

“Investors who like cash should cheer for Peris.”

—JEFFREY KOSNETT, editor of *Kiplinger's Investing for Income*

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# DIVIDEND IMPERATIVE

HOW DIVIDENDS CAN NARROW THE GAP  
BETWEEN MAIN STREET AND WALL STREET

**DANIEL PERIS**

AUTHOR OF *THE STRATEGIC DIVIDEND INVESTOR*



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BETWEEN MAIN STREET AND WALL STREET**

**DANIEL PERIS**



New York Chicago San Francisco Lisbon London Madrid  
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## Introduction

In early 2011, I published a book—*The Strategic Dividend Investor*—that argued that investors should focus on dividends if they wanted to enjoy superior returns from their stock portfolios. At the time, the U.S. stock market had been offering investors a dividend yield (annual dividend/stock price) of 2% or less for over a decade, and the dividend payout ratio (dividends/profits) for the S&P 500 Index companies was around 30%. I pointed out that both of these figures were well below what they had been historically and what they ought to be from a financial math perspective. In that light, long-term investors would be well served to return their focus to dividend-paying and dividend-growing equities. Indeed, long-term returns were dominated by dividend payments and the growth of dividends, and dividend-focused portfolios had handily outperformed non- or low-dividend alternatives over all but the shortest measurement periods. Two years later, the situation remains little changed. If anything, as interest rates have moved even lower and the baby boomers have edged two years closer to retirement, the need for income by large swathes of the population—retirees, endowments, pension funds, etc.—has become even more pressing.

This volume builds upon the first to address a much broader and arguably a more important issue: corporate America needs to pay higher dividends. At a time when the capital markets seem to alternate between scandal (Madoff, mortgage-backed securities, insider trading) and bubble (social networking companies like Facebook, Groupon, and their ilk) and are broadly distrusted by the public, a greater focus by Wall Street on dividends rather than just share prices would be good for everyone involved. Indeed, the toggling from bubble to scandal and back again is not accidental. It is evidence of the capital markets not working as well as they might. Given that business performance is cyclical and that the humans who make up the stock market have greed and fear and emotion in abundance, the cycle of boom and bust is not likely to cease anytime soon, but a greater reliance on using the stock market as a business investment platform, rather than as a grand casino available to all, would go a long way toward tamping down that volatility. It's easy to oversell an idea, and dividend payments from large, mature, publicly traded corporations are not a panacea for all of our financial and corporate ailments. In a "back to basics" period, however, putting our investment return expectations more rather than less on a cash basis would be a substantial improvement over the current situation, which is driven almost entirely by speculation in the price of stocks rather than by the receipt of cash distributions from ongoing enterprises.

What's at stake? In 2011, it was around \$480 billion. Over the past decade, it was over \$3 trillion. That's the amount of money that could have been paid by S&P 500 Index companies in dividends to investors and was instead redirected elsewhere, to share repurchase programs. That's a sum large enough to interest the average investor and businessperson. But there is more to it than that. As I argue in the final chapter,

what's really at stake is the trust relationship between Wall Street and Main Street. The year 2011, when *The Strategic Dividend Investor* was released, was one of protests against Wall Street excesses. The narrative of the 1% versus the 99% carried over into the 2012 presidential election. In that context, it might seem peculiar to be suggesting dividends would be part of the solution to the perceived failure of the capital markets to serve the best interests of the economy and the society at large. Or to put it another way, aren't dividends the problem, and should we really concern ourselves with what made Mr. Rockefeller happy? It may strike some as a radical notion that dividends are not the problem, but part of the solution. The abuses in the stock market, and the misperception of stocks in general, are the main culprit, not the underlying businesses that feed, house, and equip our society and employ our workforce. And it is those businesses that quite properly ought to distribute their profits in the form of dividends, not only to the Rockefellers, but also to Main Street shareholders.

Consider this then a wake-up call not only for investors, but also for corporate America, and the Wall Street that lives off both. After a 30-year drop in the dividend payout ratio—I call it here the Great Retreat—it's time for senior executives and board members to step back and clearly, soberly examine how they allocate capital and what they do with the profits that their businesses generate. This work is my contribution to that debate. It is avowedly polemical, making assertions that will be dismissed out of hand by more than a few traders, hedge fund managers, and investment bankers who like things just the way they are. So be it. Those individuals notwithstanding, the issues raised here should be top of mind for Main Street investors and high on the agenda of the company directors and officers purporting to be acting in their interests.

My argument is laid out in four sections. The first asserts the linkage between the state of a company's dividend and the value of its business. This revisits the "stocks go up because dividends go up" foundation from *The Strategic Dividend Investor*. It garnered a lot of attention, as well as some push-back, from the "buy low, sell high, repeat frequently" crowd on Wall Street. It's worth reviewing because the key element in the argument is viewing a stock as an ownership claim on an enterprise, not just a piece of (electronic) paper whose value goes up or down according to the dictates of speculators. Once you see a stock in that light, it is no surprise that over time the value of that business—as reflected in its share price—would rise (or fall) in line with the profit distributions coming from it. Getting to see the business behind the stock and the role of profit distributions in determining the value of a given business (and its stock) lays the groundwork for the subsequent chapters. The majority of the effort here is spent on debunking the notion that you can and should focus on the alternative notion—as Wall Street encourages you to do—of near-term earnings as the primary criterion for valuing a company. One of the oldest "earners" and dividend payers in the country—The Procter & Gamble Company—serves as the case study for this analysis. The lesson here is that investors need to stop concentrating on near-term earnings, and corporate executives need to stop managing to them. This obsession with near-term earnings, rather than long-term dividends, has contributed materially to the culture of Wall Street abhorred by so many on Main Street. Stop playing games with our hard-earned money!

The second chapter focuses on the fate of the corporate cash that is currently not being distributed to company owners. Greenbacks held on the balance sheet of corporate America have been rising in recent years as cost cutting has

increased profitability but caution about a slowing economy has led to lower investment back into the business that would naturally consume those dollars. As company owners, investors have every reason to expect that corporate boards will responsibly deploy that cash in the business, and that if they cannot, they would then return it to company owners as a profit-sharing check—that is, as a dividend. That goes for all companies, not just publicly traded entities. Alas, profit-sharing plans for shareholders are about the last idea that comes to mind for far too many executives of large, publicly traded corporations in this country. Instead, they believe that taking your money and putting it—get this—into the stock market, of all places, to buy the company’s own shares, is equivalent to or even better than sending out a check to company owners. This section shows why the Great Retreat from dividend payments to share repurchases has been a very bad use of company cash, of your cash. Many corporate executives and “hot money” managers (who trade stocks frequently) will take strong exception to this argument. At a minimum, those in favor of the \$3 trillion spent on share repurchases during the last decade will get an opportunity to defend their stance.

The third section draws on the first two to suggest that investors and corporate board members need to take a fresh look at the S&P 500 Index of large, generally mature companies, where most of the market’s value is located. The index’s low dividend payout ratio, around 30%, and its equally low 2% yield, reflect a fundamental mismatch between legitimate growth opportunities and the capital priorities of these corporations. Even after taking into account our country’s exceptionally low interest rates (a key figure in a lot of financial equations), those yield and payout ratios rightly belong to a small business in growth mode, not to the largest businesses on the globe with long-term sales and profit growth that is a



variant of U.S. GDP or, at best, global economic expansion. In short, the main part of the stock market—the companies that make up the S&P 500 Index—ought to be a dividend-distributing powerhouse, with a dividend payout ratio at the 50% or better level. It is not. Instead, it is set up for “buy low, sell high, repeat frequently” speculators. Now don’t accuse me of being a spoilsport. Investors seeking “swing for the fences” opportunities may claim that encouraging the S&P 500 Index companies to pay higher dividends amounts to taking away the punch bowl just as the party heats up—to borrow a metaphor usually applied to the Federal Reserve Board and interest rates. The answer is most certainly not. There are plenty, literally thousands, of stocks of smaller companies out there with little or no dividends and potentially great growth prospects. Investors can own them as they will. I wish each and every one of you an early stake in the next eBay or Google. But let us not confuse speculation in small, high-risk, high-growth businesses with investments in the main part of the market.

The final section takes on several of the big, hot-button issues of our day—in particular the popular antipathy toward major U.S. corporations and the role that corporate boards have played in allowing the current situation to come about. I argue that the directors of the S&P 500 Index companies bear an enormous responsibility for the Great Retreat’s multi-decade shift away from dividends. And in doing so, they have shown themselves to not be acting in the best interests of shareholders. They now need to lead the charge back and wrest control of the capital allocation process from empire-building CEOs and their investment banking buddies. If there is to be any meeting of the minds between Main Street and Wall Street, the boards of large corporations have to be “reborn” to practice the oversight functions that they were originally designed to perform. And if they do that, and take

into consideration the reasonable investment needs of their enterprises, as well as how their excess cash has been spent in recent years, boards should and will come to the conclusion that a higher dividend payout ratio is warranted.

In addition to benefiting shareholders, a return to a cash payment system from America's largest corporations might have a chance (albeit a small one) to bridge some of the long-standing, wide gap in this country between "capital" and "labor." I want to be so bold (and readily admit to being so naive) to suggest that a renewed focus on paying dividends as the preferred profit-sharing mechanism for U.S. corporations has a positive role to play in trying to overcome the seemingly never-ending conflict in our country between organized labor and senior management. History indicates that this is a perilous task, with little chance of success, but after a century of very bad blood between these two presumed polar opposites, it is worth taking an unbiased view and suggesting that workers might be interested in a dividend-paying ownership stake in their businesses and that having everyone pulling in the same direction would attract management as well.

