

C A M B R I D G E A S S O C I A T E S L L C

U.S. MARKET COMMENT

DIVIDENDS: ARE COMPANIES WILLING AND ABLE?

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Dividends: Are Companies Willing and Able?

The dividend yield for the S&P 500 has been stuck in a range of 1.1% to 1.8% since 1997, well below the post-1960 average of 3.2%. While it is not unusual for corporations to be reluctant to raise dividends during a bear market and recession (2001-02) or when deflation looms on the horizon (2003), dividends have yet to make the post-bubble comeback some predicted they would. Not only have many of the macroeconomic risks dissipated, but corporate cash flows have been rising substantially against a paucity of new investment opportunities. Add to this the fact that the preferential tax treatment for capital gains has been lifted, and corporations appear to have little reason not to hike payouts—and hike them substantially. However, corporations must not only be *able to pay*, but must also be *willing to pay* higher dividends. Some of the best-capitalized corporations have recently begun to return cash to investors (e.g., Microsoft and Intel), but their preference for one-time special dividends or share buybacks suggests that they remain noncommittal. To the extent that equity returns continue to fall at the lower end of their historical range and current tax laws hold, investors may (and should) demand that corporations ante up.

Ability to Pay

Corporations are currently awash in cash. As of June 30, 2004, U.S. nonfinancial and nonfarm corporations held \$940 billion in cash and cash equivalents; an all-time high. More importantly, the 4.5% cash-to-assets ratio is at its highest level in 40 years (Table A). Despite all this cash, there has been no pickup in reinvestment by corporations, debt reduction, or payouts to shareholders. For example, capital expenditures have grown at just 3.6% per year over the last four years. This compares to average growth of 8.4% and 9.3% over the periods 1947-99 and 1992-99, respectively. In addition, while corporations have refinanced to lower their interest-rate burdens, they have not used excess cash to pay down debt. Despite the fact that debt has grown at just 5.3% per year since 1990, or one-half the average annual rate of the previous two decades, both aggregate debt and debt-to-asset ratios are at or near historic highs. However, net interest payments as a percentage of cash flow are a very manageable 11.8%, near the 1948-2004 average of 10.3% and well off their peak of approximately 20.1% in 1989 (Table B).

Similarly, this excess cash has not been used to increase dividend payments, as the current dividend yield of 1.7% remains well below the post-1960 average of 3.2%. The payout ratio of 33.4% is near the historic low of 32.5% experienced in 2000 and well below the post-1960 average of 49.3%. Excluding the cash-rich financial sector, dividend payouts are equivalent to nearly 100% of after-tax *reported* earnings. However, cash earnings are more indicative of a firm's ability to pay dividends and cash earnings have exceeded reported earnings by an average of 116% per year since 1970.¹ As of second quarter 2004, cash earnings were 131% higher than reported earnings, indicating that even beyond the financial sector, corporations have the means to increase dividends.

¹ Comparisons of reported and cash earnings are based on the S&P Industrials. Cash earnings, calculated as cash flow plus depreciation, have always exceeded reported earnings, with a minimum of 48% premium (1974) and a maximum of 334% (2003).

Given that standard dividend yield calculations include only payouts to shareholders they do not reflect the true dividends received by investors. Adjusting yields to reflect share buybacks net of new issuance increases dividend yields from 1.7% to 2.9%—much closer to the post-1975 average net adjusted yield of 3.2% (Table C). However, the impact of net share buybacks is not always positive and has had no net impact on the dividend yield over the 30 years for which we have data, as the dividend yield without adjustments for net buybacks also averaged 3.2%. While the adjusted dividend yield is close to historical averages, more than 40% of this yield is from less reliable share buybacks at present.

Willingness to Pay

Historically, managers have only increased regular dividends when they believe they can be maintained going forward, since slashing dividends has resulted in severe punishment by the capital markets. As a result, the practice of reducing dividends has been unpopular: since 1988, 54.6% of the S&P 500 companies have announced favorable dividend actions each year, compared to an average of just 7.2% with unfavorable announcements. It has also become taboo for the managers of “growth companies” to increase dividends substantially, as this suggests that future growth prospects for the company are quite dim. However, as the leading growth industries from previous cycles make the inevitable transformation into value industries, investors should *encourage* these companies to increase dividends. This is especially true of well-capitalized, cash-rich companies at a time when the real return on cash is negative.

