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REMEMBERING THE FUTURE

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A Global Dividend Play

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Introduction

The theme of this month's newsletter is the upward trend we expect to materialize regarding payout ratios of stocks that pay healthy dividends to their investors. The rationale for this call is based upon facts whose trajectory has become obvious over the course of years as well as over the course of the current financial crisis.

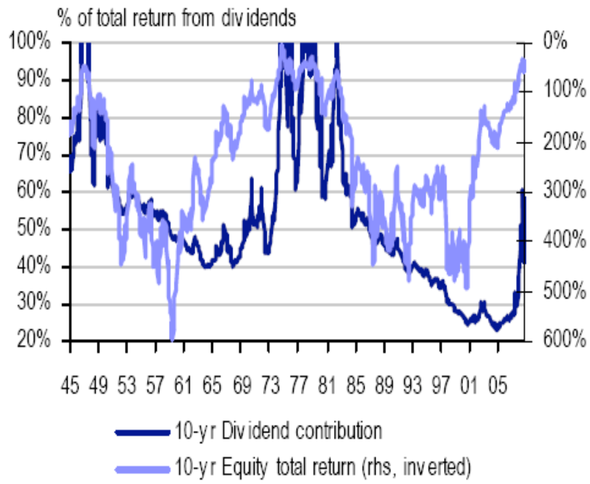
First of all, pressure will be exercised on companies for increased returns. Given the expected slow recovery and growth of sales, the pressure will likely increase for returns in the form of cash, hence higher dividends. Second, we have entered into a period of higher uncertainty and volatility, therefore the risk premium will increase, which historically is associated with higher dividends. Third, growth opportunities will be challenged, since investment opportunities will be limited, which in turn supports a higher payout ratio. Fourth, companies will have to demonstrate a healthy balance sheet that enables and allows them to pay dividends. Fifth, consumers will seek out better returns than the ones offered by certificates of deposit, consumers will want to know that their funds are not subject to significant risks and will be looking for healthy companies that project good payout ratios. Sixth, while the economy may show signs of recovery (and thus investors' risk appetite is higher than in the beginning of this year) the uncertainty about deficits, will motivate investors to look for yields outside the Treasury notes and into equities whose dividend yield offers some hedge against inflationary trends. Seventh, the recent split (even among the current administration's advisors) concerning the role of regulation and banking segmentation (see Paul Volcker's recent comments about the need to separate investment from commercial banking as well as the increasing calls about regulating the toxic assets a.k.a. derivatives) point to a possible return to the fundamentals of investing, where the returns from dividends and price appreciation will be moving in the same direction rather than diverging over time. Last but not least, the fact that US dividend yields have been lagging behind other regions makes US equities attractive because of our declining dollar, especially the ones that offer dividend yields similar to the ones that can be found in other regions.

In the following sections we elaborate on the above issues and we also suggest that you call our offices in order to discuss specific stocks and allocations based upon the screening we recently completed. Those specific stocks meet our strict criteria and also exhibit a healthy trend regarding their dividends and payout ratios. Of course, the necessary precautions are recommended since investing always carry risks.

The Historical Role of Dividends

If we took a look at the returns of stocks through price appreciation and growth since 1996, we could possibly point out that they are zero, and the only factor that contributed to positive returns is the role that dividends played over the course of that time period. Therefore, a return to reason – given the higher regulatory environment we are moving into - and to the return to the basics of investments would justify a climate where investors seek the "security" of a healthy dividend yield. Although past performance doesn't guarantee future results, historically dividends have contributed as much as 40% of the total return of the market. The role of the dividend in terms of total yield has been diminished since the1980s, as the following figure shows.