A shift back in the direction of cash profit distributions from major corporations to shareowners large and small won't prevent future scandals or bubbles, but on the margin, it would make the stock market less of a gambling parlor and more of a healthy, transparent platform for business investment that could and should be a good deal more trusted than it is today. Ultimately, it comes down to trust, not finance. In the current environment of mistrust, the allure of regulation (and lawsuits) is high, but without an underlying culture of responsibility and accountability (by chief executives and especially by corporate boards) and trust (on the part of Main Street shareholders), additional regulation will provide only the illusion of a healthy financial system, not the real thing.

A number of the issues raised here were mentioned, in some instances just in passing, in *The Strategic Dividend Investor*. This book should be seen as a complement to the earlier work. It is, in effect, Volume Two. While it would be helpful to familiarize yourself with that material, it is not absolutely necessary. The overlap between the two volumes is minimal by design. The one exception is the first chapter, which addresses the same key issue: looking through the stock market to see the businesses behind it. Investors cannot be reminded of the importance of this frequently enough. This work is also similar to *The Strategic Dividend Investor* in that there is enough theory—even a few math equations—to scare off some casual readers. Please do not be deterred. Read this material closely if you can; skim it if you must. But I am firmly of the belief that a basic conceptual understanding of how a complex system works positions you to have a better experience when you engage it. My purpose is not to make you into a finance expert but to get you to think like a businessperson when you approach the investment platform known as the stock market. If you run your own business, if you have an IRA or 401(k) program at work, if you own mutual funds, if you oversee your own brokerage account, dispelling some of the black-box nature of the stock market should be of use to you.

But this book has another audience: the treasurers, chief financial officers (CFOs), and board members of corporate America and their high-priced consultants. Wake up and start paying dividends. It's long overdue. A higher dividend payout ratio for the S&P 500 Index companies may not herald a strengthening economy, but the current miserly payout of many large U.S. corporations most certainly does invite a speculative environment in the markets and a hostile view toward the whole notion of stocks and the companies behind

them from large parts of our society. Executives and board members need to start seeing themselves as part of the solution, not part of the problem. Encouraging corporations to pay higher dividends—the key message of this book—is the flip side of telling investors to seek higher dividends—the key message of *The Strategic Dividend Investor*. Having addressed the demand side of the equation, it is now time to nudge the suppliers. So if you are an investor in publicly traded stocks, make your voice heard to the boards of the companies in which you have a stake. You are a company owner; start acting like one.

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## Stocks Go Up Because Dividends Go Up

*The fundamental principle which applies here is that the value of capital at any instant is derived from the value of the future income which that capital is expected to yield.*

Irving Fisher, *The Nature of Capital  
and Income*, 1906<sup>1</sup>

**F**or an institution that is supposed to offer instant and correct valuations of businesses, the U.S. stock market does a stunningly poor job of it. So says a dividend investor. And so should say any rational observer watching the market rise a few percent one day and go down by the same amount the next. How is one to navigate such a landscape? In the spirit of offering investors something beyond Wall Street's self-serving mantra of "buy low, sell high, and repeat frequently," let's review a few basics: what a business is worth, what a P/E is, why too many companies and investors focus on near-term earnings, and why that focus gets both in a muddle.

## What's a Business Worth?

The conventional wisdom encourages investors to think of stocks, first and foremost, as things that are traded, go up, go down, and, if you are lucky, are bought by someone else at a much higher price than you paid for them. But what is behind those stocks? Businesses. And that's where we will start. What's a business worth? The stock market is supposed to be a means of valuing businesses, but it long ago ceased being the means and became an end unto itself. So for a moment, banish stocks from your mind and think about enterprises—large, privately held businesses, or the neighborhood dry cleaner, or your insurance agent's book of business, or the family-run chain of diners, or the local widget manufacturer, or even the company that you work for. You need not be constrained by size, by sector of the economy, or by geography. And ask yourself: how are these businesses valued?

It might help to step back and review the basic business valuation techniques online or in your long-abandoned college finance textbook. If it's your own business, think about how you regularly monitor the value of your own undertaking, what you do when you buy another business or consider offers for your own. Despite the bewildering array of methods that investors use to value stocks, business valuation comes down to a few basic concepts. The first and most basic is income—what a business or asset generates to the owner on a regular basis. That income stream and any projected growth in the payments are discounted back to the current time to determine a present value, the price you might consider fair to purchase the business. This can be dressed up in many ways, but it's really nothing more than a standard DCF (discounted cash flow) exercise. No PhD required. Despite its core simplicity, a DCF does have subjective inputs, notably

the discount rate (used to come up with a present value of the future payments) and the projected growth rate of the income stream, and there are a lot of adjustments that can be made—multiple growth stages, control premiums or discounts, and so forth—but the basic math is straightforward. And consistent with that simple math, the percentage rate at which the distributions grow is what drives the change in the present value (holding the other factors equal). In short, the value of an enterprise rises in line with its distribution growth over time. If little Johnny's lawn-mowing business generates 10% more pocket cash for Johnny one summer compared to the previous one (and the higher level is sustainable and the other inputs are unchanged), the value of that business—however it is determined—should rise by the same amount. The same is true of IBM. Stocks go up (over time) because dividends go up.

But let's entertain, at least for a moment, an alternative view, that of relative valuation, which is the second major way that businesses are assessed. This approach asks what a similar asset, business, or stock has recently been bought or sold for. And there's nothing wrong with this method if the "base" enterprise has been valued properly, on an income basis. Make a few adjustments to reflect how the companies are different, and you have a reasonable estimate of worth. Alas, that is rarely the case on Wall Street. Rather, relative valuation has taken on a life of its own, with no regard for intrinsic value. It is purely relative to what a company might have sold for in the past or relative to the price of other companies.

While the seller might not care which method of valuation is being applied as long as he or she feels that the price is right, the buyer most certainly should be considering not only what other similar businesses have been valued at, but whether the intrinsic value is there—the ability of the business

to generate profit distributions that, when netted back to the present time, are equal to or greater than the purchase price. Or to put it another way, paying \$50,000 for a dishwashing machine may seem like a good idea if your neighbor had to pay \$60,000 for the same washing machine a week ago, but it still doesn't make it a wise investment. Extend the logic to buying a tech stock in early 2000, and you get my drift. At that time, you could hear brokers extolling the virtues of some stock because it was 10% cheaper than its average, or, worse yet, selling at a 15% discount to the peer group's P/E. Fifteen percent less bad is still bad. Relative valuation is just that, relative, and limiting your analysis solely to what other people are buying is an excellent way to lose money. It is in the markets as it is in life. Doing what everyone else is doing may *explain* a poor decision, but it is no *excuse* for one. You may be able to get away with relative valuation strategies for years at a time—like riding Nasdaq stocks in the late 1990s or the financial bubble a decade later—but it doesn't make it a valid long-term strategy, even if all your friends and peers are investing the same way. Ultimately, all businesses are subject to the same rules of financial math, and those are based on cash flows to the owners. It's the same for an apartment building, a manufacturing enterprise, a professional service corporation (doctors, lawyers) or even—I daresay—a stock in a publicly traded company.

Now there are real differences between how you might value a small, local business (e.g., Johnny's lawn-mowing operation) and a global corporation (IBM) whose shares trade on the stock market. Liquidity—the ability to easily purchase or sell your stake—is something the stock market offers investors. You might not always get the price you want, but between 9:30 a.m. and 4 p.m. every business day, there are buyers and sellers of IBM in the marketplace. That is worth



something. Having lots of similar companies available in the stock market probably helps, through a network effect, to raise the value of all of them. Publicly traded status also offers investors the luxury of owning part of a business without having the obligation to run it. That's worth something, too. (We'll discuss the downside of this luxury later.) On the other hand, owning a small slice of IBM means you don't control the enterprise, whereas if you buy Johnny's lawn-mowing business, you get to call the shots. My analogy has its limits, but at its heart, it is still correct: a business is a business is a business. Companies whose shares trade on public exchanges are not, by virtue of that simple fact, somehow subject to a different set of rules.

Given (mostly) free markets and the general availability of basic operating information, the prices for businesses on the stock exchanges are supposed to come pretty close to intrinsic value. Having thousands of investors doing their DCFs on a daily basis and making investment decisions accordingly should get buyers pretty close to the "right" price for a business. That is, the DCF-based valuation exercises and the relative valuation ones should end up converging and giving you a good idea of what a business, and perhaps even a stock, should sell for. This is what is believed by those who hold that the capital markets are "efficient." Alas, the reality is quite the opposite. Near-term, the market is not efficient, and the wild gyrations in stock prices make it quite clear that most investors are not doing their DCFs, or if they are, they are using wildly unrealistic assumptions such as growth rates that are too high and discount rates that are too low. (In periods of crisis, the opposite may be true—growth is underestimated and risk is rated too high.) Long term, the market has to be and is efficient, but that is small comfort for investors worried about their portfolios now.

## What's a P/E?

Let's get a little closer to the relative valuation exercises that are so broadly accepted on Wall Street. In almost all instances, investors are using valuation "multiples," the price of a stock divided by some per-share figure, usually net earnings (the P/E ratio) but sometimes sales (P/S) or a version of profits called EBITDA (earnings before interest, taxes, depreciation, and amortization) for those companies where interest, taxes, depreciation, and amortization would consume most if not all of the profits. But the most widely used, by far, is the P/E multiple. So what exactly is a P/E multiple, and how does it work?

