

Pre- or Post-Tax, Dividend Strategies Are Still About Total Return

At a time when traditional income-producing investments – such as money market funds, treasuries, and certificates of deposits – are providing low yields, it seems appropriate to revisit dividend-paying stocks as potential alternatives for generating current income.

The conventional wisdom regarding dividend stocks and dividend investment strategies holds that first, dividend stocks have modest capital appreciation potential, and second, taxes on dividends ensure that such strategies are inevitably suboptimal for taxable

investors. This paper uses broad domestic and international indices over multiple investment horizons to illustrate that neither belief has been truly accurate. In fact, total returns for dividend strategies relative to their respective benchmarks have been higher both before and after taxes over numerous and recent investment horizons.

This article assumes investors seek to maximize total returns in both taxable and non-taxable scenarios. Therefore, when applicable, dividends (both before and after taxes) are reinvested and the benefits of compounding and dollar cost averaging are utilized.

Figure 1: Dividends have historically been an important part of total return

Decade	Price Appreciation	Income Component	Total Return	Income as Percent of Total Return
1871 – 1880	2.8%	6.1%	8.9%	68.7%
1881 – 1890	-2.1%	4.8%	2.6%	NM
1891 – 1900	4.2%	4.5%	8.7%	51.4%
1901 – 1910	2.5%	4.6%	7.1%	65.1%
1911 – 1920	-2.6%	6.1%	3.4%	NM
1921 – 1930	6.7%	5.6%	12.3%	45.3%
1931 – 1940	-2.8%	4.9%	2.1%	NM
1941 – 1950	6.7%	6.4%	13.0%	48.8%
1951 – 1960	10.2%	5.0%	15.2%	32.6%
1961 – 1970	4.7%	3.5%	8.2%	42.3%
1971 – 1980	4.0%	4.5%	8.5%	53.4%
1981 – 1990	9.3%	4.6%	13.9%	33.2%
1991 – 2000	14.9%	2.6%	17.5%	14.9%
2001 – 2010	-0.5%	1.9%	1.41%	NM
Average	4.1%	4.6%	8.8%	52.3%
Standard Dev	5.2%	1.3%	5.1%	

Sources: Jack W. Wilson and Charles P. Jones, "An Analysis of the S&P 500 Index and Cowles's Extensions: Price Indexes and Stock Returns, 1870–1999", *Journal of Business*, 2002, vol 75 no 3. Data after 1990 is from Bloomberg, Confluence, and FactSet. Calculated by Thornburg Investment Management. Returns are annualized. NM = Not Meaningful.

Past performance does not guarantee future results.

Focus on Total Return

Investors focus on total return when investing, not just capital appreciation or income. Although capital appreciation may at times provide the bulk of total returns to shareholders, income has contributed its fair share as well. *Figure 1* provides these two components of total return from equities over the past fourteen decades.

Using this broad equity index for all decades since 1871, the data reveals that the income component of total return was not only greater (53.5%) than the capital appreciation, but also significantly less volatile as measured by standard deviation. Price appreciation has been as high as 14.9%, but as low as -2.8%. This wide range is unfavorable for investors when compared to the income component, which has been less volatile and can never be negative.

Returns Before and After Taxes

Investors are very heterogeneous when it comes to risk tolerances, expected returns,

Figure 2: Tax Rates

Year	Tax Rate
1990	33.0%
1991	31.0%
1992	31.0%
1993	39.6%
1994	39.6%
1995	39.6%
1996	39.6%
1997	39.6%
1998	39.6%
1999	39.6%
2000	39.6%
2001	39.1%
2002	38.6%
2003	15.0%
2004	15.0%
2005	15.0%
2006	15.0%
2007	15.0%
2008	15.0%
2009	15.0%

Source: IRS.

time horizons, and especially tax rates. Given that it is impossible to know the average tax rate of all investors, the analyses in this paper provide both circumstances where the investor is not taxed and where the investor pays the highest marginal federal tax rate on dividends.

Figure 2 shows the highest federal tax rates on dividend income since 1990. These rates are used in calculating the after-tax returns in this paper.

Global Investing Matters

More investors have assets invested internationally as they recognize the benefits of diversification and the opportunities available outside the United States. Therefore, we examine returns both domestically and abroad utilizing three indices including a U.S.-centric index, a global index that includes the United States, and an international index that excludes the United States. Each of these dividend-oriented indices is compared to their respective benchmark index (see *figure 3*). The returns are in unhedged U.S. dollars.

Time Horizons Make a Difference

When examining historic returns of stocks, the results can vary greatly based on selected time periods. As illustrated in *figure 1*, 14 decades of data are provided; however, the first few decades beginning in 1871 may not be indicative of current conditions for

a variety of reasons, including significant structural changes in the economy. The more recent decades may provide useful insights.

Utilizing data with more recent inception (starting) dates, such as 1992, not only provides more applicable information for today's investors, but it also reflects a dynamic market. Between 1992 and 2009, the global economy faced two bubbles (dot.com and housing), two recessions, a variety of tax changes, and a range of 10-year Treasury yields between 3% and 7%. Without a doubt, the markets have seen a lot in the last 17 years.

In comparing the returns of the dividend-oriented indices relative to their benchmarks, two methods were utilized. The first method calculates the returns as of the earliest available period through December 31, 2009. For instance, using the Dow Jones U.S. Select Dividend Index, the earliest period provided from our data source is March 31, 1992. These dates, as well as brief descriptions of the indices, are provided in *figure 3*.

