

Summer 2012

Market Strategies



Paying Dividends

The single greatest financial concern our clients have is outliving their financial means. Since no one knows how many years they have to plan for, nor do they know the health-care costs that may arise during their lives, financial security will always be an issue.

The odds of running out of money increase as investors live longer and cope with rising inflation. In addition, yields from income-producing investments are presently at their lowest levels in 50 years. These problems are a burden on our clients as the U.S. government grapples with the consequences of massive and rising budget deficits. Clearly the government has an incentive to keep yields low, which hurts those individuals who have actually saved money over the years and had expectations of receiving a return on their money. A historically successful tool to combat low yields and inflation has been dividend-paying stocks, and we believe the relevance of dividends will gain importance over the next few years.

Dividends have always had a significant impact on the total return of stocks. Over the last 80 years, 44% of the gains recorded by the S&P 500 stock index have been delivered via dividends with share price growth making up the rest. The current dividend yield of the S&P 500 index is 1.9%, versus the average yield for stocks held in our clients' portfolio of 2.5%. This means our portfolios produce over 30% more income than the typical market basket of stocks. A higher yield reduces downside risk and helps support a portfolio making withdrawals. A company capable of paying a high dividend tends to be more stable, which decreases

the volatility of the share price.

As we head into the second half of 2012, the dividend payout ratio for publically traded companies is close to its all time low. Over the last 60 years, companies have averaged paying out roughly 50% of their earnings to shareholders. Today, that number is down to approximately 30% earnings. One of the reasons the payout ratio is low is the result of earnings being so high. The earnings produced by the companies listed in the S&P 500 are at an all-time high, which also gives us some confidence in buying stocks at this time. The lessons learned after the credit crisis in 2008 have many corporations holding record levels of cash; these funds could be passed on as dividends. Since this is an election year and the U.S. Congress is currently questioning continuing the Bush-era tax cuts, the debate of taxation on dividends is all over the news. Keep in mind, except for REIT's, dividends are sent to shareholders only after the corporations have already paid taxes on those earnings, which can be as high as 35%. Taxing dividends at the shareholder level is often referred to as double-taxation since those dollars were already taxed at the corporate level. If companies knew the tax on dividends would remain at 15% or decrease in 2013 and beyond, the floodgates might be opened to shareholders for this idle cash sitting in

corporate coffers. If nothing is done by Congress before year-end, the tax on capital gains jumps to the income tax rates of shareholders, which can be as high as 38%. Clearly most CEO's, who are also shareholders, believe they have better uses for this cash than to pay the government more in taxes.

Rising costs equate to higher inflation. Since many of our clients are retired and not adding to their savings, spending more for the same services increases the demands on a portfolio. From 1945 to 2010, the 3.9% average inflation rate as measured by the Consumer Price Index has been more than offset by the 6.3% average increase in cash dividends paid by public companies. Buying stocks purely for income has been a popular theme lately. Evidenced by this are the prices currently being paid for utility companies. Historically, utility companies trade at a 20% discount to the broader market; however, today the utility index is trading at a 15% premium. We took advantage of this premium by selling Duke Energy in June for clients that held this utility. Also, banks were paying high dividends in 2007, which attracted plenty of conservative investors; however, when the losses from bad loans piled up, banks were the worst place to invest from 2008-2011. Chasing high yields on weak companies can be an expensive lesson.

No matter whom you support in November, we believe all clients can rally around limiting the taxes paid on dividends.

Owning companies that pay great dividends isn't enough; we want our clients to own great companies that pay rising dividends to participate in their growth.

We are not capable of controlling the markets, but we can control the selection of quality companies in which to invest your assets. Our preference has always been to own companies that have rising earnings. With interest rates at historic lows, pursuing companies with rising dividends will remain a priority moving forward.



"Trusted financial advice ~ Client focused service"

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