The Trust Company of the South

The Compass

SPRING 2003

Why Dividends Matter

Inside this Issue:

The Trust Company of the South is an independent trust company and financial planning firm focused on serving the needs of affluent individuals, families, and non-profit institutions.

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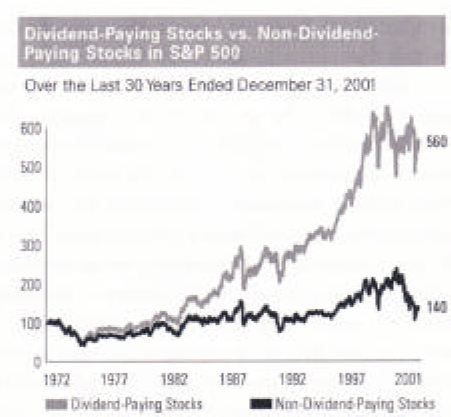
Anemic returns for stocks in recent years have given cause for renewed attention to a long-standing but almost forgotten maxim—dividends are significant contributors to returns for stocks over the long term.

Over the past 75 years, dividends have contributed over 43% of the total return (Chart 1) for stocks. Since 1972, dividend paying stocks have outperformed non-dividend paying stocks by over 420% (Chart 2). The importance of dividends was all but forgotten during the go-go stock era of the 1990's. During that decade, dividend yields dropped to historic lows and dividends accounted for only one-sixth of the 17.8% average annual returns recorded for the S&P 500 index. The idea that dividends were inefficient uses of corporate cash flow reflected "Wall Street" thinking of the period. Rather, companies commonly used cash flow to make acquisitions or to buy back stock (many of which proved to be ill-advised and made evaluating a company's fundamentals much more difficult). Many companies mirrored stock buy backs with a flood of stock option grants to employees. Thus, the original aim of the stock repurchase, increased earnings per share due to less stock outstanding, was seldom realized.



Components of Average Annual Total Return

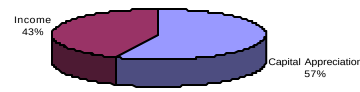


Chart 1 Source: Ibbotson

Benjamin Graham, the father of value investing and mentor to Warren Buffett wrote in 1934, "Experience would confirm the verdict of the stock market that a dollar of earnings is worth more if paid out in dividends." Perhaps Graham's cause for concern was not that companies would hoard their cash, but that they would foolishly reinvest it.

Despite a weak earnings environment, dividends declared by companies within the S&P 500 are increasing for the first time in recent years. Dividend payout ratios are near their low-

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Why Dividends Matter, Continued

est levels in 40 years. It would appear the ability to raise dividends is favorable, especially coupled with proposed favorable tax treatment for dividends.

History would suggest that stock market returns for the next 10 to 20 years will revert to the historic mean. If reduced returns are in the offing, then dividends are likely to become a more important contributor to investors returns. Dividend yields of many quality companies are near their highest levels in 30 years v. US Treasury bond yields, with the added benefit of potential growth. Seventy-five years of history strongly suggest that dividends should be considered as part of one's overall strategy when investing in equities.

-Mike Palmer, CFP®

Will Telemachus and Odysseus Ever Return?

One of my high school English teachers observed that many of life's answers can be found in Homer's epic poem *The Odyssey*. I reflected on the wisdom of this comment years later when I saw John Goodman as a modern day Cyclops in "O Brother, Where Art Thou". For those whose memory of the story is rusty, Odysseus, king of Ithaca, goes off to the Trojan War and is then held prisoner for twenty years. His wife, Penelope, is distraught over his disappearance prompting their son, Telemachus, to go off in search of his father. After many adventures and hardships the father, mother and son reunite.

In many ways Telemachus and Odysseus are peace and prosperity personified. No doubt many investors feel like Penelope, wondering whether war, terrorism, and the stock market decline will continue indefinitely.

In the simplest terms, debt (bonds) and equity (stocks) compete for capital. If investors put a majority of money on one side of the scale, the other side is forced to increase returns (i.e. lower prices) in order to attract capital. Normally, the scales are close to equilibrium. One measure investors use to analyze an investment is yield, or the anticipated income stream from an investment.