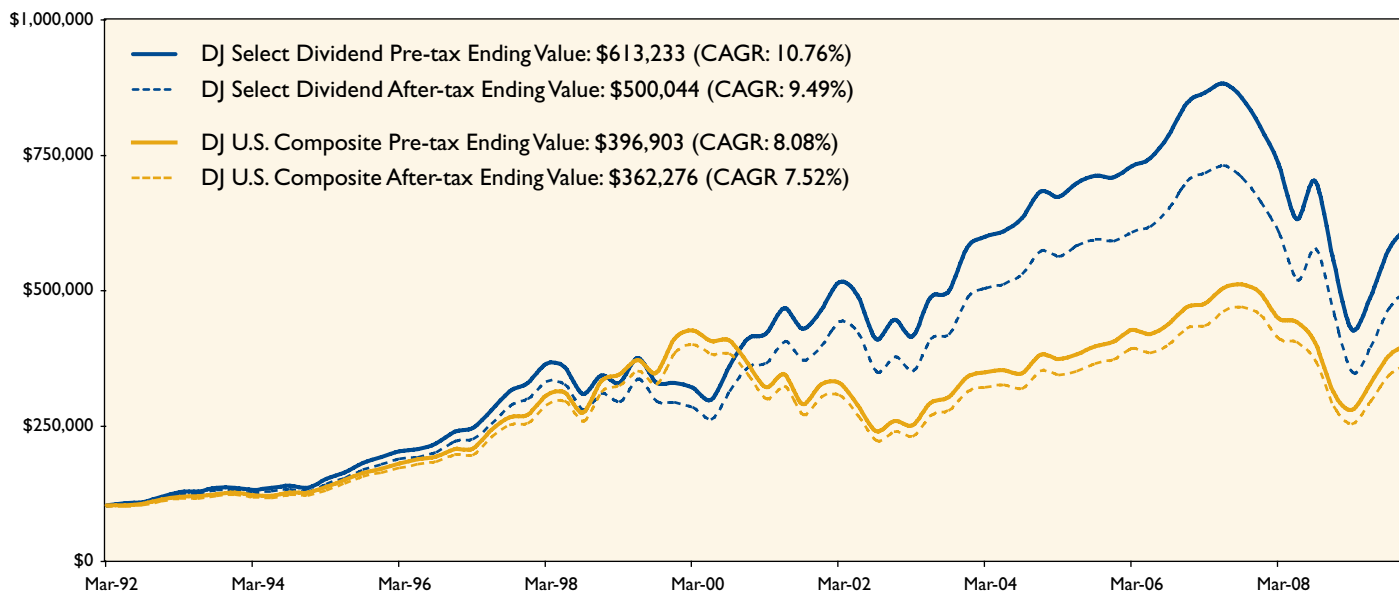
The second method uses shorter investment periods. The returns are calculated on a rolling 3-year basis beginning with the 1992-1995 period and ending with the 2006-2009 period. These two methods allow us to examine the results over both the longest time horizon available (since inception) as well as the shorter time horizons (three years) with varying start dates.

Figure 3: The Indices

Dividend Index	Description	Benchmark Index	Description
Dow Jones U.S. Select Dividend (Domestic)	Measures the performance of 100 leading U.S. stocks selected based on dividend yield and other related metrics. Data series available as of 3/31/1992.	Dow Jones U.S. TSM Composite	Measures all U.S. equities with readily available prices.
MSCI World High Dividend Yield (Global)	Measures the performance of securities within the MSCI World Index that have meaningfully higher dividend yields and other related metrics. Data series available as of 6/30/1995.	MSCI World	Measures the equity performance of developed markets including the United States.
MSCI EAFE High Dividend Yield (International ex-U.S.)	Measures the performance of securities within the MSCI EAFE Index that have meaningfully higher dividend yields and other related metrics. Data series available as of 6/30/1995.	MSCI EAFE	Measures the equity performance of developed markets (Europe, Australasia, Far East) excluding the United States and Canada.

Source: Bloomberg and Thornburg Investment Management.

Figure 4: Dow Jones U.S. Select Dividend Index vs. Dow Jones U.S. TSM Composite
Growth of a Hypothetical \$100,000, Pre-Tax and After Tax (March 31, 1992 – December 31, 2009)



Return Calculations

In presenting the results, we gathered quarterly returns for each index and separated those returns into two components: price (capital appreciation or depreciation) and income (dividends). Further, we calculated both the before- and after-tax returns.

The rates of return for both the index and its benchmark assume the dividends are paid quarterly and reinvested. The same method is used for the after-tax calculation; however, taxes are assumed to be paid quarterly and are taxed at the highest federal tax rates provided in *figure 2*. As a result, only the after-tax income is reinvested.

The results for all three comparisons are presented in the same format. The first chart (see *figure 4*) is the hypothetical change in value of an initial \$100,000 from the inception date of the index through December 31, 2009. The second chart (*figure 5*) provides the ending values of an initial \$100,000 for each 3-year period beginning with the index's inception data. In both charts, blue represents the dividend-oriented index while gold represents the benchmark index.

