paid dividends. Yet, as can be seen in Figure 2, by the bottom of the recession in 2002, only 70% of such companies paid dividends. The plunge in the number of dividend payers occurred mostly during the late 1990s tax regime and "new paradigm" growth boom, which in retrospect, turned out NOT to be permanent.

Figure 2: S&P 500 2-Year Average Payout Ratio vs. Percentage of Payers



Source: Compustat, Standard & Poors, SKBA data

As can be seen, the percentage of payers began to rebound after the 2003 tax cuts, and even the "Great Recession" of 2008-09 did not drive the number of payers to new lows (despite the payout ratio reaching a new low at 27%).

But there's more to the story about falling payout ratios. The adjacent chart on payout ratios fails to identify that today's measure of pro-forma "operating earnings" have often overstated corporate earning power due to the following:

1. The surge in employee stock options issuance in the late 1990s, which did not have to be expensed; yet they represented a significant contingent liability on cash flows to repurchase exercised options.

2. The emergence of regularly recurring "one-time" corporate restructuring charges.

These issues bring to life the old adage, "Dividends don't lie; sometimes earnings do!"

After growing 7.0% per year during both the 1970s and 1980s, through very different inflation rate environments, (CPI increased 8.0% annually in the 70s but only 4.5% in the 80s), dividend growth declined to only 3.0% annually in the 1990s. This happened even while "operating earnings" grew 9.3% per year. Certainly part of this resulted from the tax rate shifts as companies added to the S&P 500 in the latter half of the decade tended to be zero-dividend-yield companies (particularly among Technology stocks).

Figure 3 below highlights the S&P 500 payout ratio using three-year period averages that typically contain a peak and trough year in the economy (except for 2010).

Figure 3: 3-Year Average Payout Ratio % from Start of Each Decade

Period Beginning	% on Reported S&P 500 EPS	% on Operating EPS	% Charges to Restructure	% Estimated Options Expense
1970	55%	54%	-1%	Nil*
1980	46%	46%	0%	Nil
1990	65%	57%	-12%	Nil
2000	52%	35%	-29%	-11%
2010	32%	29%	-10%	Nil

Source: Factset, Compustat, SKBA data/*Nil means small impact

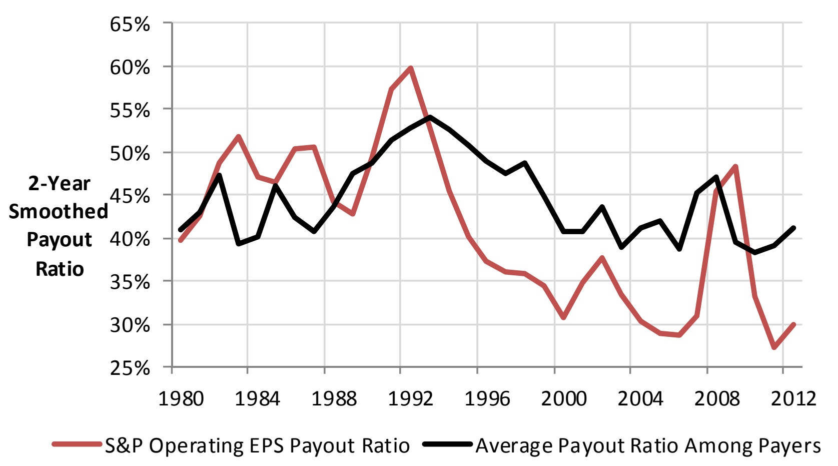
In decades past (70s and 80s), there was very little difference between reported and operating earnings. Charges for restructuring and write-offs flowed through the normal income statement, not the "operating" or "pro-forma" views offered by management today. In the early 1990s this changed dramatically as such charges rose to -12% of operating earnings. During the peak and trough at the beginning of the new century, such charges accounted for -**29% of operating earnings**! This gave rise to the belief in the "new paradigm" of S&P 500 profitability as the Index "operating" ROE climbed to nearly 18%, well above the 13% level of the 1970s and 80s. Yet, although ROE's have come back down, such pro-forma earnings adjustments remain commonplace in today's corporate reporting.

Not reported on income statements in the 1990s and the first half of the 2000s was the cost of options awards. The impact on corporate earning power was far greater than often perceived as the widespread use of stock options as a form of incentive compensation generated large contingent liabilities for many "growth" companies. By SKBA's estimate, the cost to eliminate the dilution from the exercise of stock options averaged approximately -11% of operating earnings in the first three years of the 2000s.

Operating earnings overstated true earning power of the S&P 500 during this period. Little wonder, with the change in membership of the S&P 500 (with non-dividend payers), the change in tax rates on capital gains versus dividend income in the 1990s (since reversed), the overstatement of operating earnings, and the huge dividend cuts during the "Great Recession," payout ratios fell noticeably.

If we remove non-dividend payers that were added to the S&P as dividend-payers disappeared through mergers, does the payout ratio of dividend payers suggest that dividend payments have become less important to corporate boards and management? No. Figure 4 below highlights the payout ratio of payers compared to the index as a whole.

