Myths and Realities of Dividend Investing

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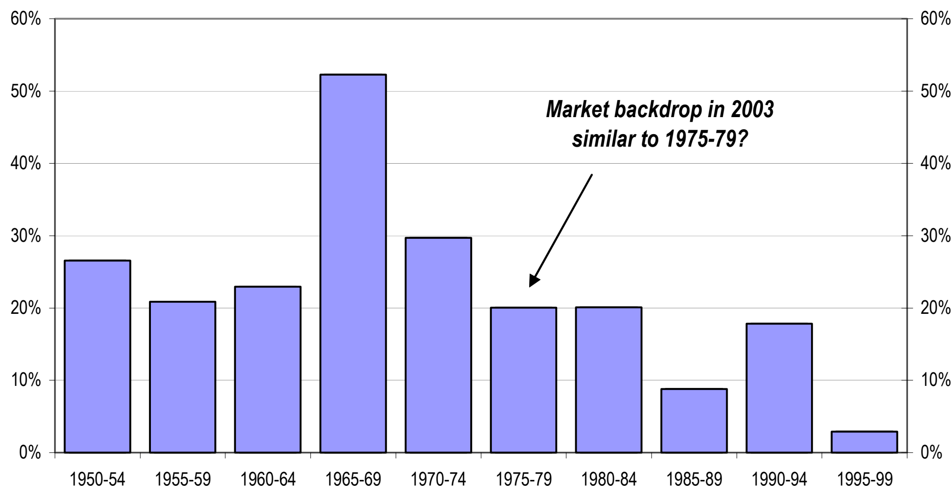
The changing of the economics guard in Washington has dominated market discussion during the past week. A key element likely to coincide with the arrivals of John Snow and Stephen Freidman is the elimination of the double taxation of dividends. The issues surrounding the implementation of such a change have already been discussed at length, and we thought it useful instead to focus our efforts on the key drivers of dividend-paying stocks over time. Although this potential tax benefit certainly wouldn't impede the market's performance in the coming year, we believe it has been overhyped by the media and is unlikely to be the catalyst that drives the market higher.

In our opinion, the market and economic backdrops alone, and not a prospective change in legislation, warrant a closer look at dividend-paying stocks. Indeed, it is important to remember that dividend yields over long periods of time represent almost 25% of the S&P 500's total return. That said, this ratio fluctuates significantly from decade to decade. Interestingly, historical periods marked by subpar returns (see the late 1960s/early 1970s example in the chart below), as we expect for the stock market in the coming years, have had a large share of total returns attributed to dividend income. In essence, the 1990s is the anomaly and not the benchmark.

Percentage of S&P 500 Total Return Attributed to Dividends



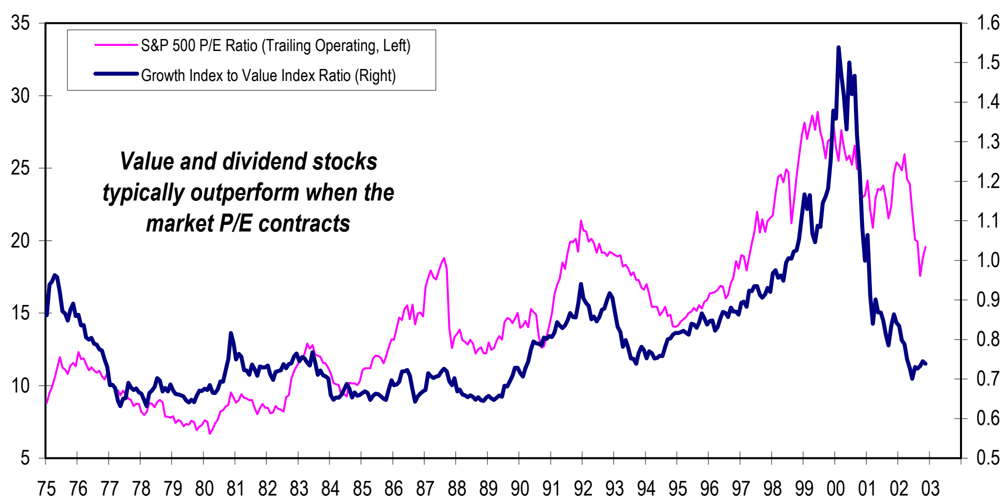
Source: Standard & Poor's; Bear, Stearns & Co. Inc.

