Why Dividends Matter

Stock Price Appreciation

CRAWFORD
INVESTMENT COUNSEL
-EST. 1980-

SEPTEMBER 2013

Looking for a way to invest where the odds are in your favor, and in which you are, in our opinion, almost assured of investment success?

We believe we have one, but in order to make it work you will have to be a patient, long-term investor in high-quality stocks. Furthermore, it's our belief you will be better off if you ignore the shorter-term issues of the economy or markets. Investors cannot totally ignore the realities of the world around them, but with this approach one will be better served to leave out the "tinkering" that comes with trying too hard to succeed in the stock investment game. One of the characteristics of this approach is its simplicity. Anyone can understand it; perhaps this is why so few embrace it.

> ***This investment approach... is not for the investor who requires "action" or who is trying to "beat the market" every year.***

By way of an explanation of this method of investing, let's start with financial theory. It states that the value of any asset is determined by the present value of all of its future cash flows. In the case of stocks, those future cash flows are dividends, the tangible return that an investor receives over the life of the asset. Most investors focus on earnings, not dividends; but keep in mind that earnings are not returned to stockholders; dividends are. We do not underestimate the value of earnings, for we recognize that they are the stuff of which dividends are created.

Taking financial theory further, the value of a stock is not only determined by the earnings and the dividend, but also by what investors are willing to pay for the earnings and dividends (price-to-earnings ratio). The dividend is therefore one of three elements that creates value in a stock. If the dividend increases, theoretically, the value of the stock should increase, all things being equal. A consistently rising dividend should lift the price of a stock over time.

Three elements create value:

- Company earnings
- Dividends
- Multiple on earnings and dividends (P/E ratio)

Turning from theory to practice, consider the purchase of a stock. Let's use Coca Cola (KO) as an example. Today the stock may be purchased for $40 per share. It pays a quarterly dividend of 28 cents per share, or $1.12 per year. This provides a dividend yield of 2.8%. For the sake of simplicity, let's say that the price-to-earnings multiple on next twelve months earnings is 20.

Remember, we stated that the investor using our approach must be willing to invest in high quality companies. Quality is often characterized by consistency of earnings and dividends, and KO qualifies on this score. It is doubtful that anyone would contest the high-quality nature of KO.

What is special about an investment in KO shares? Nothing really, except that KO is a world-class company whose business is rooted in consumer behavior and whose reach is so global that we believe it is likely to have a bright future. Let's consider the last ten years. KO grew its earnings at a compound rate of 9.3% over this period, and grew its dividend at 9.8%, almost exactly the same. The payout ratio, the percentage of earnings that is paid out in dividends, is roughly 50%, a level that has been maintained with consistency over the ten-year period. One would also be interested to learn that KO has increased its dividend each year for more than 40 years.

Now, look forward and assume that KO can continue to expand its business in roughly the same fashion as it did over the last ten years. Just to be conservative, let's assume that the dividend can only be increased by 8% per year. This could mean that the current dividend of $1.12 per share could be expanded to $2.40. This simple calculation demonstrates the power of compounding, which Albert Einstein called "man's greatest discovery". At this point the yield on the original cost of $40 could have gone from 2.8% to 6.0%. Can you see how the stock price of KO might be worth a lot more because of all of the income that it is throwing off in the form of dividends? In other words, KO shares are not likely to trade at a 6% yield, unless the investment world has been turned completely on its ear.

