



RIGHTPATH™

Investments & Financial Planning, Inc.

Sound Investment Planning Pays Big Dividends...or Does It? Spring 2007

Much of our time here is spent constructing and advising on portfolios for investors making withdrawals over long periods of time, to support various goals. Typically, these are retirees, trustees or endowment funds. Cautious investors can achieve steady income from portfolios comprised entirely of fixed-income securities such as CD's and bonds. Over time, however, the purchasing power of such income will wither against inflation.

Generating cash flow that can *rise* with inflation is the fundamental challenge for these sorts of investors. Ordinarily, to produce a growing stream of cash from such portfolios, a substantial portion needs to be invested in equities.

Equity returns come to shareholders in two forms: dividends, paid from corporate earnings, and price appreciation in the form of capital gains when shares are sold. The combination of these two elements is known as “total return.” (Since 2004 these decidedly different forms of wealth creation have been treated the same for income tax purposes.)

Small, fast-growing, cash-starved companies generally pay very little, if any dividends. Distressed companies are unable to pay dividends, either. Larger, more mature companies are far more likely to pay a regular, quarterly dividend. The payout ratio (the percentage of earnings distributed as a dividend) varies by company and industry—as well as over time. The range can be anywhere between 25% and 65%.

Polar Opposites

One of the fascinating aspects of investing—and other compelling subjects—is how exceptionally smart and successful investors can have diametrically opposed views on fundamental questions. Take the role of dividends.

This month my inbox contained quarterly shareholder letters from two long-time money managers whose words are always great reads. Both discussed the value of dividends to investors and their views could not be farther apart.

Pay Me Now

Lowell Miller, President of Miller/Howard Investments (www.mhinvest.com) wrote *The Single Best Investment: Achieve Lasting Wealth with Low Risk, Steady Growth Stocks* (1999, Adams Media).

Summary: It's a Balancing Act

Lowell Miller and Curtis Jensen—veterans of the money management world—have recently sounded off on what role dividends play in portfolios. Their opinions represent opposite ends of the spectrum.

With such divergent advice being handed down from luminaries, our advice is simple: portfolios, like life, require balance.

Miller/Howard runs “income-equity” strategies, emphasizing stocks with relatively high—and growing—dividends.

In his 1st quarter review, Miller takes dead aim at today’s withdrawal-stage planning orthodoxy of investing for total return—consistent with one’s risk tolerance—and planning to withdraw at a sustained, inflation-adjusted rate. Miller’s concern with this strategy? Bear markets of five or even ten years can reduce a withdrawal portfolio past the point of no return.

Miller advocates, instead, investing primarily in “the right portfolio” of higher-yielding stocks and spending the income. With this strategy, there is a “qualitative difference between 1) total return and 2) a return made up of income plus appreciation. If you’re spending income, rather than total return, market fluctuations become irrelevant. As the dividend increases, eventually the price of the stock producing the dividend will increase as well.”

Pay Me Later or “Management Knows Best”

Curtis Jensen is the Co-Chief Investment Officer of Third Avenue Management and Portfolio Manager of the Third Avenue Small-Cap Value Fund (www.thirdavenuefunds.com). He is a protégé of eighty-three year-old Martin Whitman, Yale Professor Emeritus in Finance, who has been the manager of the Third Avenue Value Fund since 1986—and one of the great value managers. Third Avenue is a “deep value” shop and has been able to sidestep the classic—if not existential question—in finance: how do you use the dividend discount model to value the dividend stream of a company that pays no dividends? Among equity managers, Third Avenue has been successful by employing an entirely unique methodology for valuing companies.

In *his* 1st quarter letter, Jensen decries the “‘show me the money’ attitude of today’s investment landscape, as impatient shareholders agitate for more aggressive ‘returns of capital’—whether in the form of share buybacks or dividends.” Third Avenue’s “preference is for management to use excess resources in the business to grow the per share value of the business.”

An additional benefit to conserving the cash that would otherwise be paid in dividends is the maintenance of a strong balance sheet, providing a margin of safety for companies—a Third Avenue hallmark—in anticipation of difficult times.

The Virtues of Dividends

Dividends are a good way to separate the signal from the noise, both in the market and in individual companies:

- Payment of dividends causes companies to be *more* disciplined with remaining cash.
- Dividends are not subject to manipulation to the same degree as earnings.
- International companies tend to pay higher dividends than U.S. companies.
- Historically (e.g., prior to the bull market run-up in large-cap stocks in the late 1990s) reinvested dividends have accounted for half the total return of the S & P 500. With a current dividend yield

hovering around 1.8% the market may be signaling that total returns will be lower than average in the intermediate term.

Portfolio Composition

Dividends are only one “fundamental” screen utilized to identify value stocks. Russell uses several additional value characteristics to construct their value indexes. You can see from the chart that “value” has outperformed significantly over the past decade.

We also must compare apples to apples when considering dividend strategies and exclude from comparison high-yield/pass-through securities such as Utilities, REITs and Master Limited Partnerships. These can be owned in appropriate portions in a portfolio separately from the core equity strategy.

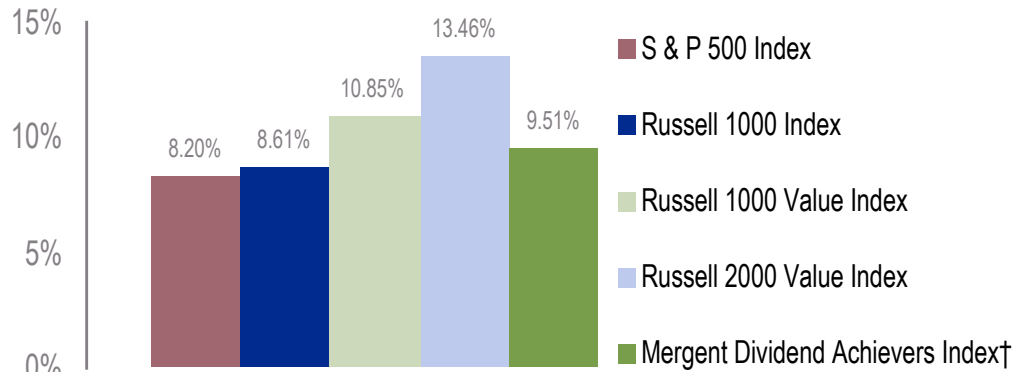
It is difficult for me to conclude that there is a “single” best investment. That said, populating a withdrawal portfolio with dividend paying securities is an excellent idea—among many—for generating cash flow.

Portfolio decisions have trade-offs. There are many good and useful asset classes, with different characteristics, the combination of which comprise the building blocks of a sound portfolio. No one type or style of investment is a panacea or can be relied upon to fulfill a portfolio strategy. As the Uniform Prudent Investor Act suggests, “no particular...type of investment is inherently imprudent. Investment decisions...must be evaluated in the context of the...portfolio as a whole and as part of an overall investment strategy.”

Portfolios are infinitely divisible by nature. We should hold some bonds and some cash. On balance—and this *is* a balancing act—it seems best to combine tactics into a strategic whole.

Note: Specific investments or resources mentioned are illustrations only and are not recommendations. Past performance does not guarantee future results.

Dividend's or Not? Sample Returns*



* Returns shown are 10 years through 3/31/2007.

† Broad market index of companies that historically increase dividends on a regular basis.

Note: The standard deviation of the S & P 500 over the period was 15.20% vs.12.81% for the Dividend Achievers, demonstrating the latter’s fairly strong *risk adjusted* return.