



Perspective on Dividends

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Featuring River Road Portfolio Managers:

James C. Shircliff, CFA

Henry W. Sanders, III, CFA

Thomas S. Forsha, CFA

What is your outlook for dividend-based investments?

Mixed. We continue to identify high quality firms that are increasing their dividend payments, yet the current environment remains challenging as aggregate dividend cuts are well outside of the historic norm. To date, the bulk of dividend cuts are occurring in the Financials sector but the recession is impacting dividend growth throughout the market. While dividend increases continue in all sectors, including Financials, we have noted a definite decline in the rate of growth. Additionally, the expected increase of the tax rate on dividend income is disappointing, but the commensurate increase in capital gains should reduce the impact on dividend-paying companies.

Is dividend-focused investing inherently defensive?

If you define a defensive strategy as one with lower volatility of return, then dividend-focused investments have proven to be defensive. The implication that a dividend-based approach produces inferior results, however, is false. The data in Table 1 suggests that since 1928 a dividend-focused strategy, represented as the 4th Quintile, has produced greater returns with lower volatility. This is an opportunity we find appealing.

Rolling 3 Yr Periods Beginning 1930

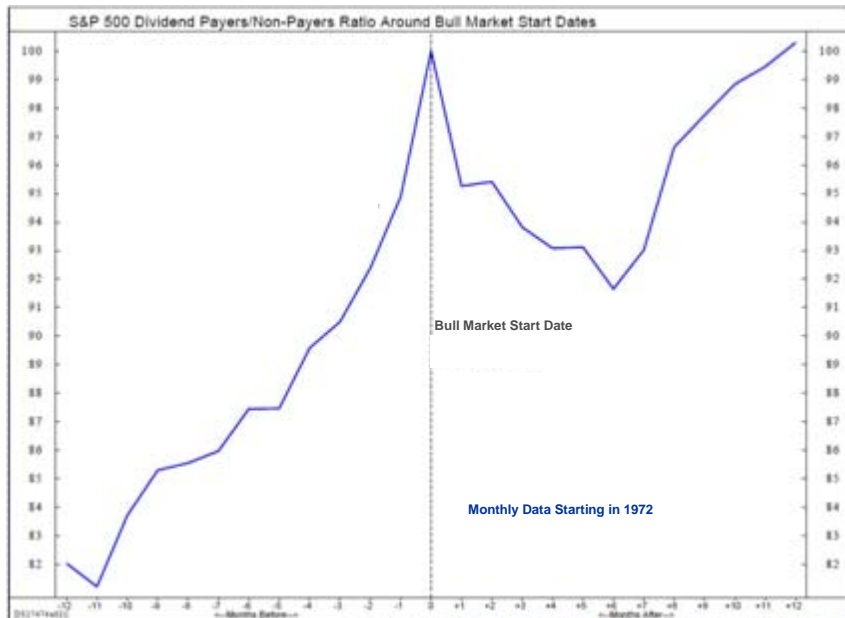
Dividend Yield	Average	Std. Dev.
Low Quintile	10.28%	12.53%
2 nd Quintile	10.42%	10.95%
3 rd Quintile	10.60%	12.31%
4 th Quintile	12.62%	12.05%
High Quintile	12.38%	13.66%

Source: Professor Kenneth R. French

Table 1

Does a dividend strategy underperform in a bull market?

Historically, underperformance is only likely in the beginning stages of a bull market. Ned Davis Research has provided some interesting insights into the relative performance of dividend payers versus non-payers following the first six months of a market turnaround. Specifically, Ned Davis examined the performance of dividend paying stocks in the periods surrounding the beginning of the ten bull markets since 1972. As the table to the right indicates, dividend payers consistently underperformed in the first six months of a bull market. The bull market of 1984 was the only exception to this observation. What was unexpected though was the dramatic rebound of dividend payers in the subsequent six month period. In seven out of the ten observations, dividend paying stocks outperformed non-payers in the seven to twelve months following the start of a bull market. On average, this outperformance exceeded the underperformance of the first six months.



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Chart 1[®]



Why are you focused on dividend growth?

Dividend growth is the cornerstone of our process because it provides an important indication of a firm's financial strength. In the current economic environment the power of this signal is magnified. Firms that continue to increase their payment are indicating that they remain comfortable with the stability of their operating cash flow and the strength of their capital position. Conversely, a firm that fails to increase their dividend as expected is sending the opposite message. We call this a "canary in the coal mine," a signal that greater problems might be lurking out of the investors' sight.

If a firm does not increase the dividend do you sell? What if the dividend is cut?

In our dividend-focused strategy, we consider dividend cuts and non-increases for their impact on our conviction. In such cases, management is providing us with an important signal and we will respond accordingly. **If a firm's dividend is lowered or does not increase as expected, we typically reduce the position to reflect the increased risk. Additionally we will look to replace the holding with a firm in which we have higher conviction and that meets our income requirement.**

Are firms still increasing their dividends in the current economy?

Yes. Despite the numerous headlines to the contrary, many firms have announced dividend increases in recent months. Some examples include *Wal-Mart Stores Inc., The Coca-Cola Company, 3M, United Technologies Corp., Sysco Corp., and Waste Management Inc.* Ned Davis reported that nearly half the companies in the S&P 500 increased or initiated a dividend in the twelve months ending February 28, 2009. Only 35 companies cut their dividend during the same time period. The impact of the recession is most readily noticed in the dividend growth-rate. Firms that typically grew their dividend at a 10-15% rate in recent years have instead chosen a more modest 5-10% increase for 2009.

