Sigma Summaries

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Orange Juice, Fish Sticks and Dividends

> "A generation that grows up drinking only frozen orange juice will forget that any other form of OJ exists; a generation that grows up thinking dividends and yields don't matter are like those OJ drinkers."
>
> Peter Bernstein, *Financial Analysts Journal*, March/April, 2005

As I read that quote from Peter Bernstein, it reminded me that as a child I used to wonder why the fish sticks we ate on Fridays during lent looked nothing like the fish I would see in aquariums. Subsequently, modern fishing methods coupled with low cost air transportation made fresh fish a non-luxury item in most households and bridged my knowledge gap. But that is a different story about growing up in the 1960's in a mid-western, middle class environment and will be saved for another Sigma Summaries.

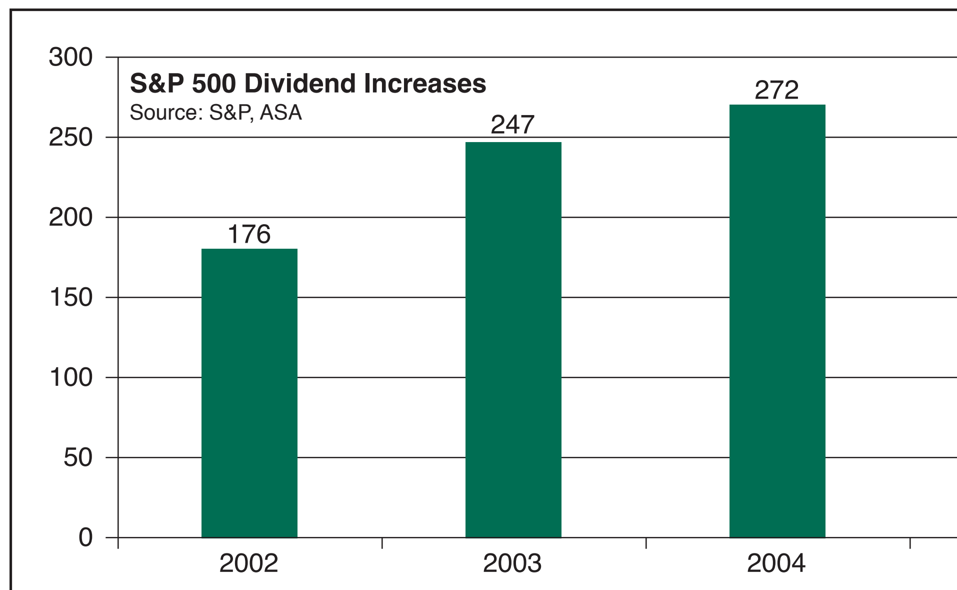
Peter Bernstein refers to a generation that grew up on dividend yields and at the onset of my career in the early 1980's dividends played a significant role in our investment process at Sigma. My mentor, Chuck Ricker, was a devotee of dividend paying stocks and most of the stocks that we invested in paid dividends.

Over the balance of the 1980's and 1990's, dividends became a fading component of investment returns. This was due in part to the tax rate differential for dividends versus capital gains. Taxes paid on dividends were calculated at ordinary income tax rates as high as 35% compared to capital gains tax rates which were/are as low as 15%. Many companies simply made the decision to stop increasing their dividends in line with their growing earnings and instead either began buying back their stock to prop up the price and give shareholders capital gains, or they used the cash for other purposes such as acquisitions.

Of course, a great deal has changed in the last five years and as a result, dividends are once again playing a prominent role in investment portfolios. According to the American Shareholders Association, February 11, 2005 newsletter, companies announcing dividend increases have accelerated markedly in the past two years (in 2002, 176 of the 500 companies in the S&P500 Stock Index raised their dividends, and this increased to 247 in 2003 and 272 in 2004).

In the Bernstein article cited above, the author expresses his puzzlement

Dividend Increases Up More than 50%



26261 Evergreen • Suite 455 • Southfield, Michigan 48076 • (248) 223-0122 • Fax (248) 223-0144

at the lack of attraction that dividend-paying stocks are getting from investors compared to those companies that do not pay dividends. He comments, “The real mystery is the lack of response by taxable investors to the fall in taxes on dividend income. Maybe one day soon the word will reach them that dividends have been enriched by an income tax of only 15 percent. If and when that day arrives, they will launch a whole new generation of investors who, at long last, will disdain frozen orange juice.”

Indeed, over the past two years or so, or roughly since the income tax rate on dividends was lowered, we at Sigma have been emphasizing investments in common stocks that pay dividends. In fact, the average dividend yield on portfolios managed by Sigma has nearly doubled from 0.9% in 2000 to 1.7% at present. In addition to investing in more dividend paying stocks, the companies in the portfolio have also been raising dividends at a healthy rate, in line with the chart above. It seems plausible that eventually, other investors will begin gravitating towards dividend paying stocks, allaying the mystery cited by Peter Bernstein.

While this may seem to be the end of the story, the dividend attraction has another equally compelling facet. Dividends are tangible, fungible, and more importantly, spendable by the investor. Reported earnings are not. The problems that rocked the securities markets in the late 1990’s and early 2000’s were generally a result of dishonest management lying about their company’s earnings (Tyco, Enron, Worldcom, etc.).

In contrast, management cannot lie about dividends. Dividends can only be paid if a company is profitable (yes, some companies do pay dividends even when they are unprofitable for short periods of time, but only if they expect profitability to resume) and therefore, dividends represent a commitment on the part of management to shareholders. The senior management of most companies does not like to suspend or reduce a dividend once it is instituted, and therefore, to a certain degree, investors might note that dividend paying companies may be more in tuned with their investment requirements. This greater sensitivity may be considered just another unexpected dividend that accrues to investors in dividend paying stocks.

This brings us full circle on the importance of dividends in the investment process at Sigma. The ability to pay a dividend, of course, is a function of the profit generating capacity of the company and this is why my colleague Roger Steed, Sigma’s Chief Investment Officer, takes great pains to focus our research effort on the fundamentals of each company we invest in, or consider for investment. This is the quantitative “blocking and tackling” of our trade, reviewing income statements, parsing cash flow statements, calculating myriad ratios including profit margins and then comparing these ratios to competitor companies. This fundamental research, married to a disciplined set of valuation metrics, results in the construction of portfolios of stocks for our clients that are financially sound, and which are expected to provide good long term investment results, made up of both rising dividend income and capital appreciation. Of this, one can be sure, if dividends rise over time, so too will the stock price.

Written by:
Robert M. Bilkie, CFA

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Your financial situation and investment objectives should be reviewed periodically to ensure applicability to your current situation. Please remember to contact Sigma Investment Counselors if there are any changes.

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