The economic backdrop is conducive to an increase in the S&P 500 dividend yield. Indeed, a number of companies are returning to profitability at a time when excess capacity is rampant. In other words, with no great incentive to invest in capacity expansion at this point, corporations flush with cash are faced with few options — one of which is increasing or initiating dividends payments. Granted, a number of companies will choose to buy back stock or reduce debt rather than pay dividends, but still, market forces should result in a larger percentage of S&P 500 companies paying dividends (currently about 70%) and a higher average yield (currently 1.7%).

The market backdrop favors dividend-paying stocks over their non-dividend brethren because they usually perform best in conditions marked by uncertainty or subpar returns — a likely climate for 2003. During the 1990s, non-dividend-paying stocks usually outperformed the dividend-paying universe in a rising market, and vice versa in a flat or declining environment. Note that the current beta of the dividend-paying universe is 0.75 compared to 1.67 for the non-dividend-paying stocks — another argument against the latter, since it is unlikely that the appetite for risk will revive quickly following a three-year bear market. From our perspective, the dividend-paying universe offers a lower-risk option to investors looking to increase equity allocations.

The style cycle can also shed light on this important relationship, since non-dividend-paying stocks have a greater probability of being growth companies (note that 60% come from the tech and health care sectors). We would expect value segments to fare best in the coming year, as they usually outperform in the initial stages of an expansion (as is currently the case) and when P/Es are declining or stable (as we expect). In other words, an emphasis on dividend-paying stocks is implicitly a style call favoring value over growth, and vice versa.

S&P 500 P/E Ratio Versus the Growth-to-Value Index Ratio

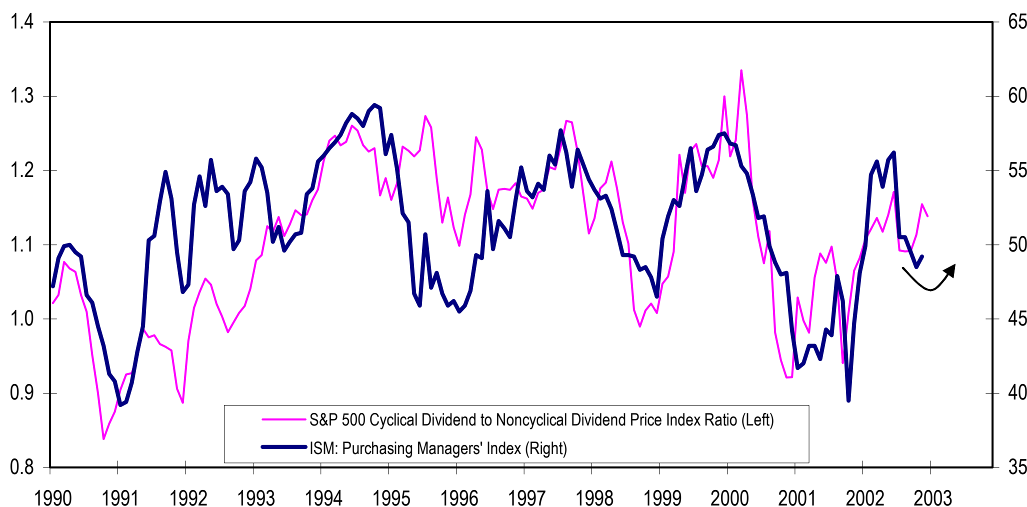


Note: S&P/Barra Growth-to-Value price index ratio from 1975 to May 1995; Russell 1000 Growth-to-Value total return index ratio from June 1995 to date.