Figure 1: Total Return and Dividend Contribution



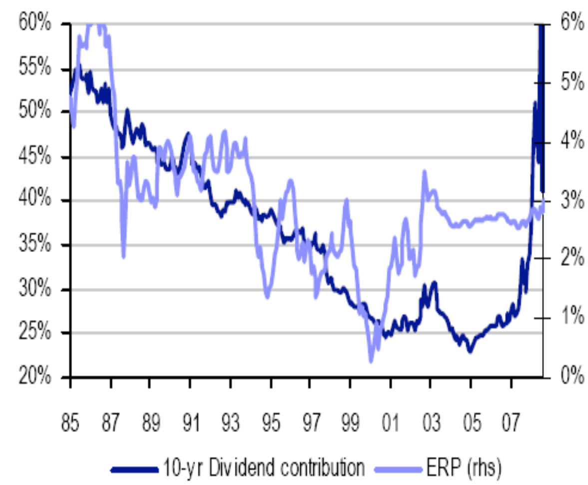
Source: Ibbotson, Bloomberg, UBS Note: Data through Sept 2008 because 10-yr total return turned negative

From the above graph, we could also state that in periods of uncertainty such as the 1970s, the great majority of the equities' return could be credited to dividends rather than to price appreciation. In the environment we are currently in (where economic growth is below trend, unemployment is rising, sales are experiencing a slow recovery and both the top and bottom lines of corporations are challenged) the role of dividends will increase and the importance of payout ratios will be revitalized.

We believe that the era where the decline of macroeconomic instability and of cyclical volatility (what Fed chairman Ben Bernanke calls "the great moderation") is a thing of the past, and that we have entered a period of higher instability and volatility which will coincide with a call to obtain some basic returns through dividends.

The next chart reflects the equity risk premium (ERP)[1] and the ten-year smoothing average[2] time series of the dividends' contribution to equities' return. As the graph portrays, the reduced importance of the dividends from the 1980s to 2008 coincides with the reduction in the ERP.

Figure 2: Dividend Contribution and the Equity Risk Premium

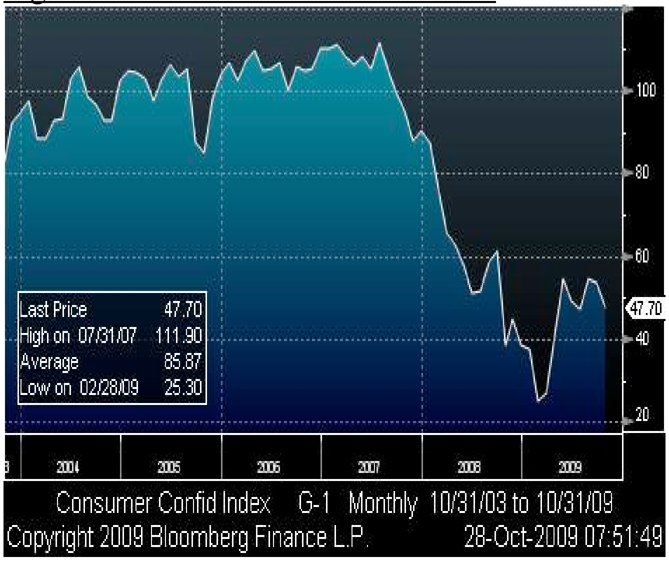


Source: UBS

From the graph above, we could see that investors are willing to accept lower yields, given the reduction in the ERP. The period of "Great Moderation" allowed the investors to rely primarily on capital gains and reduce their demands on upfront-cash returns. However, the new era which can clearly be seen from the above graph, signifies higher ERP which in turn points to greater demand for dividends. Therefore, companies that desire to be in the realm of investors' expectations, they will do their best to meet and possibly exceed those expectations. This should also bring about signal healthy cash flows and the ability to weather times of greater uncertainty and turbulence. The dividend yield may have increased due to lower stock prices, but at the same time the demands on companies will force them to exhibit a corporate behavior that is consistent with investors' demands for higher cash/upfront returns in an environment of limited opportunities; thus higher payout ratios are to be expected.

In previous newsletters we advocated the thesis of decoupling and we suggested that given the international economic and financial circumstances (including our core belief in hard assets, the shaky position of the dollar, and the fact

Figure 6: Consumer Confidence Index



The drop in consumer confidence as reported in late October, suggests that while the equities market has experienced significant gains in the last seven months, main street feels uncertain. They seem to understand that you can only go so far bailing out companies and financing the inventories of banks (whose earnings are being derived from trading and Fed's buyouts). The top-line remains weak, and if companies desire to see stability in their shares, they will likely need to revert to higher payouts as the following figure shows.

