

White Paper June 2009

## Dividend Investing:

### Favorable Long-Term Opportunities for Total Return and Income

This paper will shed light on the importance of dividends and why they have been, and should continue to be, a favorable long-term investment opportunity. First, the analysis illustrates the compelling history of dividends as a component of total returns as well as important characteristics of dividends. It then looks at past, and considers possible future, legislative changes that encourage investors to value dividend investing. Finally, it examines demographic changes and the role dividends will play in what will be an unprecedented societal transfer of wealth.

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**White Paper** June 2009

“The prime purpose of a business corporation is to pay dividends to its owners. A successful company is one which can pay dividends regularly and presumably increase the rate as time goes on.”

Security Analysis by Graham and Dodd,  
First Edition 1934

### **Introduction: Dividends Tell the Truth**

The classic axiom “the more things change, the more they stay the same” could not be more true than in the universe of dividend investing. As seen in Chart 1 on page 6, dividends have provided the cornerstone for a successful long-term equity investment strategy over most time periods. This fact has not changed in over 100 years. Even John D. Rockefeller was quoted as saying, “The only thing that gives me pleasure is to see my dividend coming in.”

Beyond their contribution to total return, dividends can also signal the success of a company’s business strategy as well as highlight its financial strength. As dividends are paid from real earnings, there is no opportunity for creative accounting or questionable financial reporting practices. Even within the confines of GAAP (Generally Accepted Accounting Principals) standards, companies find countless ways to present financial statements in the most favorable light. With dividends, however, what you see is what you get. The bottom line: Companies that pay dividends must have the cash to do so, putting actual returns in the pockets of investors.

The wisdom of dividend investing is not new, but dividend investing tends to be a foreign concept to many investors raised during the high growth periods of the 1980s and 90s, when companies mainly used cash for buying back stock or M&A. There is still a common belief that companies only pay a dividend if there are no other growth opportunities. Ironically, as can be seen in the following charts, it is usually the dividend-paying and -growing companies that are the healthiest, outperforming non-dividend paying issues and providing the best return.

Chart 1

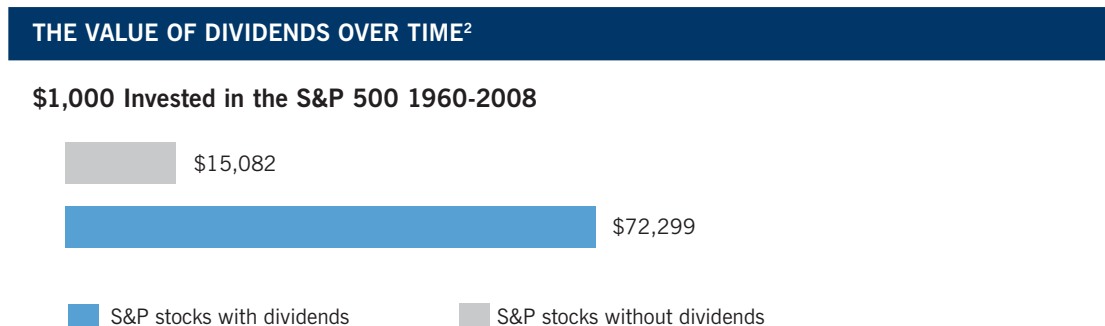
| DIVIDEND CONTRIBUTION TO TOTAL RETURN (%) |              |                                |                |
|---|--------------|--------------------------------|----------------|
|   | Total Return | Dividends As % Of Total Return | Average Payout |
| 1930s                                     | 14.1         | N/A                            | 90.1           |
| 1940s                                     | 135.1        | 74.2                           | 59.4           |
| 1950s                                     | 436.7        | 41.2                           | 54.6           |
| 1960s                                     | 107.9        | 50.2                           | 56.0           |
| 1970s                                     | 76.3         | 77.5                           | 45.5           |
| 1980s                                     | 370.5        | 38.6                           | 48.6           |
| 1990s                                     | 411.2        | 23.2                           | 47.6           |
| 2000s                                     | -29.5        | N/A                            | 39.0           |
| <b>Average</b>                            | <b>190.3</b> | <b>50.8</b>                    | <b>55.1</b>    |

Source: ISI. Data is up to May 1, 2009.