Alternatively, managers of companies in traditionally higher-yielding industries may have good reason to be apprehensive about hiking payouts today. For example, many of the high-dividend-paying telephone companies of the 1980s transformed into the cash-poor and debt-laden telecom, fiber optic, and wireless companies of the late 1990s. Add in the pension deficits that some of these firms face, and the sustainability of business operations and ability to pay dividends look highly uncertain. Although some of the healthier companies in slower-growing growth industries (e.g., technology and health care) may be able to counter these financial strains, it is unlikely that they will become the highest-yielding industries (Table D).

While it may have been defensible for corporations to reinvest rather than pay out retained earnings over the two decades ending in 2002, prior to the tax law change that equalized capital gains and dividend taxes, the argument for low dividends is much more difficult today. Managers should have returned cash to shareholders if the expected return from reinvesting that cash was below the *after-tax* return investors could earn on dividends, with dividends being taxed as ordinary income. Further, investors were happy for management to reinvest cash on the promise of higher returns, which is not altogether surprising since capital gains trumped dividends by a factor of more than 10:1 in the late 1990s. However, when the dust settled, earnings growth did not match expectations and much of the associated unrealized gains were subsequently forfeited. Poor investment decisions made during the bubble period of the 1990s provided a vivid example of managements’ ability to make less than optimal investment decisions. This is particularly true when investment capital is readily available, as illustrated by examining the relationship between dividend payout ratios and earnings growth. Historically, lows (highs) in payout ratios have often been a leading indicator for

lows (highs) in subsequent earnings growth. This fairly weak, but positive, relationship suggests that higher retained earnings *do not* presage higher earnings growth.² (See Table E.)

Signs of Change; Room for Improvement

The nominal dividend growth rates of 8.2% in 2003 and 8.9% year-to-date are well above the 1926-2003 average annual compound growth rate of 4.3%. More importantly, this appears to be a trend change relative to the 2.4% average growth rate experienced from 1991-2002, during which annual growth exceeded 5.0% only once (1996). Investors appear to be taking notice; year-to-date through August 31, 2004, dividend-paying companies in the S&P 500 outperformed nondividend-paying companies by 10.4 percentage points (4.8% versus -5.6%). Dividend payers outperformed nonpayers in only one year between 1985 and 1999 (1986).

Currently, 376 of the S&P 500 companies (85% of the index market value) pay dividends, up from a low of 351 in 2001 and 2002 and slightly ahead of the 1999-2003 average of 369. However, the number of dividend payers remains well below the average of 422 since 1980. While only 38.4% of S&P 500 companies have made favorable dividend announcements year-to-date, this is above the pace at the same point last year (34.0%) and 45% of companies ended up making favorable announcements for all of 2003.

The recent \$32 billion one-time payout by Microsoft was astonishing in magnitude, but it was quite similar to the increased use of special dividends that took flight in 2003. In 2003, 197 companies made special, one-time dividend payments, the highest level since 1989 and well above the 100 companies that did so in 2002. This suggests that some companies are willing to unload what they have today, but are reluctant to promise similar deliveries down the road. Additionally, one-time payouts and share buybacks are a way for “growth companies” to pay dividends without suggesting that they foresee lower long-term growth.

Conclusion

Investors have been bombarded with evidence that equity returns over the next five to ten years are likely to fall short of the average returns over the past 100 years—i.e., 4% to 5% real rather than 7% real return earned in the twentieth century. However, without help from higher dividend yields, earning 5% real could prove to be a daunting task (Table F). Given that companies are awash in cash, which is at its highest

