Crawford Investment Counsel

Environment For Dividend Investing

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DIVIDEND ENVIRONMENT AND OUTLOOK

» Companies that pay dividends, especially those that raise their dividends on a consistent basis, are a primary focus at Crawford Investment Counsel. Consequently, we keep a close eye on dividend-related metrics in the broader market as we look for clues about the future actions of Corporate America and its dividend practices.

» We believe dividends are likely to rise as companies continue to achieve both higher profit levels and allocate a larger portion of those profits to shareholders. When combined, increases in these two factors can lead to growth in dividend levels at a higher rate than growth in company earnings.

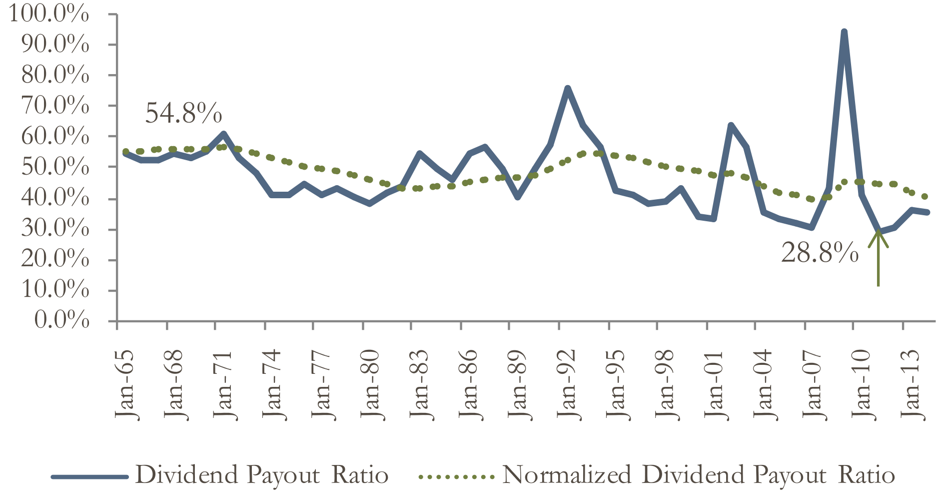
» Throughout the following slides we examine several historical metrics related to dividends and the companies who pay them within the Standard and Poor's 500 ("S&P 500"), which is representative of Corporate America. The metrics we look at include the dividend payout ratio, dividend yield, Treasury bond yields, cash on balance sheets, and corporate profits. We also include information on share repurchases, another form of return of capital to shareholders.

DIVIDEND PAYOUT RATIO: ROOM TO RISE

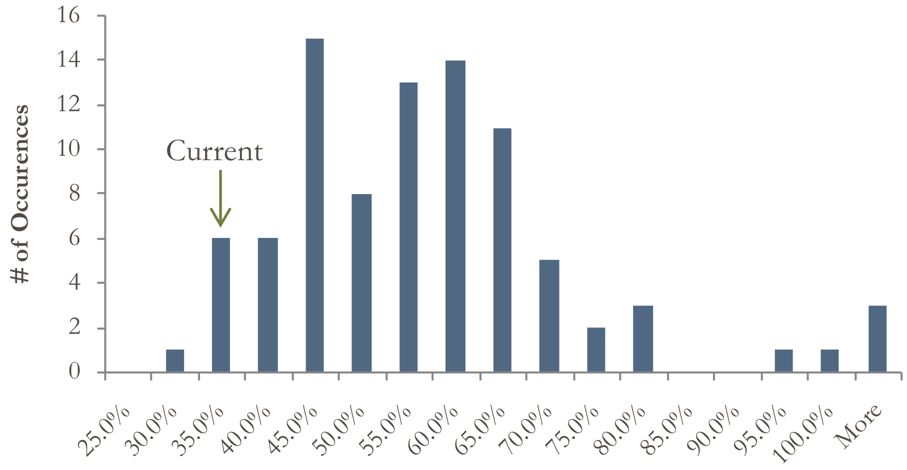
Dividend Payout Ratio = Dividends Per Share / Earnings Per Share

Measures the percentage of earnings a company pays out in dividends

S&P 500 Dividend Payout Ratio



S&P 500 Dividend Payout Distribution (1926-2013)



» **Investment Implications:** Since 1965, the payout ratio has fallen from 54.8% to 28.8% but has since risen to **35.9%*** after the Great Recession. Despite the recent increase, dividends still have substantial room to rise.

