

There is More to Dividends Than Just Yield

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There is more to building a dividend-oriented portfolio than simply buying high-yielding stocks. In fact, chasing the highest yields can lead investors into serious trouble. Rather, numerous factors must be considered to successfully invest in dividend-paying stocks. When a disciplined and comprehensive strategy is applied, the benefits of dividend-paying equities can be significant. For instance:

- Dividend-paying stocks have been shown to outperform the broader market over long time horizons.
- Studies illustrate that companies with a responsible dividend policy actually grow earnings faster than companies that pay little or no dividends.
- Dividends can provide a potentially growing income stream, which can be useful particularly for individuals needing to supplement their retirement income and keep pace with inflation.
- Both endowments and pension plans can utilize the dividend income to fund annual spending needs rather than taking market risk when selling securities to fund these needs.

The reasons are many. However, a smart dividend

strategy doesn't focus on the highest yielding stocks, but on the fundamentals of the company - the aim is to understand the ability and willingness to pay the dividend. A company that is able to pay a rising dividend is one that has a strong business model, growing earnings power, and consistent cash flows from operations. As for the willingness, the company must have a management team and board of directors that know how to allocate capital efficiently in order to sustain business growth as well as dividend growth.

Alternatives to Dividend Payers

Notwithstanding the positive reasons for investing in dividend payers, a prudent investor might ask if non-dividend-paying counterparts could be a better investment. This is a valid consideration - there are various circumstances when the non-payers could be better investments for shareholders.

For example, non-dividend-paying companies could increase their earnings power substantially by reinvesting 100% of earnings at attractive rates of return, driving up shareholder value. In this case, the investor is rewarded through the eventual appreciation of the stock price. This assumes two critical and not guaranteed factors. First, the earnings must be reinvested at rates of return greater than the cost of capital; otherwise,

the company is not creating value. Second, the market must realize that value is being created in order for the stock price to rise above your purchase price.

Share buyback plans represent another instance of potential value in non-payers. Companies that have excess capital may choose to reward shareholders by buying back shares rather than paying dividends. Assuming the company is buying back more shares than it issues to employees through grants and options, the number of shares will decrease, thus increasing the per share price of the stock. This does not increase the value of the overall enterprise, but it does increase the value of the outstanding shares, as fewer remain. This is, indeed, a very attractive and tax efficient way to return value to shareholders. Only one caveat exists - the company must buy back the shares when they are at or below fair value. In practice, most companies institute share buyback programs when business is strong; hence earnings may be above normal, and that's why they have excess earnings to distribute. Compounding that further, these companies experiencing above-average earnings frequently have stock prices that reflect an overvaluation. Naturally, few management teams feel their stock is ever overpriced, and fewer would do anything to discourage investors from owning their stock at an inflated price. Therefore, without regard to the intrinsic

value of their firms, they will buy back shares anyway, thus destroying shareholder value. These same management teams are the first to cut the buyback plans at the first sign of trouble. If a temporary change in the business results in lower-than-average earnings, the share price could suffer and may become undervalued. Despite this being the perfect time to buy back shares, most companies eliminate or cease their buyback plans! So in theory, buying back shares is a great way to enhance shareholder value without creating a taxable event for those that choose to hold; however, in practice the result isn't always in the best interest of the shareholder.

A significant problem with solely investing in non-dividend payers is that when an investor or institution needs income, it must sell securities to fund this need. As the past two years have illustrated, the markets can be very volatile. When an investor requires capital to fund spending needs, it may be at a time when market prices are severely depressed. A better investment option would be to have regular income streams that eliminate the need to sell in an unfavorable environment.

The Case for Dividend-Paying Equities

Once we begin considering how to construct a portfolio of companies that have attractive dividend yields, satisfactory growth rates for the underlying businesses, and good business

models, it quickly becomes apparent that a significantly smaller universe of companies will meet these criteria. However, the result of uncovering and investing in these securities can be very rewarding to one's financial health.

Performance Impact

History illustrates that dividends affect an investor's total return. As cited on Standard & Poor's web site, dividends represent almost half of the total return over the 83 years from January 1926 through March 2009. The annualized total return for the S&P 500 Index was 9.51% per year, as shown in **figure 1**. The dividend component consisted of 44% of the return. An investor ignoring the long-term impact of dividends does so at their own financial peril.