Source: Standard & Poor's; Russell; Bear, Stearns & Co. Inc.

Regardless of a dividend emphasis or style preference, the cycle dominates most other investment themes. The chart below shows that dividend-paying cyclical stocks usually outperform their dividend-paying noncyclical peers when economic pressures are building (denoted by the rising ISM Manufacturing Index). If the uptick in the ISM last month is an indication of things to come, or if we are finally past Chairman Alan Greenspan's soft spot, then the dividend-paying cyclical stocks present an interesting investment vehicle for the coming year. This theme is consistent with an expanding economy marked by an uncertain investment backdrop.

S&P 500 Cyclical to Noncyclical Dividend Payer Index Ratio



Source: FactSet Research Systems Inc.; Bear, Stearns & Co. Inc.

Since the economic cycle should dominate the investment backdrop during the coming year, a strategy of overweighting cyclical stocks, with a particular emphasis on those that pay a lofty dividend, is a way of participating in the market at reduced risk. We have screened the Bear, Stearns & Co. Inc. coverage universe for four parameters: cyclical sector, Market Weight or Market Overweight analyst industry rating, Outperform-rated stock, and dividend yield greater than or equal to the market yield of 1.7%. This best-of-breed screen is compiled in the table below. Note that six out of ten stocks (Eastman Chemical Co., DuPont, Fluor Corp., The Limited Inc., Knight-Ridder Inc., and Nucor Corp.) are S&P 500 stocks. This compilation provides investors looking to increase equity allocations, but weary of market risk, with a list of investment ideas.

Cyclical Sector Dividend Payers

Symbol	Company	Market Capitalization ($Millions)	Closing Price 12/10/02	BSC 2003E EPS	P/E 2003E	Current Dividend per Share	Dividend Yield	S&P Sector
EMN	Eastman Chemical	$2,853.7	$36.980	$3.00	12.3x	$1.76	4.8%	Materials
CNX	Consol Energy	1,181.2	15.000	1.40	10.7x	0.56	3.7%	Materials
DD	DuPont	42,716.5	43.000	2.48	17.3x	1.40	3.3%	Materials
TOC	The Thomson Corporation	16,826.1	25.970	1.15	22.6x	0.72	2.8%	Consumer Discretionary
RGC	Regal Entertainment Group	2,839.4	21.650	1.12	19.3x	0.60	2.8%	Consumer Discretionary
TP	TPG N.V.	7,894.8	16.620	1.31	12.7x	0.42	2.5%	Industrials
FLR	Fluor Corp.	2,109.2	26.240	2.35	11.2x	0.64	2.4%	Industrials
LTD	The Limited, Inc.	7,811.5	14.940	1.15	13.0x	0.30	2.0%	Consumer Discretionary
KRI	Knight-Ridder	5,081.0	61.740	3.85	16.0x	1.08	1.7%	Consumer Discretionary
NUE	Nucor Corp.	3,494.4	44.700	2.90	15.4x	0.76	1.7%	Materials

Source: FactSet Research Systems Inc.; Bear, Stearns & Co. Inc.

One interesting characteristic of the list above is that it contains no technology stocks. We have discussed how corporations with sound balance sheets, increasing profitability, and excess capacity may be faced with mounting pressure from investors to initiate dividend payments. A number of these would fall into the tech space, since it is the industry with the most excess capacity at this stage. In the next table, we list those S&P 500 tech constituents with the wherewithal to pay dividends.

A number of corporations have used the double taxation of dividends over the years as an excuse to not pay dividends, since they view it as not being in the best interest of the shareholders. Should a policy change lead to the end of double taxation, then we would expect many tech companies to shift their rationale for maintaining high cash levels toward future acquisitions or perhaps share buybacks. In any case, the corporation would retain greater flexibility than paying dividends would allow it. In other words, we believe it likely that a few tech companies will initiate dividend programs, but we would not expect this to become a sectorwide phenomenon. The list below does not guarantee that these companies will necessarily initiate or increase dividends, but rather that they have the ability to do so — a big difference.