» **Current vs. Potential**: Considering the extreme lows we have seen recently in the dividend payout ratio, it is very possible that dividend growth could exceed earnings per share growth over the next decade. Our focus on robust dividend-growing companies could benefit from this rising trend in dividend payouts.

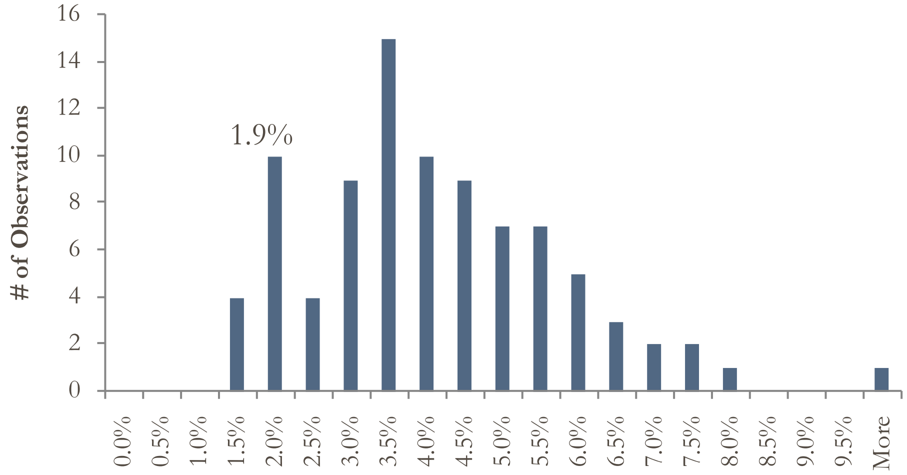
Source: Standard & Poor's, Shiller (As of 12/31/2013)

Low Dividend Yield and Low Income Returns

Dividend Yield = Dividends Per Share / Stock Price

Measures the income component of return for a stock

S&P 500 Dividend Yield Distribution (1926-2013)



Summary Statistics of Annual Returns of Large Cap Stocks

1825-2013	Return %	Standard Deviation %
Total Return	8.6%	18.3%
Income Return	5.0%	2.0%
Capital Appreciation	3.4%	17.9%

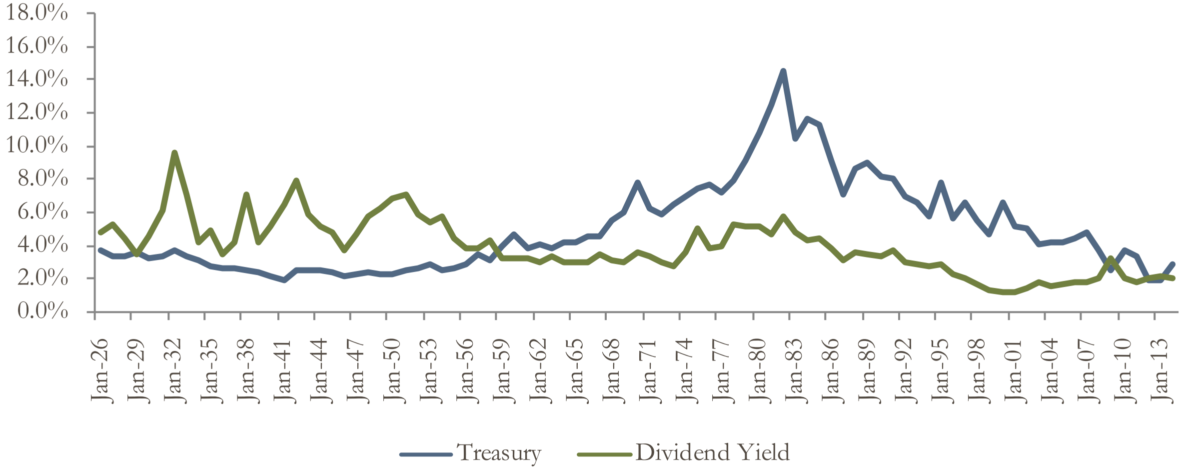
1926-2013	Return %	Standard Deviation %
Total Return	10.1%	20.2%
Income Return	4.0%	1.6%
Capital Appreciation	5.8%	19.5%