This will likely come as a surprise to most investors, but earnings multiples are just a shorthand way of expressing the key components of a DCF analysis. Bear with me while I review the math, but if you can make your way through the next few pages, you'll be better positioned to understand why you need to focus on cash distributions when you make investments. At its simplest, the P/E ratio reduces a stock's value to the inverse of the discount rate being applied to the stock's current earnings forecast out into the future.<sup>2</sup> Whoa—what's that actually mean? It means that if you hear that a stock has a P/E of 8, the stock is selling for 8 times current net income on a per-share basis. That P/E ratio implies that, assuming earnings stay where they are, investors are applying a 12.5% discount rate ( $8 = 1/0.125$ ) to the company's future profit stream to account for the risk that those profits might not be delivered or might not be worth as much in purchasing power tomorrow as they are today. Add up all those future earnings discounted back to the present time at 12.5% per year, and they will sum to 8. That's a pretty high discount rate for the types of large, publicly traded corporations one might encounter as part of the S&P 500 Index, and that's why a major stock with a P/E of 8 is considered to be cheap.

Take a company with a P/E of 20, and it suggests that investors are using a discount rate of just 5% on that flat stream of future profits. In contrast, that is quite a low discount rate, which makes the stock expensive.

So the next time you are told that a stock is trading with a P/E of 10 or 20, you can puff out your chest, quickly do the math in your head, and opine with a definite swagger as to whether the implied discount rate is too high or too low. But do discount rates really go through the minds of investors when they are contemplating the P/E of a stock? Of course not. Investors use the P/E not as shorthand for discount rates, but as a simple measure of how expensive a stock is relative to its history and relative to other stocks. Price per share divided by profits per share. Period. Lower is better than higher, and if it must be high, let it at least be less than it has been in the past, or at least lower than the P/E of similar businesses. That's pretty much it. In an only marginally more sophisticated manner, a P/E can be viewed as a measure of a "payback" period. That is, if a stock costs \$100, earns \$10 per share, and has a P/E of 10, purchasers will get their money back in one decade. Lower payback periods are better than higher ones. This notion does not take into account either inflation or the rather obvious fact that what a company earns is not necessarily what the investor gets.

P/Es are convenient and allow comparison between similar entities, but, like any shortcut, they can be a little too simple. Notably, they assume flat, constant earnings into the future. Many investors believe that companies with legitimate growth potential can therefore support higher P/E ratios. But those long-term growth prospects come with a higher risk of falling short. Thus, as one factor moves up, so too would the offsetting one of the discount rate. Hence investors can employ a P/E as a simplified form of a DCF analysis and

use it to compare broadly similar enterprises. In the case of close companies in one industry, say Hershey Foods (HSY) and Campbell Soup (CPB), where the growth rates and discount rates might reasonably be expected to be similar to one another, the P/E ratio is not entirely without use.

But whether stock market participants realize it or not, when using P/Es to value investments, we are back to the underlying notion of the income approach. Why is a DCF behind the P/E calculation? Because in the end, *all* financial investments have to be valued on the basis of an explicit (DCF) or an implied (P/E) cash flow analysis. There is no other way. The value of any business (or any other type of investment) is the summation of current and future income to company owners discounted to the present time. It was that way 100 years ago; it is that way now; it will be that way two centuries from now. There are other ways to value a business that may be relevant in some cases—what it would cost to replace physical assets (OK for manufacturing enterprises, not so good for brand or service businesses), contingent values based on certain circumstances such as a buyout (high discount rates), and so forth. But when looked at closely, they too end up being some variant of a DCF. Investors should take comfort from this. There is a system, and despite the fact that market participants ignore it much of the time, it does work in the long run.

The dividend discount model (DDM) is just a specific instance of a DCF where the cash flow being valued is the actual dividend received by the company owner. It's the relevant form of the DCF for large, publicly traded companies that have and distribute profits. In cases where all the cash generated is paid out to company owners as a dividend, the DCF and DDM will be identical. That is the theory. In current stock market practice, however, DCFs are used to value

the profits that are in the hands of the corporate managers, not the company owners. Company owners may have a claim on those profits in a legal sense, but they do not see them except when they get their quarterly checks in the mail, assuming the company pays a dividend. But as the dividend payout ratio in this country remains stubbornly around 30%, the dividend discount model applied to a public company's declared dividend is going to yield a far smaller value than the DCF applied to all the cash being generated by the corporation overall. In theory it should not, as the 70% of the profits that are reinvested back into U.S. businesses (not paid out) are supposed to generate a higher growth rate in the future profits that are paid out as dividends. Oh, that it would. The problem is simple: that 70% left in the hands of corporate managers isn't always well spent. (We'll take up one of the biggest ways it is not well spent in a subsequent chapter.) As a consequence, the current low payout ratios that characterize many large, publicly traded U.S. corporations do not always (in fact, rarely) generate the higher dividend growth trajectory used to justify sending out such small profit-sharing checks to company owners in the first place.

And so we're back to the dividend payout ratio. Companies with legitimate growth prospects do and should reinvest some or even all of their profits—perhaps for many years—to take advantage of those growth opportunities. That is, a DDM based on a company with a low payout ratio should have a higher growth rate in the equation. But I'll just remind you again of that devilish little discount rate going up in tandem with the expected growth rate of profits. Sustaining very high rates of growth for very long periods of time is the rare exception, not the rule, despite the examples of Google (GOOG), Amazon (AMZN), and the piles of business plans sitting on the desks of venture capitalists in Silicon Valley

that promise to touch all Internet users or new consumers in China and India.

At this point, you are probably asking what on earth am I going on about, and what does this have to do with the stock market? Rightly so. So let me return to the matter at hand. Investors in the stock market should value companies on the basis of DCFs of the dividends paid to company owners. They do not. Instead, they use relative valuation, most notably of earnings multiples, or P/Es. The next section takes a look at P/Es and suggests why, in their current form, they are not a very good way of valuing stocks. P/E ratios are no longer particularly useful, not because of the P part (price is there for all to see) but because the E (the supposed earnings in this simple equation) have become largely unusable.

### **Earnings? Which Earnings?**

In claiming that dividend growth drives long-term share price appreciation, I can be charged with confusing cart and horse, and that instead, earnings drive dividends and therefore share price appreciation. Guilty as charged. If you would kindly show me which earnings horse, I'll be happy to hitch it up to the dividend cart, and we can then happily trot down the lane of asset appreciation. Now dividends are of course related to earnings—the former are paid out of the latter—so a company's earnings trajectory is relevant to what a company's ultimate dividend path will be. And over the long term, earnings and dividend patterns will be very similar. So feel free to track long-term earnings growth. And if we were conducting valuation exercises in the 1950s or even the 1970s, one could point to earnings growth and use it synonymously with dividend growth to make a point about a company's changing value to investors. But not at the present time. While the

math shows clearly that the increase in the value of a business over time should and will track the growth in distributable (and distributed) profits, it's equally clear that in the near term, changes in the dividend aren't driving stock prices on most days. Those publicly traded U.S. corporations that pay a dividend generally do so four times each year, and they might change it to once a year. Stocks, including the more than half that do not pay a dividend—yes, more than half of common stocks traded in the United States with a market value above \$50 million do not pay any dividend—reprice every business day, around 250 times per year.<sup>3</sup> Obviously something other than dividends is driving those daily share price moves. That something could be money moving into or out of the stock market (from bonds or cash), the latest bit of economic news, or something specific to individual companies. But if asked, traders and investors will say that the one thing that drives individual company share prices over time is earnings, or the perception among thousands of genuine investors and an equal or greater number of speculators as to what those earnings might be in the next quarter or year. But trying to second-guess the views of countless others may well be the lesser of the challenges facing the long-term investor seeking to understand the trajectory of the profits from which his or her dividends will be paid. The far greater challenge is just figuring out which earnings figure to use.

Let me outline the problems with “earnings.” It's a long list, so I am going to go ahead and number the issues:

### **1. Dilution from Stock Options, Preferred Shares, and Convertible Debt**

We'll start with an easy one, dilution. Even casual investors in the stock market have seen or heard reference to “diluted” EPS, but few investors pause to consider the implications of

having to use “diluted” (as opposed to full strength?) earnings. For our purposes, however, it’s worth reviewing what others too easily assume. What exactly is dilution, and where does it come from? The most common source is stock options. Companies regularly grant high-ranking employees the opportunity to purchase shares at a set price at a future point in time, one that is generally equal to the price at the time of the grant. These grants are part of compensation and long-term retention packages and often show up in small, young companies that may not have a lot of cash on hand to make payroll. Basically these employees are being paid in shares with the assumption that as the share price rises over time and the options “vest,” the employees can cash in their chips. Even in large, mature corporations, stock options can be a significant component of executive compensation.

In theory, there is nothing wrong with the granting of stock options, other than the fact that it distorts management incentives to “get the stock up” in time for option vesting, rather than focusing on making the right long-term business decisions. But setting aside that quibble, the existence of options has one practical consequence: it leads to companies printing two sets of EPS figures, one based on actual shares outstanding and one based on the shares outstanding taking into account the option grants. The latter figure is typically lower than the former for any company that has options outstanding, which means that the claim on company profits by current, “real” shareholders is being diluted by the shares that will be distributed in the future via options.

But it gets even more complicated. Companies whose share prices have risen will have more of their options “in the money” (market price above the option’s “strike” price) and therefore have greater dilution. Share prices that have declined or just remained flat over time will have fewer



options that are in the money. Therefore the dilution is less. The point is that the degree of dilution to existing company owners will vary not only with the number of stock options granted but also with the share price itself. So in addition to having to determine the amount of earnings that might be available for distribution as dividends, investors also have to figure out how many claimants there might be based on the stock options granted and the share price.