S&P 500 Information Technology Companies with the Wherewithal to Pay Dividends

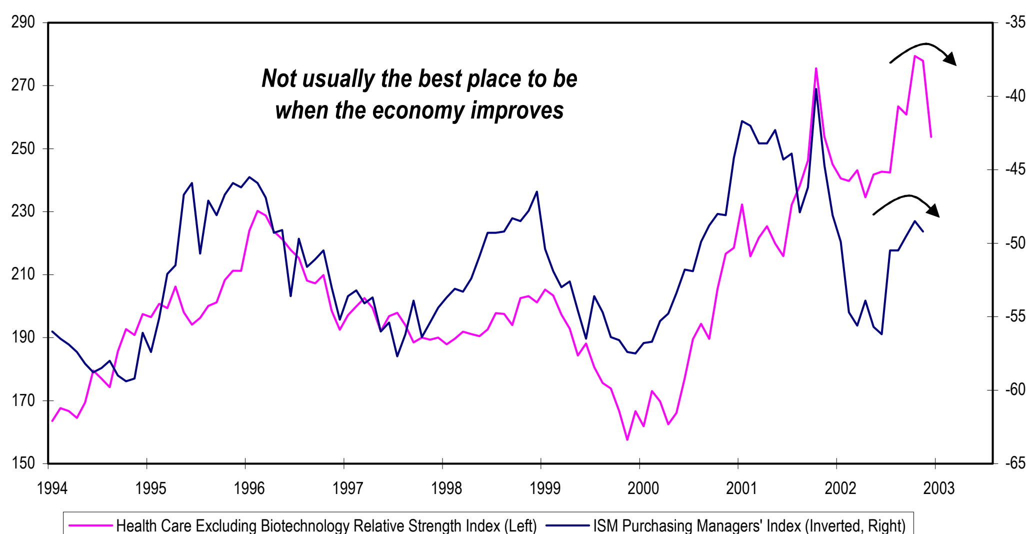
Symbol	Company	Market Capitalization ($Millions)	Closing Price 12/10/02	Cash Less Total Debt Relative to MCAP	Cash per Share	LTM Free Cash Flow per Share	Analyst Mean 2003E EPS	P/E 2003E	Current Dividend per Share	Dividend Yield
PSFT	PeopleSoft Inc.	$5439.7	$17.38	31.2%	$5.42	$0.89	$0.61	28.6x	$0.00	0.0%
VRTS	Veritas Software Co.	6976.6	16.95	23.9%	5.16	1.18	0.61	27.8	0.00	0.0%
MSFT	Microsoft Corp.	288737.4	54.01	14.0%	7.57	3.09	1.98	27.3	0.00	0.0%
ORCL	Oracle Corp.	57309.2	10.70	10.7%	1.20	0.56	0.44	24.2	0.00	0.0%
ADBE	Adobe Systems Inc.	6145.4	26.01	10.4%	2.69	1.19	1.00	26.1	0.05	0.2%
CSCO	Cisco Systems Inc.	100755.7	13.93	10.2%	1.43	0.53	0.54	25.6	0.00	0.0%
ERTS	Electronic Arts Inc.	9137.6	62.99	10.1%	6.39	2.82	2.89	21.8	0.00	0.0%
QCOM	QUALCOMM Inc.	30545.0	39.61	8.8%	3.62	1.07	1.19	33.2	0.00	0.0%
INTC	Intel Corp.	120111.2	18.13	8.3%	1.70	0.56	0.63	28.8	0.08	0.4%
XLNX	Xilinx Inc.	7241.1	21.48	8.2%	1.77	0.82	0.68	31.8	0.00	0.0%
INTU	Intuit Inc.	10210.6	49.75	8.1%	4.18	3.20	1.36	36.7	0.00	0.0%

Source: FactSet Research Systems Inc.; Bear, Stearns & Co. Inc.