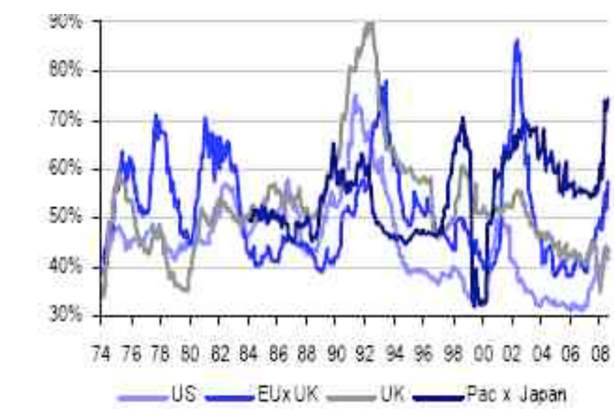
Figure 6:Payout Ratio and Earnings Growth

Source: MSCI, UBS

We believe that it's worth pointing out from Figure 6, that while earnings experienced a significant drop in the 2007-2008 period, the payout ratio increased. The same thing happened again in the short recession of 2000-'01. We would like to refer our readers to our newsletters since June, 2009. In these newsletters we argued for a slow economic recovery that will be associated with slow earnings and sales, both of which will contribute to a new economic environment. (We have introduced this argument in previous newsletters also)

Since we have advocated a greater percentage allocation in the international sector, we also need to point out that this trend of higher payout ratios in cyclical downturns is universal (Figure 7). Therefore, our suggestion about global diversification stands firm.

Figure 7: Payout Ratios Around the World



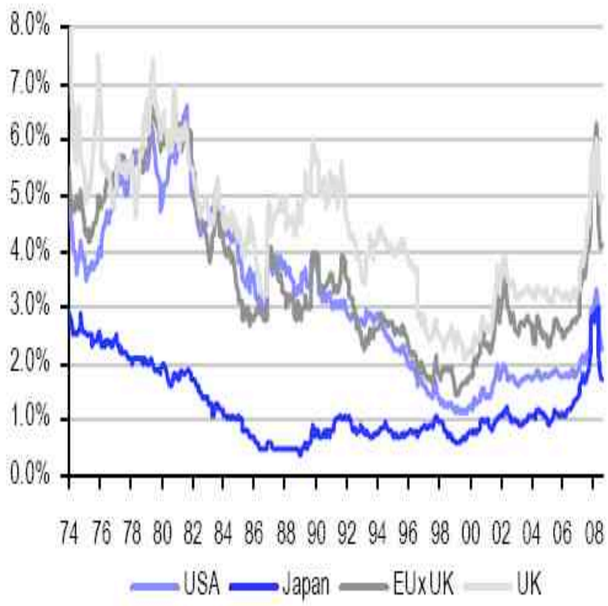
Source: MSCI, UBS

The above analysis suggests a promising outlook for higher dividends; however, we should not forget that such an outlook is subject to the sector of the particular company (financial companies may not conform), the growth/investment opportunities of those companies, the capital structure of the particular firm, as well as its preferences between debt re-payment and payout ratio.

Conclusion: And Now What?

In this month's newsletter, we tried to analyze the reasons for our expectations regarding higher payout ratios and dividend yields in the new economic era. Among other things, we pointed out that paper assets do not constitute capital and the possibility of growth) it would be prudent for investors to allocate a greater percentage of their portfolios in non-US markets. As a result we recommend analyzing dividend yields in different regions around the world. Our next graph does exactly that, and as it can be seen, the US trend of declining dividends can be found in the other regions as well.