As a practical matter, dilution is most significant in the small company and tech start-up world, and even among the larger, more mature companies that can and do pay dividends, the issue of dilution is nowhere near the problem it was a decade ago, when compensating employees through rising share prices seemed like a great idea. At that time, the market had been gaining steadily for nearly two decades. More than 10 years of flat stock market returns since, however, have poured cold water on the idea and have led many companies to discontinue or scale back their stock option programs. (A change in the law that made options granted to employees an “expense” that lowered EPS also contributed to the move away from the practice.) For the S&P 500 Index companies, the median dilution has fallen over the past decade to 1%, but as of the end of 2011, there were still 29 S&P 500 Index companies with dilution over 4% and 10 with dilution over 10%. Notable companies near the top of the list include Accenture Technology (15%), Chesapeake Energy (11.9%), Goldman Sachs Group (8.0%), Procter & Gamble (7.1%), priceline.com (6.3%), Colgate-Palmolive (4.7%), and EMC Corp (4.5%). For the top 500 stocks that trade on the Nasdaq, the median dilution is higher (1.3%): Sirius XM Radio dilutes its shareholders by 73%. Micron Technology is at 18.4%, NetApp at 9.1%, Broadcom at 7.1%, etc.<sup>4</sup> A certain amount of dilution is tolerable and to be expected in

an environment when restricted stock or stock options are widely spread throughout the corporate compensation structure. Investors can take that into account as they make their calculations. Dilution can also come from sources other than stock options such as preferred shares, convertible debt, warrants, and the other means by which companies raise capital, and there is nothing wrong with having debt instruments that turn into equity under certain conditions. But as we make our way through the figures used to determine what a company might be worth, it is necessary to keep in mind that not only is the size of the profit pie variable, so too is the number of people who might claim a slice. Remember this when we visit the issue of share buybacks in a later chapter. Then dilution really does matter.

## **2. Normalized Earnings**

Having to deal with just two sets of numbers—basic and diluted earnings—isn't so bad. How about four? Or eight? In addition to dilution, investors have to confront results presented according to GAAP (generally accepted accounting principles) as well as “normalized” or “adjusted” earnings—usually non-GAAP methods of presenting results in a manner that can be specific to each and every company. These adjustments are intended to smooth out some of the volatility associated with accounting rules and to give investors a better sense of the underlying condition of a business. That's all good. Indeed, it is fitting that some accommodation be made for exceptional circumstances when determining the worth of an enterprise. One bad period of operations, a legal settlement, a plant fire, or an unexpected large tax refund need not change the long-term value of a business. In many instances, GAAP accounting properly insists that certain expenses be viewed as “one-time” or “extraordinary” in nature.

This accounting accommodation may have some value, but the widespread use of non-GAAP measures presents a slippery slope that far too many management teams have slid down, to the peril of investors. The reality is that all too often such “one-time” charges find their way into company results just about every year, the dictionary definitions of the word “unusual” be damned. Just recall from your own investing experience the number of times you have heard the media and brokers talk about how a company, before charges and special items, earned such and such.

Given the frequent changes in accounting rules and guidelines (regarding the amortization of goodwill from acquisitions, the expensing of stock options, the measurement of pension obligations, etc.), it would be hard not to keep multiple sets of books. Indeed, to not take certain charges could be a violation of securities law, but company discretion is also involved. In many instances, a company can identify expenses it has incurred during “restructurings” and even call them out to investors, but has the option of simply flowing them through to net income without necessarily printing a second set of numbers. But that would lower reported earnings used for the P/E calculation and therefore the company’s putative value. And in a stock-price-driven world, we can’t have that!

When taken regularly as they are, these “unusual” charges allow companies to say things are better than they in fact are, all with the blessing of the accounting industry and the investment community, which is so focused on delivering higher earnings and therefore higher valuations when those earnings are pushed through a P/E multiple. Perhaps the most objectionable charge from my perspective is the writing down of goodwill from acquisitions. Goodwill is the amount paid for a company that exceeds the value of the acquired company’s net assets. For some companies in the technology space, much of

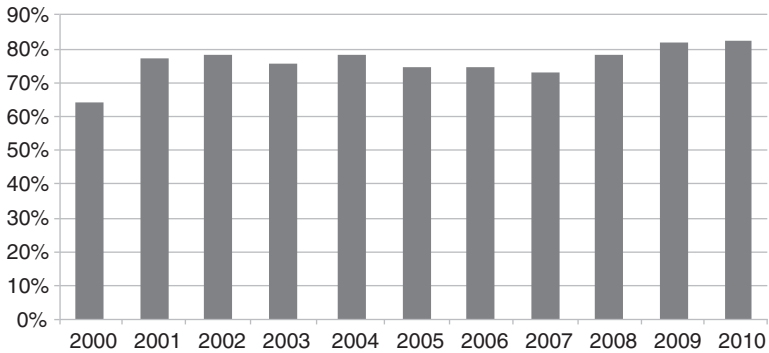
the purchase price may be accounted for on the books of the acquirer as goodwill. For instance, let us say a small but rapidly growing enterprise with \$100 million in net assets is acquired by a larger company for \$1 billion. So far, so good. The difference between the purchase price and acquired assets (\$900 million) goes on the books as goodwill (or as an intangible asset, basically the same thing) of the acquired company. It is viewed as an asset, albeit a “soft one,” that will generate profits in the future. But if the acquisition doesn’t work out quite as well as planned, and many of them do not, that goodwill will often get written down in a few years to a lesser value, or zero. Wall Street and corporate executives blithely dismiss this as a “non-cash” charge against earnings. But while the write-down might be non-cash, it was cash (or shares) that went out the door at the time of the acquisition. If the acquisition was paid for with cash that was sitting on the balance sheet, it was your cash. If it was paid for with shares, you agreed to have your stake in the company be diluted. If it was paid for with debt, you agreed to have your equity bear the burden of that additional obligation. One way or another, your money was used to buy the asset. When the asset or part of it is written off to nil, you are expected just to “turn the other cheek” as if nothing has happened and no money has been wasted. I beg to disagree.

You need look no further than your desktop computer to find a perfect example. In 2007, Microsoft (MSFT) purchased aQuantive, an Internet advertising service, for an eye-popping \$6.3 billion. Microsoft paid cash. Five years later, in mid-2012, Microsoft announced that it was writing off \$6.2 billion of that amount—essentially the entire purchase price—as the goodwill from the acquisition was now deemed to be “impaired.” Microsoft’s press release and most of the brokerage community took great pains to note that it was a “non-cash” charge. If you were a shareholder of Microsoft at the

time of the acquisition, however, that was your money heading out the door, or shall I say, down the drain. If you became an owner of Microsoft after the acquisition, the aQuantive asset was on the balance sheet of Microsoft and was supposedly part of the enterprise that you were purchasing with your cash. And then it wasn't.

Other charges, typically for “restructuring,” can indicate that a company was overearning in the past, and now the day of accounting reckoning has come. Yet the higher “normalized” earnings are deemed to be useful for determining the value of a company, while the “one-time” charges are removed from the equation. Or as my violin teacher often says of my playing, it is quite good except for all the bad parts. Imagine that you run your own business—say, a retail shop—and you let the front of your building fall into disrepair. Well, when it comes time to repaint, do you really delude yourself into believing that the periodic costs of refreshing the storefront are “unusual” or “one-time” in nature, just to claim that your “core” profitability is higher? In the real world, businesses cannot get away with such nonsense, at least not for long. And public company accounting (GAAP) insists that all expenses, whether extraordinary or not, be acknowledged in reported net income. However in the never-ending pursuit of better *Es* (earnings) that would justify higher share prices, investors turn a blind eye to the shenanigans of “normalized” results. But my violin teacher and I know the truth, and you should as well.

The chart in Figure 1.1 captures the number of S&P 500 Index companies each year in the last decade that have reported “unusual” expenses. Yes, you are reading this correctly. Every year, no less than 60% and up to 80% of all companies in the S&P 500 Index report such charges.<sup>5</sup> That means that many individual companies are reporting these expenses year after year after year.

**FIGURE 1.1** Percent of S&P 500 Index companies recording unusual expenses

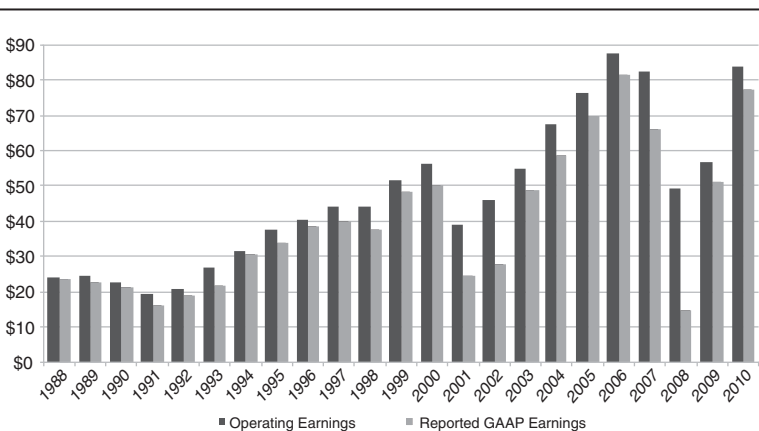
Source: Société Générale Cross Asset Research and Federated Investors, 2012.

And remember what an unusual item represents. It is almost always a loss or expense (though it can in theory be a gain) that means that the company has been overstating profits in previous years by the amount of the charge. (In the rare instance when it is a net gain, the company's profits have been understated by that amount.) In our own analysis of Compustat data from 1990 through 2011, we found two members of the S&P 500 Index have taken charges of one form or another every single year. It's amazing that they have survived as long as they have given those practices. Compared to those sinners, the saints were Genuine Parts (GPC) and Chubb Corp (CB). Both companies have belonged to the S&P 500 Index throughout the measurement period but have had just one year with a net "normalized" EPS result, as determined by Compustat.<sup>6</sup> Let's hear a Bronx cheer for the sinners, which I choose not to identify, and a genuine (pardon the pun) round of applause for the saints. Now to be fair to corporate executives, their hands are tied in many instances.