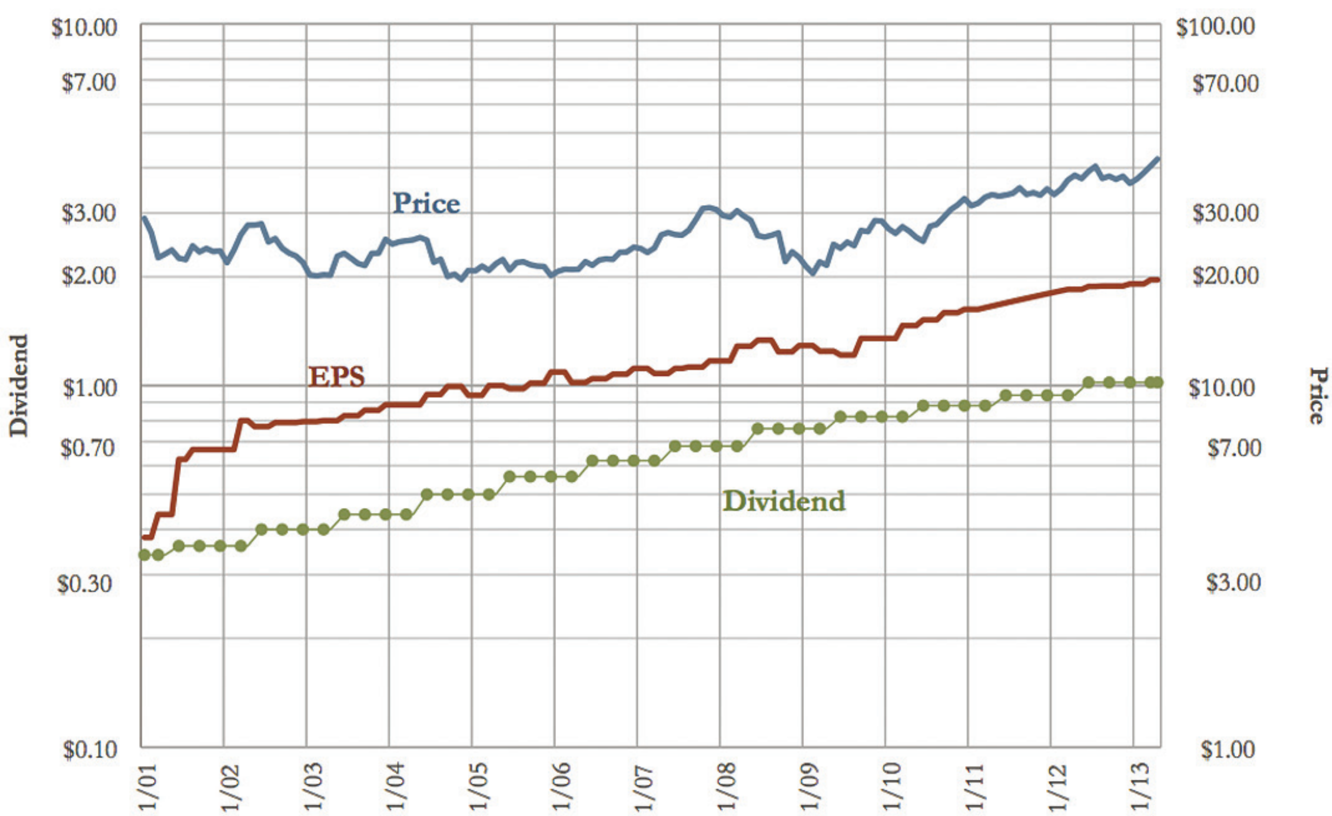
Based on this example we cannot predict at what price KO shares would trade, because it would depend on what multiple investors would be willing to put on its earnings, where interest rates are, how investors feel about the longer-term outlook for KO, and to a lesser extent, how the global economy is performing. But, there is such a vast difference between a 2.8% yield and a 6.0% yield that KO shares are likely to be trading higher.

We produce the chart below to graphically illustrate the process. Note how the earnings and dividend lines parallel each other. This is the consistent payout ratio noted above. The price of KO stock, when looked at in relation to its earnings, has experienced volatility. This has to be expected; for no matter how consistent a business might be, stocks are stocks, and they never follow perfectly in line with earnings and dividend growth. In fact, the valuation on KO shares has contracted slightly over the period, but the price has still been driven higher.

One can see from the example that a consistently rising dividend can be a factor in driving the price of a stock upward. In fact, in our opinion it may be the most powerful factor. We like to call a rising dividend the "silent factor" in the portfolio. Its impact over the short term is minimal, and therefore goes unnoticed by many. But the slow, consistent buildup of dollars being thrown off by the dividend seeps into the price of the stock over time. Jeremy Siegel, noted author, professor, and market commentator says it well: "The importance of dividends in generating stock returns is not just historical happenstance. Dividends are the crucial link between corporate profits and stock prices."[1] Yes, earnings are the stuff of dividends, and rising dividends are the stuff of price appreciation.

Most likely, some readers are responding by saying, yes, this will work in KO, but you have cherry picked the best, and there are not that many stocks like KO. How likely might one be to choose a portfolio of stocks like KO? We admit that KO is a sterling example, but we also know that there are about 200 publicly traded companies that have raised their dividends in each of the last ten years, at least. It's our belief that using this criterion, one could have just as easily invested successfully in Procter and Gamble, Wal-Mart, Genuine Parts, Johnson and Johnson, McDonalds,

Coca Cola



Source: FactSet

[1]Jeremy Siegel

Exxon Mobil, United Technologies, Intel, IBM, and Texas Instruments, just to name a few.

How should one look at this type of investing? As stated earlier, it requires patience, discipline, and a longer time horizon. It is not for the investor who requires "action" or who is trying to "beat the market" every year. It is tax efficient, for the turnover is obviously very low, and it takes time for the dividends and dividend growth to positively affect the prices of the stocks. But as in the KO example, it is our belief it will happen over time. It is also our belief that it is a less risky approach to investing because of its focus on very high quality companies and its dependence on dividends. Dividends are real and known, therefore any dividend-based strategy is likely to be less chancy than one based on "growth" or "concepts".

We started this paper with the claim that we have an investment approach that is almost assured of success if employed properly. That is a very strong claim, but we stand by it. In our opinion, steadily rising dividends in high quality companies are likely to eventually drive the prices of these stocks upward. Dividends, especially those that increase on a consistent basis, have attractive features, not the least of which is the ability to provide appreciation in the value of a stock over time.

CRAWFORD INVESTMENT COUNSEL, INC.

600 Galleria Parkway, Suite 1650, Atlanta, Georgia 30339

(770) 859-0045

www.CrawfordInvestment.com