Figure 3: Dividend Yield in Different Regions



Source: MSCI, UBS

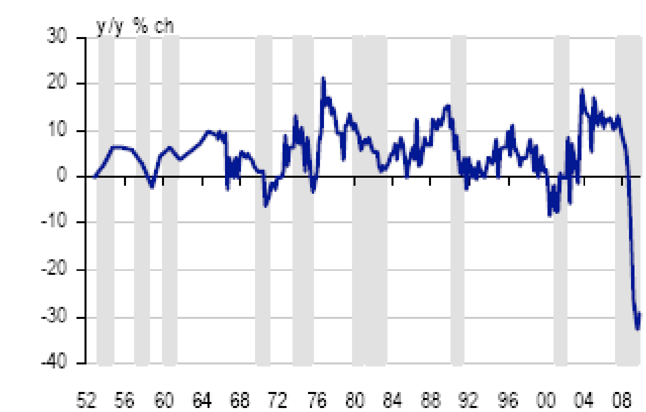
However, we also need to point out that payout ratios outside the US have been historically higher than the ones found in the US. Thus, while dividend yields may have fallen throughout the world (due to higher price growth, lower volatility, and higher macro-stability, as explained earlier) higher dividend payouts in Asia (which are double those in the US) and the EU have not crimped profits and earnings growth, since the latter has been similar to those in the US. Since the opportunities for income generation will be limited in the new environment, it is normal to assume that investors will be demanding higher payout ratios, which in combination with the ability of corporations to offer higher payout ratios, will create a dynamic in which such a projection can materialize.

Crisis, Business Cycles, and Dividends

The graph below shows us that dividend growth turns negative only during extraordinary circumstances, such as during a time of downturn similar to the one that started in the summer of 2007 and culminated throughout 2008. Such a development during the current crisis implies a very weak earnings environment. Moreover, the latest figure on consumer confidence (late October) could also imply weak sales projections (see figure 5 below.)

If we assume that corporations are currently repairing their balance-sheets, then the significant drop in dividend growth may soon reverse and will lead companies to demonstrate their ability to sustain themselves and to generate positive returns in an environment of uncertainty and higher capital requirements.

Figure 4: Dividend Growth (US data)



Source: S&P, UBS Note: Data are annual pre-1965

Thus, while corporations are on a balance-sheet strengthening expedition, and consumers feel shaky about their finances (see figure 5), the historical trend indicates that companies will increase their payout ratios as evidence of their ability to manage challenging times as well as the need to calm down investors to avoid a run on their shares.

the historical norms, the slow recovery, the need for income alternatives, the lack of growth opportunities, the global facts about payout ratios and dividend growth, and the need for companies to show strength to their shareholders during times of uncertainty.

Where do we go from here? This is the obvious question to follow such discussion and the answer should focus on the sectors and more particularly the companies that offer such promising dividend yields.

We have analyzed several companies and by using specific screening criteria (among them a healthy balance sheet, cash flow, P/E ratio, sales projections, global diversification, payout ratio, etc.) and we have compiled a list of companies that would fit into those criteria. The dividend yields from that selected list currently range from 4% - 14.5%.

We would be happy discuss the results of our dividend yield screen as well as your current portfolio structure and asset allocation. Feel free to call us.

In the meantime, please enjoy the ride!

[1]The excess return that an individual stock or the overall stock market provides over a risk-free rate. This excess return compensates investors for taking on the relatively higher risk of the equity market. The size of the premium will vary as the risk in a particular stock, or in the stock market as a whole, changes; high-risk investments compensated with a higher premium.

[2]In statistics, **exponential smoothing** is a technique that can be applied to time series data, either to produce smoothed data for presentation, or to make forecasts. The time series data themselves are a sequence of observations. The observed phenomenon may be an essentially random process, or it may be an orderly, but noisy, process. Whereas in the simple moving average the past observations are weighted equally, exponential smoothing assigns *exponentially decreasing weights* as the observation get older.

Exponential smoothing is commonly applied to financial market and economic data, but it can be used with any discrete set of repeated measurements. The raw data sequence is often represented by $\{x_t\}$, and the output of the exponential smoothing algorithm is commonly written as $\{s_t\}$ which may be regarded as our best estimate of what the next value of x will be. When the sequence of observations begins at time $t = 0$, the simplest form of exponential smoothing is given by the formulas

$$s_0 = x_0$$
$$s_t = \alpha x_t + (1 - \alpha) s_{t-1}$$

where α is the *smoothing factor*, and $0 < \alpha < 1$.