A More Challenging Backdrop For Noncyclicals

The environment could hardly have been more supportive for noncyclicals in 2002. First, economic and earnings growth assumptions early in the year proved well too optimistic. Second, the equity market was rocked by issues of corporate governance and fraud. Third, geopolitical flares sparked in the Middle East, while oil prices rose substantially. The coming year could prove more challenging for these segments, as all three factors may dissipate. We have argued that the projected backdrop should provide cyclical segments of the market with a slight edge over their noncyclical peers. However, here, too, sector selectivity is key.

S&P 1500 Health Care (Ex. Biotech) Sector Relative Strength Index Versus the Purchasing Managers' Index



Source: Standard & Poor's; The Conference Board; Bear, Stearns & Co. Inc.

The chart above shows that the health care sector usually underperforms the overall market when the ISM Manufacturing Index is rising — or when cyclical pressures are increasing. The table below shows that the same relationship also holds true with other economic variables, including the OECD Leading Economic Indicators or, alternatively, interest rates. Since the Federal Reserve Board's next move is more likely to be a rate hike than a rate cut, in our opinion, the environment for the health care sector could prove to be more difficult. That said, the subdued nature of the economic recovery will probably muddle historical relationships to some degree.

Noncyclical Index Correlations — January 1994 to Date

S&P 1500 Sector	OECD LEI [1]	ISM	10-Year TNote Yield	FFunds
Staples	-0.19	-0.14	-0.62	-0.54
Health Care (ex. Biotech)	-0.50	-0.58	-0.59	-0.58
Staples Rel. Strength / Health Care (ex. Biotech) Rel. Strength	0.40	0.52	0.07	0.13

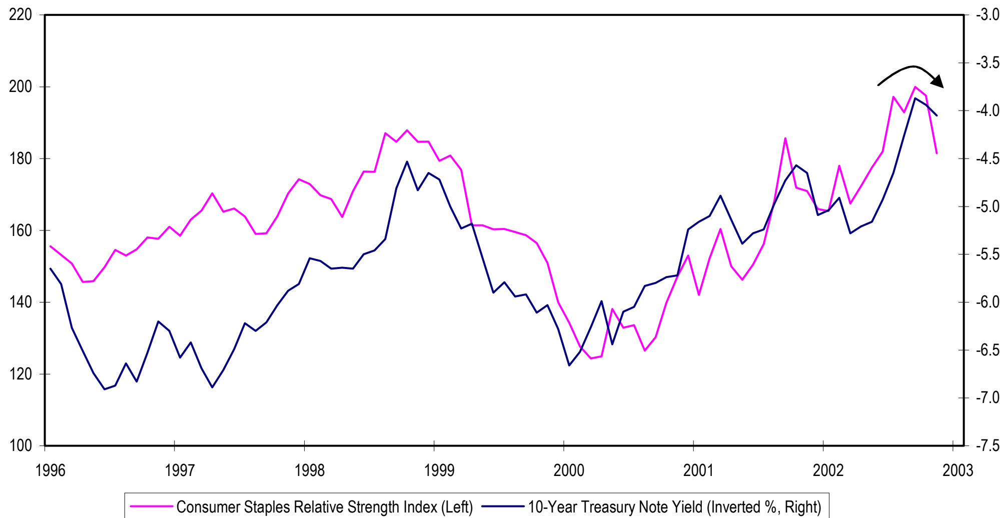
(1) 12-month rate of change of OECD Leading Economic Index. Data through 10/02; all other correlations through 11/02.

Source: FactSet Research Systems Inc.; Standard & Poor's; Bear, Stearns & Co. Inc.

