

Dividend Stocks: Income and Appreciation Opportunity

March 2011

The past few years have been very challenging for income seeking investors. Bond yields have been near historical lows and inflationary concerns are becoming a threat to bond prices. As a result of the current climate, many investors are wondering, “Should I add other sources of investment income to my portfolio?”

High corporate cash levels, favorable demographic trends, and attractive valuations are a few of the reasons dividend paying stocks are growing in popularity. And, dividend stocks have the potential to mitigate the negative effects of inflation. Also amplifying their appeal, dividend paying stocks have delivered attractive returns, with a lower level of volatility, compared to the broader equity market over several decades.

Attractive Historical Returns

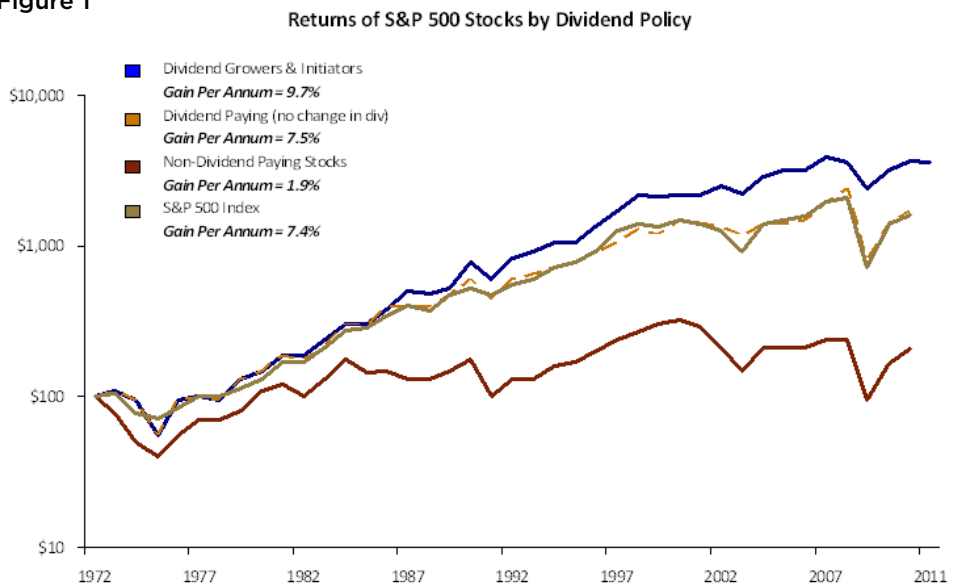
Figure 1 demonstrates that dividend paying stocks have outperformed non-dividend stocks over an extended period of time. In particular, stocks with increasing dividends have widely outperformed non-dividend paying stocks and the S&P 500 Index since 1972.

In addition, the return from dividends has been a stable and significant contributor to the total return of the S&P 500, as shown in Figure 2. From 1930 through 2009, dividends accounted for about 44 percent of the Index’s 9.3 percent average annual total return.

The percentage contribution of dividends to the total return has declined since the 1940s as companies have deemphasized dividends and investor preference has shifted toward capital appreciation. However, dividends still accounted for about 27 percent of equity market returns over the last 20 years.

In the future, we expect dividends to remain a significant portion of total equity market returns, especially in periods in which stock prices are declining or only exhibiting modest appreciation.

Figure 1



Source: Ned Davis Research. Past Performance does not guarantee future results.

Lower Volatility

In addition to producing attractive long term returns, dividend paying stocks exhibit lower volatility (commonly expressed as standard deviation) than non-dividend paying stocks, as shown in Figure 3.