» **Investment Implications:** The S&P500 current dividend yield of 1.9% is on the low end of the historical range, reflecting the low dividend payout ratio, low inflation, and low interest rates in the current economic environment. Under this criteria alone, stock valuations are at the upper end of their historical range.

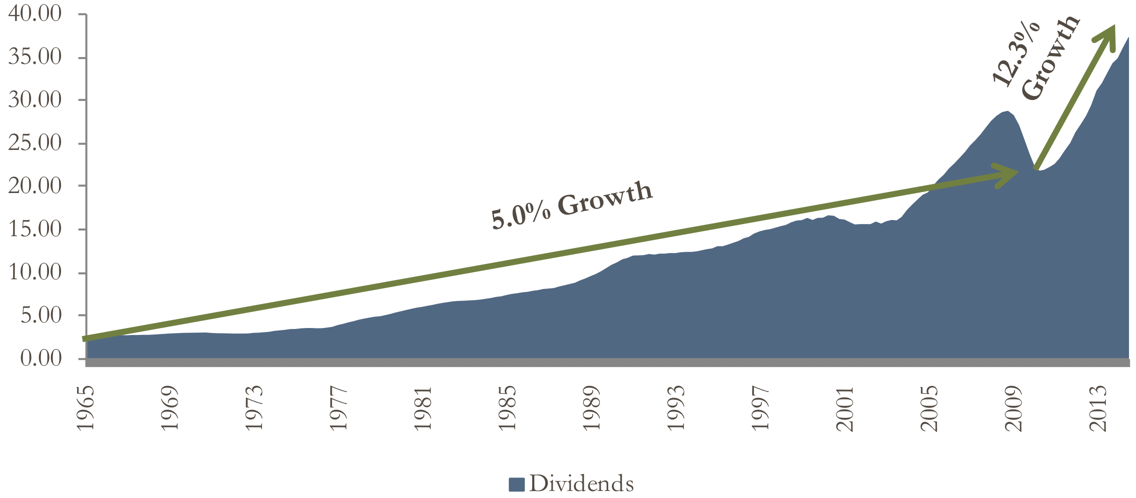
» **Low Income Returns:** Historically, returns from dividends have been a higher component of total investment return, relative to capital appreciation. This trend has shifted in the last century toward a larger component of total returns resulting from capital appreciation. This lower share of returns attributable to dividends is consistent with low payout ratios and could be enhanced by possible increases of dividends in the coming years.

WILL HIGHER DIVIDENDS FOLLOW?

S&P 500 Dividend Yield vs. U.S. Treasury 10 Year Yield



S&P 500 Dividend History



» **Dividend Yields vs. 10-year Treasury**: 10 year Treasury bond yields have exceeded dividend yields for the last 50 years until recently. Currently, the difference between the two is very narrow.

» **Investment Implications:** Stocks offer reasonable income as compared to bonds while also providing potential for dividend growth and capital appreciation. Bonds do not offer room for growth in income as they provide fixed payments.

» **Growth in Dividends**: The S&P 500 had annual dividend growth of 5.0% from 1965 through 2010. Since 2010, dividend payments have recovered and increased at over 12% annually. This improvement in the dividend return is before capital returns and it reinforces the potential for a continuation of higher dividends in the coming periods.