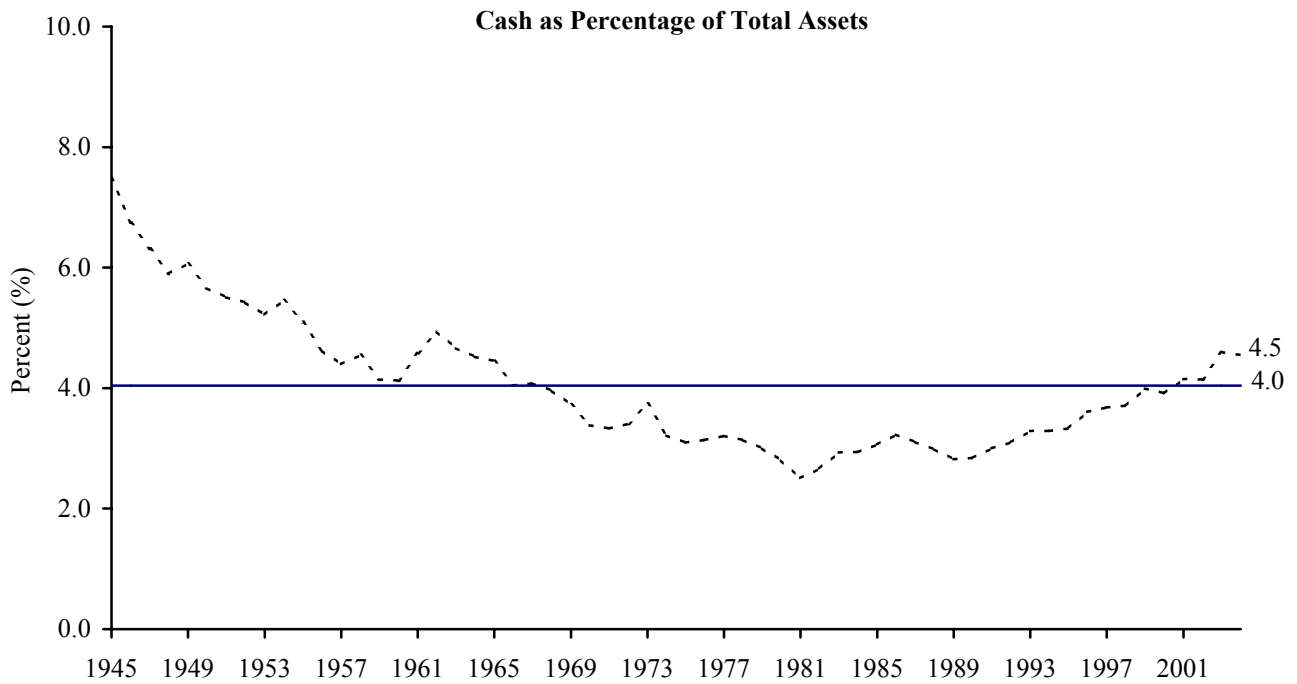
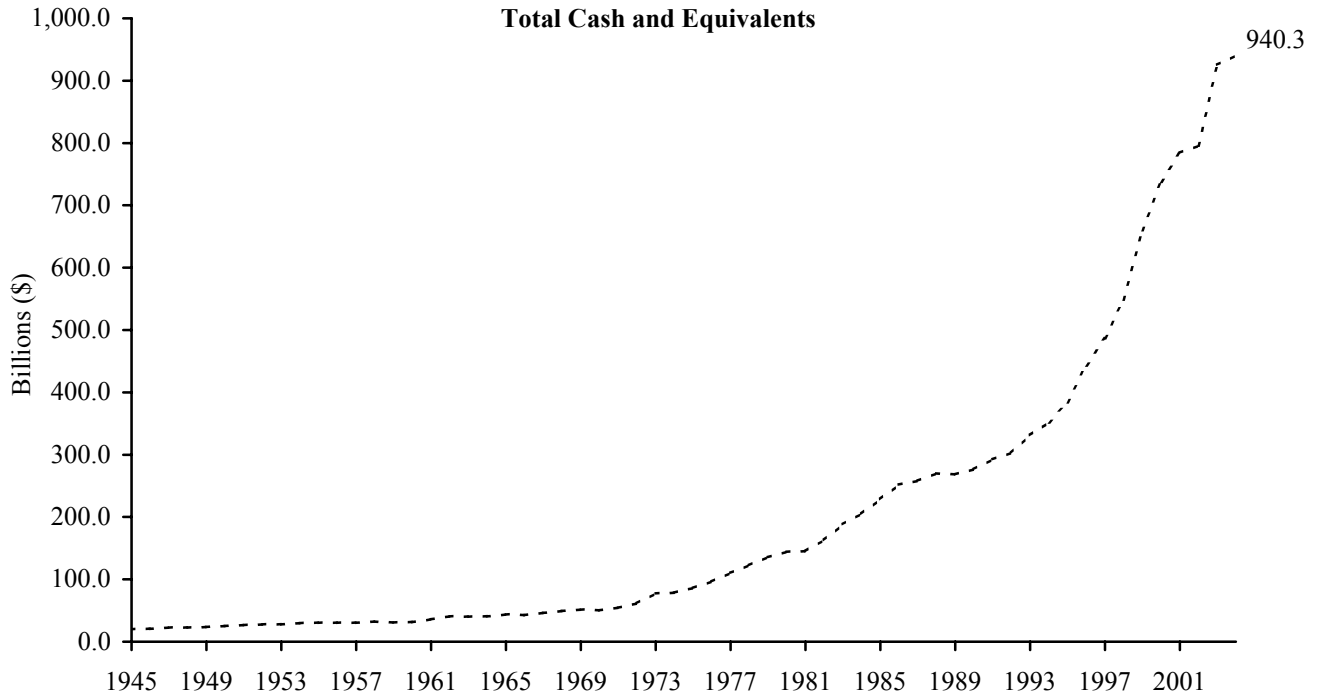
² Part of this may be due to the fact that payout ratios tend to spike when earnings trough because slashing dividends is the last resort for corporate managers. As a result, the subsequent rebound in earnings growth following high payouts can be partially explained by mean reversion in earnings growth. We will further discuss the links between dividends, payout ratios, earnings growth, and returns in our next annual publication of *U.S. Historical Capital Market Valuations*, which is scheduled for February 2005.

