

Dividend Investing

Combining Tax-Advantaged Income and Growth

As the population of the U.S. begins the largest demographic shift in the history of the country, the demand from Baby Boomers for retirement income is certain to change the investing landscape. Heightening the dilemma is the expectation of increased longevity coupled with the elimination of many corporate defined benefit pension plans and even some uncertainty about the long-term health of the Social Security system. Only adding to the potential crisis is the fact that, as retirees are forced to turn to their personal investments as their primary source of retirement income, the current low level of interest rates provides little "real return" above the rate of inflation. Even holders of tax-exempt bond portfolios are feeling the pinch as their income shrinks from the 6% coupons of the past to the sub-4% returns of today. As shown in the chart below, one answer to this problem lies in the area of "enhanced dividend" investing.

| Category | Gross Return% | After-Tax Return%* |
|---|----------------------|---------------------------|
| 3-year Treasury | 5.00% | 3.25% |
| 3-year U.S. Agency | 5.35% | 3.48% |
| 3-year Tax-Exempt Municipal | 3.95% | 3.70% |
| Average High-Yield Bond Fund | 6.50% | 4.23% |
| Enhanced Dividend Portfolio** | 8.00% | 6.80% |
| * @ 35% Tax Rate | | |
| ** Enhanced Dividend Portfolio represents a sample investment in a diversified equity portfolio of option enhanced closed-end mutual funds and does not represent a specific security or portfolio strategy. Yields are quoted as of 7/15/2007. | | |

Rejuvenating a Traditional Strategy

The wisdom of dividend investing is far from a new concept. As stated in Graham and Dodd's seminal text, *Security Analysis* (First edition, 1934), "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." While income investors historically turned to dividend-paying stocks for their stability, income stream, and price appreciation, this style of investing moved to the back seat during the high growth 1980s and '90s. However, as the market slumped from 2000-2002 and headlines were filled with the corporate governance debacles of Enron, WorldCom and numerous others, investors were primed for a return to more stability and predictability. The triggering event was the Jobs & Growth Tax Relief Reconciliation Act of 2003, which lowered the maximum tax rate on both long-term capital gains and qualified dividends to 15%. Under prior tax law, dividends were taxed like interest income at the then maximum rate of 38.6%, while long-term capital gains received a preferential 20% rate. Not only was the tax bite on qualified dividend income reduced to less than 40% of its prior level, the tax preference for long-term capital gains compared to dividends was eliminated.

The Historical Performance of Dividend Investing

Before examining the current opportunities for dividend investors, it is instructive to look at the historical role played by dividends as part of total equity returns. In a recent research report by Judith A. Saryan, CFA and Michael A. Allison, CFA entitled *Dividend Investing: Favorable Long-Term Opportunities for Total Return and Income* (March 2007), the authors cite statistics

from Lipper Inc. which showed that, over the past 45 years, more than half of the annualized total return of the S&P 500 Index came from dividends. While a \$1,000 investment in 1960 in the S&P would have grown to \$108,748 through the end of 2006, \$85,067 of the total return would have been attributable to component stocks that paid dividends with only \$23,681 coming from non-dividend payers.

A longer-term study by Ibbotson Associates compared the returns of stocks, 20-year corporate bonds and 30-day Treasury bills over the past 80 years. As expected, stocks returned 10.4%, followed by 5.9% for bonds and 3.7% for T-bills. More revealing is the fact that over 40% of the stock return (4.3% of the 10.4% total) came from dividends alone, even outpacing the T-bill return.

Finally, Saryan and Allison cite research performed by Ned Davis Research, which examined the relative performances of stocks between 1972 and 2006. The S&P 500 was divided into five categories based on dividend policy. The compelling results of this 35-year timeframe were as follows:

| Category | Annualized Return |
|--|--------------------------|
| Dividend Growers and Initiators | 11.0% |
| All Dividend Paying Stocks | 10.3% |
| Dividend Payers with No Changes in Dividends | 7.2% |
| Dividend Cutters or Eliminators | 3.6% |
| Non-Dividend Paying Stocks | 2.4% |

The Risk Side of the Dividend Strategy

As impressive as these “return based” studies are, our historical examination would be incomplete without considering the risk side of the equation. Here, we turn to a study by Lehman Brothers Global Equity Research, which measured the annualized

return and risk (as measured by the standard deviation) of the 1,000 largest U.S. firms between 1969 and 2005. When divided into quintiles by dividend yield, not only were the returns for Quintiles 1 and 2 markedly higher than Quintiles 3-5, the volatility/risk of the top dividend payers (Q1) was roughly one-half that of the lowest yielding group (Q5).

