Client Newsletter

SKBA CAPITAL MANAGEMENT

May 2009

The Perfect Dividend Cut

By Andrew W. Bischel, CFA
CEO & Chief Investment Officer

After a four-year streak of annual dividend growth amounting to 11.3% per year for the S&P 500 from the end of 2003 thru 2007, dividend growth came to an abrupt halt in 2008. In fact, the last twelve months of dividend payments (ended March 31, 2009) fell -5.0%, the worst performance in the last two decades. For the first quarter alone, the year-to-year decline was even worse at -16.2%.

Companies do NOT set their dividend levels whimsically. Boosting the annual dividend rate is often a signal of a company's confidence in the level and growth in its future earnings and cash flows, which would be sufficient to sustain its dividend rate into perpetuity, whereas a dividend cut can also be seen as a signal of long-term economic deterioration. This signal is particularly useful when dividends are raised during times of economic recession and the earnings or balance sheet distress that can accompany tough economic times. So is this severe dividend cut in the S&P 500 a sign that we've entered a new *imperfect or deteriorating* world order for dividend payments? At SKBA, we don't think so.

The economic environment has been rough on corporate America lately. The current recession is on its way to being the worst in the post World War II era. But has this led to an unusually large number of dividend cuts, as seems to be the perception among investors? The table below highlights a somewhat different story.

S&P 500 Dividend Changes (in indicated annual dividend rates)[1]

	2008-2009*		2000-2002**	
	% Raise/Initiate Dividend	% Cut or Omit	% Raise/Initiate Dividend	% Cut or Omit
Consumer Discretionary	38%	20%	38%	9%
Consumer Staples	75%	8%	61%	20%
Energy	54%	5%	48%	10%
Financials	32%	47%	80%	11%
Healthcare	30%	4%	33%	5%
Industrials	75%	7%	38%	17%
Information Technology	24%	3%	10%	6%
Materials	48%	24%	43%	20%
Telecommunications	56%	11%	44%	0%
Utilities	68%	6%	40%	30%
All Sectors	45%	15%	45%	13%
	*12/31/2007 through 4/30/2009		**12/31/2000 through 12/31/2002	

The recession is not yet over, nor are corporations likely done adjusting to the financial distress this recession has caused, yet approximately 45% of S&P companies raised their annual rate of dividend payments (or initiated new dividend payments) during this slowdown, as well as in the last slowdown (over the two years to the end of 2002 and a similar amount of companies have done so since the end of 2007 to April of 2009). As can be seen in the table, the most stable dividend payers remain in the consumer staples sector where 75% of the companies have raised their dividends this recession cycle versus 61% in 2001-2002. Yet slightly

more companies have cut dividend payments in this latest period (15%) compared to the prior recession (13%). The real culprit in the difference between the periods is the financial sector.
Financial stocks were the stalwart dividend payers in 2001 and 2002, with 80% of the companies raising their dividends during this period and only 11% cutting or omitting dividends. The contrast with the current recession could not be more stark as 47% of financial companies have cut their dividend rates. Certainly some banks should have cut their dividends to preserve retained earnings and capital during this time of accelerating loan losses, but the average dividend cut amounted to -83%. The only time we've seen anything similar was in the financial crisis of 1990 when bank regulators forced banks to create a new loss reserve class that coined the term, "performing non-performing loans," which reduced bank regulatory capital ratios, exacerbating the credit crunch in the commercial real estate market. This cycle, real estate lending excesses combined with the "tyranny of one price," (meaning that financial institutions have been forced to severely mark to "market" illiquid assets based on the observable index value which may or may not be representative of the assets, and whose values may or may not have been distorted or manipulated by speculators) created huge holes in the capital ratios of banks and other financial companies.

Just as was the case in 1990, today's environment also resulted in the trashing of financial stock shareholders. The credit crisis that began in the summer of 2008 has ushered in a period of regulatory uncertainty, or more colorfully a "regulatory reign of terror" over corporations, particularly financial companies. Certainly regulatory reform needs to come to the financial sector, particularly in regard to the creation and use of financial derivatives like Credit Default Swaps (CDS), but today's environment is ripe for counterproductive finger pointing, as blame for the financial crisis belongs in every direction (Congress, banks, mortgage brokers, borrowers, and investors). When Larry Summers (President Obama's Director of the National Economic Council) came out in January and signaled that the government and regulators believed banks receiving government support (i.e., TARP funds) should conserve capital and pay only de minimus dividends, bank dividends went from being set based on long-term economic considerations, to being set based on short-term regulatory expectations. The important part of this action was that it temporarily removed the value of using the dividend as a differentiator of quality in financial institutions, and insofar as there has been a problem with regulatory intervention in the financial sector thus far, it is illustrated by this fact: regulatory actions have not served the process of creative destruction, but to actually undercut it Since the largest banks paid some of the largest dividends in absolute terms, the negative impact on the overall dividend payments of the S&P 500 was magnified beyond the simple number of companies cutting dividends (leading to the -16% year-to-year decline).

