

# DIVIDENDS

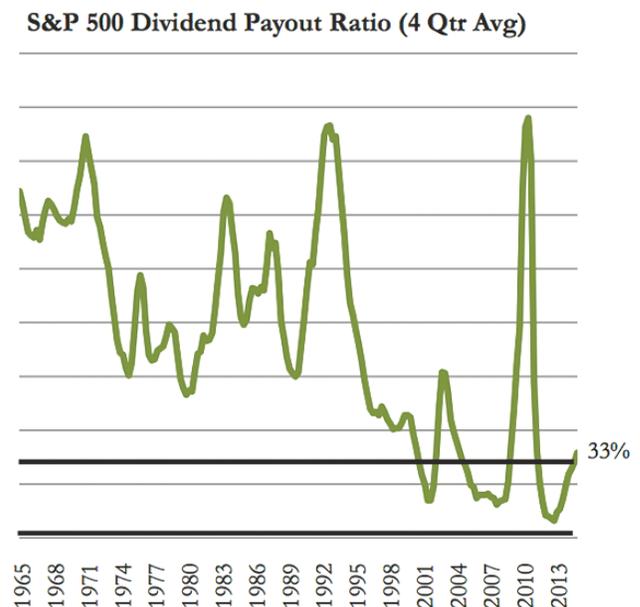
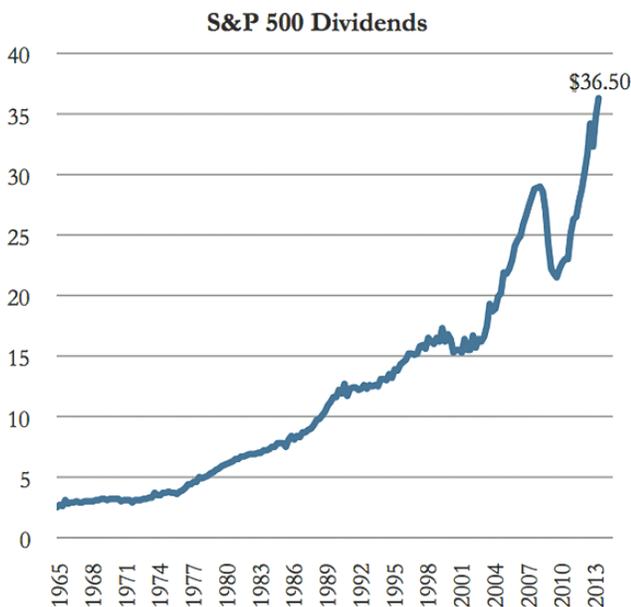
## WILL THE PENDULUM SWING TOWARD A HIGHER PAYOUT RATIO?



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At Crawford Investment Counsel we are intensely interested in companies that pay dividends, and even more focused on those that raise their dividends on a consistent basis. Consequently, we keep a close eye on the dividend payout ratio, or the amount of earnings that companies return to shareholders in the form of cash dividends. In addition to identifying companies for investment, we are always looking for clues about the future actions of Corporate America with regard to their dividend practices. Currently, we believe dividends are likely to be rising as a percentage of corporate profits, a trend that we expect to be supportive of stock prices in general.

Each company that pays a dividend has its own payout ratio, and we typically favor those companies with progressive capital allocation practices. Corporate America, which in our discussion will be represented by the Standard and Poor's 500 (S&P 500), has become more focused on returning capital to shareholders. A glance at the two charts below and a few historical facts will put the current payout ratio in perspective.



Source: ISI Group, LLC  
Time Period: 3/31/1965 - 9/30/2013

Notice that the chart on the left indicates that dividends now being paid by S&P 500 companies are at an all time high. Yet, the chart on the right shows that the payout ratio resides near an all time low in percentage terms. There seems to be a disconnect between the two charts, so let's consider several factors that may be informative.

It is necessary to think back a few years and consider the effect of the Great Recession of 2007-2009 on the earnings

and dividends of companies. Operating earnings dropped by some 46% over the two years of 2007 and 2008. As a result, many dividends were either reduced or eliminated, especially among the large banks that almost went out of business and were forced to suspend dividends altogether. Other large companies, especially those that were peripherally involved in the finance sector, like GE, also reduced their dividends. During this period, all corporate management teams were very cautious, and while there was a group that maintained

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or raised their dividends, the rates of increase were lower than normal. The result was a dramatic drop in the payout ratio from 57% in 2008 to a low of 27% in 2010. Then, when earnings began their somewhat spectacular rebound in 2009, dividend gains just could not keep up. As an example, in the three years 2010 through 2012, operating earnings of the S&P 500 increased by 85%, while dividends increased at a very respectable, but far less impressive rate of 38%. This further reduced the payout ratio.

It may be helpful to consider factors that are affecting dividend payments. Dividends can only come from one place: the cash flow of the company. Yet, there are other competing needs for cash flow, namely, capital spending and stock buybacks. These three choices are all somewhat discretionary, and will reflect the capital allocation policy of a company. Capital spending needs have been subdued in recent years, mainly because capacity utilization is less than full. This has left the bulk of cash flow to be used for dividends and stock buybacks. In the trade-off between the two, dividends may be at a disadvantage to stock buybacks for several reasons. First, when a dividend is declared it is sending a message about management's vision of the future. Cutting a dividend is one of the last things a company wants to do for it sends a poor signal about the current and expected results of the company. As such, this risk is an inhibiting factor in the raising of dividends. Second, there is more flexibility in stock buybacks. Once authorized, there is no mandatory completion of them. The buyback becomes discretionary and affords management much more flexibility than the dividend does. Third, the buyback can be used as a means of increasing earnings, and in the view of management may be a better way to increase the price of the stock. For these and other reasons, more cash flow has been targeted for stock buybacks than for dividends.

One other factor should be noted. Many companies have expanded their businesses globally, and while foreign

earnings become a part of their earnings per share, those earnings in many cases remain overseas in order to avoid repatriation taxes. So while they expand earnings, foreign earnings may not be available for dividends. This factor tends to subdue the payout ratio.

While our preference is for dividends and especially consistently rising dividends, we appreciate the value of buybacks, and favor companies that are doing both. One advantage that the dividend may have over stock buybacks is the fact that bond yields are so low currently, that in many cases there is a yield advantage to the dividend-paying stock. It is not that difficult to find any number of stocks that yield at a higher level than bonds, and have the added prospect of higher yields in the future due to dividend increases.

One of the tried and true investment maxims is reversion to the mean. This principle rests on the assumption that all investments follow cycles, swinging to overvaluation or undervaluation, but in the end cycle back to the historical mean. Dividend payout ratios are clearly below the historical mean. We would expect the payout ratio to gradually return to more normal levels, if not to the mean, because of the reasons we have discussed. There appears to be a growing constituency of shareholders who are desirous of higher dividends. Their wishes are likely to be heard. Furthermore, as large banks continue to recover they will eventually be allowed to restore their dividends. And as earnings and dividends continue moving into higher ground, as expected, even if dividends do not get the lion's share of cash flow, they will participate with higher payouts.

All things considered, the payout ratio seems too low. As it moves higher it is likely to support higher stock prices, and at least act as somewhat of a floor under them. Dividends and dividend growth have been major contributors to common stock total returns in the past, and we expect the same to be true in the future.

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