level in decades, investor demand for greater payouts should increase. Indeed, the investment management community has already begun to develop products focused on higher-yielding stocks. The most attractive of such strategies would be those that focus on companies with both higher-than-average yields and higher-than-average dividend growth, as the former without the latter often portends problems rather than promise.

Table A

CASH POSITION OF U.S. NONFARM NONFINANCIAL CORPORATIONS

1945-2004

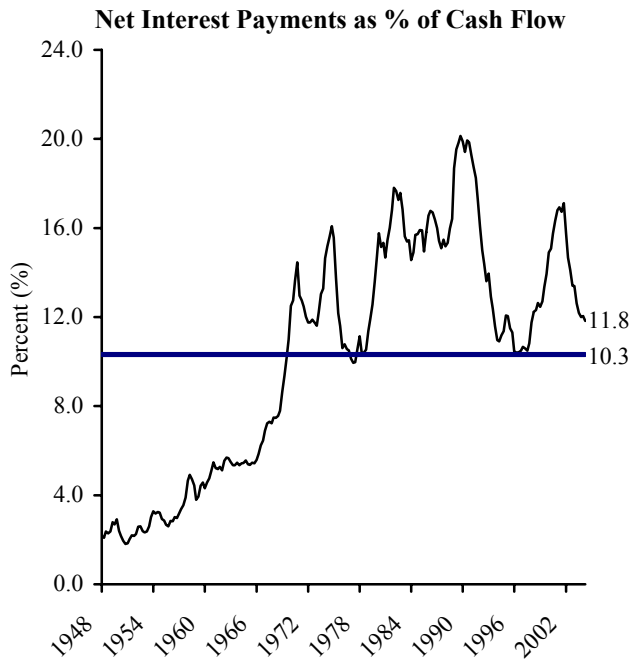
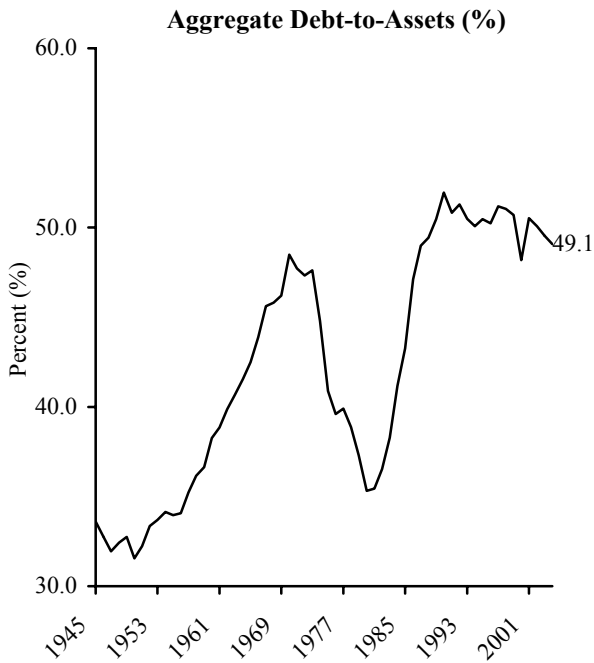
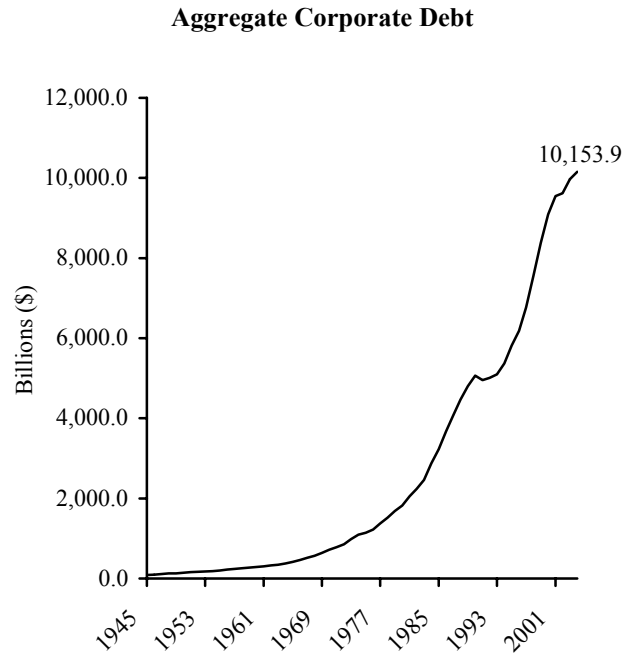
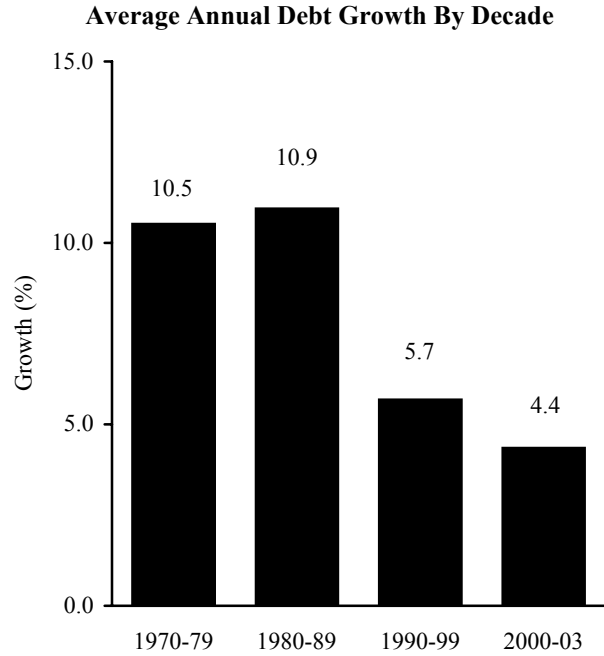


Source: Federal Reserve.

Notes: All data are annual and in billions of dollars except for 2004, which is as of June 30. Quarterly figures are seasonally adjusted annual rates.

Table B

AGGREGATE DEBT AND INTEREST PAYMENTS OF U.S. NONFINANCIAL CORPORATIONS



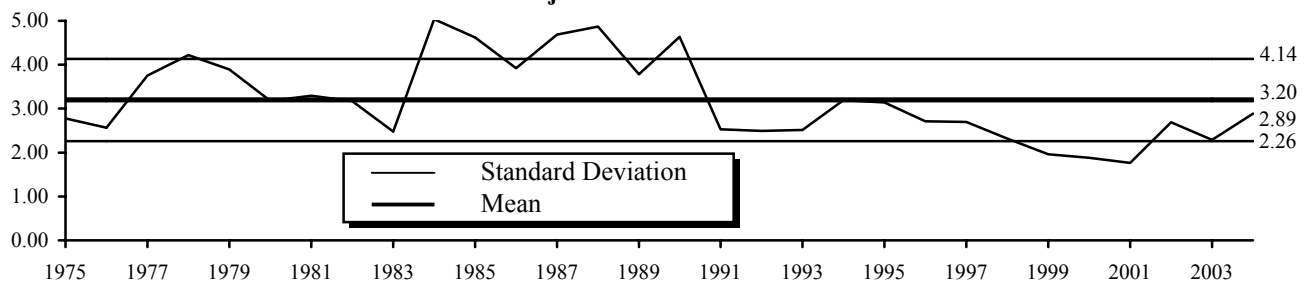
Sources: The Federal Reserve and Ned Davis Research.

