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Dividends' New Allure

Before you yawn and turn the page, consider this: Back at the end of June 2000, when the Dow, while off its highs was roundly 1,000 points higher, and the Naz, bless its little heart, was at double its current level, Gail Dudack, then UBS Warburg's U.S. equity strategist, was sounding alarums, in a graceful piece aptly headlined, "Pulling Back The Curtain On Accounting," about the green eyeshade contingent's increasing propensity to generate earnings while simultaneously lowering the quality of same. Also about intimations that investor infatuation with growth by acquisition was fading, that "the trend of turning pension funds into profit centers is unsustainable over time," and that employee option compensation was not all it was then cracked up to be. Granted, Gail's clients and bosses, by and large, didn't cotton to her bearish tone. So came the PaineWebber merger and she got her walking papers. Yet that piece is as germane today as the day Gail penned it.

Gail, now setting up shop as managing director of research for Sungard's institutional brokerage operation, is not quite ready to re-enter the fray of regular publication. But the coming-to-fruition of many of her premonitions in the Enron fiasco moved her last week to issue a special report, part of which we're sharing on our website as a "Guest Perspective."

What really caught our eye, though, in Gail's "Not Quite Ready For Prime Time" report, as she too modestly describes it, was her latest prediction, encapsulated in the headline above. Or, as she put it, "When investors do return, we believe that high yielding stocks with a good history of dividend payments and dividend coverage may become 'the new new thing'."

Bingo! We obviously share her bias. It's not that dividends are fat and juicy these days. Far from it. S&P says the average dividend payment shrank 3.3% last year, more than in any year in the last 50. Or even that dividends are the part of total return that are real enough to use to buy a Whopper. Though there's certainly something to be said for instant gratification on that level. The thing is, as Gail points out, that with trust re-emerging as a crucial factor in investing, it's soon going to dawn on investors that "only companies with real earnings can commit to paying dividends."

The table below is Gail's screen for solid dividend-paying stocks with positive earnings trends and lower-than-market P/Es. The surprise is that it actually includes a couple of industrials. —KMW

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Sungard Institutional Brokerage

By: Gail Dudack, Research

"Today there is an emerging crisis of systemic confidence in our markets."
Ex-SEC Chairman Arthur Levitt at the Enron Senate hearing,
January 25, 2002.

ENRON AND THE ROLE OF BANKRUPTCIES IN A BUBBLE

In the beginning, I did not think that Enron was the landmark bankruptcy of the 2001-2002 post-bubble recession. Yet, I certainly believe that every post-bubble era has a classic recession and bankruptcy finale. There is a defining moment in every majordown-cycle in which investors think "Oh, no! This is not what I expected" and their knees get weak. Are we there yet? What do you think?

At first glance, Enron Corp. ($0.67), an energy stock, simply did not seem to be a fitting "model bankruptcy" to end the 1990's dot-com era. It appeared to be an isolated event. It did not pose systemic risk to the banking system. It did not shatter the well-honed belief that the 1990s technology/telecommunications/productivity combination was the pathway to an era of unending growth and success. Therefore, it did not read as the fitting ending to the story. But today we would not discount Enron's potential as the "whack behind the knees" event. Enron may not be a classic choice, but it is an American tragedy of substantial proportions. It also may be an investment turning point in ways that are not yet obvious.

History proves that keynote bankruptcies become an important part of Wall Street history. They are given full chapters in historical documentaries and help to define the excesses of the previous cycle. In a simpler way, each recession or dramatic market sell-off has its own memorable Chapter 11: Penn Central Railroad (1970), Equity Funding (1971), Franklin National Bank (1974), the Chrysler bailout in 1980, Penn Square Bank (1982), Continental Illinois National Bank and Trust Company (1984), Drexel Burnham (1990) and Long Term Capital Management (1998) are among those that come quickly to mind. Note that banking or financial stocks dominate this list. Typically, the sins and excesses of the previous boom period come home to roost in the banking sector. This is one good reason to avoid the financial sector today. Banks may appear to have reasonable multiples, but we are skeptical of the earnings forecasts and fear the tangential risk they have to Argentina, Kmart (KM $0.86), asbestos, overstretched consumers and many other possible problems along the way.

Early in the year we wondered whether the 537 internet companies that folded in 2001 were the benchmark bankruptcies that represented the demise of the mania. But we feared not. We watched Global Crossing (GX - $0.51), Lucent (LU - $6.78) and even AT&T (T - $18.46) as prospects. Enron was not on our radar screen, yet in many ways it does represent the sins of the last cycle: the failure of corporations to disclose transparent and honest financial statements, the failure of corporations to have a solid long-term business plan, the failure of analysts to ask corporate America probing questions and write thought provoking research, the failure of accounting and legal firms to do their jobs objectively, the failure of Congress to protect its citizens instead of focusing on campaign funding, and the failure of average investors to stop chasing rainbows for the pot of gold and to kick the tires before they buy a stock. Certainly, there are more good businessmen, analysts, lawyers, accountants, politicians and investors, than bad or careless ones. However, few are blameless. Investors had been "investing" based upon their faith, hope and confidence that stocks would go up rather than balancing or even caring about the risks and rewards involved. Now, after many hard lessons learned, it would appear that investors cannot trust analysts, accountants, lawyers, and corporate executives. If this view persists, will investors still buy stocks? Will they hold on to the stocks they have? Will the pendulum swing from too much trust to too little trust? Or is it possible that the pendulum swings back to dead center and rational thinking? After watching many market cycles, I would not count on rational thinking to suddenly materialize.

This generates the real question. Despite the huge sell-off to date, stocks represent 44% of household financial assets while cash represents 34%. This is a dramatic shift from 1999 when equities represented more than 58% and cash was 23%. However, the decline in equity holdings has taken place due to two factors: the decline in stock prices and the fact that in the last 12 months, new flows into mutual funds have gone disproportionately into money market funds. It did not occur due to heavy selling of stock by the public.

All market troughs have been characterized by heavy public selling at the bottom once investors conclude that equities are a high risk investment. We felt this cycle might end differently due to the huge expansion in defined contribution plans which converted many employees into quasi-long-term portfolio managers. In our view, investors would hold stocks for their long term benefits, but new demand for stocks would be curtailed dramatically. But now, given the spreading fallout from the Enron bankruptcy, an investor sentiment change may be on the horizon. The post-Enron world will also be a wake-up call to accounting firms; it will result in the sterilization of income statements which will not increase earnings power and it is likely to result in the uncovering of further accounting manipulation. Public disenchantment with equities is apt to increase.

Bubble markets happen only once in a generation and in the aftermath, investors typically retreat into the background for an extended period of time. After the 1930s, it took 20 years for investors to rediscover stocks. After the 1973-74 bear market, investors were sidelined for ten years. We believe time will be compressed in this cycle. Nonetheless, a two to five year sabbatical from stocks is not an unreasonable expectation given what investors have suffered recently. This means we are no more than half-way through an investment drought. Moreover, the worst of the outflows may lie ahead since investor sentiment has remained so robust throughout all the pain.

Investors will return to the stock market only when they can see and trust the benefits of putting new money into stocks. When investors do return, we believe that high yielding stocks with a good history of dividend payments and dividend coverage may become "the new new thing". Companies that pay dividends must have real earnings, not a manipulated income statement! Moreover, Baby Boomers will come to appreciate what generations of investors have learned before them: the turtle wins the race. Total return investing is a way to build equity holdings slowly and steadily over time.