April 2009 – Dividends

A few months ago a client asked me how I judge a dividend, that is, whether or not the dividend will increase, decrease or continue at current levels. In todays' turbulent times and with very low interest rates, I believe the client asked an excellent question – one that if answered correctly, in practice as well as in theory, should produce very good returns.

Currently, several of the companies we follow have high yields at current dividend levels. In fact, dividend yields on stocks were at or near historically high levels whereas yields on U.S. Treasuries were at historical lows. This presents opportunities – and dangers. For example, consider the following:

	December 31, 2008			**March 13, 2009**		
Company	Stock Price	Annual Dividend	Yield	Stock Price	Annual Dividend	Yield
GE	$16.20	$1.24	7.65%	$ 9.62	$0.40	4.16%
JP Morgan	$31.53	$1.52	4.82%	$23.75	$0.20	0.84%
Pfizer	$17.71	$1.28	7.23%	$14.54	$0.64	4.40%

What happened? The answers are always specific to the company and are not always simple. Certain reasons are:

- GE's business model requires the ability to refinance its debt. Credit markets are demanding that GE have more capital. Cutting its dividend adds billions of dollars a year to its capital.

- JP Morgan is a bank and must meet mandatory capital levels. Large bad debt provisions erode capital so the bank is basically required to cut its dividend.

- Pfizer is proposing a merger with Wyeth, and Pfizer cut its dividend to help finance the $60+ billion purchase price.

In fact, Pfizer's dividend decrease came after 41 consecutive years of dividend increases! These companies are not alone. Dow Chemical cut its dividend for the first time in 97 years.

Dividends are very important. As Mike Hogan noted in his column in the March 16, 2009 issue of Barron's, dividends are cash payments to owners and historically represent over a third of a stock's total return. Given that they are so important, how do we judge dividend safety?

Dividend Safety

There are three different kinds of cash flows that must be considered in judging dividend safety:

- Operating Cash Flows – First, dividends must be earned. Therefore, a company must make money – not necessarily every year, but it can only go so long before it will run out of cash. Some companies pay great dividends right up to the point they go bankrupt and the investor loses the entire investment.

- Financing Cash Flows – Secondly, the cash flow from earnings must be sufficient to meet debt obligations. Pfizer must not only earn enough to pay the Wyeth acquisition debt, but also fund large research and development activities.

- Investing Cash Flows – Thirdly, cash flow must also provide capital for building, repairing and replacing physical facilities. AT&T has to make large investments to support a sophisticated wireless network.

A company that is in danger of cutting or dropping the dividend is one that does not generate enough cash from operations to pay its obligations and build for the future. This information can be found through analysis of the company's cash flow statements. Borrowing to pay dividends is clearly a warning sign.

The factors we pay very close attention to in evaluating dividends are:

- Earnings history and quality – year in and year out. Examples are McDonald's, Wal-Mart, Johnson & Johnson, Microsoft and many utilities.

- Dividend payout ratio. If the dividend is a high percentage of earnings, it may not be sustainable.

- Earnings prospects. If a company tries to keep its dividend ratio at a certain level, say 50%, and earnings decrease it may have to cut its dividends. Currently, Conoco Phillips' dividend yield is near 5.0%. If oil and gas prices stay low, it's a good bet that it may have to cut its dividend.

- Regulatory requirements – The government may require a company to cease or significantly lower its dividend. This is particularly true of banks and other companies receiving federal assistance.

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- Debt requirements – Lenders may require that they be paid back before distributions can be made. They also frequently require certain capital levels. This is just like the regulatory requirements above.

- Higher than normal yields – People are always saying if it's too good to be true, it probably is. We agree. Look at Bernie Madoff and Stanford Financial.

Another important point – just because a company has a low yield or doesn't pay a dividend doesn't mean it is an investment to be avoided. Warren Buffet's company Berkshire Hathaway, for example, does not pay a dividend, but its owners have seen great returns.

Other companies are growing so rapidly that they must retain their earnings to avoid financing their growth with too much debt. Over time, investors in Cisco and Apple have been well rewarded.

In conclusion, the client's question was an important one because dividends mean something. They put cash in our pocket and they support the price of the stock. Dividends also protect us from inflation. Many companies raise dividends at a higher rate than inflation. Fixed income investments never do.

In making our investment decisions, dividends always count.

We continue to believe that an accurate assessment of risk tolerance and a consistent allocation of diversified financial assets including stocks represent the best way to create and preserve financial security. We are grateful for the opportunity to help you with that.