Unsurprisingly, the table above shows that the staples sector is also negatively correlated with indicators of economic activity. The most interesting conclusion to be drawn from this correlation analysis is that the relative performance of the staples sector to the health care sector is positively influenced by economic variables. In other words, the staples sector usually outperforms health care when the economy is improving. This is not to say that staples will outperform the market, but rather that it is slightly more influenced by cyclical forces than health care, and usually a better investment in an economic recovery.

The staples sector has been strongly negatively correlated to trends in the ten-year Treasury bond yield in recent years (coefficient rate of negative 0.62 since 1994). This makes sense in light of the fact that the bond market has likely ended its secular decline, which has helped it to become a better gauge of cyclical forces. The positive correlation between the stock market and bond yields also implies that it will be very difficult for any market advance to be led by the staples sector — not an impossible task, but certainly an improbable one.

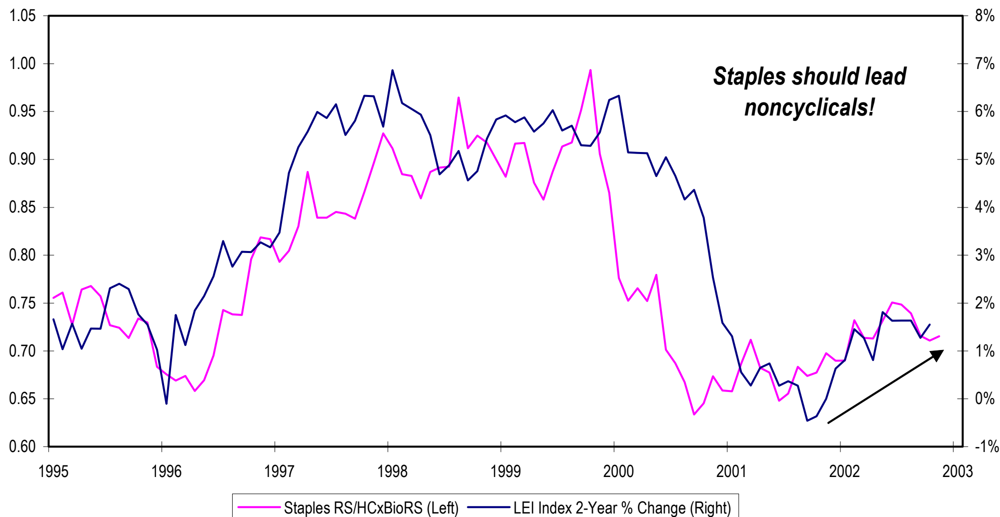
S&P 1500 Consumer Staples Sector Relative Strength Index Versus the Inverted Ten-Year Treasury Note Yield



Source: Federal Reserve; Bear, Stearns & Co. Inc.

Still, among noncyclicals, the staples sector presents a better investment vehicle during an economic recovery. The chart below shows that the sector usually outperforms its health care counterpart when the U.S. Leading Economic Indicator is improving, as has been the case since late 2001. A similar relationship exists between the staples and utilities sectors. Therefore, 2003 should be slightly less challenging for staples than it may be for the health care or utilities sectors.

Relative Strength Index Ratio of S&P 1500 Consumer Staples to Health Care (Ex. Biotech) Versus the LEI Two-Year Change