Dow Jones U.S. Select Dividend Index

The Dow Jones U.S. Select Dividend Index outperformed the Dow Jones U.S. TSM Composite Index under all measures of return both before and after taxes. Although we are focused mainly on total returns, it

Figure 5: Three-Year Rolling Returns, After-Tax Ending Values
Beginning Hypothetical Value: \$100,000

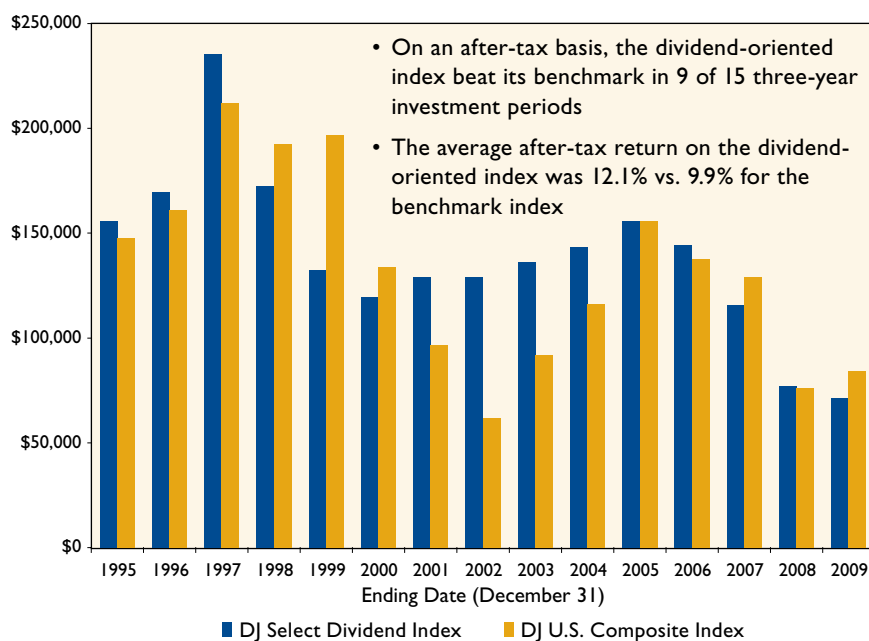


Figure 6: Dow Jones U.S. Select Dividend Summary

Simple Mean Returns 3/31/1992 – 12/31/2009	Select Dividend Index	U.S. TSM Composite	Difference
Price Return	8.1%	7.7%	0.4%
Income Return	4.4%	2.0%	2.4%
Total Pre-Tax Return	12.5%	9.6%	2.9%
Total After-Tax Return	11.2%	9.1%	2.1%

Past performance does not guarantee future results.

Figure 7: MSCI World High Dividend Yield Index vs. MSCI World Index
Growth of a Hypothetical \$100,000, Pre-Tax and After Tax (June 30, 1995 – December 31, 2009)

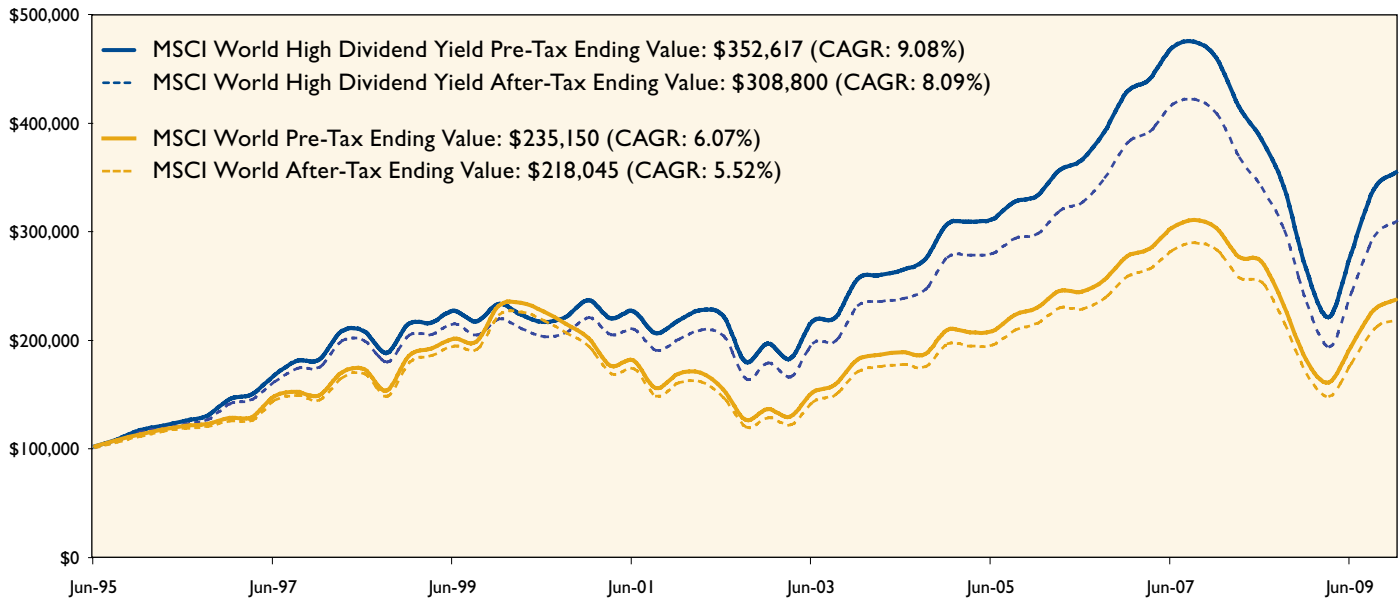
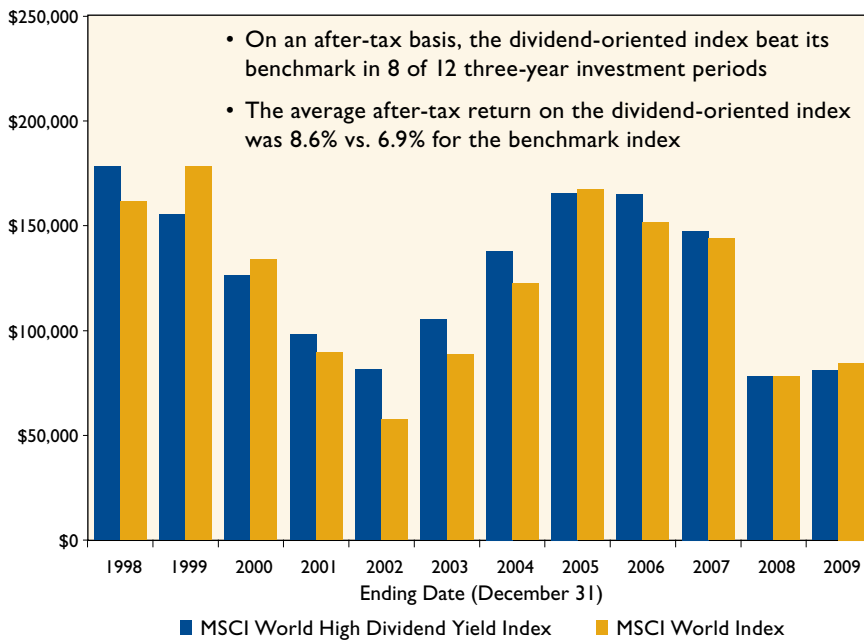


