



The Truth About Dividends

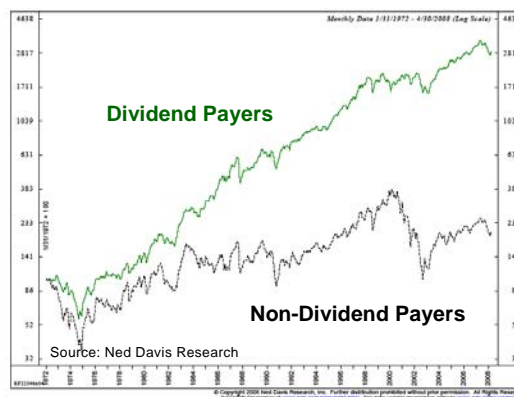
The recent performance of dividend paying stocks has captured the attention of investors. Is dividend-based investing a short-term fad or a long-term investment strategy? In this brief we address the most common misperceptions regarding dividends, including historical performance of dividend paying stocks, future earnings growth, and (surprise!) large cap stocks as the primary universe in which to search for high yield equity.

FACT: Dividend-paying companies outperform non-dividend paying companies over time

According to Ned Davis Research, from 1972 – April 2008 the index of equal-weighted dividend-paying S&P 500 companies returned **9.7%** annualized, versus a return of **2.0%** for non-dividend paying companies. Additionally, firms that initiate or increase their dividend also outperform. Over that same time period, the equal-weighted index of firms that increased or initiated their dividend returned **10.5%** annualized, versus a return of **8.2%** for those companies that left their dividend unchanged.

While the outperformance of dividend payers has been consistent over time, it has been particularly important during periods of poor market performance. For example, during the bear market of 2000-2003, firms that paid a dividend **increased 16%** while non-dividend payers **declined 49%**.

Returns of S&P 500 Stocks by Dividend Policy



FACT: Companies with high payout ratios grow earnings faster than companies with low dividend payouts

Conventional wisdom holds that the higher the percentage of earnings a company retains, the greater the earnings growth potential for that company. While retained earnings may create the “potential” for growth, in practice the opposite tends to be true. Two prominent research papers published by the CFA Institute examined the relationship between dividend payout levels and future earnings growth. The study conducted by *Arnott & Asness*¹ in 2003 focused on this relationship market-wide. A follow-up study by *Zhou & Ruland*² in 2006 examined the relationship at the company level, concluding that **companies with high dividend payouts typically experience a higher level of future earnings growth than companies with low dividend payouts.**

FACT: Dividend-paying companies include more than just Banks and Utilities

Primarily focusing on Banks and Public Utilities greatly diminishes the diversification and total return opportunities available for income-oriented investors. While clearly the Finance sector is an important component of the equity income universe, a simple examination of U.S.-listed firms with a yield in excess of 2% reveals numerous sectors with potentially attractive investment opportunities. Even within the Finance sector, there are opportunities to diversify into high yielding non-bank companies, such as REITs and registered investment companies.

Sector	Weight	Wtd. Avg. Yield
Financials	28.51%	4.63%
Energy	13.97%	3.78%
Telecommunication Services	13.65%	3.78%
Consumer Staples	9.87%	2.90%
Health Care	9.06%	4.08%
Consumer Discretionary	7.39%	3.01%
Industrials	6.05%	3.30%
Utilities	5.38%	3.63%
Information Technology	3.20%	2.75%
Materials	2.93%	3.52%
Total	100.0%	3.83%

FACT: Smaller companies tend to have a higher dividend yield than larger companies

Contrary to popular belief, market capitalization is *inversely* related to dividend yield. As portrayed in the chart on the right, the highest yielding companies tend to be small. Additionally, the small cap universe has more high yield companies and is widely considered more inefficiently priced than large cap. Thus, investors seeking high current income, **plus** the potential for capital appreciation would be well-served by investing in a portfolio with exposure to the small and mid-cap asset classes.

Yield by Market Capitalization.		
	# of Firms	Yield
Mkt Cap <\$2B	971	5.23%
\$2B <Mkt Cap <\$10B	266	4.49%
Mkt Cap >\$10B	204	3.71%

Universe: U.S.-listed equity; yield > 2%; mkt cap > \$1 million
Source: FactSet Research Systems, Inc.; data as of 5/12/2008

We believe dividend paying stocks are poised for continued outperformance

According to Ned Davis Research, since 1925, 42.5% of the total return from equities has been attributable to dividends. During that same period, the payout ratio for the S&P 500 has averaged over 56.2%. In the first quarter of 2008, the payout ratio for the S&P 500 was 47%. This is a significant change from 2007, in which an all-time low of 30% was reached. The spike in 2008 is the result of lower aggregate earnings due to asset write downs in the Financial sector.

While dividend growth has been strong over the last few years, earnings growth has been significantly stronger. We believe this portends the continuation of above average dividend growth. **Combined with the income demands of retiring baby boomers and the favorable tax treatment granted in 2003 to qualified dividends, we believe high dividend equities are in the early stages of a potential long-term uptrend.**

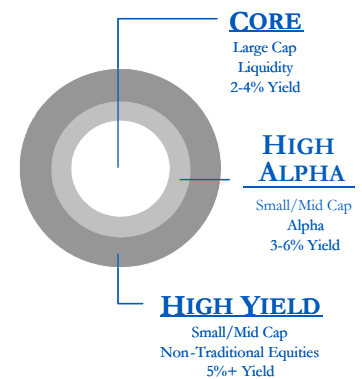
River Road's Dynamic Equity Income portfolio was designed to address these misperceptions

River Road's Dynamic Equity Income portfolio was designed to capture the broad and often unrecognized opportunities that exist among high income equity securities. The DEI investment process incorporates diversification that addresses the breadth of opportunities across: **1) Market Capitalization; 2) Security Type; 3) Industry Sector; and, 4) Corporate Sovereignty.**

This diversification, combined with River Road's Absolute Value investment philosophy, results in a portfolio of equity securities that combines:

- The liquidity of large cap stocks, with;
- The high alpha potential of small and mid cap stocks, and;
- The high yield equity opportunities available outside traditional common shares.

We believe the interaction of these three groups results in **balanced diversification**, **high current income**, and the opportunity for **high-alpha total return**.



References

- ¹ – Arnott, Robert D. and Asness, Clifford S. 2003. "Surprise! Higher Dividends = Higher Earnings Growth." *Financial Analysts Journal*, (January/February): 70-87.
² – Zhou, Ping and Ruland, William. 2006. "Dividend Payout and Future Earnings Growth." *Financial Analysts Journal*: (May/June): 58 – 69.

Disclosures

River Road Asset Management, LLC ("RRAM") is a registered investment adviser formed in April 2005 and is 55% independently owned and 45% owned by Fortis SA/NV. The S&P 500 Index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Updated as of June 30, 2008.

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

River Road Asset Management, LLC, is a partially-owned affiliate of Fortis SA/NV.

For additional information,
please contact:

Michele Robbins

Vice President of Client Services
Michele.Robbins@RiverRoadAM.com
502.371.4132