Notes: All data are annual and in billions of dollars except for 2004, which is as of June 30. Quarterly figures are seasonally adjusted annual rates.

Table C
S&P 500 DIVIDEND YIELDS ADJUSTED FOR SHARE REPURCHASES AND ISSUANCES
January 1, 1975 - June 30, 2004

Year	Dividend Yield (%)	Share Repurchases (\$ billions)	Dividends (\$ billions)	Dividends Per Share (\$)	Ratio of Share Repurchases to Dividends	Gross Adjusted Dividend Yield (%)	Share Issuance (\$ billions)	Net Share Repurchases (\$ billions)	Net Adjusted Dividend Yield (%)
1975	4.1	0.7	21.9	3.7	0.0	25.1	7.7	-7.0	2.8
1976	3.8	1.1	25.1	4.1	0.1	3.9	9.1	-8.0	2.6
1977	4.9	2.8	29.7	4.7	0.1	34.2	9.9	-7.0	3.8
1978	5.3	2.8	33.0	5.1	0.1	5.7	9.4	-6.6	4.2
1979	5.2	3.4	37.5	5.7	0.1	37.9	13.1	-9.6	3.9
1980	4.5	4.7	42.3	6.2	0.1	34.6	17.4	-12.7	3.2
1981	5.4	4.4	47.1	6.6	0.1	42.0	22.7	-18.4	3.3
1982	4.9	8.2	49.5	6.9	0.2	41.0	25.6	-17.4	3.2
1983	4.3	7.8	52.7	7.1	0.1	36.7	30.1	-22.3	2.5
1984	4.5	26.4	55.5	7.5	0.5	49.0	19.8	6.6	5.0
1985	3.7	40.1	57.4	7.9	0.7	46.1	26.6	13.5	4.6
1986	3.4	38.8	63.5	8.3	0.6	42.2	29.5	9.3	3.9
1987	3.6	45.9	67.6	8.8	0.7	45.9	24.5	21.3	4.7
1988	3.5	46.7	83.3	9.7	0.6	46.8	14.2	32.5	4.9
1989	3.1	42.9	78.0	11.1	0.6	34.2	26.6	16.3	3.8
1990	3.7	38.6	82.0	12.1	0.5	36.5	17.0	21.7	4.6
1991	2.9	21.3	82.6	12.2	0.3	3.7	32.4	-11.1	2.5
1992	2.8	27.7	86.1	12.4	0.3	3.8	38.3	-10.6	2.5
1993	2.7	33.7	90.1	12.6	0.4	26.5	39.6	-6.0	2.5
1994	2.9	38.4	93.1	13.2	0.4	28.6	27.9	10.5	3.2
1995	2.2	65.8	105.8	13.8	0.6	27.9	23.2	42.6	3.1
1996	2.0	77.1	111.8	14.9	0.7	25.5	38.3	38.8	2.7
1997	1.6	117.4	117.7	15.5	1.0	24.2	36.2	81.2	2.7
1998	1.3	147.5	128.7	16.2	1.1	22.5	49.5	97.9	2.3
1999	1.1	157.3	131.4	16.7	1.2	19.6	61.6	95.7	2.0
2000	1.2	152.0	140.1	16.3	1.1	22.1	78.4	73.6	1.9
2001	1.4	133.1	143.1	15.7	0.9	24.1	91.9	41.2	1.8
2002	1.8	128.9	144.5	16.1	0.9	31.1	60.5	68.4	2.7
2003	1.6	131.6	158.3	17.4	0.8	26.1	57.9	73.7	2.3
2004	1.7	91.4	67.5	18.6	1.4	13.9	39.3	52.1	2.9

S&P 500 Net-Adjusted Dividend Yields Since 1975



Sources: Kevin Cole, Jean Helwege, and David Laster, "Stock Market Valuation Indicators: Is This Time Different?," *Financial Analysts Journal*, May/June 1996 and Standard & Poor's Compustat.

Note: Data for 2004 are year-to-date through June 30, with the exception of the dividend yield, which is based on 12-month trailing dividends, and dividends per share.