Figure 8: Three-Year Rolling Returns, After-Tax Ending Values
Beginning Hypothetical Value: \$100,000



may be surprising to some readers that the price component on the dividend-oriented index was on average greater than that of the benchmark (see *figure 6*). This suggests that investors did not have to sacrifice price appreciation for higher current income.

On average the dividend-oriented index outperformed by a significant margin; however, it underperformed the benchmark in some periods such as during the growth-oriented dot.com mania during the mid-to-late 1990s. In *figure 5*, we see this illustrated during the periods ending 1998, 1999, and 2000 (around the height of the bubble). However, the subsequent decline was not as severe for the dividend-oriented index and it quickly regained its relative dominance.

MSCI World High Dividend Yield Index

When incorporating a global strategy, the results are similar to those described in the U.S.-centric case above. As shown in *figure 9*, the MSCI World High Dividend Yield Index outperformed its benchmark on all return metrics (price, income, and total) in both before- and after-tax scenarios. Similarly to the previous example, the dividend-oriented index underperformed in the years leading up to the technology bubble.

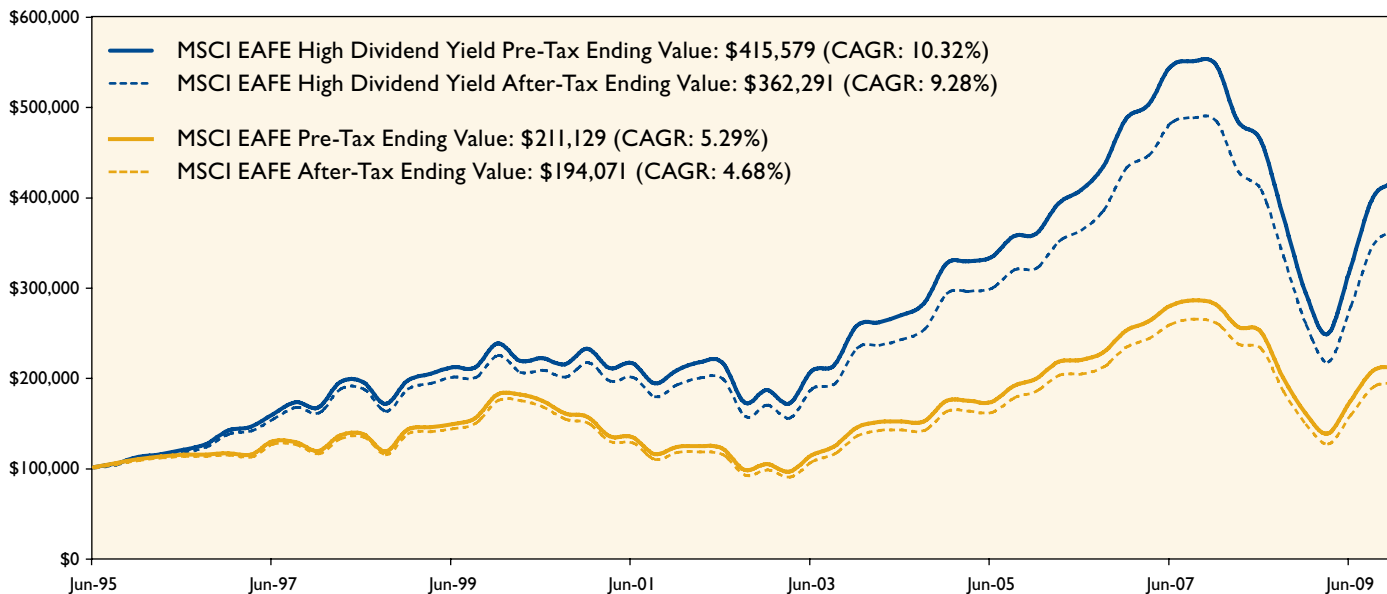
Finally, it is interesting that the price appreciation was on average higher for the dividend index relative to the benchmark (the same result as provided in the previous

Figure 9: MSCI World High Dividend Yield Summary

Simple Mean Returns 6/30/1995 – 12/31/2009	World High Dividend Index	World Index	Difference
Price Return	7.0%	5.7%	1.3%
Income Return	3.9%	2.2%	1.7%
Total Pre-Tax Return	10.9%	7.9%	3.0%
Total After-Tax Return	9.9%	7.3%	2.5%

Past performance does not guarantee future results.

**Figure 10: MSCI EAFE High Dividend Yield Index vs. MSCI EAFE Index
Growth of a Hypothetical \$100,000, Pre-Tax and After Tax (June 30, 1995 – December 31, 2009)**



example). Again, investors did not sacrifice price appreciation for higher current income.