They may not be able to file their quarterly reports with the SEC (Securities and Exchange Commission) unless their auditors, guided by FASB (Financial Accounting Standards Board) or SEC rules, sign off on their quarterly statements. The rules and personnel behind those rules turn over frequently, such that some of the charge taking ends up being unavoidable and deeply embedded in the “system.” That is unfortunate.

At the aggregate level, there’s a lot of money at stake. The chart in Figure 1.2 shows S&P 500 Index reported (GAAP) earnings and “operating” earnings (a proxy for “normalized earnings,” calculated by Compustat) per share for the 23 years from 2010 back to 1988. Every year operating earnings are higher than the results according to GAAP. Some years the gap is bigger than others, but there is always a gap. The median annual “overage” of profits is 9%. Add up all those charges and they amount to big bucks. According to S&P’s data, the S&P 500 Index companies have reported a total of \$1.4 trillion in charges and non-operating expenses out of reported profits

**FIGURE 1.2 S&P 500 Index operating earnings vs. reported earnings, 1988–2010 (per unit of index)**



Source: S&P Dow Jones Indices and Federated Investors, 2012.

of \$7.7 trillion in the same period. Put another way, operating earnings are 18% higher than the reported results.<sup>7</sup>

Recall why we are looking at this: If we are going to use P/Es to value companies and the market as a whole, we had better have a good handle on the *E* part of the equation. Coming in 18% high strikes me as being a tad off the mark. It's OK in a relative world where one bad number is as useful (useless?) as another bad number, and where everyone is allowed to cheat by about the same amount. But if you are that rare investor seeking to determine the profits that will be available for distribution as dividends, then earnings as they have come to be presented by companies and valued on a daily basis by market participants—this torrent of numbers—are for all intents and purposes of no help.

### 3. Which Normalized Earnings?

For the time being, however, let's go along with the ruse and value companies based on normalized earnings. Here another problem is encountered. Whether looking for a record of earnings to measure a company relative to its history or for recent EPS to compare it with its peers, some consistent standard is needed. But just determining which "normalized" figure to put into the equation can itself be tricky. Indeed, different data systems offer various ones. For instance, FactSet Research Systems, a large, well-regarded financial data aggregator used by many investment firms, offers a Core EPS figure for each company based on adjustments made by S&P to determine normalized results. The even better known Bloomberg data system reports two separate "special" numbers: the first is Diluted EPS before Extraordinary Items. What is considered "extraordinary" is narrowly defined by the accounting community so it doesn't vary much from regular diluted EPS. But Bloomberg also offers Diluted EPS based on "Normalized



Net Income.” When I initially conducted this analysis, the “normalized” result was called Diluted EPS before Abnormal Items. It appears that this figure has had a linguistic “make-over.” Is it an example of life imitating art? In Mel Brooks’s 1974 comedy *Young Frankenstein*, Marty Feldman’s memorable hunchbacked character, Igor, is dispatched to a lab to get the brain of a deceased great scientist to be put into the reanimated creature. Having dropped the jar with that brain, Igor comes back with one that had been labeled “Abnormal.” But he just tells Dr. Frankenstein that it is the brain of a woman, Abby Normal. What was Abnormal is now Normalized . . . . And as you’ll see in the example below, Bloomberg’s notion of normalized EPS is not the exact same as FactSet’s S&P Core figure. To confuse matters further, Bloomberg characterizes each year of numbers as either “original” or “restated.” And then there are the numbers presented directly by the company itself. These too can change year to year as companies sell off businesses, restate historical results, and offer their own version of normal, one that is separate from both the S&P Core calculation and the Bloomberg version.

In Table 1.1, I have displayed all these figures for the Procter & Gamble Company (PG) for the past two decades. Let me start out by saying P&G is one of the good guys, one of the very best from the perspective of the dividend investor. It’s been sending out a check to company owners every year since 1890—over 120 years—and has raised the dividend every year for over a half-century. And P&G is in the business of selling soap. I mean that in a most positive way: the company’s products are very popular and its business model is relatively transparent. Moreover, P&G operates in a largely noncyclical part of the economy, and by virtue of selling its goods in just about every country around the globe, the company is somewhat insulated from the business ups and downs of any individual geography.

**TABLE 1.1 Procter & Gamble Company Earnings Table**

FY ending June 30	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
<b>FactSet Earnings Figures</b>											
EPS S&P Core (diluted)	—	—	—	—	\$0.93	\$1.08	\$1.15	\$1.19	\$1.08	\$0.81	\$1.28
Year over year change						16.4%	6.5%	3.5%	-9.7%	-24.7%	58.0%
EPS (diluted)	\$0.61	0.07	\$0.73	\$0.87	\$1.01	\$1.14	\$1.28	\$1.30	\$1.24	\$1.04	\$1.55
Year over year change		N/A	N/A	0.0%	15.5%	13.2%	12.5%	1.2%	-4.6%	-16.2%	49.3%
<b>Bloomberg's Earnings Figures</b>	Original	Original	Original	Original	Original	Original	Original	Original	Original	Original	Original
Normal-ized EPS (diluted)	\$0.66	0.06	\$0.77	\$0.93	\$1.07	\$1.14	\$1.28	\$1.43	\$1.48	\$1.56	\$1.80
Year over year change		N/A	N/A	20.1%	15.4%	6.5%	12.3%	11.3%	3.5%	5.8%	15.1%
Diluted EPS Before XO Items	\$0.66	0.06	\$0.77	\$0.93	\$1.07	\$1.14	\$1.28	\$1.30	\$1.24	\$1.04	\$1.55
Year over year change		N/A	N/A	20.1%	15.4%	6.5%	12.3%	1.2%	-4.6%	-16.2%	49.3%
Diluted EPS	\$0.66	(0.28)	\$0.77	\$0.93	\$1.07	\$1.14	\$1.28	\$1.30	\$1.24	\$1.04	\$1.55
Year over year change		N/A	N/A	20.1%	15.4%	6.5%	12.3%	1.2%	-4.6%	-16.2%	49.3%
<b>Procter &amp; Gamble Earnings Figures</b>											
Diluted EPS—annual report	0.61	(0.24)	0.73	\$0.87	\$1.01	\$1.14	\$1.28	\$1.30	\$1.24	\$1.04	\$1.55
Year over year change		N/A	N/A	19.6%	16.1%	12.9%	12.3%	1.2%	-4.2%	-16.1%	48.6%
Diluted EPS cont ops.											
Core EPS								\$1.43	\$1.48	\$1.56	\$1.80
<b>"Diluted EPS, or Core EPS where available"</b>	<b>\$0.61</b>	<b>\$0.63</b>	<b>\$0.73</b>	<b>\$0.93</b>	<b>\$1.07</b>	<b>\$1.14</b>	<b>\$1.28</b>	<b>\$1.43</b>	<b>\$1.48</b>	<b>\$1.56</b>	<b>\$1.80</b>
Year over year change		3.3%	15.9%	27.1%	15.4%	6.5%	12.3%	11.3%	3.5%	5.8%	15.1%

Source: FactSet Research Systems, Bloomberg L.P., company reports, and Federated Investors, 2012.  
 Note: Company data is from most recent annual report available.

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012		
										Median Growth	Standard Deviation
\$1.58	\$2.17	\$2.45	\$2.60	\$2.96	\$3.24	\$3.38	\$3.53	\$3.95	\$3.54		
23.4%	37.3%	12.9%	6.1%	13.8%	9.5%	4.3%	4.4%	11.9%	-10.4%	8.0%	19.0%
\$1.85	\$2.32	\$2.66	\$2.64	\$3.04	\$3.64	\$3.58	\$3.53	\$3.93	\$3.12		
19.4%	25.7%	14.7%	-0.8%	15.2%	19.7%	-1.6%	-1.4%	11.3%	-20.6%	11.9%	16.1%
Original	Original	Restated	Original	Original	Restated	Restated	Restated	Original	Original		
\$2.04	\$2.32	\$2.53	\$2.64	\$3.04	\$3.42	\$3.47	\$3.67	\$3.95	\$3.85		
13.6%	13.7%	9.1%	4.3%	15.2%	12.5%	1.5%	5.8%	7.6%	-2.5%	10.2%	5.8%
\$1.85	\$2.32	\$2.53	\$2.64	\$3.04	\$3.56	\$3.39	\$3.53	\$3.93	\$3.12		
19.4%	25.7%	9.1%	4.3%	15.2%	17.1%	-4.8%	4.1%	11.3%	-20.6%	10.2%	15.9%
\$1.85	\$2.32	\$2.53	\$2.64	\$3.04	\$3.64	\$4.26	\$4.11	\$3.93	\$3.66		
19.4%	25.7%	9.1%	4.3%	15.2%	19.7%	17.0%	-3.5%	-4.4%	-6.9%	10.7%	15.1%
\$1.85	\$2.32	\$2.66	\$2.64	\$3.04	\$3.64	\$4.26	\$4.11	\$3.93	\$3.66		
19.4%	25.7%	14.7%	-0.8%	15.2%	19.7%	17.0%	-3.5%	-4.4%	-6.9%	13.8%	15.2%
			\$2.49	\$2.79	\$3.36	\$3.35	\$3.47	\$3.85	\$3.12		
\$2.04			\$2.85	\$3.15	\$3.50	\$3.47	\$3.61	\$3.87	\$3.85		
<b>\$2.04</b>	<b>\$2.32</b>	<b>\$2.66</b>	<b>\$2.85</b>	<b>\$3.15</b>	<b>\$3.50</b>	<b>\$3.47</b>	<b>\$3.61</b>	<b>\$3.87</b>	<b>\$3.85</b>		
<b>13.6%</b>	<b>13.7%</b>	<b>14.7%</b>	<b>7.1%</b>	<b>10.5%</b>	<b>11.1%</b>	<b>-0.9%</b>	<b>4.0%</b>	<b>7.2%</b>	<b>-0.5%</b>	<b>10.8%</b>	<b>6.6%</b>

Now an earnings table like this might be used by an investment analyst to determine what P/E P&G normally trades at, or used in conjunction with a similar table for other companies. The end goal is the same: relative valuation of a stock, relative to its past or relative to others. Yet, tracking P&G's earnings over the past 20 years is nothing short of chaos. Beyond having regular versus diluted earnings throughout due to stock option and preferred debt dilution, P&G had five years of restructuring starting in the late 1990s that resulted in a non-GAAP "core" EPS figure. In recent years, P&G has sold off several businesses, thus bookending the large acquisitions the company had made earlier in the decade. (Oh, to be an investment banker, collecting a handsome fee at each transaction!) Those sales and a new round of restructuring that was just announced have led to yet another series of "core" EPS results as well as the further complication of reported EPS from continuing operations and EPS from discontinued operations—the businesses to be sold.

