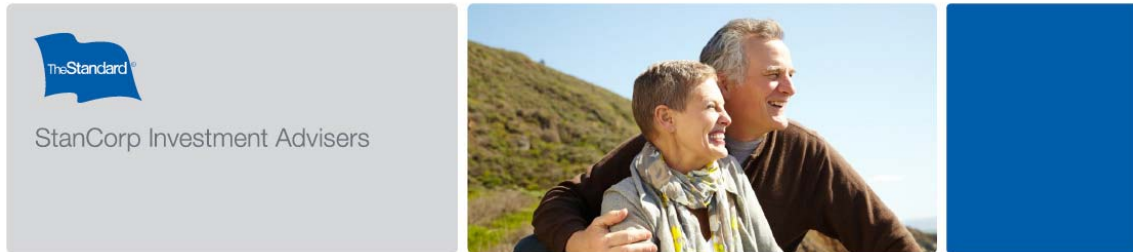


# A New Era for Dividends?

October 2011

Kent Bartell, CFA<sup>®</sup>

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Before World War II, dividends were far more important to U.S. investors than they are now. Back then, investors expected regular dividend payments and companies complied. From 1871 through 1948, average dividend yields generally ranged from 5-7%, according to data compiled by Robert Shiller (*Irrational Exuberance*, 2000). This is far higher than most companies pay today. According to Standard and Poor's, the average yield for the S&P 500 Index is currently 2.39% as of September 30, 2011, less than half of the 5-7% that investors could reasonably expect a half century ago. Over time investor preference shifted away from dividends and towards capital appreciation, allowing companies to reinvest profits for future growth. So what caused this shift in investor preference? We believe that it was a rational response to the exceptional growth opportunities available during that time.

## **Post World War II Expansion**

Following World War II, the U.S. experienced historic economic expansion. Pent-up consumer demand, the need to rebuild Europe, and the continuation of military spending in order to fight the Cold War jump-started the economy. The initial wave of economic growth was reinforced by a population becoming increasingly optimistic about the future. The U.S. saw a significant jump in post-war births, which created additional consumers and an increased need for housing. Businesses consolidated and became more efficient. Labor was also able to win its share of the economic gains, catapulting a larger percentage of citizens into the middle class. The burgeoning middle class further bolstered the economy, creating a virtuous cycle of economic growth. The U.S. economy, as measured by real (in excess of inflation) growth in Gross Domestic Product (GDP), grew an average of 3.6% per year from 1948 through 2000. (U.S. Department of Commerce, BEA)

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Throughout this economic expansion, attitudes about dividends changed. Companies and investors correctly concluded that dividend payments were often counterproductive. Under U.S. tax law, if businesses earn profits and pay dividends, the profits are effectively taxed twice—once at the corporate level and then again at the investor level once they are paid out in the form of dividends. Therefore, if a company has significant growth prospects and needs cash to take advantage of those opportunities, it is often better to reinvest profits directly. The alternative is to make a taxable dividend payment and then raise money by issuing additional stock or more debt, a more costly choice for all parties involved.

When a company decides not to pay a regular dividend, it signals investors that it can reinvest that cash more effectively than the investor could on their own. Investors who believe in the growth potential of the business and trust the leaders are now content to forgo regular dividend payments in exchange for the prospect of significant capital gains. Many companies, such as Berkshire Hathaway and Microsoft, built substantial value for their investors during the latter part of the 20th century almost exclusively through capital appreciation. These examples, along with many others, convinced investors that capital appreciation was the best form of wealth creation during that time.

## **Attitude Shift**

So far, the 21st century has not been as kind to the U.S. as the previous one was. Economic growth slowed substantially after 2000. Annual real GDP growth, which had averaged 3.6% for the prior five decades, slowed to an average of 1.6% for 2001 through 2010, far below our prior experience during the worst ten-year stretch of the post World War II expansion. (U.S. Department of Commerce, BEA)

The immediate future does not look much brighter. In contrast to the expansion days of old, we seem to be combating headwinds rather than tailwinds. We are now faced with likely European contraction as opposed to rebuilding. The Cold War is over and military spending is coming under pressure due to increased calls for deficit reduction. People born in the post-war boom have grown up and are now looking to retire. Increased foreign competition has

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prevented labor from participating in the meager economic gains available, resulting in stagnating wages and a shrinking middle class. The path to resume historical growth is unclear. As of September, 2011, the International Monetary Fund (IMF) estimates U.S. GDP growth will be 1.5% for 2011, 1.8% in 2012, and 2.5% in 2013.

How have investors responded to this shift in economic outlook? We believe with a renewed appreciation for dividend-paying stocks. Now that growth is no longer easy, investors have begun to demand a more immediate payoff and are beginning to lose faith in company leadership to use that cash better than they could on their own. Strong dividend-paying companies are beginning to look attractive to investors once again.

## **A Look at the Numbers**

Our theory is that the current expected low-growth environment could be conducive to investing in dividend-paying stocks, and may continue to reverse the trend favoring capital appreciation established from 1948 through 2000. But this begs the question, do dividend-paying stocks actually outperform during low-growth periods? To test our theory, we compared the historical performance of the Dow Jones U.S. Select Dividend Index to the S&P 500 Total Return Index. The Dow Jones U.S. Select Dividend Index is an index of 100 dividend-paying stocks, selected by yield, growth rate, payout ratio and trading volume. Although it has only been explicitly calculated since November 3, 2003, back-tested data on the index is available beginning December 31, 1991.

We analyzed quarterly performance data for both indexes from January 1, 1992 through December 31, 2010, comparing it to real U.S. GDP growth experienced during the quarter. We then separated the results experienced during low-growth quarters (<0.75%), from results experienced when quarterly U.S. GDP growth was above 0.75%. (Quarterly GDP growth of 0.75% was chosen as the threshold because it roughly annualizes to 3% annual GDP growth, low by historical standards.) During the 19-year period studied, there were approximately an even number of quarters above (36) and below (40) the 0.75% threshold.

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The data shows that, while the Dow Jones U.S. Select Dividend Index has outperformed the S&P 500 overall during the 19-year time period, the outperformance tends to occur in low-growth quarters, resulting in an average quarterly outperformance over the S&P 500 by 2.15% during that time. By comparison, the Dow Jones U.S. Select Dividend Index has underperformed the S&P 500 by -0.41% during quarters where U.S. GDP growth has exceeded 0.75%.

	Number of Dividend Outperformance Qtrs	Percentage of Dividend Outperformance Qtrs	Average Quarterly Outperformance
GDP Growth < .75%	25	63%	+2.15%
GDP Growth > .75%	17	47%	-0.41%

## Conclusion

The data appears to support our theory. Dividend-paying stocks have outperformed the S&P 500 during recent quarters of sluggish U.S. GDP growth. As discussed previously, the IMF expects GDP growth to be well under the 3% annual (average less than 0.75% quarterly) threshold at least through 2013. Consequently, we expect dividend-paying stocks to continue to outperform throughout the next few years, particularly during individual quarters where U.S. GDP growth is low.

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