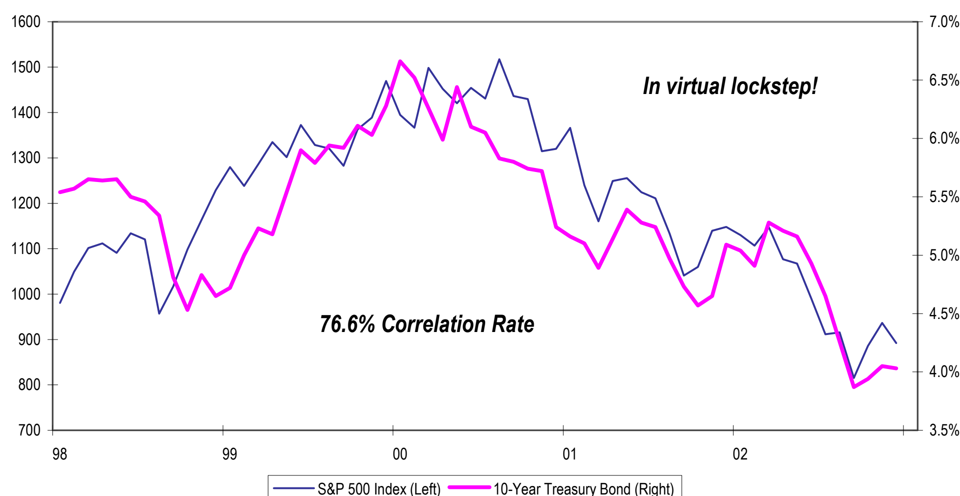


Source: The Conference Board; Standard & Poor's; Bear, Stearns & Co. Inc.

Playing for Pennies in Interest-Sensitives

We have written at length about the similarities of the current market backdrop to that of the early 1960s. Much like today, Treasury bond yields and the equity market were strongly correlated during that period. This has significant repercussions for portfolio positioning, since it implies that the stock market and the bond market cannot rally simultaneously. Apart from asset allocation issues, this relationship suggests that it would be extremely difficult for interest-sensitive segments of the market to lead any sort of equity recovery. In other words, an optimistic view of the equity market for the coming year, to be consistent, has to be cautious on the interest-sensitive segments of the market.

S&P 500 Versus the Ten-Year Treasury Bond Yield — 1998 to Date



Source: Standard & Poor's; Federal Reserve; Bear, Stearns & Co. Inc.

The financials sector is most at risk in this regard, since it possesses the strongest negative correlation to the ten-year bond yield. That said, not all industries within financials are likely to react in the same manner. The real estate and bank segments are probably the most vulnerable in the present environment, while industries such as consumer finance and brokerage are less susceptible to this dynamic and more influenced by the economy and stock market. Moreover, Standard & Poor's definition of the bank group is a loose one that includes a number of market-sensitive stocks, so not all constituents are likely to face this interest rate headwind.

Financial Segment Correlations to the Ten-Year Treasury Note Yield — January 1994 to Date

S&P 1500 Segment	Correlation
Financials	-0.84
Banks	-0.79
Diversified Financials	-0.74
Insurance	-0.54
Real Estate [1]	-0.85

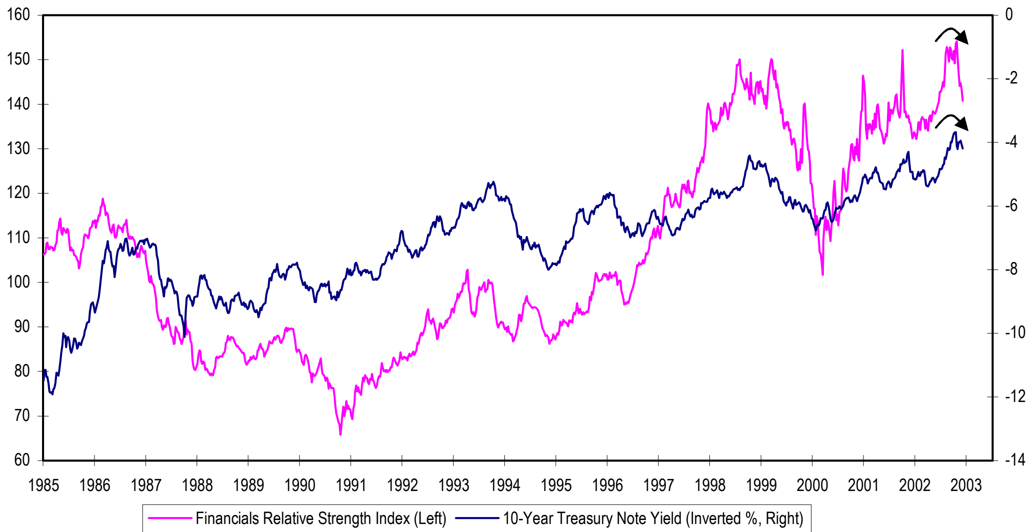
(1) Calculated from October 2001 to date.