Table D

**TOP 20 DIVIDEND PAYERS AND WEIGHTED AVERAGE DIVIDEND YIELDS BY
S&P 500 SECTORS**

As of August 31, 2004

Top 20 Dividend Payers

<u>Company Name</u>	<u>Sector</u>	<u>Dividend Yield</u>
Equity Office Properties Trust	Financials	7.0
Apartment Investment & Management Co.	Financials	6.8
ChevronTexaco Corp.	Energy	6.6
AT&T Corp.	Telecommunication Services	6.4
TECO Energy Inc.	Utilities	5.7
Altria Group Inc.	Consumer Staples	5.6
Ameren Corp.	Utilities	5.4
Consolidated Edison Inc.	Utilities	5.4
Equity Residential	Financials	5.3
Progress Energy Inc.	Utilities	5.2
Peoples Energy Corp.	Utilities	5.2
Public Service Enterprise Group Inc.	Utilities	5.2
Nicor Inc.	Utilities	5.2
UST Inc.	Consumer Staples	5.2
Reynolds American Inc.	Consumer Staples	5.0
DTE Energy Co.	Utilities	5.0
Duke Energy Corp.	Utilities	5.0
SBC Communications Inc.	Telecommunication Services	4.8
General Motors Corp.	Consumer Discretionary	4.8
Bristol-Myers Squibb Co.	Health Care	4.7

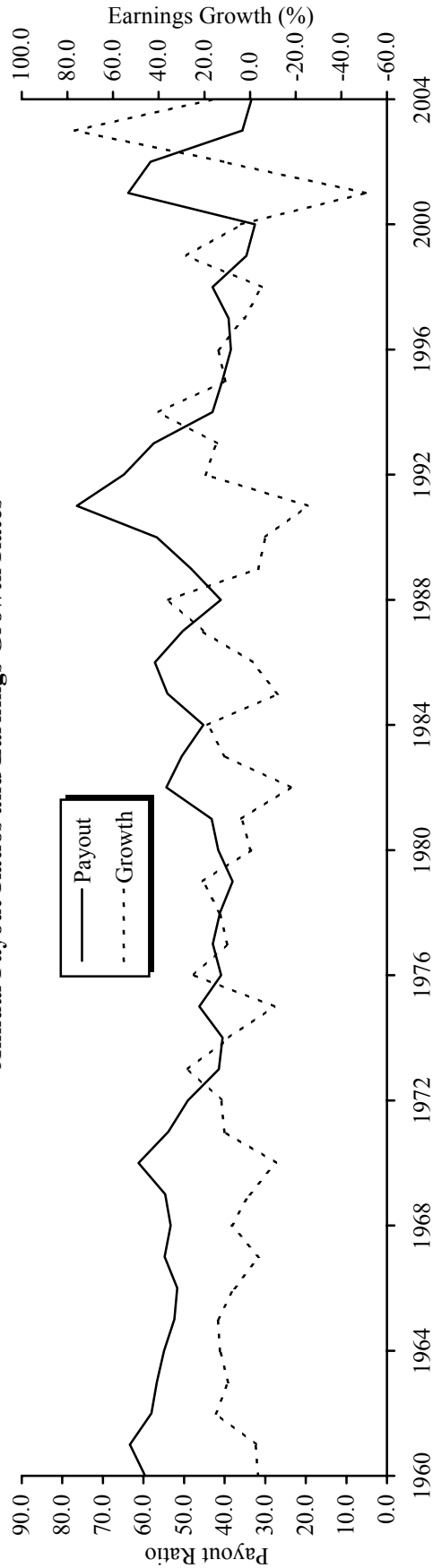
Dividends by Sector

<u>Sector</u>	<u>Weighted Average DY</u>	<u>Number of Companies</u>	<u>Number Paying Div</u>	<u>%</u>
Utilities	3.7	33	27	82%
Telecommunication Services	3.3	11	8	73%
Energy	2.6	27	22	81%
Financials	2.4	80	79	99%
Materials	2.1	33	30	91%
Consumer Staples	2.0	37	34	92%
Industrials	1.8	58	51	88%
Health Care	1.5	54	30	56%
Consumer Discretionary	1.0	86	71	83%
Information Technology	<u>0.5</u>	<u>81</u>	<u>24</u>	<u>30%</u>
Weighted Average	1.8	500	376	75%

