Brother, Can You Spare a Dividend?

EMAIL THIS ARTICLE PRINTER FRIENDLY BECOME A FOX FAN

Thursday, January 09, 2003
By Hilary Kramer

FOX NEWS

***DISCLAIMER*: THE FOLLOWING "Brother, Can You Spare a Dividend?" CONTAINS STRONG OPINIONS WHICH ARE NOT A REFLECTION OF THE OPINIONS OF FOX NEWS AND SHOULD NOT BE RELIED UPON AS INVESTMENT ADVICE WHEN MAKING PERSONAL INVESTMENT DECISIONS. IT IS FOX NEWS' POLICY THAT CONTRIBUTORS DISCLOSE POSITIONS THEY HOLD IN STOCKS THEY DISCUSS, THOUGH POSITIONS MAY CHANGE. READERS OF "Brother, Can You Spare a Dividend?" MUST TAKE RESPONSIBILITY FOR THEIR OWN INVESTMENT DECISIONS.**

ADVERTISEMENT

"I was always there, right on the job
They used to tell me I was building a dream…
Once I built a tower, up to the sun,
brick and rivet and lime.
Once I built a tower, now it's done --
Brother, can you spare a dime?"

These lyrics were written in 1932 about the typical American unemployed worker during the Great Depression. Seventy years later, today's typical American unhappy investor is finding those verses to ring just as true. Investors who were recently putting their capital at work to finance the American dream now seem to need a proverbial handout from a relative. Instead of a brother, though, it's Uncle Sam to the rescue throwing an economic stimulus package into our hats.

On January 7, President Bush unveiled a proposal highlighted by accelerated tax write-offs for new capital investments, an extension of unemployment benefits, an increase in the child tax credit and the elimination of the corporate dividend tax. Political mayhem ensued as politicians and their rhetoric predictably assembled along party lines. Democrats immediately blasted the plan's alleged bias to the wealthy and decried its supposedly minimal impact on the overall economy. Republicans defended the proposal's capacity to encourage investment and its ability to produce job growth. The only thing both sides appeared to agree on is that some sort of tax cut is necessary to stimulate the economy.

But while economists debate whether or not the Bush Administration's proposal will ultimately help middle and lower income households, one thing seems clear: the plan will certainly benefit investors. President Bush considers growth in the stock market to be a critical sign of the economy's health. By terminating corporate dividend taxes, he focuses squarely on this task of boosting the stock market.

Although the Tax Reform Act of 1986 simplified the code by taxing all capital gain income at the same rate, it failed to take the most important step of all -- abolishing the double taxation of dividends. So, with an average 35 percent tax on corporate income combined with personal income tax rates as high as 38.6 percent, the effective tax rate on corporate profits to an investor is as much as 60 percent. In practice, even an ordinary taxpayer pays a higher tax rate on corporate dividends than high-income taxpayers pay on their earnings. As I mentioned in my October article on the **Double Taxation Deficit**, doing away with double taxation will accomplish several things that benefit the economy. Most notably, it will attract investors back to the stock market (particularly senior citizens); encourage profitable, cash-hording companies to pay out earnings; and reduce investors' incentive to speculate on volatile and risky stocks.

Mature companies with steady stock prices have traditionally used dividends to entice investors to hold on to their stocks. Paying out profits to their shareholders gave them returns that the company's stock gains alone could not achieve. But the extraordinary stock appreciation of the 1990's skewed the way investors looked at their return parameters. The combination of a bull market with preferential capital gain tax treatment caused shareholders to base their investment returns primarily on

PHOTOS

Click image to enlarge

RELATED INFORMATION

Kramer's Corner Archive
Show Navigation
This Week's Show
Last Week's Show
Terry Keenan's Bio
mailto:cash@foxnews.com
Cashin' In Home

COMING UP ON FNC

The O'Reilly Factor
Wed. 8 pm / 11 pm ET
Should taxpayer money fund public schools for gays? O'Reilly weighs in.