MSCI EAFE High Dividend Yield Index

Notably, the MSCI EAFE High Dividend Yield Index, which does not include U.S. stocks, not only beat its benchmark by the highest overall amount, but did so in almost every 3-year investment period. Once more, the price appreciation was higher from the dividend-oriented index illustrating an investor did not have to accept lower capital appreciation in order to earn higher current income.

Conclusion

These results challenge the commonly held belief that dividend-oriented strategies generate inferior total returns as the three dividend indices outperformed the benchmarks by sizeable amounts during numerous investment periods. As to be expected, the dividend-oriented indices generated higher returns through income; however, many readers probably didn't expect these indices to provide higher capital appreciation as well. Intuition tells us that in order to be rewarded with higher current income, an investor would have to settle for lower future capital appreciation of the stock price, but that was not the case.

Finally, these results remained intact when dividend taxes were taken into account. This

Figure 11: Three-Year Rolling Returns, After-Tax Ending Values Beginning Hypothetical Value: \$100,000

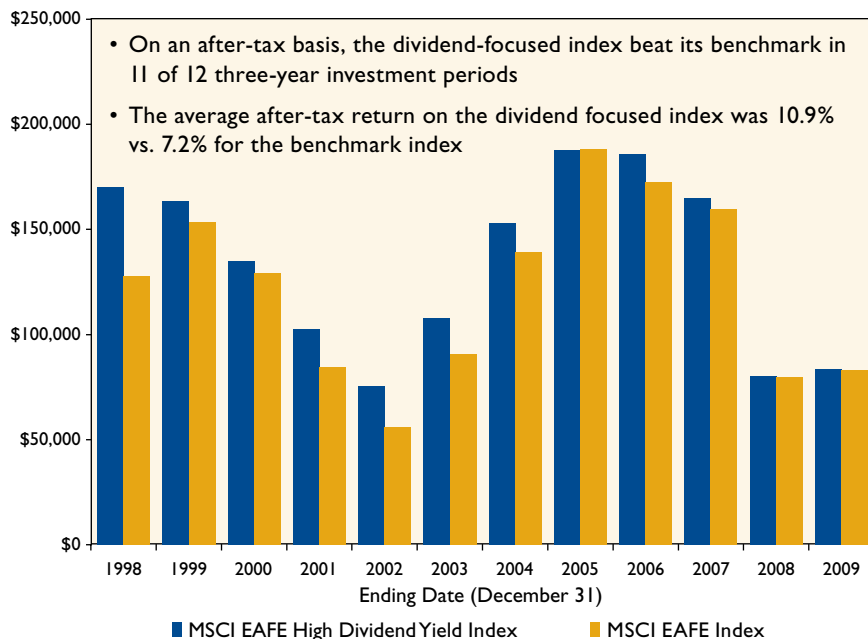


Figure 12: MSCI EAFE High Dividend Yield Summary

Simple Mean Returns 6/30/1995 – 12/31/2009	EAFE High Dividend Index	EAFE Index	Difference
Price Return	8.4%	4.9%	3.5%
Income Return	4.2%	2.5%	1.7%
Total Pre-Tax Return	12.6%	7.4%	5.2%
Total After-Tax Return	11.5%	6.8%	4.8%

Past performance does not guarantee future results.

Figure 13: Dow Jones U.S. Select Dividend Index vs. Dow Jones U.S. TSM Composite Growth of a Hypothetical \$100,000, Pre-Tax and After Tax* (March 31, 1992 – December 31, 2009)

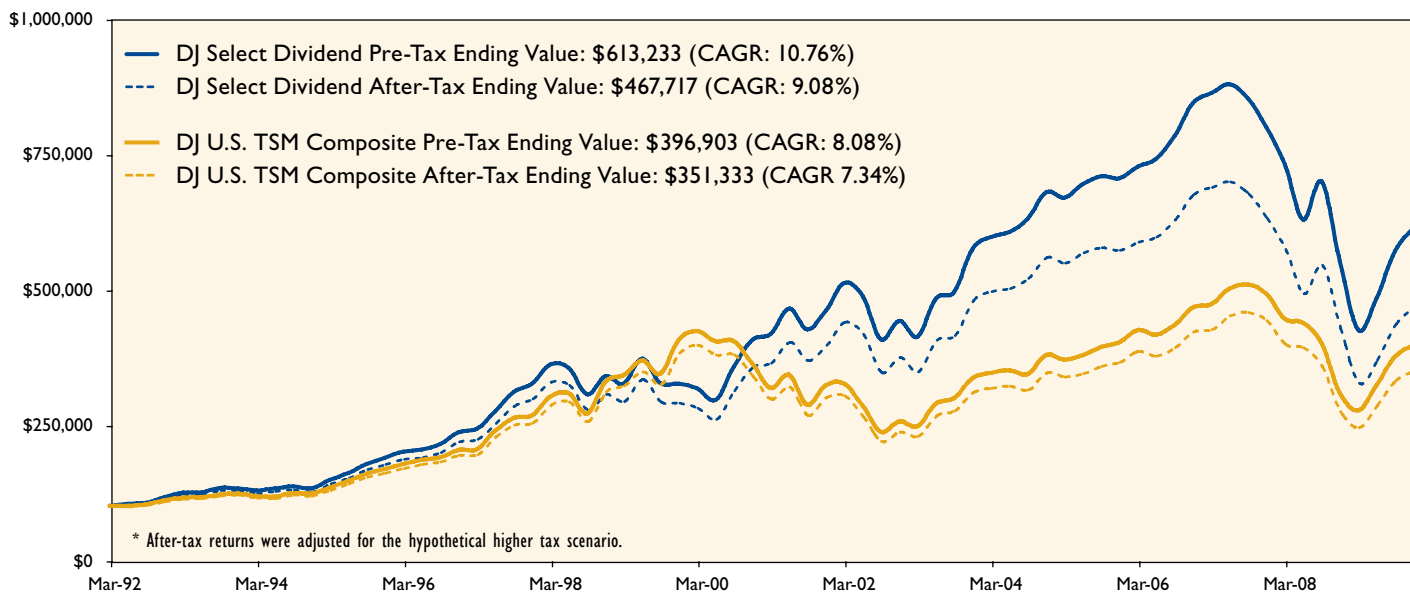
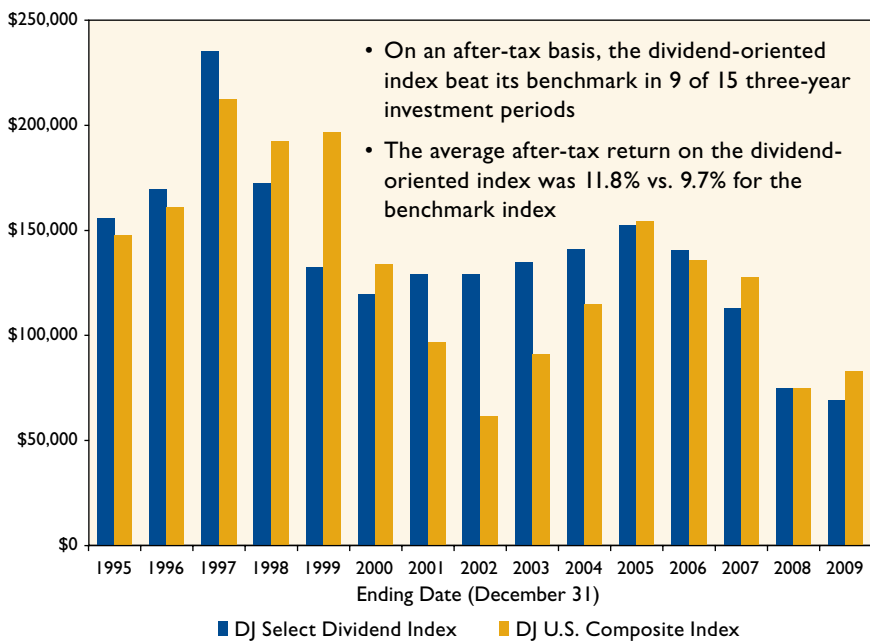