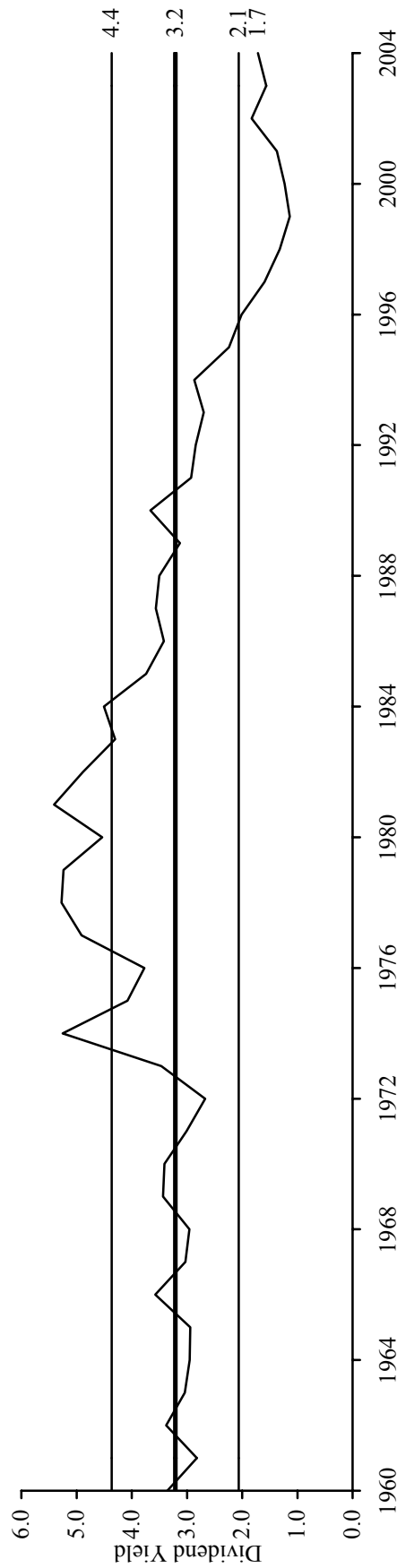
Sources: Standard & Poor's and Standard & Poor's Compustat.

Table E
RELATIONSHIP BETWEEN PAYOUT RATIOS AND EARNINGS GROWTH FOR THE S&P 500

January 1, 1960 - August 31, 2004
Annual Payout Ratios and Earnings Growth Rates



Annual Dividend Yields



Source: Thomson Datastream.

Notes: All data are annual data except for 2004, which is as of August 31, 2004. All 2004 data is preliminary.

Table F

NOMINAL DIVIDEND GROWTH REQUIRED TO SUPPORT EXPECTED RETURNS

*Component returns are equal to the average real compound earnings growth plus average dividend yield.

Scenario 1 - Today's Nominal Dividend Yield Plus Real Compound Earnings Growth of 2.0%

Dividend	Real Earnings	Real Component
<u>Yield</u>	<u>Growth</u>	<u>AACR</u>
1.7%	2.0%	3.7%

Scenario 2 - Average Nominal Dividend Yield and Real Compound Earnings Growth since 1960

Dividend	Real Earnings	Real Component
<u>Yield</u>	<u>Growth</u>	<u>AACR</u>
3.2%	1.4%	4.6%

Scenario 3 - Average Nominal Dividend Yield and Real Compound Earnings Growth 1980-2000

Dividend	Real Earnings	Real Component
<u>Yield</u>	<u>Growth</u>	<u>AACR</u>
3.1%	1.9%	5.0%

Nominal Dividend Growth Required To Achieve Real AACR	
<u>Scenario 1</u>	5.5%
<u>Scenario 2</u>	8.3%
<u>Scenario 3</u>	8.6%
Note: Highest 20-year nominal dividend growth historically was 7.3% (1945-64).	

Notes: Required annual dividend growth equal to level of nominal dividends required to maintain dividend yield over 20 years given expected price return for S&P 500. Price return assumed to track growth in real earnings (no change in P/E). Assumes 3.5% inflation.

* This is used to break down the AACR into component returns over a 20-year period; alternatively, the arithmetic average earnings growth could be used to estimate the arithmetic return.