Figure 4: 2-Year Average Payout Ratio for S&P 500 and Dividend-Payers (un-weighted average)



Source: Compustat, Standard & Poors, SKBA data

Although even though there continues to be cyclical volatility in corporate earnings and the payout ratio, the payout on normalized operating earnings appears to revert back to the 40-45% range, providing the answer to question #2.

Managements that have an established dividend paying culture do appear to be signaling their view of underlying sustainable earning power in the way they set their dividends.

Figure 4 is not intended to suggest that companies that do not pay a dividend are poorly managed. Indeed, one of the reasons a company chooses not to initiate or pay dividends is that the required capital investment to support growth opportunities consumes all available cash flow. Yet when a company chooses to cut its dividend rate, this can be a serious matter.

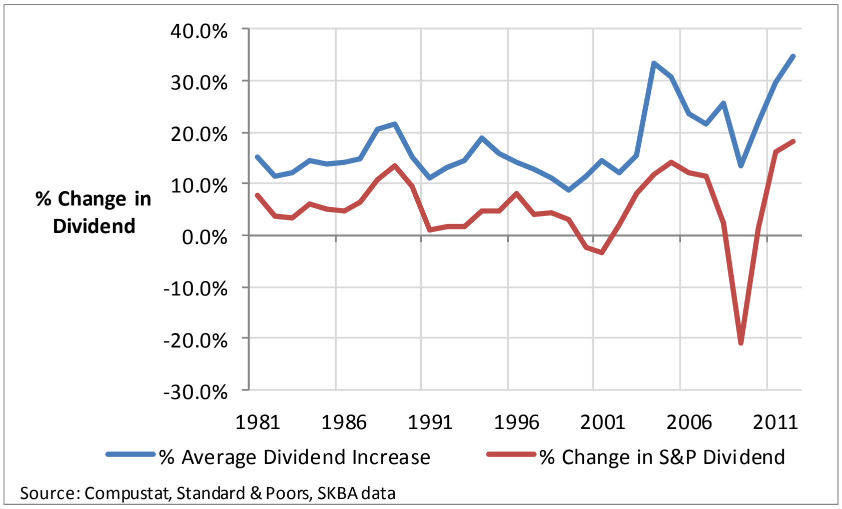
What then, causes a company to cut its dividend? There are three key reasons:

1. A dividend cut "signals" that management and the board of directors no longer believe today's "depressed" earnings will recover to the level necessary to sustain the current dividend rate.
2. Financial leverage is too high, and a dividend cut may restore more conservative capital allocation and also possibly persuade Rating Agencies not to cut the company's debt rating, particularly if the rating cut would lower the debt rating to non-investment grade.
3. Regulatory rulings or pressures result in a dividend cut to improve capital retention.

An example of the last reason came in the winter of 2009, when Larry Summers, then Chairman of the Council of Economic Advisors, "suggested" that banks that took TARP money ought NOT to pay dividends. The result—the S&P 500 suffered the largest single year cut in dividend payments in the post-World War II period.

Figure 5 below illustrates what happened in **2009 as the aggregate dividend rate plunged -21%**, much of which was due to the importance of financial sector dividends to the overall S&P 500 dividend**!**
While a dividend cut is an undesirable event, does this mean that a dividend cut is automatically “bad” for future stock performance? Not necessarily. Often, most of a company’s stock price decline occurs in advance of a dividend cut, as (and if) the fear of just such a cut grows. If the actual dividend cut is widely anticipated or is less than 50%, the stock may rebound after the cut. This rebound in price occurs because the uncertainty surrounding the possibility the dividend might be cut is resolved. The proverbial “shoe” has been dropped, and the greater retention of earnings and cash flow may improve the company’s balance sheet more rapidly than before the cut. The “perfect” cut as we define it is less than 50%, which has the above benefit as well as often leaving the resulting dividend yield high enough to allow investors desiring income to remain invested in the stock.

Figure 5: S&P 500 % Dividend Changes Versus % Dividend Growth of Dividend Increasers



In contrast, what a statement a company makes when, in the midst of economic distress, it increases its dividend rate. While less than 200 S&P 500 companies raised dividends in the 2002 and 2009 recession years, the average percentage increase for these companies was 12% and 14%, respectively.

Following the 2002 and 2009 recessions, it is also noteworthy that the pace of dividend growth among payers accelerated sharply. This trend has continued in 2013. It most likely bears witness to the improvement that has occurred in corporate earning power and the concomitant improvement in corporate balance sheets. It appears that both corporations and investors have gained a greater appreciation of the benefit of paying and receiving dividends, respectively.

We have often stated: from companies with established dividend payment policies, we as investors, get a public view into the private mind set of management and the board of directors regarding the company’s earning power by the way it sets and grows its dividend rate. As a result, the answers to the first two questions posed at the beginning of this report are no matter what the environment, corporate dividend policies do reflect a company’s view of its earning power.

Stay tuned for Part II in December.

Disclaimer: The analysis and opinions expressed in this report are subject to change without notice, and they do not represent a buy or a sell recommendation.