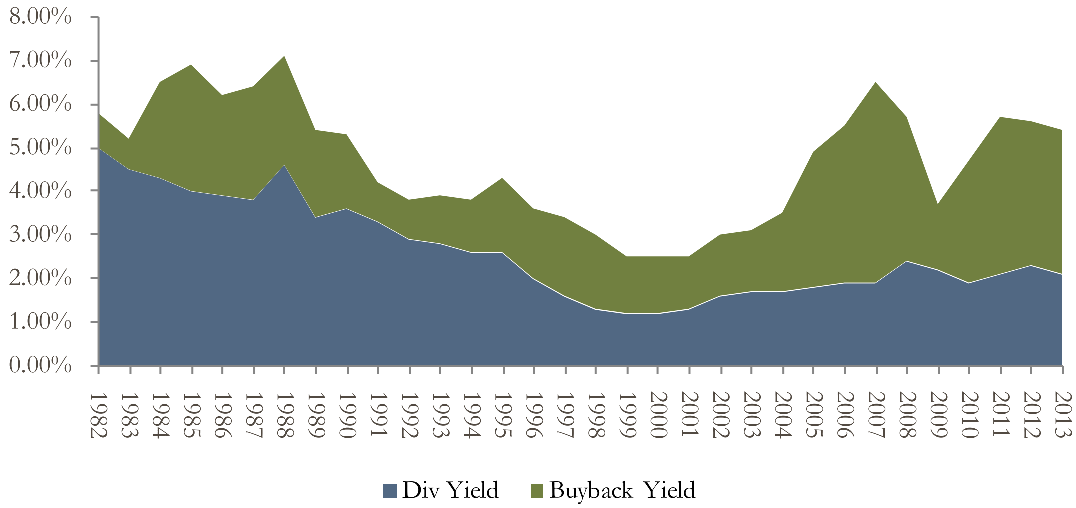
Source: Standard & Poor's, Shiller (As of 06/30/2014)

RISING TOTAL SHAREHOLDER YIELDS AND CASH ON BALANCE SHEETS

Total Shareholder Yield = Dividend Yield + Buyback Yield

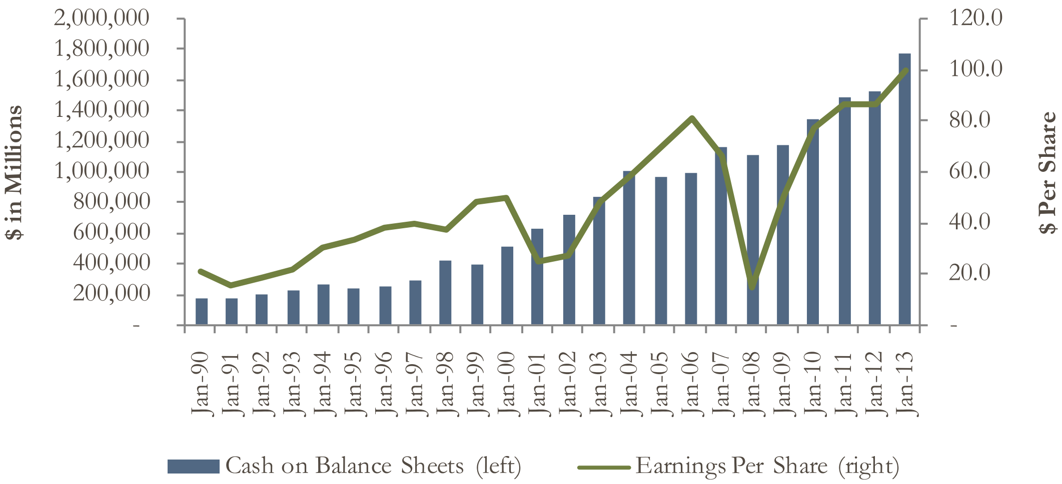
Measures the total cash returned to shareholders in the form of dividends and buybacks

S&P 500 Total Shareholder Yield



» **Investment Implications:** Share buybacks are an important part of the capital allocation process. The recent rise in share buybacks after the Tech bubble suggests that the dividend payout ratio may not get back to peak levels, but it shows healthy corporate returns of capital to shareholders. We expect the shareholder yield to remain at a healthy level, given the emphasis and corporate priority of returning cash to shareholders.