Credit Suisse produces a report annually that demonstrates the performance impact of companies based on dividend yields, or lack thereof. For the 30 years ended December 2008, **figure 2** shows that when the S&P 500 Index is divided into deciles based on dividend yield, the highest yielding deciles outperformed the S&P 500 Index, and the lowest yielding deciles underperformed. As previously mentioned, chasing the highest yield is not a good strategy – notice how deciles 8 and 9 are the sweet spot for savvy investors. We will provide an explanation for this outcome below.

Capital Discipline & Earnings Growth

We believe paying a dividend instills capital discipline in management teams, better aligning the sometimes conflicting interests of management and shareholders. Although this is a more qualitative factor, we consider it a

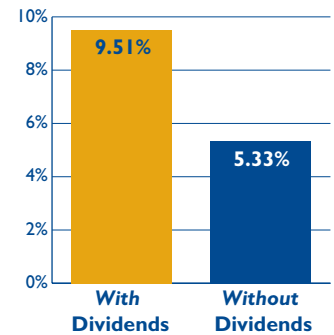
major issue when constructing our portfolios. Since corporate boards, management teams, and investors can never control for all potential conflicts, having a dividend policy is helpful for investors. This factor supports the notion that it is not coincidental that over longer time horizons dividend-paying companies tend to be attractive investments. One reason we believe investors should be partial to dividend payers is that dividends are quite sticky. While a company could cease dividend payments at any given time, this stickiness means that management teams are aware that when they reduce their dividend, even by a small amount, the stock prices of their companies can suffer significantly. This creates two results. First, companies want to pay a dividend that is sustainable and not overly burdensome in a recessionary environment. Second, the company must be considerably more aware of its capital allocation decisions. An ideal dividend policy will balance both the needs of the company to fund growth and pay shareholders a meaningful dividend that has the ability to grow over time. This stickiness differs from the share buyback plans that are canceled at the

slightest sign of trouble and do not reward all shareholders equally.

As further support of the capital discipline theory, it has been shown, through an extensive study that was published in the *Financial Analysts Journal* in 2003 and co-authored by Robert Arnott and Clifford Asness, that on average companies with higher dividend payout ratios actually generated higher real earnings growth rates compared to companies with low payout ratios (*see figure 3*). This is counter to the long-held belief that in order for a company to grow its earnings, it had to retain more of its capital. Further, the study showed that the companies which retained the most capital (i.e. had the lowest payout ratios) actually reported real negative growth rates in earnings over the subsequent 10-year period, thus suggesting that management teams on average invested in underperforming projects when they had almost unrestricted access to the shareholders' earnings. In order to control for small companies that subsequently fail; the study utilized the S&P 500 Index for the period 1926-2001 and a similar index by Cowles from 1871-1925 (the S&P 500

Figure 1: Contribution of Dividends to Total Return

S&P 500 Index Average Annual Return from January 1926 to March 2009

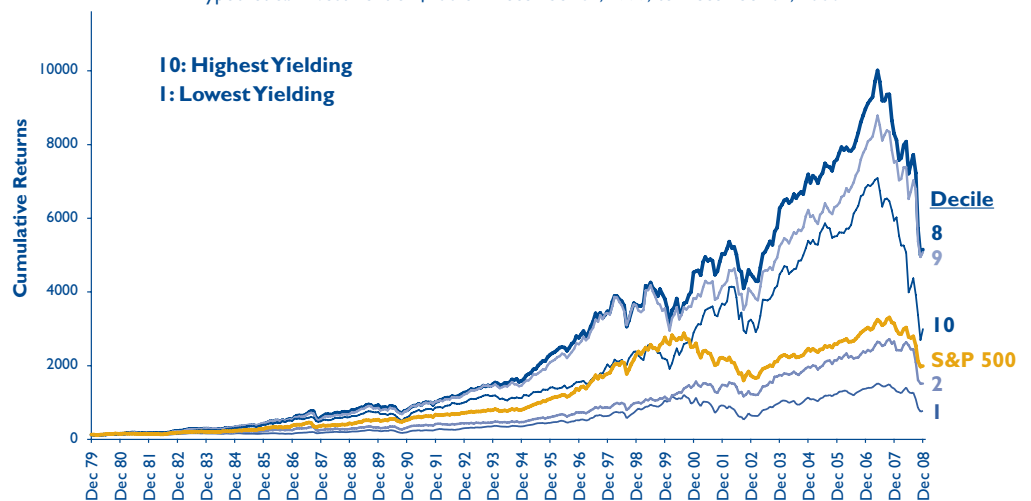


Source: Standard & Poor's. Return with dividends includes the reinvestment of dividends. Return without dividends is price appreciation only. Past performance does not guarantee future results.