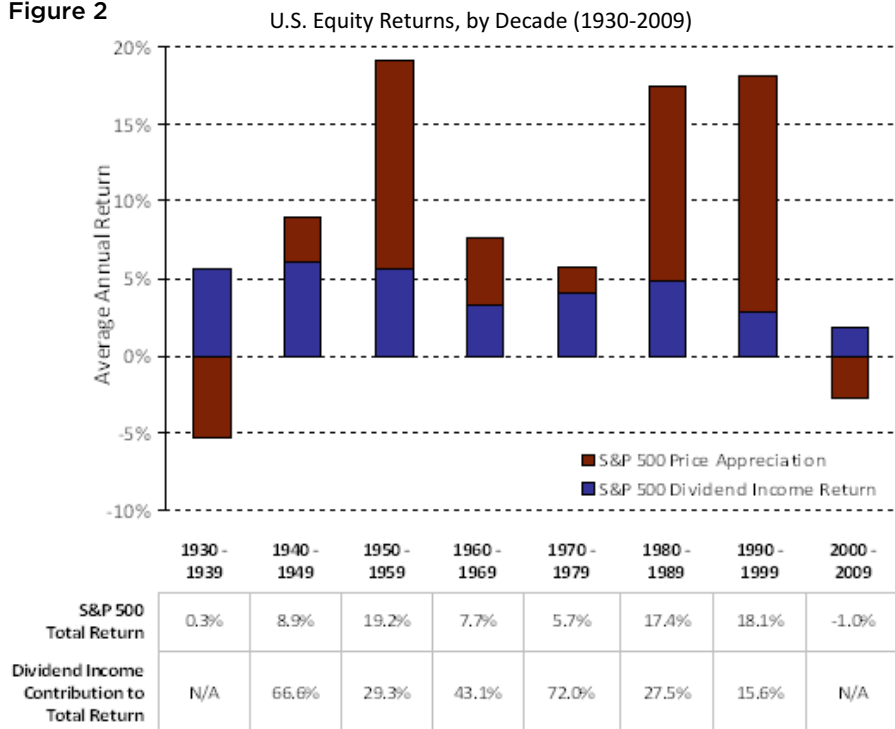
Why is this so? Companies that pay dividends are typically able to generate stable cash flows from year-to-year, supported by mature businesses with diversified revenue sources and lower than average operating risk. In addition, companies that raise dividends are usually signaling that their outlook for the future is good. A company does not begin to pay or increase its dividend unless it is confident it can do so on a regular basis. Companies are very reluctant to reduce dividend payouts, even in difficult economic times as dividend cuts may be interpreted by investors as negative statements about future earnings, which may trigger a decline in share price. As a result, increases in dividend payments are often more reliable than earnings growth in gauging the future of the company. As volatility in the equity market continues, we believe the greater income certainty and stability of dividend paying stocks will have growing appeal to both institutional and individual investors.

A Complement to Bond Investing

Bond yields have been near historical lows for an extended period of time as a result of the restrained interest rate environment. When rates do rise, medium and long duration bonds will face a significant headwind, likely leading to price declines. In addition, monetary policy in recent years and increasing commodity prices, particularly in emerging markets, has greatly increased the risk of global inflation, which is one of the biggest threats to bond prices. Amidst all of these concerns, dividend paying stocks may be an attractive complement to bonds for income seeking investors.

Treasury bonds must compete with dividend paying stocks for the investment dollars of income-oriented investors. Figure 4 compares the average of the 91-day Treasury bill yield and the long-term Treasury bond yield with the S&P 500 dividend yield. Currently, the yield spread between these two alternatives is as low as it has been in decades, encouraging many bond investors to more strongly consider the dividend and capital appreciation potential of equities, despite the difference in risk between bonds and stocks.

Figure 2



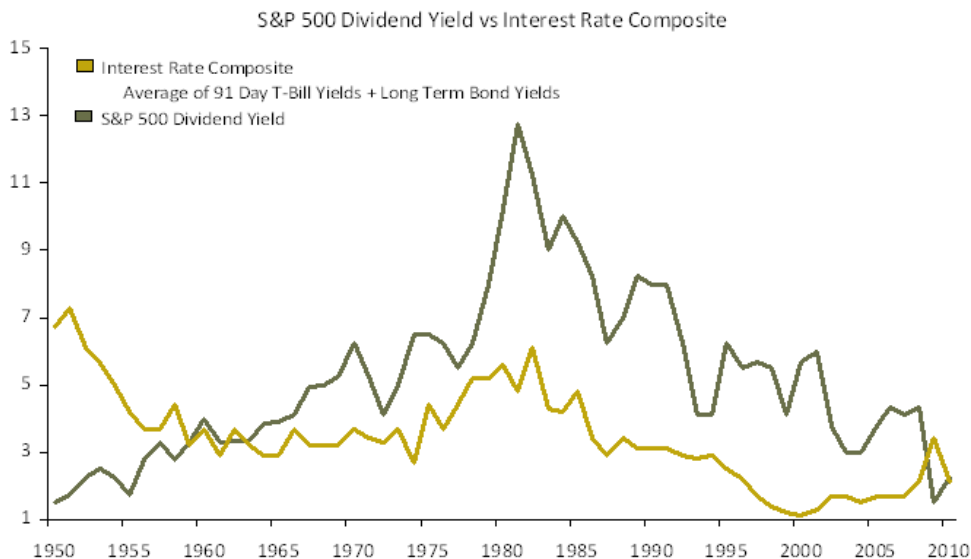
Source: Ned Davis Research. Past Performance does not guarantee future results.

Figure 3

S&P 500 Return & Volatility, 1972 through February 28, 2011		
	Returns	Standard Deviation
Dividend Growers	9.70%	16.30%
All Dividend Paying Common Stocks	9.00%	17.10%
S&P 500 Index	7.40%	18.10%
Non-Dividend Paying Common Stocks	1.90%	25.80%

Source: Ned Davis Research. Past Performance does not guarantee future results.