Figure 14: Three-Year Rolling Returns, After-Tax* Ending Values Beginning Hypothetical Value: \$100,000



* After-tax returns were adjusted for the hypothetical higher tax scenario.

is an important point for investors to bear in mind as tax rates are subject to uncertainty. The dividend-oriented indices outperformed in periods of both high- and low-tax environments. For an even more conservative view, examine *figures 15-21*. This supplemental analysis calculates the returns as if the Jobs and Growth Tax Relief Reconciliation Act of 2003 did not exist. As a result, the dividend tax rate is increased from 15% to 38.6%. The results again illustrate that on average the dividend-oriented indices continued to generate higher capital appreciation, income, and total returns.

Given this information, there seems to be merit in an investment strategy focused on companies that pay dividends to shareholders especially if 1) the stocks are trading at a discount to their intrinsic values, 2) the companies have the ability and willingness to pay increasing dividends, and 3) the portfolio is diversified across sectors and geographies.

Figure 15: Dow Jones U.S. Select Dividend Summary

Simple Mean Returns 3/31/1992 – 12/31/2009	Select Dividend Index	U.S. TSM Composite	Difference
Price Return	8.1%	7.7%	0.4%
Income Return	4.4%	2.0%	2.4%
Total Pre-Tax Return	12.5%	9.6%	2.9%
Total After-Tax* Return	10.8%	8.9%	1.9%