FNC Schedule

gains in stock price, and the attractiveness of dividends declined substantially. During that period, the S&P 500 dividend payout ratio hit a record low of 31.8 percent with dividend yields averaging 1.7 percent -- near all-time lows -- compared to a historic average of approximately 3.6 percent over the past half century.

All of this changes if the President's proposal to eliminate corporate dividend taxes is passed. The Bush Administration expects the plan to push stock prices up by about 10 percent. In fact, we've already seen some movement in the stock market based on speculation about the announcement alone. But what other implications might we expect from all this?

Higher Stock Values for Dividend Paying Stocks

The obvious effect, of course, is that stocks which already pay dividends will get an immediate boost. Investors would be willing to pay more for those stocks, at least by the amount of their tax savings on future expected dividend payments. Mutual funds which focus on equity income objectives should enjoy a similar boost in values. Beyond these immediate effects, there are several complimentary effects that may contribute to enhancing the stock prices of dividend paying stocks.

• Senior Citizens Will Find Dividend Paying Stocks to be Even More Attractive

Half of corporate dividend income already goes to senior citizens. As a group that is more likely to invest in income-paying (rather than capital appreciating) stocks, eliminating the dividend tax altogether further encourages this growing demographic to invest in dividend paying stocks. Increased demand for such stocks may provide additional support for higher stock prices. Richard Berner, Chief U.S. Economist at Morgan Stanley notes, "With capital gains and disinflation more limited, dividends and yields will figure more importantly in how investors allocate funds among asset classes."

Independent of any proposal to eliminate the dividend tax, there are reasons to look toward dividend paying stocks.

• Dividends Already Matter

Steve Galbraith, Morgan Stanley's Chief U.S. Investment Officer describes the current market as a "back-to-basics" stock market. In the midst of uncertainty and concerns over accounting practices, investors demand sustainable and visible earnings from companies. Of course, it may take time before those gains are reflected in company valuations. But, a savvy investor will realize that now is the time to take advantage of this new paradigm. Mr. Galbraith says, "The implications of such an environment are profound: Dividends and yields matter again." What does this all mean?

• Dividends Don't Lie

In the first half of 2002, the median S&P 500 stock with a dividend outperformed the median S&P 500 stock without a dividend by 2020 basis points.

• Dividends are Predicted to Rise

With the proper combination of economic improvement and interest rate stabilization, there is reason to anticipate corporate profitability and subsequent increases in dividends. "Indeed, the ratio of the dividend yield on stocks to the yield on the 10-year Treasury is now back to its long-term average. The odds are that this will improve in the New Year, since dividends are likely to rise in the wake of the recovery in earnings while the Federal Reserve will probably keep interest rates down," says Dr. Irwin Kellner, the Weller Professor of Economics at Hofstra University.

Higher Stock Values for Stocks in General

Even though President Bush's proposal directly affects the values of dividend paying stocks, stock values in general will likely improve because of a lower cost of capital and increased consumer spending. In the words of Sen. Don Nickles, R-Okla., chairman of the Senate Budget Committee, "If you encourage people to invest in the stock market you're going to have an increase in stock values. That will help everybody." Eliminating the dividend tax may also help the stock market by encouraging companies to alter the way they do business.

• Imposes Greater Discipline on Companies to Focus on Earnings

By leveling the playing field between short-term capital appreciation and dividend income, investors will have less incentive to speculate on more risky stocks. Companies that do pay dividends will enjoy a stock boost, forcing companies that do not pay dividends to deliver earnings in order to win back investors.

• Encourages Companies to Stick to What They Know and Pay Out Earnings

Steady, profitable companies with large cash hordes like Dell, Cisco and Microsoft may opt to pay out earnings in the form of dividends. With the elimination of the dividend tax, their shareholders might apply pressure on management to do so,

especially if the stock prices remain flat. Likewise, companies will be less likely to use their cash to venture into new fields -- which may not be their core competency. Of course, this brings to mind many examples such as AT&T deciding to compete with Big Blue. As we know now -- and investors learned via their wallet -- this telephone giant of yesterday was not cut out to take on Michael Dell.

Besides these currently non-dividend paying technology cash cows, there are several dividend paying stocks that might be worth taking a look at in light of the tax cuts.