Now to be fair to P&G, many of the numbers coming from the various data vendors over the past 20 years agree with one another, but to be even fairer to investors, there are way, way too many of these numbers and they vary too much to expect that tracking any single one of them—even if you could do that reasonably well—would be helpful in understanding the key question for an investor (What is a company worth based on its payments to owners?) and the key question for the speculator (What do other people think it may be worth?). And these are annual numbers. Multiply by four and you get a lot of figures to ponder if you are trying to make an investment decision based on near-term results.

Maybe it would not be such a burden if each earnings variant were consistent in its trajectory. But they are not. Under each row of earnings figures, I've added the percentage growth

over the previous year. P&G is to be commended for having had such success in expanding its business over the years, and doing so with laudable consistency, but let's take a closer look at those year-over-year gains. On the far right of the table, I've added a column that shows the standard deviation—the degree to which the results have jumped around—of the growth rates. The answer is a lot, even after adjusting (see how hard it is not to normalize!) for some really sharp up-and-down performance in the early 1990s. Most of the earnings growth figures have standard deviations in the teens, which is really quite high. One is as low as 5.8%. When I put together a composite earnings record—the last row, in bold—consisting of the company's preferred “core” figure plus the reported diluted earnings per share number from the company in those years when it did not take a charge, the standard deviation is still 6.6%. Let's give P&G a well-deserved break and stick with the numbers that generate only 6% volatility.

#### 4. Earnings Estimates

Think I'm done? Not yet. We need to add yet another series of numbers to the P&G earnings equation. The stock market is supposed to be a discounting mechanism. That is, participants in the market make investment decisions based on what they think something might be worth at some point in the future. Dividend investors look at a company and see, in addition to the current profit distribution, growth in those payments, and come to a conclusion as to whether the business at the current price makes a good investment over a multiyear, if not a multi-decade, period. But we are, alas, still a small minority in a vast population of would-be buyers who are focused only 6 or 12 months out and as a result, necessarily, care not a whit about the dividend, just about the movement in the share price. For these individuals *cum* speculators, near-term earnings do mat-

ter, as that is all they have to work with. That's where earnings estimates come in. You've probably heard reference to "consensus" estimates, which is the median view of all the brokerages as to what a company might earn in the next quarter or year. (It goes without saying that these estimates are for diluted, normalized earnings.) As a practical matter, these estimates may be more important than what the company actually reports, as the latter tell us only about the past, while the estimates foretell (or are supposed to) the future.

In Table 1.2, I have listed what the brokerage community over the past 20 years has expected P&G to earn in the course of the company's fiscal year, at the start of that period. (P&G has a July 1 through June 30 fiscal year.) In the second row, I have compared it to the company's actual results, and in the third line, in an effort to tilt the scales as much as possible toward legitimizing the earnings game as it is currently played, I have compared both with the "best fit" composite earnings from the matrix above. As you can see, that best fit isn't a very good fit at all. In fact the brokerage community is generally quite a bit off. For the last couple of years, when P&G has sold businesses, the estimates made before those sales have necessarily been well wide of the final mark, but that too is important to note. If the stock market is a discounting mechanism for future profits, the chance of correctly estimating those prof-

**TABLE 1.2 Consensus Earnings Estimates for P&G**

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Consensus earnings estimates for FY, at beginning of FY	\$0.73	\$0.80	\$0.90	\$1.06	\$1.21	\$1.36	\$1.47	\$1.60	\$1.62
Delta with actual	(0.97)	(0.07)	(0.03)	(0.05)	(0.07)	(0.08)	(0.18)	(0.36)	(0.58)
Delta with actual/core	(0.10)	(0.07)	0.03	(0.06)	(0.07)	(0.08)	(0.04)	(0.13)	(0.06)

Source: Sanford C. Bernstein & Co. and Federated Investors, 2012.

its goes down when there are a lot of asset sales and restated results. Note that in two-thirds of the cases, the consensus estimates at the beginning of the year are too optimistic. The company comes in light. It seems that Wall Street's perennial optimism is too great even for an impressive and steady grower like P&G. (Other studies have shown that Wall Street analyst estimates are on average about 20% too bullish.)

At this point, I can hear you begging for mercy, that I am torturing you with data, and minutiae at that. But the sad reality is that this is how the stock market works and how your retirement nest egg is being managed. If you prefer, you can stash your savings in the mattress. Then you'll know exactly how much you have. But then you get wiped out by inflation, as well as having a lumpy mattress. No, it is better to make the effort to understand how the stock market works rather than to turn a blind eye to it and hope for the best. So one last round of torture, and then I'll set you free. In fact, if you can hold on a little longer, I promise to offer up a soothing balm for the psychic wounds that I have inflicted.

## 5. "Beat by a Penny"

Heretofore I've been using annual results: the 12-month numbers reported by the company, the yearly numbers gathered by the data aggregators, and the forecasted annual earnings put

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
\$1.66	\$1.97	\$2.24	\$2.56	\$2.93	\$2.99	\$3.48	\$3.87	\$3.78	\$3.99	\$4.27
(0.12)	(0.13)	0.08	0.10	(0.29)	0.05	0.16	0.39	0.33	(0.06)	(0.61)
0.14	0.07	0.08	0.10	(0.08)	0.16	0.02	(0.40)	(0.17)	(0.12)	(0.42)

out by the brokerages. But publicly traded companies in this country must report their results quarterly. So the whole exercise—multiple sets of results, estimates, etc.—gets repeated four times each year. Yet there is something peculiar going on here. I noted earlier how estimates at the beginning of the year tend to be high and are most certainly off from what a company—even an easy company to track like P&G—will generate. But when we look at the quarterly results, a different picture emerges. For the decade ending in 2011, P&G has reported diluted quarterly operating results 40 times. In 37 of the 40 quarters, the company met or “beat” consensus estimates. In only three quarters did the company “miss.”<sup>8</sup> But wait. Weren’t the annual estimates usually too high? How can that be? How can a company come in below the estimate at the annual level but consistently be ahead of the estimate at the quarterly level? There’s something fishy going on here. And it is not limited to P&G. You can find this pattern of “beats” across the large-company investment spectrum.

Welcome to the Wall Street quarterly earnings game. It turns out both conditions are true—the brokerages have too optimistic estimates at the beginning of the year, but at the quarterly level, the company meets or beats those same estimates. That’s because during the course of the year, the estimates generally come down. That can result from disappointing earnings early on or from the company either explicitly or quietly “guiding down” the brokerage estimates as it gives its presentations to investors. From the outside, it is absurd, but this is how things get done on Wall Street. I am reminded of the delightful scene early in *Casablanca* where Captain Renault is entertaining Victor Laszlo at Rick’s café:

Captain Renault: *Emil, please. A bottle of your best champagne, and put it on my bill.*



Victor Laszlo: *Captain, please—*

Captain Renault: *Oh, please, monsieur. It is a little game we play. They put it on the bill. I tear up the bill. It is very convenient.*

This game is being played with your money. You should be outraged. Why aren't you outraged?

As a young analyst for traditional “buy low, sell high, repeat frequently” portfolios, I was always looking for more information and relied upon the quarterly revelations of publicly traded U.S. corporations to make my recommendations. At the time, I bemoaned that most European companies did not report full quarterly operating results. As a portfolio manager, I now regret that U.S. companies offer so much information, and so frequently. The flood of highly orchestrated numbers coming from large corporations (or small ones for that matter) can lead only to poor long-term decision making by investors.

From the perspective of the companies themselves, the situation may be far worse. For these large, usually stable corporations to have to bare all every three months is a tremendous waste of resources. The quarterly calls with investors, the conference presentations, and the road shows all take up management time and energy that could better be spent running the business. Instead, senior managers spend an inordinate amount of their time trying to sell the stock. I see this every day in my capacity as an institutional investor. But it's not just a matter of wasted time. Executives who have worked at both privately held and publicly traded companies have noted that the pressure on the publicly traded ones to perform quarterly and to show immediate results for investment projects gets in the way of making good, long-term business decisions. Such projects can take numerous

quarters if not years to bear fruit, and in a private company setting, they may well be given that luxury. Long-term strategic planning is a good deal harder for publicly traded companies, where projects and people are judged in three-month increments.

## 6. Earnings Beyond P&G

If this is disturbing from an everyday company with straightforward accounting like P&G, take a look at the earnings record of a major financial services company or diversified conglomerate. Parsing the quarterly results of JPMorgan (JPM), Bank of America (BAC), Citigroup (C), or General Electric (GE) can be a maddening exercise. From a simple “how’s business?” perspective—a question that can still be asked and answered in regard to P&G—the leading financial services companies and large conglomerates offer, sorry to say, very little means of directly addressing that question. Instead, they put forth adjustment after adjustment, calculation after calculation. Even from smaller financials, the reporting can be challenging. Consider the following 2011 headline from a midsized bank. (I have removed the name of the specific institution because it simply does not matter. It could be from just about any similar financial services company.)