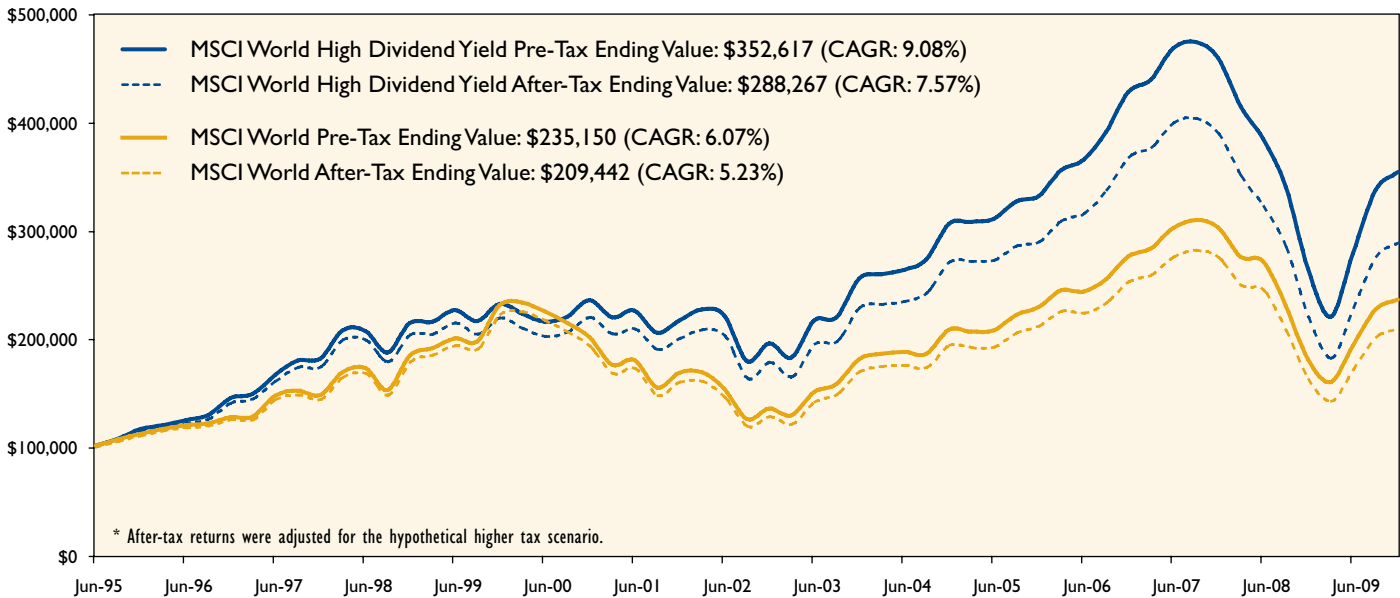
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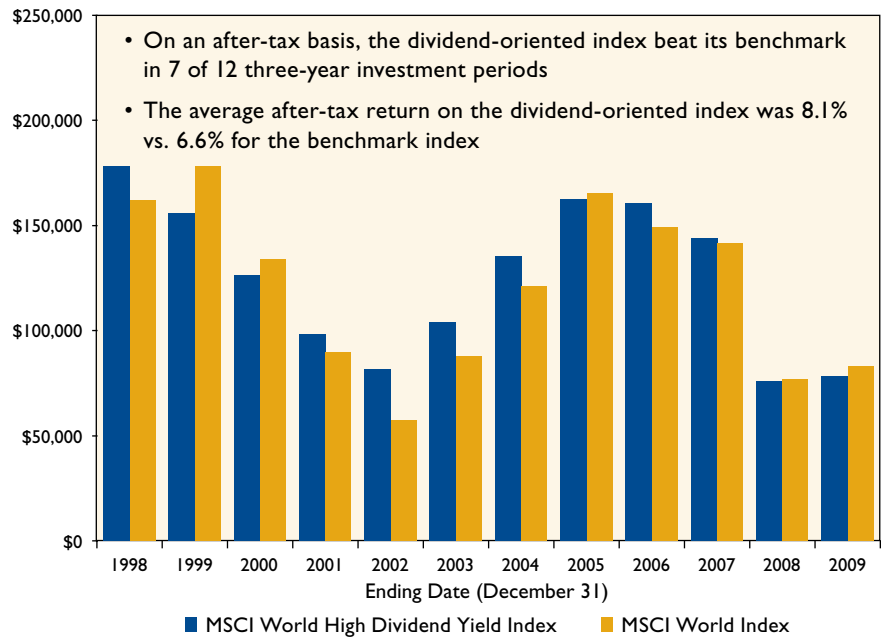
Appendix: Alternate Tax Scenario

Figures 15-21 use the same methodology as above; however, the tax rates for 2003-2009 are increased from 15% per year to 38.6% per year. This is to simulate the potential impact of the reduced tax rates on dividend income. Naturally, the after-tax returns declined when these higher tax rates were applied. Nevertheless, the dividend-oriented strategies continued to outperform the benchmarks.

**Figure 16: MSCI World High Dividend Yield Index vs. MSCI World Index
Growth of a Hypothetical \$100,000, Pre-Tax and After Tax* (June 30, 1995 – December 31, 2009)**



**Figure 17: Three-Year Rolling Returns, After-Tax* Ending Values
Beginning Hypothetical Value: \$100,000**



* After-tax returns were adjusted for the hypothetical higher tax scenario.

Figure 18: MSCI World High Dividend Yield Summary

Simple Mean Returns 6/30/1995 – 12/31/2009	World High Dividend Index	World Index	Difference
Price Return	7.0%	5.7%	1.3%
Income Return	3.9%	2.2%	1.7%
Total Pre-Tax Return	10.9%	7.9%	3.0%
Total After-Tax* Return	9.3%	7.0%	2.3%

Past performance does not guarantee future results.

* After-tax returns were adjusted for the hypothetical higher tax scenario.

The information given should not be considered tax advice. Please consult your tax advisor for personal tax questions and concerns.

The views expressed by Mr. Remily reflect his professional opinion and should not be considered buy or sell recommendations. These views are subject to change.

Following a dividend-focused strategy does not assure or guarantee better performance and cannot eliminate the risk of investment losses.

Diversification does not assure or guarantee better performance and cannot eliminate the risk of investment losses.

Special risks may be associated with investments outside the United States, especially in emerging markets, including currency fluctuations, illiquidity, and volatility.

Certificate of Deposit (CD) – A savings certificate entitling the bearer to receive interest. A CD bears a maturity date, a specified fixed interest rate and can be issued in any denomination. CDs are generally issued by commercial banks and are insured by the FDIC. The term of a CD generally ranges from one month to five years.

Compound Annual Growth Rate (CAGR) – The year-over-year growth rate of an investment over a specified period of time. It describes the rate at which an investment would have grown if it grew at a steady rate.

Money Market Fund – An investment fund that holds the objective to earn interest for shareholders while maintaining a net asset value (NAV) of \$1 per share. Mutual funds, brokerage firms and banks offer these funds. Portfolios are comprised of short-term (less than one year) securities representing high-quality, liquid debt and monetary instruments.