Source: FactSet Research Systems Inc.; Standard & Poor's; Bear, Stearns & Co. Inc.

Aside from financials, there are a number of other interest-sensitive segments that could face a less friendly environment in the coming year. Homebuilders rapidly come to mind, of course, as do other housing-related industries such as home furnishing and household appliances. The one element common to all interest-sensitives is that relative valuations on a price-to-revenues basis are approaching or already beyond levels seen in past cycle peaks. This is particularly true of the bank group and is a characteristic that leaves them vulnerable in the current backdrop, in our opinion.

The financials sector has always been strongly influenced by the bond market — no surprise here. Still, the relationship between bond yields and the relative performance of the average financial stock has increased in recent years. The correlation rate between the two series was around 0.07 in the latter half of the 1980s and is now on the order of negative 0.84. The explanation for this is twofold — first, a move beyond the secular issues of the late 1980s, and second, a change in constituents favoring the addition of more rate-sensitive stocks such as real estate investment trusts (REITs).

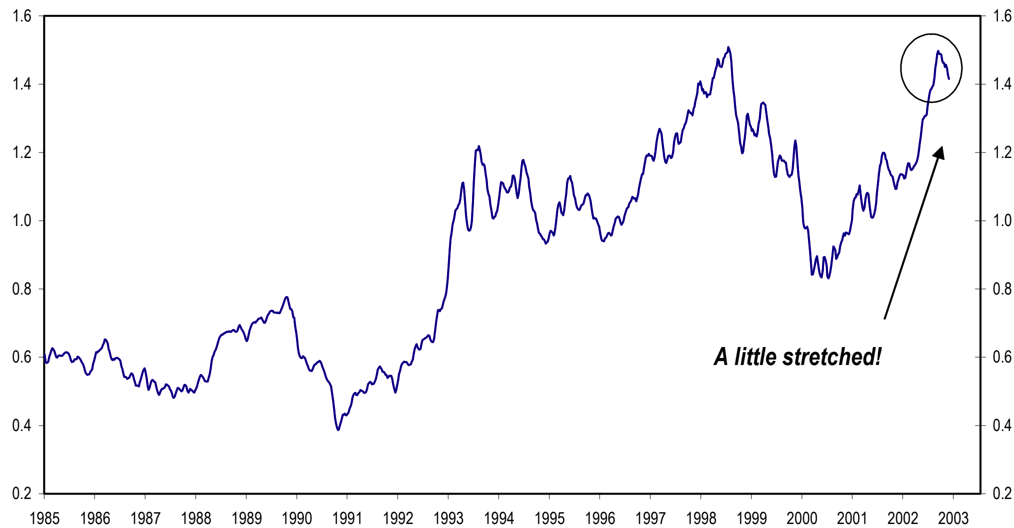
S&P 1500 Financials Relative Strength Index Versus the Ten-Year Treasury Note Yield



Source: Standard & Poor's; Federal Reserve; Bear, Stearns & Co. Inc.

The relative price-to-revenues ratio of the financials sector is currently at levels associated with the cycle peak of 1998 and higher than levels seen in the 1980s. Intuitively, this makes sense, since long-term interest has declined dramatically during the past two decades. The issue is whether valuations can withstand the pressures of rising long-term interest rates — a difficult headwind to face, in our opinion.

S&P 1500 Financials Relative Price-to-Sales Ratio Versus the Ten-Year Treasury Note Yield



Source: FactSet Research Systems Inc.; Standard & Poor's; Bear, Stearns & Co. Inc.