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Dividend Stocks Haven't Caught Investors' Fancy

Despite 2003 Tax Break in U.S., Bull Market Investing Still Favors Nonpayers Making the Big Gains

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For the past two years, pundits have been forecasting a new era in dividend investing, but like many new eras, this one is off to an uncertain start.

President Bush's move to cut dividend taxes to 15%, which took effect in 2003, was widely expected to provoke a flurry of dividend increases and investment in dividend-paying stocks. Half of that happened: Companies did announce a surge of dividend boosts, highlighted by the \$32.62 billion special dividend -- \$3 a share -- that Microsoft Corp. paid last year.

But the new passion for dividend stocks simply hasn't taken hold, at least not yet. Since the current bull market began in October 2002, investor treatment of dividend stocks has been about the same as it was in past bull markets.

That is, when the market has seemed strong, investors have tended to favor faster-growing stocks that don't pay dividends. Only during periods of market weakness have dividend stocks taken over leadership. Dividend stocks, in other words, continue to be treated as a refuge in times of trouble. They aren't emerging as leaders in times of strength.

The result: Since October 2002, stocks that don't pay dividends have produced significantly stronger returns than dividend-paying stocks.

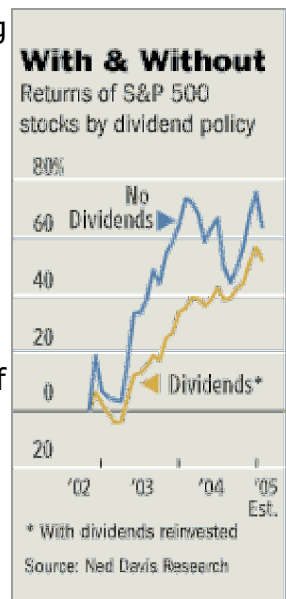
"I have been very surprised" that dividend stocks haven't done better since the tax cut, says Terence McLaughlin, president and chief investment officer of New York money-management firm Lighthouse Growth Advisors, who likes dividend stocks. "Given how people got decimated after 2000, you would tend to think that people would want to come back and start owning more conservative stocks, which would pay them a dividend each year."

Mr. McLaughlin says he thinks dividends will become more popular with investors with time, but that remains a question mark. So far, to the concern of some analysts, investors don't seem entirely to have shaken the lust for highfliers that they demonstrated during the bubble of the late 1990s.

The nondividend stocks in the Standard & Poor's 500-stock index rose more than 63% since October 2002, according to Ned Davis Research. The dividend payers rose less than 52% -- and that includes their reinvested dividends, before taxes. After dividend taxes, the dividend-stock gains would have been less.

Some analysts say that it could take time for investors to get excited about dividends, and that the results will come. They point out that the dividend payers did much better last year than the nonpayers, rising more than 16% compared with less than 7% for the nonpayers. But the gains for dividend payers came when the market was soft, a time when investors feared the future, when dividend stocks historically have tended to be at their strongest.

When investors were more hopeful, dividend stocks fell behind. Starting in September, as confidence



began to creep back, nonpayers again eclipsed dividend payers. Nonpayers rose 21% from the start of September through year's end, compared with a 13% gain (again, including dividends) for the dividend payers. It wasn't until the start of this year, as market confidence again plunged, that dividend payers again performed better. Through Thursday, they had fallen 3% since the year began, compared with a 7% decline for nonpayers. Of the 500 stocks in the S&P 500 index, 121 don't pay dividends.

While this failure of dividend stocks to become leaders may seem odd when you focus just on the tax cut, it makes some sense when you step back and consider the market as a whole. Investors always look for the biggest possible return, and at most times, they expect that to come from stock-price appreciation, not from dividends. Although dividends historically have made up more than 40% of stock returns, they make up far less today.

Even with all the dividend boosts of late, dividend payments represent less than 2% of the value of the stocks in the S&P 500. That 2% looks like great protection when investors think stocks are headed for trouble, but it doesn't catch their eyes when stock prices are rising.

"The dividend by itself isn't enough to make an investor buy," says Jack Ablin, chief investment officer at Harris Private Bank in Chicago. "It is just going to be the caboose on this whole decision."

Part of the problem, he says, is that the Bush tax cut applied to individuals, but not to pension funds or foundations, which represent a huge part of the investment community and tend to be more active investors than individuals. Such institutional investors never paid dividend taxes and are no more interested in dividends than they were before, he says.

Last week, the Dow Jones Industrial Average finally did rise, after beginning the year with three consecutive weekly declines. That mild recovery helped nondividend stocks a little, but not much. Stocks appear ready to finish January with a monthly decline, which could bode ill for the rest of the year. The Dow industrials edged up 34.21 points on the week, to 10427.20. That included a decline on Friday of 40.20 points and left the industrials down 3.3% in 2005. The S&P 500 behaved similarly.

One thing some analysts forget is that, at about the same time dividend taxes were cut, capital-gains taxes were cut, pushing the top capital-gains tax rate to 15%, says Tim Hayes, chief investment strategist at Ned Davis Research in Venice, Fla. That made it as attractive to take a capital gain as to receive a dividend -- more so for some people, since the capital gain may come years down the road, postponing the tax.

"If anything it may have increased the appeal of the stock market in general," Mr. Hayes says, rather than of dividend stocks in particular. At the same time, he adds, "there is a lagging effect between tax-law changes and dividend payouts." It is possible that dividend stocks will become more popular as investors slowly wake up to what is afoot and as companies raise dividends further.

Another thing that could help dividend stocks would be a prolonged period of weak stock performance, which is what many analysts fear may be in store.

In 2003, the Dow industrials rose 25%, making dividends seem puny. But last year, they rose only 3%, so a couple percentage points in dividends on top made a big difference. If stock gains continue to be moderate, investors could begin to chase dividends more actively. They could become even more interested in owning dividend stocks if the market were to continue the downward drift it has begun this year.