Standard Deviation – A statistical measurement of dispersion about an average which, for an investment,

Figure 19: MSCI EAFE High Dividend Yield Index vs. MSCI EAFE Index
Growth of a Hypothetical \$100,000, Pre-Tax and After Tax* (June 30, 1995 – December 31, 2009)

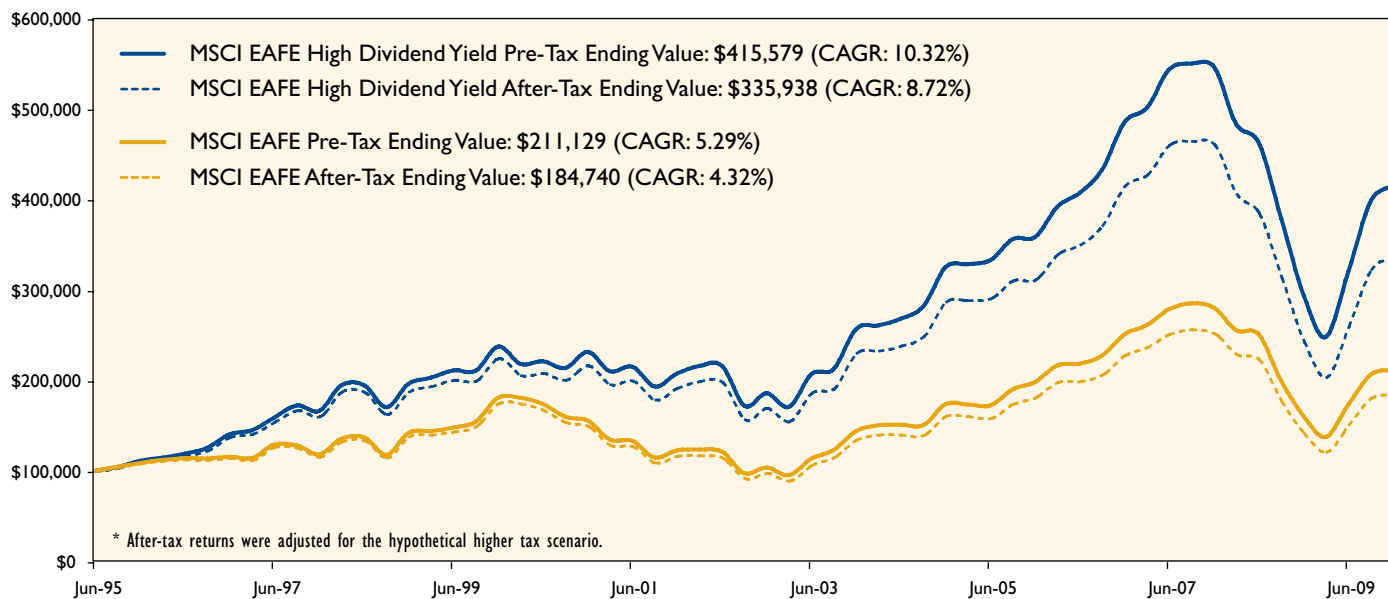
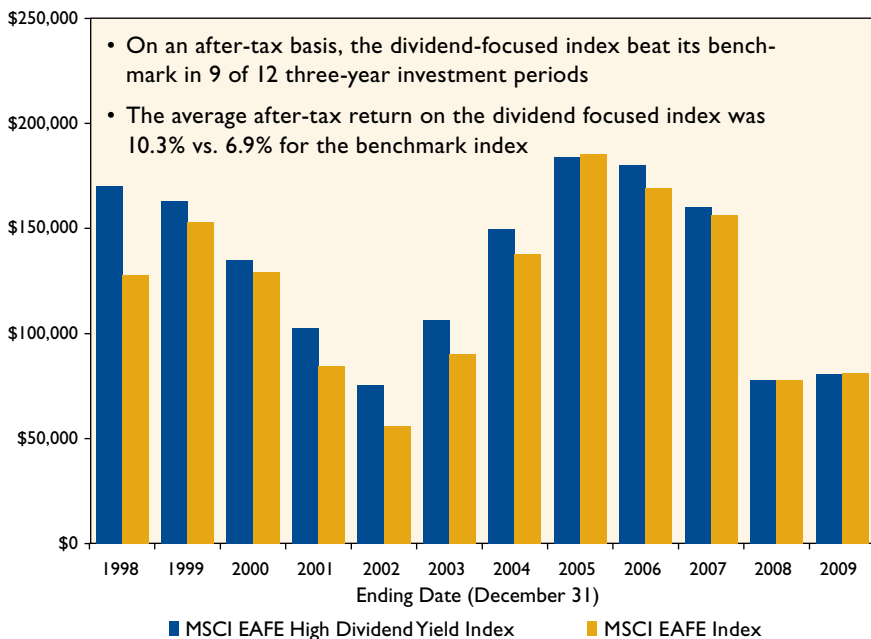


Figure 20: Three-Year Rolling Returns, After-Tax* Ending Values
Beginning Hypothetical Value: \$100,000



* After-tax returns were adjusted for the hypothetical higher tax scenario.

depicts how widely the returns varied over a certain period of time. Investors use the standard deviation of historical performance to try to predict the range of returns that are most likely. When an investment has a high standard deviation, the predicted range of performance is wide, implying greater volatility.

Treasuries – U.S. Treasury securities, such as bills, notes and bonds, are negotiable debt obligations of the U.S. government. These debt obligations are backed by the “full faith and credit” of the government and issued at various schedules and maturities. Income from Treasury securities is exempt from state and local, but not federal, taxes.

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.

Unless otherwise noted, the source of all data is Bloomberg with calculations by Thornburg Investment Management.

Before investing, carefully consider the 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.

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Figure 21: MSCI EAFE High Dividend Yield Summary

Simple Mean Returns 6/30/1995 – 12/31/2009	EAFE High Dividend Index	EAFE Index	Difference
Price Return	8.4%	4.9%	3.5%
Income Return	4.2%	2.5%	1.7%
Total Pre-Tax Return	12.6%	7.4%	5.2%
Total After-Tax* Return	10.9%	6.4%	4.5%

Past performance does not guarantee future results.

* After-tax returns were adjusted for the hypothetical higher tax scenario.