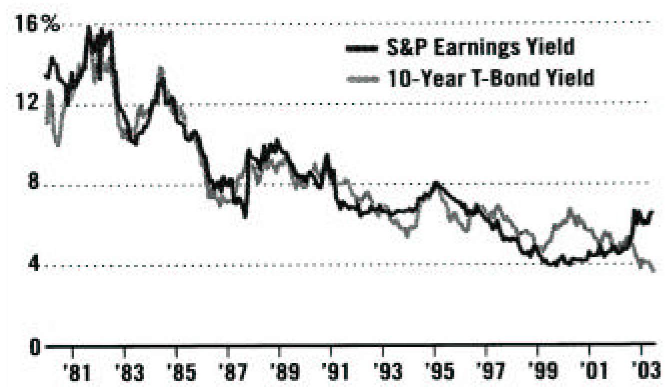
For example, as of April 11, 2003 the yield on a 10 year US Treasury bond was 3.98%. This is a "risk free" return provided the investor holds the bond to maturity. The S&P 500 is currently at 867 with a 2003 estimated earnings of $54. This equates to an earnings yield on the S&P 500 of roughly 6.2%. Over time, the S&P earnings yield and the Treasury yield generally track one another (see chart opposite page). Presently, the spread, or gap between stock yields and bond yields is over 200 basis points, a level not seen since the early 1980's, which, as it turned out, was an excellent time to buy stocks.

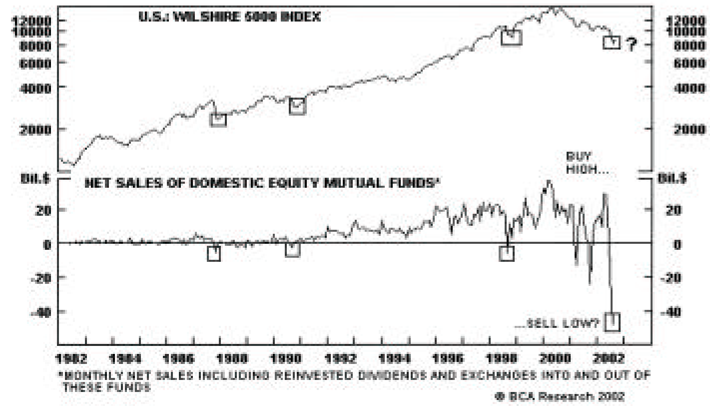
In fairness, there are several ways the yield gap could close. We support the idea that stock prices are likely to go up. Conversely, bond yields could rise, which would be bad news for all the investors who have been plowing money into bond funds over the last 12 months. In 2002 bond funds experienced their best year ever gaining $140 billion in new investment. As we are fond of saying, the herd is usually wrong!

The other way the yield gap could narrow is if earnings come up woefully short of expectations. Factoring in a 20% overestimation of S&P 2003 earnings brings the earnings yield down to 5%, still 125 bps over the Treasury yield. The current mood of the "investor class" is rather dark and gloomy, with the infectious greed of the late 1990's replaced with infectious fear and paralysis. If bonds continue to yield 3.5% and stocks 6% sooner or later investors will conclude 6% is better.

-Mike Palmer, CFP®

Bonds Look Expensive, Stocks Look Cheap





Why Bonds are No Longer DIY Investments

When meeting with prospective clients we are sometimes asked how we add value to the purchase of bonds. Many investors believe they are better off simply buying laddered Treasury bonds and holding them to maturity.

There are a number of ways we can add value to fixed income portfolios. Let's start with pricing. Bonds, unlike NYSE stocks, don't trade on an exchange, so prices (and as a result the yields-to-maturity) can range rather significantly. For example, on Friday April 11, 2003 we analyzed all reported trades on a five year, AAA rated GE Capital 4.25% due 1/15/08. The prices and yields on this bond ranged from a low of 103.104 (yield of 3.53%) to a high of 104.948 (yield of 3.12%).

It is difficult if not impossible for individual investors to "shop the street" for the best value when either buying or selling bonds. This is particularly true of investors with "odd-lots." As a fiduciary we are obligated to shop for best execution and are prohibited from buying or selling bonds from ourselves, a practice common in the brokerage industry known as taking a bond out of inventory.

The other main reason it is difficult for individual investors to compete in the fixed income arena is the increasing complexity of the bond market. The change in make up of the Lehman Aggregate Bond Index illustrates this point:

	1995	2002
Treasury	46%	22%
Agency	7%	13%
Corporate	17%	26%
Mortgage	28%	37%

Source: Federated

Investors in fixed income increasingly require a diversified portfolio of bonds comprised of a variety of bond instruments in order to secure competitive returns. Our fixed income alliance with PIMCO, managed by Bill Gross, provides our clients with sophisticated fixed income solutions and a long track record of delivering superior returns. The average investor is simply ill-equipped to manage a fixed income portfolio solo.

Quote of the Quarter

"A monkey will type out a Shakespeare play before an "independent" mutual-fund director will suggest that his fund look at other managers, even if the incumbent manager has persistently delivered substandard performance. When they are handling their own money, of course, directors will look to alternative advisors – but it never enters their minds to do so when they are acting as fiduciaries for others."

-Warren Buffett March 2003

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Or in person or by phone

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