## Historical Perspective

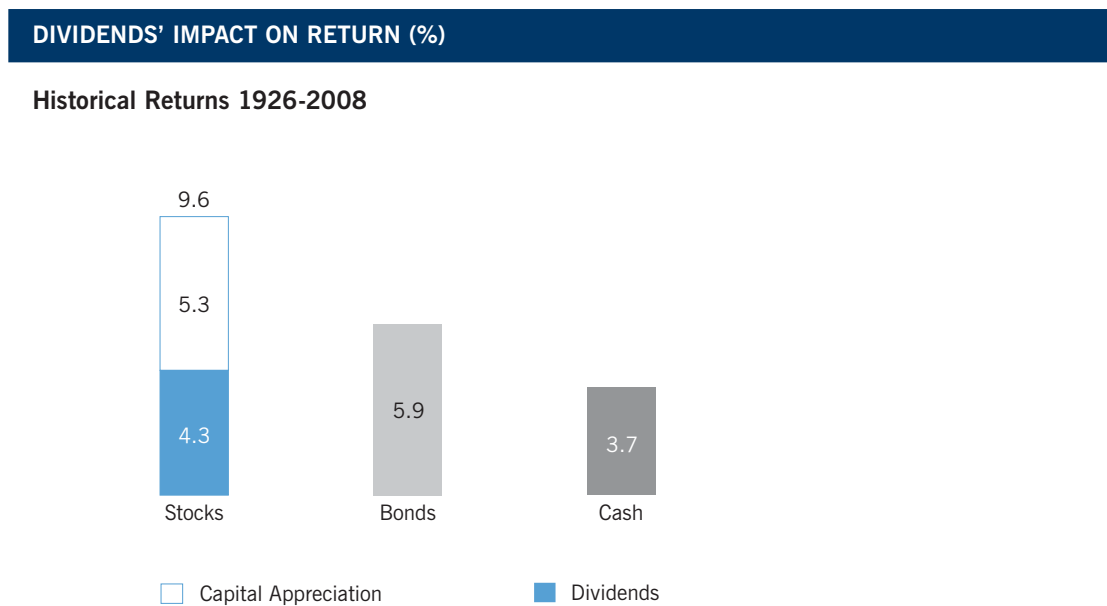
Dividends have been a major component of investment return over the long term. In fact, over the past 48 years, more than 50% of the annualized total return of the S&P 500 Index came from dividends.<sup>1</sup> Consider Chart 2: \$1,000 dollars invested in 1960 in the S&P 500 would have grown to over \$72,299 at the end of 2008. But if you take away dividends, that same \$1,000 dollars would be worth only \$15,082.<sup>2</sup>

Chart 2



<sup>1</sup>Total return is annual price appreciation, or loss, plus dividends. <sup>2</sup>Source: Lipper Inc. Not meant to represent income from any Eaton Vance fund. S&P 500 Index is an unmanaged index commonly used as a measure of U.S. stock market performance. For illustrative purposes only. Past performance is no guarantee of future results. It is not possible to invest directly in an Index.