### *FINANCIAL COMPANY X*

*REPORTS 2Q 2011 DILUTED GAAP EPS OF \$0.27, DILUTED CASH EPS OF \$0.33,  
AND DILUTED OPERATING EPS OF \$0.26*

*Board of Directors Declares \$0.25 per Share Quarterly Cash Dividend*

Footnotes in the press release explain the differences among the three separate earnings figures that are in the headline, but the point is that the coda for the EPS array is just one

simple dividend amount. Obviously, an investor needs to understand whether the company can afford its dividend, but it is equally clear that releases like this, issued quarterly, aren't really helpful in answering that question. Or, as the common retort to an embarrassing revelation might go: "too much information."

And it's not just financials. Using P/Es on cyclical companies can easily get out of hand. In a recent popular work on stock valuation, Aswath Damodaran, the leading expert in the field, offered four separate P/E ratios per stock in order to show the challenges of valuing oil companies, whose businesses are naturally quite cyclical. He then took an average and median of the group to see where they stood vis-à-vis one another. There were 16 oil companies in total, so the resulting P/E table is a matrix of 72 entries.<sup>9</sup> Don't get me wrong; Damodaran is excellent on the various ways to value companies, and he is equally clear in emphasizing the importance of intrinsic valuation based on cash flow analysis. He is and should be widely followed by investors seeking the ins and outs of valuation exercises. But in this case, his determined effort to get to a useful P/E ends up highlighting how convoluted such an exercise can become.

Yes, company profits necessarily underpin both "earnings" and dividends, but it is not just a semantic issue when earnings are a matter of the current quarter, are as often as not "managed," and belong primarily to executives to spend as they please, while dividends are a matter of years, are what company owners actually get, and ultimately generate the total return investors purport to care so much about. Estimating long-term dividend growth is far from a fully objective exercise, but it involves much less guesswork than trying to come up with near-term earnings, or a series of earnings figures that are then averaged. As a valuation frame-

work, focusing on long-term dividends is not only theoretically superior, it is also just a lot more straightforward than chasing near-term earnings.

Critics with a longer-term view will charge that I have exchanged one subjective exercise (forecasting earnings) for a different one (forecasting dividends). Is it possible that I am oversimplifying to justify a focus on one long-term factor? Perhaps. And there is still substantial work to be done to assess whether a company has the ability to pay and increase profit distributions to its owners, and whether management has the inclination to do so. However great the challenge of forecasting dividend growth, it pales in comparison to the monumental and ultimately futile task of trying to figure out what someone else might pay for a stock a week or a month or even a year hence based on the P/E game.

Dividends are paid out of earnings, it is true, and over the long term, both must follow a similar trajectory. But the financial services industry, and the businesses themselves, have made such a mess out of earnings—dilution, too many adjustments, too many sets of numbers, and a focus on quarterly results—that they no longer can be used in any meaningful sense by long-term investors. Earnings are supposed to be the means to the end of dividends, but on Wall Street and regrettably on Main Street, the means has become the end. For stock speculators, that’s all for the best. But investors

**TABLE 1.3 P&G’s Dividend Growth for the Past 20 Years**

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Annual dividends	\$0.26	\$0.27	\$0.31	\$0.35	\$0.40	\$0.45	\$0.51	\$0.57	\$0.64	\$0.70	\$0.76
Year over year change		7.3%	12.7%	12.9%	14.3%	12.5%	12.2%	12.9%	12.3%	9.4%	8.6%

Source: FactSet Research Systems, 2012.

who see themselves as company owners should simply focus on what they actually derive from their stake—the dividend they receive—and assess the company’s ability to support and increase it over time.

## The Dividend

You can relax now. The cavalry has arrived. Table 1.3 shows P&G’s dividends for the past 20 years. They are as reliable as Tide detergent and as consistent as 99-44/100% pure Ivory Soap. Note that in contrast to earnings, there is only one set of numbers, no dilution, no “normalized” dividend, no “core” dividend. There is no disputing the value of a dividend when it is paid; it is always a positive value. Regardless of the data source, the figure is the same. More importantly, note the growth rate of the dividend over the two-decade period—an admirable 12% per year. And even more critically, the standard deviation of that growth rate is very low, just 2%, one-third the volatility of the earnings results with the lowest standard deviation.

P&G proudly trumpets the company’s long history of dividend payments, starting in the late nineteenth century, and justifiably notes nearly 60 years of annual increases, since 1954. That’s an exceptional record and a testament to a very-well-run company. If you believe that this impressive rate of

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Median Growth	StDev
\$0.82	\$0.93	\$1.03	\$1.15	\$1.28	\$1.45	\$1.64	\$1.80	\$1.97	\$2.14		
7.9%	13.7%	10.5%	11.7%	11.3%	13.3%	13.1%	9.9%	9.3%	8.6%	11.9%	2.1%

dividend growth can be sustained, and if you find the current yield attractive, you might want to consider becoming a company owner. The stock market gives you the opportunity to do so with relative ease. A stake in Tide and Ivory, as well as Crest Toothpaste, Olay, Pampers, Bounty, and many other leading brands is just a few keystrokes away.

Yes, yes, you say. That's all fine, but what about the *stock*? Well, here's the point: over time, the share price follows the dividend growth. In P&G's case, since 1962 (as far back as I have detailed data), the dividend has risen by a compound annual growth rate of 9.6%. In the same time period, the share price has gained at a rate of 8.8%.<sup>10</sup> With the exception of the last decade, when share prices have been sluggish, the relationship between P&G's stock and dividend has been remarkably steady: *asset prices follow the trajectory of the profit distributions*. In the next section, I'll produce more examples, but suffice it here to note that over the long term, the relationship for S&P 500 Index-type companies is close, with a high correlation between dividend growth and share price appreciation. So if you like "stocks" (and are perhaps indifferent to the underlying company) and you want them to "go up" over the long term, you should still focus on the dividend.

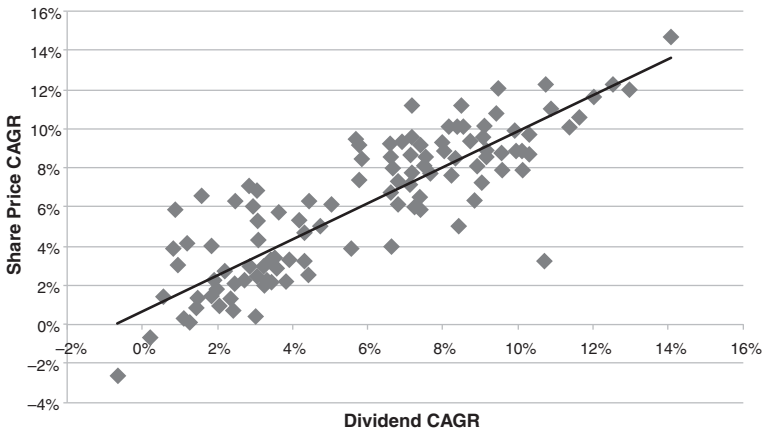
After all of this buildup and a detailed review of earnings at one of America's best-run companies, let me summarize the point of this chapter: *It's not that you can't play the Wall Street game of guessing near-term earnings in order to figure out where the stock might trade a week or a few months from now; it's more a matter of why would you want to?* That's not how you manage your own business. Why would you treat your investment portfolio—an aggregation of businesses—any differently?

## The Stock Market Classes of 1962, 1970, 1980, 1990, and 2000

Stocks go up over time because earnings rise, and dividends are the clearest manifestation of that underlying gain in profits. It's a simple enough concept, even if it is no longer acknowledged on a Wall Street crazed with quarterly earnings and a Main Street that has been cajoled into playing the quarterly earnings game. Stepping back from the example of P&G, there are 154 companies that were trading publicly in the United States on December 31, 1962, and were still trading on December 31, 2010. That's 48 years. Of those, 14 did not have dividends at the starting point, and 13 of them that had dividends at the beginning did not have them at the end. Four companies did not have dividends at either the beginning or the end. That leaves 123 companies trading then and now with dividends at the start and finish.

The scatterplot in Figure 1.3 shows the relationship between the dividend growth and share price appreciation for those companies. The correlation—the fact that the data points fall pretty much in a line—between the two is 86.6%. I would also note that this group had a median total return of 10.66% while the 13 stocks still surviving but with no dividend at the end point had a median return of just half that, 5.33%.<sup>11</sup>

Scatterplots aren't usually found in books on the bestseller list, and that is a pity. The chart provides a straightforward visual representation of an even more straightforward business concept: *the change in the value of a business closely follows changes in the profit distributions of said business.* Statistically oriented readers may object to the overwhelming survivor bias in this analysis. I would say that that is precisely the point: a characteristic of survivors is that they have profits and can distribute them. There will also be instances of com-

**FIGURE 1.3** Share prices and dividend growth since 1962

Source: FactSet Research Systems and Federated Investors, 2012.

panies going back and forth on their dividend payments. That will trouble the statisticians, but it should not trouble investors. Investing for dividends is not the outcome of a narrow statistical analysis; it is a basic business proposition.