Index did not exist prior to 1926). Therefore, these were established companies that had minimal survivorship biases. The conclusion illustrated that, over a 130-year study, companies with low payout ratios subsequently had low earnings growth, while companies with high payout ratios (dividend payers) had higher earnings growth. These findings help explain why deciles 8 and 9 in the Credit Suisse study (**figure 2**) actually had the greatest out-performance. Not only do you get paid today with a current income, but you also may get

Figure 2: Over the Long Term, Higher Yield Stocks Have Significantly Outperformed

Hypothetical investment of \$100 on December 31, 1979, to December 31, 2008



Source: Credit Suisse Quantitative Equity Research. Decile returns are equal weighted. Returns reflect the reinvestment of dividends and capital gains, but do not reflect the fees and expenses of investing. Past performance does not guarantee future results.

higher subsequent growth over the next 10 years.

Conclusion

We will leave you with a few guidelines that are useful in evaluating potential dividend-paying stocks.

First, chasing the highest yielding stocks can often lead to trouble. Although not always the case, these are frequently companies that are in financial distress. The low stock prices, hence high yields, could be an indicator of future dividend cuts. Also, as we saw in *figure 2*, the highest yielding stocks are not necessarily the best performing. Along the same lines and despite our skepticism of management's ability to allocate capital perfectly, we recognize that in order for a company to grow its business and earnings power, it must retain some amount of capital. In fact, because we seek to invest in companies with good business models, we naturally assume they can grow their values over time.

Second, a growing dividend stream is significantly more valuable than a flat or declining one. However, there is no guarantee that a company with a growing dividend will continue to increase payments. Therefore, one must understand the business, the industry, the growth expectations, and the cash needs of the business in order to make an edu-

cated decision as to whether or not a company will be able to increase its dividends per share indefinitely.

Third, and the most critical factor when considering any investment, is the price you pay. This will be the driving force in determining the success or failure of any investment; so above all, be patient with your capital and look for companies that meet all of your criteria before investing. ■

Following a dividend-focused strategy does not assure or guarantee better performance and cannot eliminate the risk of investment losses. There is no guarantee that a company paying dividends in the past will always pay a dividend in the future.

Figure 3: Average Subsequent 10-Yr EPS Growth

Starting Payout Quartile	Worst	Average	Best
One (Highest Payout)	0.6%	4.2%	11.0%
Two	-1.1%	2.7%	6.6%
Three	-2.4%	1.3%	5.7%
Four (Lowest Payout)	-3.4%	-0.4%	3.2%

Source: Robert D. Arnott and Clifford S. Asness, "Surprise! Higher Dividends = Higher Earnings Growth?", *Financial Analysts Journal*, Jan/Feb 2003. Data analyzed: 1946-2001. This is the most recent data available. Inclusion of subsequent periods could change the results.



Thornburg Investment Income Builder Fund

Income Builder Fund was conceived to enhance all phases of an investor's life - whether it be accumulating and growing capital or generating income. The fund focuses on high-quality, dividend-paying companies and seeks to generate a growing dividend that can be reinvested or paid out quarterly. A side benefit may be some capital appreciation.

Designed for investors seeking . . .

- Exposure to the stock market in the form of dividend-paying equities.
- A diversified portfolio consisting of domestic and foreign equities with a fixed income component constructed to ease volatility.
- Investment in international equities in the form of established, dividend-paying companies.
- An income-oriented portfolio built on the bottom-up, fundamental research for which Thornburg Investment Management is known.
- Capital appreciation potential.

For additional information regarding the fund, please visit www.thornburg.com/iib

Before investing, carefully consider the Fund's investment goals, risks, charges, and expenses. For a prospectus containing this and other information, contact your financial advisor or visit thornburg.com. Read it carefully before investing.

The views expressed by the Portfolio Managers reflect their professional opinions and should not be considered buy or sell recommendations. These views are subject to change.

Standard & Poor's 500 Stock Index (S&P 500) — An unmanaged index generally representative of the U.S. stock market.

The performance of any index is not indicative of the performance of any particular investment. Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Investors may not make direct investments into any index.

Investments in the Fund carry risks, including possible loss of principal. Special risks may be associated with investments outside the United States, especially in emerging markets, including currency fluctuations, illiquidity and volatility. Investments in small capitalization companies may increase the risk of greater price fluctuations. Funds investing in bonds have the same

interest rate, inflation, and credit risks that are associated with the underlying bonds. The principal value of bonds will fluctuate relative to changes in interest rates, decreasing when interest rates rise. Investments in the Fund are not FDIC insured, nor are they deposits of or guaranteed by a bank or any other entity.