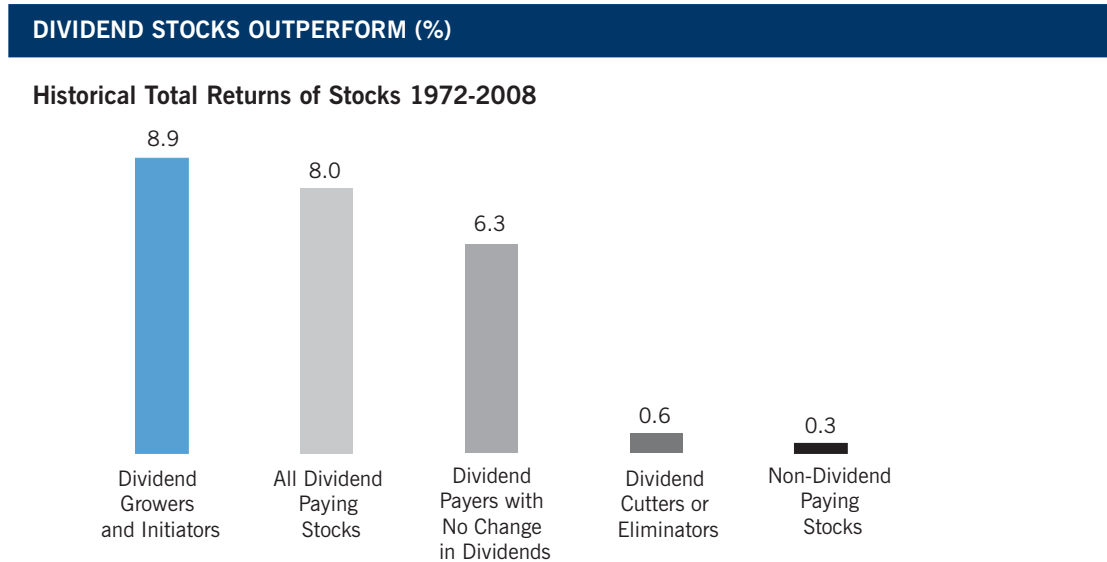
Chart 3



Source: Ibbotson Associates Stocks, Bonds, Bills and Inflation 2008 Yearbook. Stock represented by the S&P 500 Index. Bonds represented by long-term corporate bonds with maturity near 20 years. Cash represented by Treasury bills with approximately 30 days to maturity.

Compared to bonds and cash, the results are equally as impressive. Chart 3 shows that during the 82-year period ending 2008, stocks posted an average annual return of 9.6% compared with 5.9% for bonds and 3.7% for cash. But that's not the whole story. An impressive 45% of stocks' total return came from dividends. The historical return from dividends alone has exceeded cash returns.

Chart 4



The long-term performance of dividend-paying stocks is compelling. When investors think of dividend stocks, blue-chip stocks generally come to mind. Many of these ‘tried and true’ stalwarts of the investment world pay dividends to their loyal shareholders and have been doing so for decades. But there is a significant pool of companies that either raise or initiate dividends each year. This simple metric has had the most meaningful impact on total return over time. Dividend growth is a critical component of long-term total return. As demonstrated in Chart 4, companies that grow or initiate dividends had better returns than all dividend-paying stocks, and dramatically outperformed non-dividend paying stocks. This reality is in stark contrast to the common belief that only slow or no growth companies pay dividends.

### Characteristics of Dividends

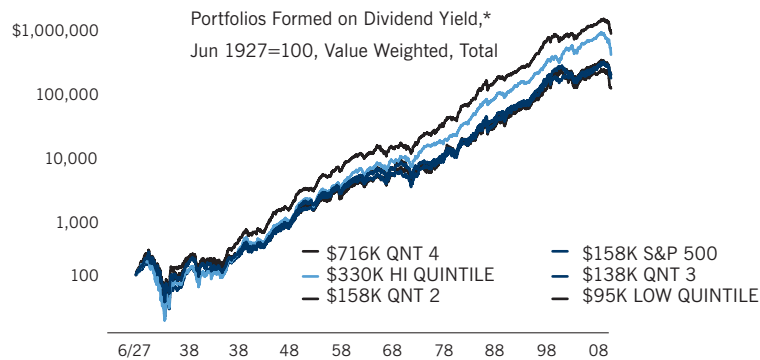
**Outperformance.** Strategies emphasizing dividend-paying stocks have outperformed strategies downplaying or ignoring dividends since the 1920s, as shown in Chart 5 on page 9. This outperformance has been most successfully realized by pursuing the sweet spot of dividend yields

—i.e., not the highest yielders, which can be risky—but, rather, investing in the fourth quintile (the chart’s top line). This group has outperformed the market (the lowest, most visible line) significantly. In this case, \$716K return versus \$158K for the S&P 500, as of Dec. 31, 2008. That’s a compound annual rate of 11.7% versus 9.4% for the market. The story is the same for most other time periods. Of course, past performance is no guarantee of future results.

**Chart 5**

**EVEN LONGER TERM, DIVIDEND PAYERS OUTPERFORMED**

**Dividend Yield Quintiles vs the S&P 500, Value Weighted  
June 1927 – December 2008**



Source: RBC Capital markets, Kenneth R. Frewnch.