S&P 500 Dividend Growth and Decline		
GICS Sector	2008 Dividend Growth/Decline	Y-o-Y Growth as of Feb 28
Energy	10.6%	13.0%
Materials	-3.4%	-12.1%
Industrials	4.3%	7.4%
Cons. Disc.	-6.2%	2.2%
Cons. Staples	6.7%	5.4%
Health Care	7.5%	8.8%
Financials	-23.1%	-39.9%
Info. Tech.	7.2%	11.7%
Telecom.	8.7%	10.4%
Utilities	6.7%	7.8%
Overall S&P 500	-3.1%	-7.0%

2009 Ned David Research. www.ndr.com Table 2

Are there any specific pockets of growth?

Yes. Seven out of ten economic sectors posted positive growth in the period (see Table 2); Financials, Materials, and Consumer Discretionary were the exceptions. The overall dividend growth rate did decline in 2008 and will continue to decline in 2009. To date, however, the decline is not widespread and we are seeing selective increases throughout the economy.

How can firms continue to increase their dividend in this economy?

A company's ability to increase a dividend stems from financial strength and the stability of cash flows from the underlying business model. Firms expecting to generate free cash flow in excess of the dividend and that have limited near-term maturities on their debt retain the ability to raise their dividend payment. We are not surprised to see firms responding to the recession with smaller dividend increases. From our perspective, though, the size of the increase is not necessarily as important as the increase itself. In a recession, a dividend increase is a much more valuable signal of relative strength than in periods of broad economic growth. It is easy for a majority of firms to increase their dividend while the economy is booming, but only the healthiest can continue to do so during a protracted economic decline. In other words, **the signal is most valuable when it is most needed.**

What will be the impact of tax changes on dividend income?

The economic axiom, "if you want less of something, tax it more," certainly applies. **All else being equal, raising the tax on dividend income would lead to a decline in the growth of dividend payments and may lead firms to rethink their dividend policy altogether.** We are monitoring the tax rate on dividend income relative to that of capital gains. Corporate boards understand the tax efficiency of limiting dividend payments when the tax on capital gains is lower. If the tax rate on dividend income is increased more than the tax on capital gains, we not only expect a decline in future dividend growth, but modest underperformance of dividend paying stocks versus non-dividend payers over the short-term. Fortunately, the budget proposed by the new administration reduces this concern since it proposes an increase to 20% for both capital gains and dividend income (from the current top rate of 15% for both).

How has TARP impacted your view on dividend growth for the banking industry?

TARP has negatively impacted our view on banks that have accepted Federal capital. Accepting capital from the Capital Purchase Plan (CPP) gives the U.S. Treasury the ability to veto any dividend increases and has resulted in significant pressure on banks to cut their dividends. Due to this, we do not expect any firm to increase their dividend payment while they are the recipients of this capital. Instead, we believe this group will continue to cut payments in order to conserve capital and avoid the perception that taxpayer money is being handed out to shareholders. This is why we focus on investing in banks that have strong balance sheets and that have declined federal capital. We are carefully monitoring reports on banks looking to pay back the tax-payer funds. We find this development encouraging but will wait until the process is completed before considering these firms for investment.

Has the recent surge in dividend cuts impacted the size of your investable universe?

Yes, in the sense that every dividend cut removes a firm from our investable universe. In recent months, however, this has been partly offset by the introduction of companies whose stock price declines have made yields attractive. Overall there has been a modest decline, but it has not had a significant impact on the management of the Portfolio.

What are your expectations for dividend growth in the future?

Dividend cuts typically continue after a recession ends, leading us to expect dividend cuts will continue in coming quarters. The government pressure on banks has made this cycle more intense than those in the past, but ultimately the length and severity of the recession will dictate the overall decline in dividends. We believe investors will continue to be attracted to dividends, which will keep companies interested in paying them. Demographic trends are such that a large segment of the working population is looking toward retirement and, subsequently, will be looking for income from their investments. As the average life expectancy has risen, income vehicles that exhibit real growth potential are an important consideration for retirees. Investing in the stock of strong, growing companies with a long history of regularly raising their dividend provides investors with the opportunity for both a growing income stream and significant capital gains potential.

S&P 500 Dividend Payers/Non-Payers Ratio Around Bull Market Start Dates

*Data at right
coincides with
Chart 1.

Bull Market Start Dates	% Chg 12 Mos. Leading	% Chg 6 Mos. Leading	% Chg 6 Mos. Later	% Chg 12 Mos. Later
12/31/1974	2.70	19.58	-19.58	-7.90
02/28/1978	2.28	-3.48	-15.16	-10.64
04/30/1980	20.95	13.14	-5.51	-4.67
08/31/1982	15.38	5.88	-12.23	-16.91
07/31/1984	25.71	15.97	5.73	28.69
10/31/1987	0.51	9.04	-2.43	7.04
10/31/1990	38.37	30.23	-8.46	0.35
08/31/1998	19.91	8.70	-12.63	-16.08
09/30/2001	96.77	30.48	-4.00	41.25
10/31/2002	42.25	23.37	-9.23	-18.17
Mean	26.48	15.29	-8.35	0.30

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RIVER ROAD ASSET MANAGEMENT, LLC

The Meidinger Tower
462 South Fourth Street, Suite 1600 Louisville, KY 40202 U.S.A.
502.371.4100 www.RiverRoadAM.com

For additional information,
please contact:

Michele Robbins

Vice President, Client Services

Michele.Robbins@RiverRoadAM.com
502.371.4132