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William A. Harris, CFA
Portfolio Manager

As Stock Prices Rally, Don't Lose Sight of Dividend Yield

Common stockholders reside in a part of the capital structure more precarious than most realize; such obliviousness has been a privilege of post-war America. I introduced this notion in my July 2008 letter, "The Dilution Solution: Rediscovering Equity's Essence as a *Residual Claim*," and I want to revisit it now by looking at equity income through the prism of valuation and against a backdrop of recent dividend cuts wider and deeper than seen in decades.

According to Standard & Poor data for 1926-2008, 43.3% of the S&P 500's 9.7% annualized total return derived from reinvested dividends. This income has mitigated some of the precariousness of common equity's position as a residual claim.

Now, indulge me in some gross oversimplification.

The current yield on the S&P 500 is about 2.10%. Assuming that the historical relationship between total return and dividends will hold going forward (i.e. $TR = \text{div yield}/0.433$), this implies prospective annual returns on the index of 4.85% long-term, or about half the 10% so many investors seem to think they're entitled to. Indeed, backing out the dividend component from total return suggests annual appreciation of just 2.75% from here. Two things can get the stock market back to its historical trend line: dividends jumping and/or the market dropping to a price level which reestablishes the historical relationship. In some combination, dividend yield's numerator would have to rise and its denominator fall.

As I said, this oversimplifies, both in the math (reinvested dividends won't snap so neatly free of the appreciation component) and most of all in the use of a single underlying assertion (that market dividend yield is determinative, whereas it's just one factor). Don't regard this as a prognostication, but rather an exercise illustrating a general tendency which we believe to be a powerful one.

The exercise should at least drive home the point that if dividends matter anymore, something is out

of whack, either in stock prices or in how much cash companies are sharing with their owners. Given that few companies seem flush these days, and that a goodly portion of recent profit improvement comes on the back of shrinking payrolls rather than from top line gains, we think support for rising stock prices will be increasingly vaporous.

It's also worth noting that, historically, large company dividend income has been among the most stable of financial series, with an annual standard deviation of just 1.5% and a serial correlation of 0.89. It cleaves closely to trend. In contrast, the appreciation component of total return is a statistical basket case, with an annual standard deviation of 19.5% and serial correlation of 0.03, a coefficient indicating near-utter randomness in year-over-year outcomes.

All of this comes from Ibbotson data for the eight decades starting 1926. Translated into English it means this: dividends are persistent, and interim appreciation is wildly unreliable; if something's out of whack, chances are it's prices. Given dividends' stickiness – their tendency to trend – we have a queasy feeling we may be stuck for a time at a low plateau (though not, we trust, a permanent one!). Dividends may still trend, but at a reduced process mean. If prices gravitate accordingly, prospective total return will be punky in both components.

How does this inform our investment decisions? For one thing, it makes us appreciate our core dividend stalwarts all the more: companies which have not just maintained their payouts, but raised them through the turmoil. They deliver something you can pocket while perched precariously in the capital structure's residual reaches. At the same time, while leery of market imbalances, we try to heed Lord Keynes's admonition that "the market can stay out of equilibrium longer than you can stay solvent." Indeed, market dividend yields lower than today's have persisted for years – though, it should be noted, mostly with poor cumulative returns for a long stretch of years following!

As usual we are exiting old positions and entering new ones incrementally, and not in an effort to "time" the market but rather to keep square on risk control and pursue undervaluation in those few corners where we still see it.

When will the markets will fall or rise to share our appraisals of value? On that count, we remain agnostic.