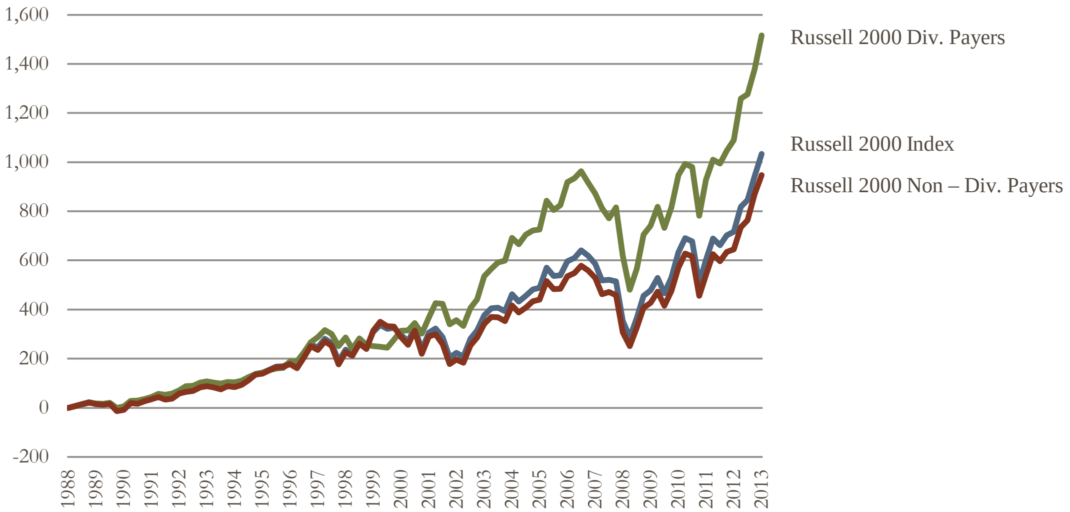
S&P 500 Cash on Corporate Balance Sheets and EPS



» **Investment Implications:** Investors can monitor the level of cash and corporate profits generated by Corporate America. Cash on corporate balance sheets and earnings per share are at all time highs. Both of these measure the financial health of corporate entities and indicate that **Corporate America has a healthy capacity to begin seriously returning capital to shareholders.**

The Performance of Dividends

» **Investment Implications:** The performance of the S&P 500 Index stocks, grouped by their dividend policy, highlights the benefit of investing in dividends over a long period of time. We believe the dividend policy is a strong indicator of financial strength and a company's ability to preserve capital. Over time, these companies have provided attractive risk-adjusted returns.



» **Investment Implications:** The benefit of investing in dividends is also true for smaller companies. The performance of the dividend paying companies within the Russell 2000 Index supports the dividend performance premium over time.

Source: Ned Davis Research - Monthly Data 1/31/1972 - 6/30/2014 (Log Scale)
Source: Russell, Crawford (As of 12/31/2013)

Key Takeaways

» The dividend payout ratio is close to historic lows. Considering the low current levels of the dividend payout ratio and the current upward trend in the ratio, there is good potential for dividend growth.

» The dividend yield is also near historic lows and has recently comprised a lower portion of total return than in previous periods. These low yields imply that dividends could normalize to higher levels in the future as markets succumb to mean reverting.

» The dividend yield and the 10 year Treasury yield have converged post-crisis. This is a reversal of Treasury's higher yield than the dividend for almost 50 years. Additionally, dividend growth post-crisis has grown at an above average rate of 12%. The continuation of both of these trends would produce more normal, higher dividend yields in the future.

» Corporate profits and cash accumulation are at record highs and total shareholder returns have followed by ascending close to peak levels. The combination of these two factors means more capital is returning to shareholders. However, post-crisis the total return has been comprised more of share buybacks. Despite this composition, we note that dividends still have room to rise before they return to pre-crisis levels.

» Dividends have played a meaningful role in the return of the stock market over long periods of time. Companies committed to their dividend policy have performed well on a relative basis. These companies, both big and small, have also provided downside protection during periods of market turbulence.

SOURCES

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3. Callahan, Dan and Mauboussin, Michael. (2013, May 6). "Disbursing Cash to Shareholders." Credit Suisse. Retrieved from https://plus.credit-suisse.com/researchplus/ravDocView?docid=udm5cr

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