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Cheat Sheet: Dividends

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By Steven Taddie

WHEN CONSIDERING INVESTING in stocks, one usually thinks about capital appreciation-you know, buy low and sell high. Instead of approaching investing from this trading mentality, think about it from the perspective of a small business owner who seeks to balance the need for income to support a family, with the desire for long-term growth of capital. This perspective has proven to be quite useful when investing in the stock market... it's not all about growth.

For investors, dividends create a positive cash flow, which has historically helped individuals meet current income needs, served to stabilize investment portfolios, and contributed handsomely to the overall return of stock portfolios. During the boom of the '80s and '90s, dividends fell out of favor as the spotlight focused on growth rather than income. The market meltdown of the last few years has reinforced the importance of dividends as a component of an investment's total return.

Dividends, which are typically a cash payment to shareholders, are independent of a stock's price. They are paid when companies are profitable, and decide to return a portion of net earnings to the owners (i.e. shareholders) rather than reinvest in the business. Shareholders typically receive dividends on a quarterly basis, after senior obligations of the corporation have been met. The dividend rate can be raised or lowered by the company depending on the success of their operation. The dividend yields of common stocks can range from 0% to 12%, but typically average between 1% and 3%. They are an important part of total return when stock markets are going up, and an important part of mitigating losses when markets are going down.

For example, suppose that you bought Peoples Energy Corporation common stock (NYSE: PGL) in July 2002 at \$30 per share. PGL pays a \$2.10 dividend (52 ½ cents per quarter), which at the time of purchase equated to a 7% yield-\$2.10 divided by \$30-on an annual basis. If you sold it in April 2003 at \$35, you would have a \$5 capital gain on the sale, plus three dividend payments totaling \$1.575 (52 ½ cents multiplied by three), for a total gain of \$6.57 or about 22%. Without the dividend, your return would have been about 16.5%.

If instead, you bought PGL in April 2002 at \$39 per share, with the same \$2.10 dividend, which at the time of purchase equated to a 5.4% yield, and sold it today at \$35 per share, your return numbers would be different. You would have a \$4 capital loss on the sale, plus all four quarterly dividend payments (52 ½ cents) totaling \$2.10, for a total loss of \$1.90 or about 5%. Without the dividend, your loss would have been about 10%.

As the above example shows, the longer you hold dividend-paying stocks, the more dividends you receive-and the more important that dividend can become in determining your total rate of return. If the dividend is increased during your holding period, the contribution to return may be higher, or the mitigation of loss lower. (In both the examples, commission costs, which vary from firm to firm, were excluded.)

The statistics support the power of dividends. Between 1928 and 2001, annualized returns for the S&P 500, including dividends, were 10.34%. Excluding dividends, annualized returns were 8%; meaning investors received a 2.34% cash flow plus appreciation. In addition, a study performed by Standard & Poor's showed that dividend paying companies in the S&P 500 out-performed non-dividend payers in 2002, declining approximately 18.4% versus non-dividend paying stocks, which declined 30.3%. Empirical data shows that portfolios of dividend paying securities exhibit less volatility than those constructed with non-dividend paying securities. This should come as no surprise.



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Dividends have also proven to be a steady source of income. A Northern Trust study covering the period of 1926 to 2001 reveals that dividends accounted for 1.1% to 8.3% return. The standard deviation associated with this return was a mere 1.5, meaning that 66% of the time, a portfolio constructed with a 4.4% yield would have realized dividends between 2.9% and 5.9%, thus providing a very stable flow of income. During this period, dividends were rising, so the standard deviation mostly reflects the result of dividend increases rather than reductions, thus the bell curve of the study was likely positively skewed.

Dividend paying stocks also offer a strategic benefit versus bonds in today's environment. With the 10-year Treasury yield at close to 40-year lows, many stocks offer dividend yields that are close to, or even higher than, the 10-year Treasury rate. While stocks carry more principal risk than bonds, they also have the potential to pay increasing dividends and the potential for capital appreciation as a company's earnings improve. By contrast, capital appreciation in bonds generally occurs only if interest rates decline or the issuers' credit rating is upgraded, and is generally limited by the maturity of the bond. In addition, most bonds do not have the ability to pay increasing interest payments.

Recently, President Bush announced his desire to put an end to the double taxation of dividends. (Dividends are currently taxed twice, once as corporate earnings and a second time as income received by the investor.) While this proposal may be a long way from becoming law, outside of the basic fairness issues, there is debate on the application of the law as it relates to which type of dividends would be tax-free as well.

There are often significant changes made to proposals in an effort to broaden their appeal and improve the chances of it becoming law. So much so, that any detailed analysis regarding proposed tax treatment is likely to be outdated as soon as the ink is dry. It should suffice to say, any loosening of the tax law as it relates to dividends will most likely be a positive for stocks, and provide one more reason to own a dividend paying stock.

Positive cash flow is the source of a dividend's power as it enhances "total return," reduces "portfolio volatility" and provides "reliable income" for the investor to spend or reinvest. In addition, a cash dividend provides a reality check for investors concerned about creative accounting practices, as it is tough to fake a dividend payment.

Again, think about investing from the perspective of a small business owner, who wants to receive a reliable return on investment and a balance of income and growth. If you tilt the financial structure of your firm too heavily towards growth or income, you are likely to increase the risk of your business... it's the same with investing. The goal of any investment, whether it is a business, bonds, stocks or real estate, is to generate an attractive return on investment, which includes both appreciation and income.

Stephen Taddie (staddie@stellarmgt.com) is managing member of Stellar Capital Management, a Phoenix-based investment management firm with a successful 18-year track record of custom tailored portfolio management.

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