

Dividend Debate in The Twilight Zone

In a classic Twilight Zone episode, aliens land and remake earth with technology, eliminating warfare, wiping out hunger and eradicating disease. They provide transportation for everyone to visit their planet, described as even more wonderful than the “new” earth. What do the aliens want in return? As they tell the United Nations, “We ask only that you trust us. Only that you simply trust us.” An intelligence officer heads a team trying to decipher a book one of the aliens accidentally dropped. They are reassured when they finally translate the title, “To Serve Man.” As the intelligence officer is boarding a shuttle to the alien planet, however, his hard-working assistant runs up shouting “It’s a cookbook!”

95 percent of historical investor returns have come from dividends and the reinvestment of dividends.

Almost forty years after the episode aired, history repeated itself. Instead of aliens, however, this time it was corporate executives and Wall Street firms that lulled investors into trusting them as a result of wonderful new technologies. In the modern version, the revelatory exclamation is “They’ve cooked the books!”

Measured by the Standard and Poor’s 500 index of large company stocks, the market decline from 2000 through 2002 was worse than any three calendar year period since 1930 to 1932, when the country was sliding into the Great Depression. While investors fared better than the earthlings in the Twilight Zone episode, clearly their trust has not been rewarded. To help investors, the current administration has proposed legislation to eliminate the double taxation (at both the corporate and individual levels) on dividends paid on common stock.

We think the recent debate about the dividend tax proposal misses two important points. First, the matter of dividends is not trivial -- dividends are a much bigger component of investor returns than most investors realize. Second, investor desire for dividends has historically had more to do with trust than taxes. While investors ignored dividends in the 1990s, as yields were dwarfed by rapid gains in the stock averages, dividends have been crucial to long run investor returns. From 1928 through 2002, price appreciation in the Standard and Poor’s 500 index accounted for less than five percent of the total return earned by investors – more than 95 percent of investor returns resulted from dividends and the reinvestment of dividends. Even in the modern era, dividends have been important. From 1983 through 2002, a period encompassing the biggest bull market in U.S. history, dividends and the reinvestment of dividends counted for more than 46 percent of total returns.

If dividends are so important, why have they been ignored over the past decade? Pundits tell us that investors are avoiding the double taxation of dividends. In an economist’s fantasy world with no taxation or transaction costs,

investors would be indifferent whether corporate earnings are retained or paid out in dividends. Corporate managers would retain earnings if they believed they could earn a higher return within the corporation than the investor could obtain elsewhere. Adding double taxation of dividends to the picture tilts the scales towards corporations retaining earnings to repurchase stock in the open market or reinvest the money in the business.

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In the real world, however, things are never that simple. When a corporation retains earnings rather than paying dividends, the shareholders are being asked to trust the corporate managers to do the right thing. Since the bursting of the bubble, corporate executives are now perceived as having blown shareholder money on fast living, self-enrichment and wasted investments in obsolete technologies. Even if retained earnings were used to repurchase stock in the open market, the repurchases were made at historically high prices relative to business fundamentals. Taxed or not, a dollar in the hand is now perceived as being worth far more than a dollar retained by the corporation. As the president said when introducing his proposal, “profit is an opinion but cash is a fact.”

We believe the primary issue regarding dividends is not taxes, but trust. One has to be a chronological snob to believe previous generations of investors were too dim-witted to recognize that they were being double-taxed on the dividend payments. The average dividend yield on the Standard and Poor’s 500 index over the past 50 years has been about 3.4 percent, compared to about 1.9 percent now. As recently as 1982, the yield was above six percent. For much of this period when dividend yields were appreciably higher than now, the marginal tax rate on what was called “unearned income” was much higher than today’s rates, and a much smaller proportion of investments held in tax-deferred retirement accounts. No, previous generations of investors were just not as credulous as the investors of the 1990s. Speculators who rode the Nasdaq Composite down 78 percent should be wary of calling past investors stupid. The anomaly is the low dividend yield for the past ten years, not the higher yield in the previous 200 years.

The fate of the proposal on dividend taxation is in doubt in the sausage factory of legislation – we may wind up with nothing, or a bill substantially different than what is now proposed. The fact that many corporations are already announcing dividends, though, tells us that the bigger issue is attracting investors. Faith, once betrayed, is not easily regained. A major risk is that, having been burned by a hot stove, investors will be wary of cooking again. Increased dividend payouts by corporations, whether taxed or not, can help investor confidence by reducing the need to trust corporate managers and Wall Street. If you would like to develop a rational investment plan with people you really *can* trust, give us a call. We’ve been serving man (and woman, corporation, charitable endowment and retirement plan) since 1993.