MICHIGAN LAWYERS WEEKLY

www.milawyersweekly.com

Vol. 25, No. 21

April 4, 2011

THE DOLAN COMPANY

MICHIGAN LAWYERS WEEKLY focus on Banking & Finance

Dividend Investing

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It is easy to lose focus as an investor. While everyone recognizes the need to maintain a long-term perspective, almost every bit of information we hear is short-term in nature.

In reality, there are only two ways to earn a return on your money. You can make a profit from the appreciation of an investment, or by receiving a distribution on the investment. If you own stock, the growth is considered a capital gain and the distribution is called a dividend.

Historically, dividends have accounted for almost half of shareholder returns. Until the 1980s, it was common for many companies to distribute more than 50 percent of their income in the form of dividends.

With the start of the bull market in the '80s, investors became increasingly comfortable receiving their return through price appreciation. With returns consistently averaging double digits, the importance of dividends was lost, and management focused on building shareholder wealth through business reinvestment, stock repurchases and acquisitions.

A number of divergent factors are leading investors to refocus on dividend paying companies — including low interest rates, reduced return expectations, an aging population, and a lingering distrust of Wall Street.

Investors need income and corporations are well positioned to provide it. According to Barclays Capital, corporate cash balances are at levels not seen since the early 1960s and represent close to 7 percent of liquid assets.

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Corporations are listening to investors and beginning to respond. According to Nuveen Investments, in 2010 there were 243 companies in the S&P 500 that increased dividends, compared to 151 in 2009. This represents a 60 percent increase, while only five companies decreased dividends (compared to 78 in 2009). In addition, 13 companies paid a dividend for the first time, compared to only six in 2009.

When a company commits to paying or raising a dividend, it demonstrates management's confidence in the financial strength of the company. Management recognizes that a dividend is a type of corporate tattoo. Once initiated, it is extremely painful to remove.

Few things can arouse more shareholder anger than a reduction or elimination of the dividend. A natural benefit of a strong commitment to dividends is that corporate discipline is instilled since, prior to any major financial decision, management must consider the potential impact on the dividend.

From the investor perspective, it is important to focus on more than just the current yield of stock, which is calculated by dividing the dividend by the stock price. While the yield is the logical starting point, there are a number of additional factors that need to be considered prior to investing.

What are the general prospects for the company and its industry? Is the dividend payout ratio (the percentage of dividends paid as a percentage of earnings) sufficient to sustain the dividend? Has the company demonstrated a commitment to growing its dividend?

Building a portfolio of dividend paying stocks has long been recognized as a conservative investment strategy. In the past year, there have been investment white papers by Ridgeworth Investments, Oppenheimer Funds and Nuveen Investments that have focused primarily on the benefits of investing in companies that have a track record of consistently raising their dividends.

Relying on data provided by Ned Davis

Company	Symbol	Current Yield 3-21-11	Closing Price 3-21-11	Number of Consecutive Dividend Increases
Procter & Gamble	PG	3.10%	$61.30	54 Years
Coca-Cola	KO	2.90%	$63.57	49 Years
McDonald's	MCD	3.20%	$73.76	34 Years
Exxon Mobil	XOM	2.10%	$82.84	28 Years

Research, Inc., the most important conclusion was that, since February 1972, in addition to experiencing lower volatility, investors in companies that increased their dividend each year outperformed non-dividend payers and the market as a whole. Of course, past performance is not a guarantee of future results.

There are a number of companies that have demonstrated a commitment to raising their dividend each year. The Dividend Aristocrats is a list of all of the companies in the S&P 500 Index that have raised their dividend for at least 25 consecutive years. There are 42 companies that currently meet this standard.

The most comprehensive list of all publically traded companies that have increased their dividends each year is compiled each month by David Fish, the publisher of *The Moneypaper*. According to Fish, there are 97 publicly traded companies that have raised dividends for more than 25 consecutive years and 131 companies that have raised dividends for more than 10 years but less than 25 years.

An additional benefit of dividend investing is that they receive preferential treatment under the tax code. As a result, it is important to consider the after-tax benefit of any distribution.

Since 2003, most dividends are taxed at 15 percent, the same tax rate as capital gains. Taxable interest is taxed based upon the investor's marginal tax rate and can be as high as 35 percent for taxpayers in the highest tax bracket. This means that a 4 percent stock dividend results in the same amount after-tax yield as a 5.23 percent interest payment.

"Thou shall not spend principal" would certainly be near the top of the Ten Commandments of Investing. With interest rates at record lows, living off of traditional sources of income such as Certificate of Deposits and bonds has become all but impossible.

It makes sense for investors to make stocks, with a history of raising their distribution, the foundation of their investment portfolio. In addition to generating excellent cash flow, these companies have historically provided above average returns with lower volatility.

BIOGRAPHY

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