Figure 4



Source: Ned Davis Research. Past Performance does not guarantee future results.

price appreciation potential increase the probability that stocks remain attractive relative to bonds, especially if interest rates remain low for an extended period of time. Nevertheless, it is important to be mindful that companies may reduce dividend payouts and dividend stock prices may decline for unforeseen reasons.

For further comparison, the current yield on the Barclays Aggregate Bond Index (one of the most widely used bond indices) is approximately 3.0 percent. Presently, nearly 90 stocks in the S&P 500 Index have a yield greater than 3.0 percent and the average yield of these stocks is 4.5 percent. Similarly, there are over 400 stocks in the Russell 3000 Equity Index with a dividend yield of greater than 3.0 percent and the average yield of these stocks is over 5.0 percent.

Although bonds offer lower volatility than stocks, high dividend yields and

Inflation Protection Potential

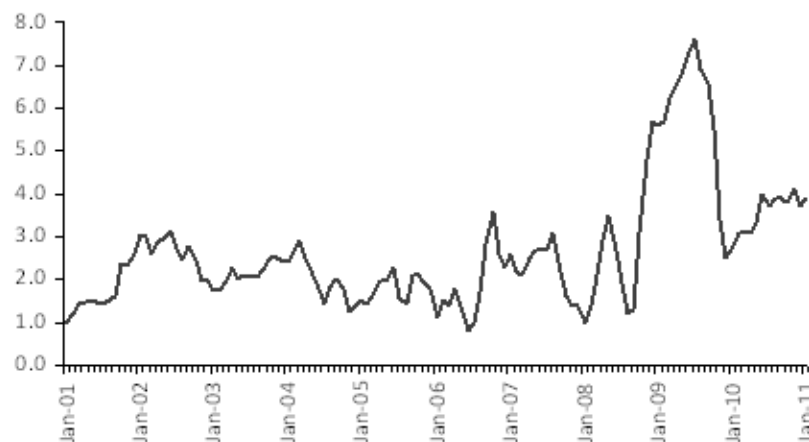
A common concern among investors is the potential for inflationary pressures to arise sooner than expected due to monetary policy and rising commodity prices, particularly oil prices. Figure 5 demonstrates that inflationary concern is now significantly higher than in other periods over the last ten years.

In some inflationary periods of the past, dividend-paying stocks have outperformed bonds due to dividend growth and capital appreciation. In contrast, it is much more difficult for bonds to keep pace with inflation given the fixed-payment nature of these securities.

One example of this is the inflationary period between 1974 and 1980, noted in Figure 6. During this time, the average annual rate of inflation was 9.3 percent, well above the 3 percent historical average. Given the high level of inflation, it is not surprising that bonds only produced an annual return of 5.3 percent. However, dividend stocks delivered a 9.9 percent annual total return, with dividends accounting for about half of the return.

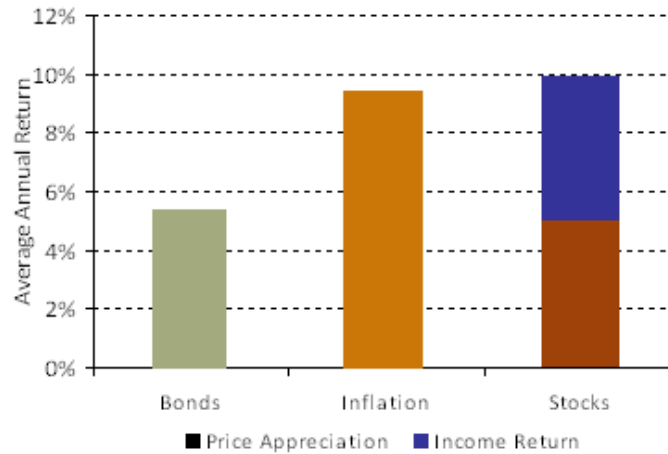
Figure 5

Expected Inflation Minus CPI (Year-to-Year Change)
(January 2001 - January 2011)



Source: Ned Davis Research. Past Performance does not guarantee future results.

Figure 6 Performance During Inflation of 1970s (1974-1980)



Source: Morningstar EnCorr and FMRCo. Past Performance does not guarantee future results.

Other Favorable Tailwinds

There are several other factors that make for a favorable environment for dividend stocks. Corporations, on average, are holding a larger amount of cash on their balance sheets than at any other time in the last 45 years. Although a portion of the cash will be spent on growth initiatives and share repurchase programs, many companies have expressed strong intentions to also boost dividend payouts. In addition, dividend paying stocks will likely grow in popularity for many years as baby boomers enter retirement with a lower risk appetite and greater income need. Also, dividend paying stocks remain attractively valued relative to long term earnings growth prospects, leaving ample room for further appreciation. Overall, a confluence of events is boosting the attractiveness of dividend paying stocks, making them worthy of consideration by any equity investor, particularly those seeking income.

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