But let me give you a few individual company examples that make that same point in a commonsense fashion: Abbott Laboratories (ABT) enjoyed annual dividend growth of 13% and share price appreciation of 12.1% over the 48-year period. In a nice instance of pure coincidence, longtime rivals PepsiCo (PEP) and Coca-Cola (KO), though they now have substantially different businesses, came in exactly the same, with dividend growth of 10.9% and share price appreciation of 11.0%. Relatively few companies have identical dividend and share price growth rates. The difference is explained by the yield changing over time. In some instances, investors are now paying more for an income stream, in some instances less. But in most cases, the change in yield is minor compared to the close relationship between the dividend trajectory and the share



price path. There are exceptions, such as John Deere & Co (DE), with a 7.2% dividend growth rate and a more robust 9.5% share price gain. (In 2011, Deere raised its dividend 17% and its share price declined by 7%, bringing the share price and dividend metrics closer together.) At the other end of the spectrum, Bank of America (BAC) posted share price growth of 5.9% since 1962, but after its recent cut, dividend growth of just 0.9%. (BAC shares fell 58% in 2011 while the dividend stayed flat. That gap, too, appears to be narrowing.) And then, of course, there are those unfortunates such as Eastman Kodak (EK) that had to discontinue their dividends. Those businesses have struggled, plain and simple, and the results are visible to all. The less said about them, the better.

For the class of 1970 and the subsequent cohorts, I will spare you (reluctantly) the scatterplots and just show the table of results (Table 1.4).

Read it left to right, read it top to bottom. The conclusion is the same: as the market became increasingly detached from dividends during the Great Retreat starting in the 1980s, annual returns declined and volatility (standard deviation) increased. And throughout, initiators and payers do vastly better than dividend eliminators and nonpayers, a group that grows dangerously large—half the continuously trading market by 2000.<sup>12</sup>

For the classes of 1990 and 2000, the impact of declining payout ratios among the dividend payers and the rise of a substantial group of non-dividend payers (often technology companies) can be felt. For those two cohorts, one can say that the close linkage between distributed profits and asset values (dividends and share prices) has been broken, at least for a while. That disconnect continues to this day. Too many investors have gotten used to the notion that the fabulous and justifiable successes of Oracle (ORCL), eBay (EBAY), and Apple (AAPL),

**TABLE 1.4 Dividend Growth, Share Price Appreciation, and Total Return through 2010**

Securities			Payers					Initiators				Eliminators/Non-Payers			
Class of	Total Number of Securities Trading Continuously	Median Total Return CAGR	Number of Start/Finish Dividend Payers	% of Total	Correlation between Dividend Growth & Share Price Appreciation for Payers	Median Total Return CAGR of Payers	StDev	Number of Initiators	% of Total	Median Total Return CAGR of Initiators	StDev	Number of Dividend Eliminators/Non-Payers	% of Total	Median Total Return of Dividend Eliminators/Non-Payers	StDev
1962	154	10.2%	123	79.9%	86.6%	10.7%	2.6%	14	9.1%	11.0%	2.8%	17	11.0%	7.0%	4.9%
1970	367	10.6%	251	68.4%	78.6%	11.3%	2.8%	33	9.0%	12.3%	4.4%	83	22.6%	5.0%	6.2%
1980	539	11.0%	339	62.9%	75.8%	12.0%	3.7%	53	9.8%	13.0%	5.1%	147	27.3%	4.4%	7.3%
1990	1220	9.9%	630	51.6%	62.6%	10.9%	4.9%	112	9.2%	14.3%	6.7%	478	39.2%	4.9%	10.9%
2000	2168	5.1%	864	39.9%	49.1%	8.7%	8.6%	226	10.4%	8.2%	12.5%	1078	49.7%	-1.4%	17.1%

Source: FactSet Research Systems and Federated Investors, 2011.

as businesses and as investments, are the norm, not the exception. In an earlier age, all of these companies would be robust dividend payers. (Apple actually did pay a dividend until it got into trouble in the late 1980s; it has just reintroduced a small profit-sharing plan for company owners.)

So let's finish where we started. Why do stocks go up on any given day? Because there are more would-be buyers than would-be sellers. Why? There can be a vast number of reasons, but they basically come down to investors coming to believe that the company is worth more than it was the day before. And why do they think so? Because some news has come out to suggest that the company will do better as a business (earnings) than they previously thought or because the value of those earnings may be worth more to investors (the multiple applied to the earnings). So we're back to earnings, and over the long term, stocks go up hand-in-hand with long-term earnings growth, measured over decades. But in the near term, measured in days, months, and even a few years, earnings simply can't be trusted. Quarterly numbers are too volatile to give a good indication of a company's long-term prospects. And though companies will deny it fiercely, the reality is that quarterly results are subtly manipulated by management to make or beat their "number," the consensus estimate from Wall Street brokerages, which is also "managed" by companies. That leaves us with dividends, the true, indisputable measure of underlying, long-term earnings, and that to which the stock market provides convenient and ready access, even if most investors no longer use it for that purpose.

### **Conclusion: Share Prices, Dividends, and Total Return**

The annual return from ownership of a business is equal to the cash that the business distributes to the owner plus the

growth rate of the distribution stream, assuming that the asset value will follow the trajectory of that cash distribution over time. That's rooted in basic finance. I didn't create that math, and I don't make any novel claims other than to point out that the rules are no different if the business happens to be publicly traded, except that the cash distribution is called a dividend and the asset value is known as a stock price. That being the case, the dividend yield and dividend growth will equal 100% of the nominal total return of a stock over time. That assertion makes only one assumption, albeit an important one, about the stock market's "treatment" of a business: that the yield (distribution/asset price) doesn't change materially between the measurement starting and ending points. When that condition holds, the math adds up, and 100% of the investment return can be linked directly to the dividend. When the yield falls during the measurement period—the share price outpaces dividend growth—the total return attributed to the dividend will be less than 100%. Alternatively, when the yield increases during the measurement period—the share price doesn't keep up with dividend growth—the total return attributable to the dividend will be greater than 100%. So compression or expansion of the yield does introduce some measure of return not directly reliant upon the dividend. In *The Strategic Dividend Investor*, I referenced that 85% to 90% of S&P 500 Index returns from 1926 through 2010 came from dividends. You might ask, if the math is so simple, why wouldn't it be 100% of the total return? Well, for part of that measurement period, specifically the 1980s and 1990s, share prices moved up well ahead of dividend growth. In fact, share prices shot up. Dividends increased at a more or less normal rate. The capital appreciation in excess of the dividend growth rate in the 1980s and 1990s is what makes

up that 10% to 15% of the S&P 500 Index's return not directly linked to cash payments.

The trading crowd didn't like this assertion at all. They pointed out the obvious: that stocks go up and stocks go down all the time without reference to the dividend. Indeed, you can find instances when a company cuts its dividend and the stock rallies on the news. And then there are those securities that have no dividend and seem to enjoy long and prosperous lives. True, true, and true. And for near-term speculators, that's really all one needs to know to justify focusing one's efforts on trading stocks. Investors, however, need to take a longer-term view, and that's where the high correlation between the dividend trajectory and capital appreciation becomes apparent. (And even where investors looking at non-dividend paying stocks for the long term might want to pause and realize that—in the absence of any cash payment from their holding—they are playing a trading game, not making a business investment.)

So having annoyed the traders with the observation that 85% to 90% of the S&P 500 Index's historical total return can be attributed to dividends, let me really irritate them by predicting that during the next several decades, dividend yield and dividend growth will account for at least 100% of actual returns from the main stock market index. The only variable is the S&P 500 Index's yield. If it stays at its current low level of around 2%, dividend yield and dividend growth will account for 100% of the market's future return. If, as is more likely, the market's yield returns to its more normal 4% or so level, then by definition, over 100% of the market's return will be coming from dividends. Stocks will not appreciate as fast as the dividend grows in what will be a reversal of the trend from 1982 through 2000. Whereas in that earlier period, we saw the dividend multiple (price/dividend)

expand, in this instance the dividend multiple will contract. The imbalance that was created in the 1980s and 1990s will be reversed, and the market's traditional return profile will be restored. A future analysis of the S&P 500 Index returns from 1926 through 2026 or 2036 or 2046 will show that essentially all of the return from the U.S. market's main index will have been attributed to the dividends paid out and to the growth in those payments. You read it here. I was going to write that you read it here *first*, but that's not true. You read it first in an early chapter of your finance textbook, or perhaps in the first chapter of that book on business or stock valuation on your bookshelf, or you may have seen it in Irving Fisher's seminal *The Nature of Capital and Income* (1906), or in John Burr Williams's *The Theory of Investment Value* (1938). And the same point is implied, if not actually stated in this form, by others such as Benjamin Graham and Aswath Damodaran. You've read it here just most recently: the value of an investment is the present value of the cash you derive from it. The annual total return is the combination of the annual cash generated and the growth trajectory of that cash stream.

Before I am mauled by that aggressive scrum of bloggers, let me unequivocally state that I am well aware that newly public companies in growth mode won't have dividends, and therefore attributing their near-term returns to the presence or absence of a dividend isn't a very useful exercise, that stocks trade 250 days each year and can move up or down dramatically in that period with no regard for the dividend, and that even dividend-paying and dividend-growing companies can see a divergence between their share prices and dividend trajectories for many years at a time. And finally, I readily acknowledge that a many-year period when dividends are not relevant, such as the nearly two-decade run from 1982 through 2000, is long enough to have a career as a trader and

a successful speculator. No doubt. That's not the issue. It's not that you can't make a lot of money trading stocks when the environment is conducive to that type of activity; it's that if you wish to put resources into the stock market and treat it as a business investment, you are going to take a different approach than that of the trader. And if you are looking at the S&P 500 Index as the main part of the market, it should be all about the cash payments you receive. That shift from stock to dividend, from the roller-coaster ride of daily price changes to the more stable income stream, allows genuine investors to make long-term and hopefully wise business decisions.

— THE —

# DIVIDEND IMPERATIVE

HOW DIVIDENDS CAN NARROW THE GAP  
BETWEEN MAIN STREET AND WALL STREET

DANIEL PERIS



New York Chicago San Francisco Lisbon London Madrid  
Mexico City Milan New Delhi San Juan Seoul Singapore Sydney Toronto