In the telecom sector, Verizon Communications (**VZ**) gets the double benefit of having a dividend paying stock (annual yield of 3.83 percent) and from the likely scenario that the FCC will phase out rules requiring phone companies to rent their networks to rivals at cheap rates. In fact, if Michael Powell, chairman of the FCC gets his way, we will see this deregulation come into effect as early as the second quarter of 2003. Verizon's financials are strong, though a bit debt-heavy. Verizon Wireless, the company's joint venture with Vodaphone and already the nation's largest wireless service provider, is expected to close soon on an acquisition of licenses covering major markets on the East Coast and the Midwest. Although this adds to the company's debt burden, the acquisition comes at a relatively cheap price compared to wireless spectrum auctions.

The pharmaceutical industry is another area that might benefit from current political events. Merck (**MRK**) and Pfizer (**PFE**) have a history of strong cash flows and dividend payments (2.47 percent and 1.90 percent annual yields, respectively). They also boast some of the stronger portfolios of marketed drugs in the industry. But the fortuitous appointment of Bill Frist, R-Tenn., as Senate Majority Leader could ultimately lead to an even bigger boost to these major pharmaceutical stocks. Experts predict that Sen. Frist, a heart and lung transplant surgeon and arguably the most knowledgeable health care person in Congress, will help expedite the Republicans' prescription drug benefit plan. Dr. Anthony Butler, who covers the Pharmaceutical Industry for Lehman Brothers, predicts that the incremental volume gains from this sort of drug benefit plan could be a positive for the entire industry.

Finally, financial service industry stocks may be poised to rise. J.P. Morgan Chase (**JPM**), with its 5.1 percent dividend yield making it one of the Dow's highest annual yields, has already experienced significant share gains recently. Furthermore, with some of its big overhanging problems already resolved, the company is ready for investors and management to once again focus on the basics -- a company with major market share and a capital position allowing broader flexibility than many of its financial institution brothers.

The financial stocks that may increase their dividend and, in turn, increase in value include Citigroup (**C**) and insurance giant American International Group (**AIG**). Both companies enjoy stable streams of cash flow, pay unnecessarily modest dividends (1.98 percent and 0.31 percent annual yields, respectively) and benefit from the flight to quality nature of the current stock market environment. What's more, both of these financial institutions are making significant head way into the burgeoning emerging markets—namely, the market of China---where opportunities will be endless as we ultimately leave the global recession and the paralysis that has come from the uncertainty over war and enter into a cycle of economic prosperity.

And let's not forget the many companies who do not currently pay dividends. According to Standard & Poor's, less than 40% of U.S.-listed companies now pay dividends. If President Bush's proposal to eliminate corporate dividend taxes succeeds, surely some of the 60 percent who do not pay will quickly discover that they can indeed spare a dividend.

Hilary Kramer *serves as a business news contributor at FOX News Channel. She joined the network as a regular guest on* ***Cashin' In*** *in May 2001. Currently, Kramer is the senior strategist and adviser at Montgomery Asset Management.*

BACK TO HOME BACK TO TOP

ADVERTISING LINKS

Health Plans $79/Mo
Ann Coulter FREE!
BUY THIS LINK!
WebRX Free MDConsult
SpeedUp PCFree Scan!
Discount Diet Patch
Dental Plans $99year
Free Payday Loan
Meet Military Singles

Schedule | **FOX News Bios** | **E-mail Shows** | **FAQ** | **FOX News Shop**

Find FOX News Channel in Your Area | **Find FOX News Channel Abroad**

Advertise on FOXNews.com
Jobs at FOX News Channel. Internships at FOX News Channel.
Terms of use. Privacy Statement. For FOXNews.com comments write to
foxnewsonline@foxnews.com; For FOX News Channel comments write to
comments@foxnews.com
© Associated Press. All rights reserved.
Copyright © 2003 ComStock, Inc.
This material may not be published, broadcast, rewritten, or redistributed.

Copyright 2003 FOX News Network, LLC. All rights reserved.
All market data delayed 20 minutes.