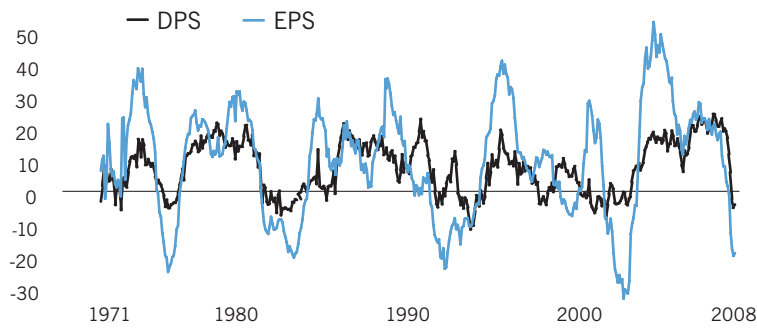
**\*About the chart:** Imagine the stock market, as represented by the S&P 500 Composite Index, sliced into five sections or quintiles, with the High Quintile (or 5th Quintile) comprising the highest dividend-paying stocks but also those taking the greatest risks for their dividend payouts. Quintile 4 —the “sweet spot of dividend yields”—is comprised of issues paying relatively more stable and predictable dividends. Quintiles 3 and 2 are comprised of issues paying progressively fewer dividends, while the Low Quintile pays virtually no dividends. The S&P 500 includes all these issues and in the chart its line marginally outperforms the Low Quintile line. Growth of \$100 assumes reinvestment of dividends.

**Low Volatility.** Another significant advantage of dividends is that, historically, dividends per share growth has exhibited lower volatility than earnings per share growth. As shown in Chart 6, earnings per share growth was 2.5 times more volatile than dividends per share.

Chart 6

**DIVIDENDS HAVE BEEN LESS VOLATILE THAN EARNINGS**

**Dividends Per Share (DPS) versus Earnings Per Share (EPS)**



Source: RBC Capital markets, Kenneth R. Frewch.

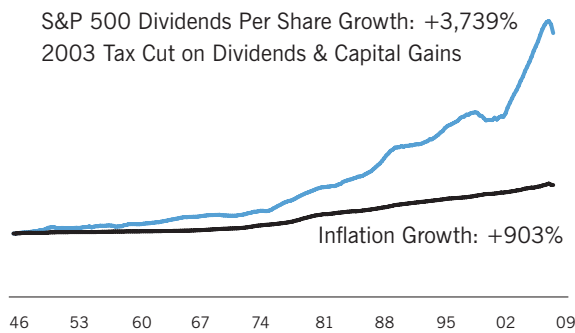
**Inflation Hedge.** Dividends have historically been an inflation hedge. Even without following the strategy of focusing on high dividend growers and initiators, investors outperformed inflation by more than 25 times—simply by receiving the dividends in the S&P 500.

Chart 7

**DIVIDENDS HISTORICALLY OUTPACE INFLATION**

**S&P 500 Annual Dividends Per Share vs. U.S. Inflation**

Indexed to 100, 12/31/46 – 3/31/09



Source: Strategas Research Partners, LLC

In summary, dividend yields are an ally, especially when times are tough. During 2008 and early 2009, the media reported that companies, one-half of them in financials, were slashing dividends. But the press did not report that firms across many S&P 500 sectors raised or maintained dividends during the downturn.\*

\*Source: "United States: Portfolio Strategy: US Thematic Views," Goldman Sachs Global Economics, Commodities and Strategy Research.

## Legislative Changes

Chart 8

| JOBS & GROWTH TAX RELIEF RECONCILIATION ACT OF 2003 – REVISED TAX RATES |                              |                               |
|---|------------------------------|-------------------------------|
|   | Old Maximum<br>Tax Rates (%) | New Maximum<br>Tax Rates* (%) |
| Qualified Dividends   | 38.6                         | <b>15</b>                     |
| Long-Term Capital Gains   | 20.0                         | <b>15</b>                     |
| Taxable Bond Interest   | 38.6                         | <b>35</b>                     |
| Non-Qualifying Dividends  | 38.6                         | <b>35</b>                     |
| Short-Term Capital Gains  | 38.6                         | <b>35</b>                     |

\*Unless new tax legislation is enacted, in 2011 federal tax rates will increase to a maximum of 20% for long-term gains and 39.6% for ordinary income and short-term capital gains. Also at that time, qualified dividends will become taxable as ordinary income. Table reflects maximum federal income tax rates for individual taxpayers. State and/or local taxes may apply also. Information presented is Eaton Vance's interpretation of tax law but should not be considered as advice. You should consult your personal tax advisor

In the 1990s, the importance of dividends diminished in the high-flying era of the Internet bubble. When the Internet stock bubble collapsed, however, overvaluation and speculation in the stock market gave way to a slew of corporate scandals and accounting fraud. Investors seeking transparent and tangible investment results were again drawn to dividend investing.