One might argue that the valuations of financial stocks would not have cratered the way they did had the Bush and Obama administrations not made key regulatory decisions to flatten the playing field, with adverse unintended consequences resulting from these actions. If the dividend cuts had truly been left up to the boards of the companies, the outcome might have been a more *perfect,* or economically informative, set of dividend cuts, rather than the nearly uniform cuts to $0.01 per quarter, which panicked investors.

So if a dividend cut is appropriate, what constitutes a "*perfect*" dividend cut?

A company usually considers cutting its dividend for any or all of three primary reasons:
1. Its earning power and cash flows have undergone a "relatively permanent" decline (due to competitive pressures or long-lasting cyclical or secular impacts on its cost structure or demand for its products, etc.), and the resulting payout ratio is too high to be sustained indefinitely.
2. Balance sheet leverage has become excessive (and/or debt repayment schedules burdensome) and requires a greater portion of earnings to be retained to reduce debt leverage. This may be triggered by pressure from rating agency threats to cut a company's debt rating as was the case during the recession of 2000-2002.
3. Regulatory pressures from the OCC, FDIC or SEC related to capital adequacy could also be a source of dividend cut pressure for financial companies or PUC's in the case of utilities.

The candidates for dividend cuts usually don't materialize over night. With companies for which revenues and earnings have disappointed investors for many quarters, the investor class has usually changed over time from those seeking growth opportunities to those seeking value and income. The dividend yield rises as the outlook dims such that those companies with the highest dividend yields often possess the greatest risk of a cut. Yet, in most cases, company distress is not so dire that a company must omit its dividend. Even if financial conditions suggest that a dividend cut is deemed necessary, a more moderate cut of 40-60%, not 70-100%, typically represents the "***perfect***" kind of cut. The reason is that once the feared dividend cut "shoe" has dropped, investors can see that greater retained earnings should improve a company's balance sheet more quickly, enabling them to reduce debt or to take advantage of new growth opportunities. Furthermore, investors who have purchased the stock for its above-average dividend yield and value are usually left with a cut yield that is still high enough to be attractive. Thus, no potential shareholder class (growth or value) is driven from the stock by the company's dividend decision that would put downside pressure on the stock as it attempts to recover.

A more severe dividend cut creates turmoil in the shareholder base, as those who require or desire income need to sell and move on to other stocks that provide such yields. Furthermore, just as often, a deep cut signals deep distress, and the post cut rebound in the stock may be more muted.

Yet at the March 9 stock market bottom, all stocks were so depressed in valuation, that even the massive dividend cuts among financial stocks could no long hold back the surge in stock prices as investors began to believe the future economic environment would not simply forever consist of recession or worse yet, depression. And because the dividends of financial sector companies have been hit the hardest during this recession, it is also likely that after firms raise sufficient capital to repay the TARP funds to the U.S. Treasury, banks are likely to quickly move to restore higher dividend levels in 2010.

If one looks at the payout ratio history for the S&P 500, even before the earnings debacle of 2008, dividend payout ratios of S&P companies, whether on the basis of operating earnings or reported earnings, are well below historic averages of the prior 30 years. An aggregate S&P payout ratio in the 40-45% range of reported earnings and 35-40% of "normalized earnings" (as calculated by SKBA) appears to us to be reasonable for the future. As a result, we believe that meaningful dividend growth will resume in 2010 as reported earnings begin a sharp recovery from the disaster of 2008.

S&P 500 Dividend Payout Ratio History

Period	% of Operating EPS	% of Reported EPS	% of SKBA Normal EPS
1970-2000	44.9%	47.3%	
2001-2007	32.4%	42.1%	34.6%

If nothing else, this "lost decade" of equity market returns has proven the value of paying dividends and consistently raising them as dividend payments have been the only real source of positive return for common stocks. Thus, SKBA's proven track record in purchasing dividend-paying companies in its Value*Plus* equity strategy is likely to continue to deliver attractive risk-adjusted returns for clients.

Footnote: [1]As the composition of the S&P 500 changes during each year, the calculations of dividend changes over each period reflect the changes of S&P companies in the Index at the end of each period of measurement.
