Not All Dividends Are Created Equal

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In response to the most widespread, synchronized debt deleveraging since the Great Depression, the Federal Reserve initiated a series of "easing" measures in order to lower the cost of borrowing, boost asset prices and reflate nominal GDP.

These steps are all part of the Fed's attempt to stave off disinflationary pressures and stimulate the economy by flooding it with liquidity. While its efforts went a long way toward preventing a repeat of the Great Depression, we believe the Fed's suppression of short-term yields (i.e. money market funds and short-term treasury bonds) has induced yield-seeking investors to pile into the highest-yielding, dividend-paying stocks, paying little regard for the financial strength of these companies or their ability to maintain or grow dividends long-term. This is creating what we consider to be an unsustainable 'high-yield equity bubble.'

Most bubbles are created when an expanding number of participants come to view a "logical justification" as the primary reason to own an asset, with little regard for its price. In today's investment world of negative real (after inflation) yields and volatile economic conditions, the justification for owning stable, dividend-paying stocks is simple: 1) long-term bonds no longer provide a return above long-term inflation expectations, and 2) stable, dividend-paying companies typically do not cut their dividend in a recessionary environment.

In this desperate search for yield and stability to combat low yield and economic volatility, our analysis suggests investors have driven the prices of the highest-yielding stocks to unjustifiably high levels relative to their underlying intrinsic values.

For example, the Vanguard High Dividend Yield ETF (VYM) has outpaced the return of the Vanguard Dividend Appreciation ETF (VIG) by over 8% from 12/31/2010 through 9/24/2012.

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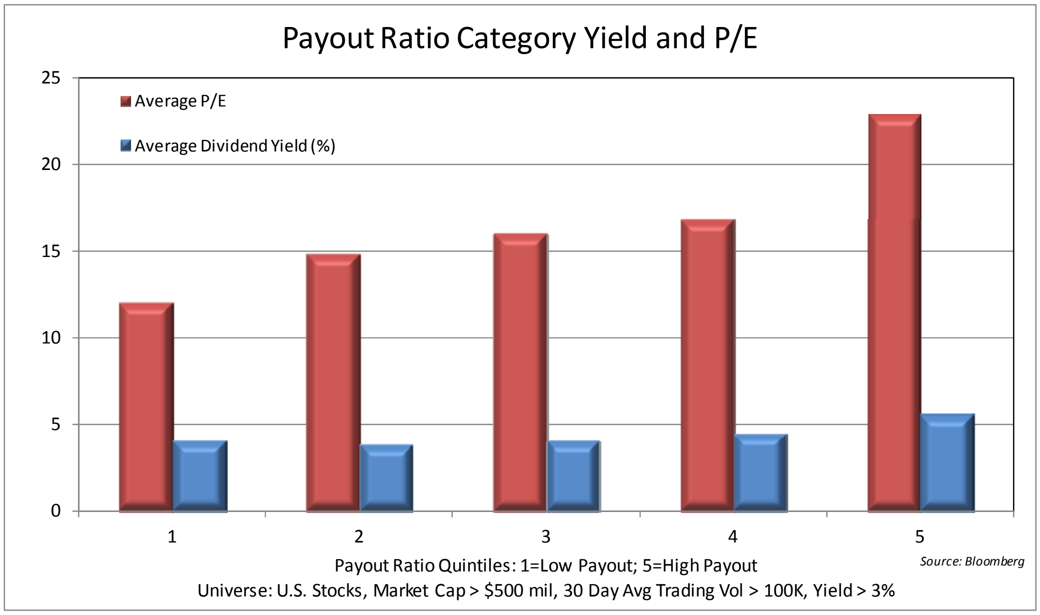
We divided a list of well-capitalized U.S. stocks with dividend yields of 3% or higher (excluding real estate investment trusts) into five quintiles based on their payout ratios (the percentage of their earnings they distribute to shareholders as a dividend). As one might expect, the highest payout category offers the highest average yield. However, stocks with the highest payout have an average P/E of nearly 23x, compared to a multiple of only 12x for the group of stocks with the lowest payout ratio. In light of this analysis it's evident investors need to be far more discriminate when considering dividend-paying stocks for their high yields: above the 3% threshold, in particular, small increments of higher dividend yield beget much more additional *risk* than return. On the other hand, high-yielding stocks with lower payout ratios (meaning they have better coverage of their



dividend) present an attractive alternative to most investment grade bonds. In many portfolios needing income we have made allocations to high-quality, high-yielding equities in lieu of low-yielding bonds.

AT&T is a great example of a high yield stock whose price has appreciated notably in 2012. The stock is up by more than 26% year-to-date but still has a yield of about 4.6%. AT&T has a payout ratio just under 90%, a total debt-to-equity ratio of 62%, a 3-year dividend growth rate of just 2.4%, and a P/E that is as high as it has been in more than *five years*.

Contrast AT&T to a stock such as Intel which yields 3.9%. Intel has a payout ratio under 40%, a total debt-to-equity ratio of only 15%, a 3-year dividend growth rate of 15.2%, and a P/E multiple under 10x. In this poignant example, investors seem to be ignoring the quality, growth and total return potential Intel provides given its superior financial flexibility, high historical dividend growth rate, and Intel's clear ability to maintain its aggressive stock buyback program. To us, the difference in the total return prospects between these two stocks seems an unduly high opportunity cost for the benefit of only 70 basis points of extra annual dividend yield from AT&T.

Extremely low interest rates have increased investor demand for high dividend paying stocks. Our research lays bare a wide range of risks regarding the cash flow support for today's dividends. Importantly, we have found that in many cases, one can buy high-yielding stocks with well-supported dividends at a *discount* to other high-yielding stocks whose dividends might be at risk. Accordingly, we caution our clients not to reach for every last penny of dividend yield; those few extra basis points might just cost you money down the road.

Market Log- October 3, 2012

S&P 500: 1,450.99
10 year T-Note: 1.62%
Crude Oil: $87.97
Gold: $1,781.10

AT&T: Price $38.33; Div. $1.76; Yield 4.6%
Intel: Price $22.58; Div. $0.90; Yield: 4.0%

If you have questions or comments regarding this or any other Research Note, please email the H.M. Payson & Co. Research Department at **hmpresearch@hmpayson.com.**

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