The appeal of dividends received an additional boost with the passage of the Sarbanes-Oxley Act of 2002, which demanded financial transparency and better quality of earnings from corporations. Once again, investors were rediscovering the financial truism that a company that generates consistent

cash flows and growing dividends is in all likelihood a successful company. In fact, 80% of corporate finance executives surveyed by Eaton Vance<sup>†</sup> believed that a firm's dividend growth rate can give investors confidence in the company's projected long-term growth potential.

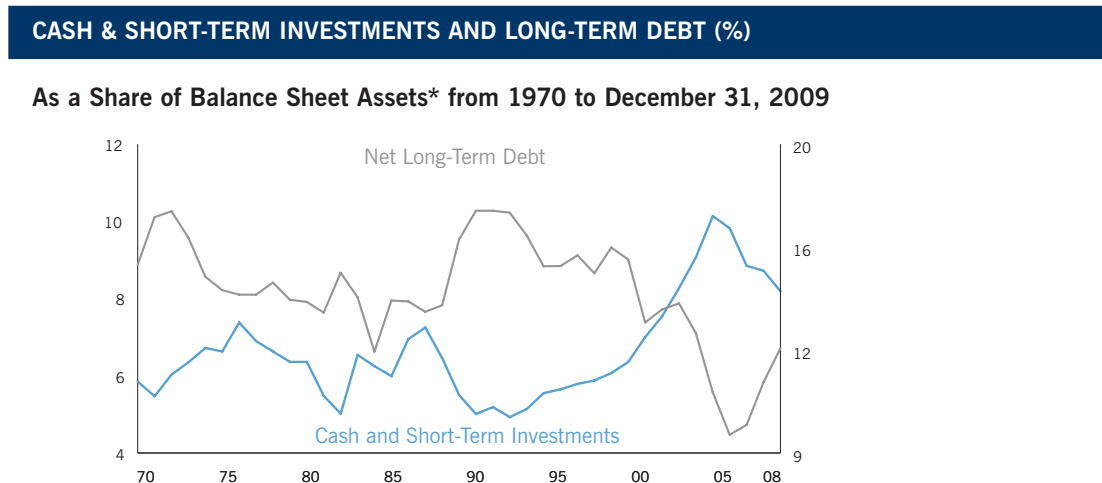
In 2003, a further impetus for the resurgence of dividends was the Jobs & Growth Tax Relief Reconciliation Act, which lowered the maximum tax rate on qualified dividends to 15%. This law allowed corporations to rethink how they would compensate shareholders. Under the Tax Act of 2003, qualified dividends are now taxed at the same rate as long-term capital gains. The lower tax rates on dividends reduced the double taxation of dividends and opened the door for renewed corporate and investor interest in dividend income. Where this will go with the new administration is uncertain, but it does appear that tax equality in the treatment of capital gains and dividends will remain unchanged in the future, a positive development for dividend investing.

Most Washington observers agree that taxes are going to increase in coming years. More specifically, the administration's budget proposal, issued in February 2009, raises taxes on dividends and capital gains on families with taxable incomes over \$250,000 per year. The proposal increases the top rate on long-term capital gains from 15% to 20%; and the top rate on dividend income from 15% to 20%—a continuation of the “tax equality” touched on earlier. Although the president's budget is merely a proposal, given the Democrat's control of Congress, it will likely serve as the initial blueprint, according to Andrew H. Friedman, an expert on legislative and regulatory developments consulting for Eaton Vance.

<sup>†</sup>2005 Eaton Vance investor survey.

## Conclusion: The Future of Dividends

Chart 9

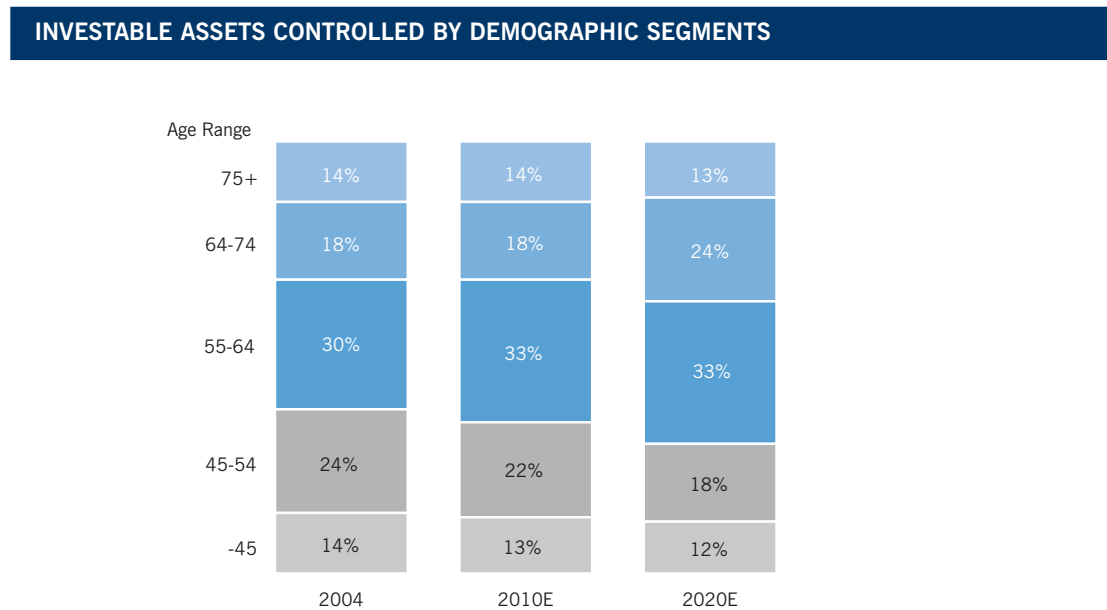


\*Largest U.S. 1500 stocks excluding autos, financials and utilities, data smoothed on a trailing one-year basis.  
Source: Corporate Reports, Empirical Research Partners Analysis

Most corporations outside the financials sector appear healthy. They have been accumulating cash balances, which have translated into record accumulations. As shown in the chart above, long-term debt is generally declining as the cash mountain (the light blue line) remains high. This cash can provide companies with the potential to continue paying, or even increase, dividend payouts. In short, this cash mountain augurs well for dividend investing in coming years.

Dividend investing is valuable for all investors, but it's especially important for baby boomers (Chart 10). The transition of the baby boom generation out of the workforce and into retirement will have a dramatic shift on financial product demand. Currently, financial products primarily focus on saving and accumulation. As this demographic shift takes hold, financial products will need to emphasize income generation. It is Eaton Vance's belief that dividend-paying stocks will play a critical role in meeting the income needs of baby boomers in the years ahead, while simultaneously offering the potential for higher equity returns to other age groups. High-quality, large-capitalization, dividend-paying equities may offer tax-advantaged income, growth potential and important diversification to an investment portfolio.

Chart 10



Source: Survey of Consumer Finances 2004; U.S. Census Bureau; McKinsey analysis.

It is our opinion that investors will need to maintain a larger portion of their portfolios in equities as they retire, to ensure they do not outlive their assets. Very possibly, these equities should feature current and potentially rising dividends.

This is solid, back-to-basics investing, the sort espoused by Graham and Dodd many decades ago (see quote below). Simply phrased, a dividend in your pocket is better than a promise in your future.

“Experience would confirm the established verdict of the stock market that a dollar of earnings is worth more to the stockholder if paid him in dividends than when carried in surplus.”

Security Analysis by Graham and Dodd,  
First Edition 1934

Past performance is no guarantee of future results. The financial position, dividend policy and other conditions may affect a company's desire and ability to pay dividends.

## Author Biographies

**Judith A. Saryan, CFA** is a Vice President of Eaton Vance Management and Portfolio Manager of Eaton Vance Dividend Builder Fund. She also co-manages Eaton Vance Tax-Managed Dividend Income Fund, Eaton Vance Dividend Income Fund, Eaton Vance Tax-Advantaged Dividend Income Fund, Eaton Vance Tax-Advantaged Global Dividend Income Fund and Eaton Vance Tax-Advantaged Global Dividend Opportunities Fund. Before joining Eaton Vance in March of 1999, Ms. Saryan was a portfolio manager and equity analyst for State Street Global Advisors. In her 18 years at State Street Global, Ms. Saryan's principal research specialties were the telecommunications, consumer nondurables and utilities industries. Ms. Saryan holds a degree in economics from Wellesley College and spent a year overseas studying developmental economics and comparative economic systems.

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