More important than any statistic is the historical record of dividend vs. non-dividend paying stocks during periods of market decline. According to a study by Standard & Poor’s, during the 25-year period ending December 31, 2005, there were five calendar years – 1981, 1990, and the years 2000 to 2002 – when the S&P 500 posted a loss. During these years, the S&P lost an average of 10.22%, with non-dividend-paying stocks losing materially more – an average of 14.6%. Not only did the average yield of 3.2% provided by the dividend-paying stocks act as a buffer during these down years, the category as a whole posted an average annual gain of 1.14%.

Based upon the results of these convincing studies, dividend investing emerges as a solid risk/return and tax efficient investment approach. Remembering that dividend investing is stock market driven and includes risk beyond the traditional income portfolio of “laddered” maturity bonds, the next step is to construct a portfolio that meets each investor’s income and growth expectations.

Building Blocks of a Dividend Portfolio

With the S&P 500 still yielding less than 2%, it’s not hard to find dividend yields of 3% to 5% on blue-chip companies. Among the more attractive dividend payers are financial leaders such as Citigroup (4.1%) and Bank of America (4.5%), multinational pharmaceuticals like Pfizer (4.5%) and Bristol-Myers Squibb (3.5%) and utilities such as Duke Energy (4.8%) and

Consolidated Edison (5%). For the more seasoned equity investor, a properly diversified portfolio of individual stocks can generate dividend income at least twice that of the benchmark S&P.

ETFs Join the Dividend Ranks

For those investors who want greater diversification or a ready-made option, there are a number of Exchange Traded Funds (ETFs) including the iShares Dow Jones Select Dividend Index Fund, which currently sports a 3.9% dividend. This ETF owns 100 of the market's biggest payers, predictably concentrated in financials, pharmaceuticals, and utilities. Among the overseas ETF options is the PowerShares International Dividend Achievers ETF basket, which contains 60 international ADRs (American Depository Receipts) that trade on U.S. exchanges. All of these companies have increased their annual dividend for five or more consecutive fiscal years. Finally, there is the WisdomTree family of ETFs, which weight all holdings in their ETFs based on dividends. Their offerings range from domestic (Total Dividend Fund) to international (International Dividend Top 100) to a variety of specialty international sector ETFs, such as the International Utilities sector ETF.

Preferreds, Stocks or Bonds?

One step away from the "straight equity" approach is the preferred stock category. Although preferreds are classified as an equity category, they are more interest rate and credit sensitive, generally tracking the corporate bond sector. Yields on preferred stocks will reflect the credit rating of the underlying issuer since the dividends on lower rated or "junk" issues are more likely to be reduced, deferred or missed completely. While valuations may change as the credit of the issuer is up or downgraded, the primary driver of valuations is interest rate levels, with values moving inversely to the direction of a rate change.

The equity-like features of preferreds include "stock-like" pricing (normally in the \$20-25 range), trading on the New York Stock Exchange, quarterly dividends and no fixed maturity date. Unlike stock, however, preferreds typically contain a call feature whereby the issuer may buy back the security for a designated price after a certain call date. Like bonds, the "yield to the call" is more relevant than the current yield. Care must also be taken to determine the tax character of the dividends. For example, while qualified dividends are taxed at the preferential 15% rate, distributions from REIT preferreds (Real Estate Investment Trusts) are taxed at ordinary rates up to 35%. Because the preferred stock market place is somewhat more difficult to analyze and trade, Powershares introduced the Financial Preferred Equity ETF, the first ETF to access this market within the ETF structure.

Adding Options and Leverage

The highest yielding (and consequently the highest risk) of the dividend strategies are the option income funds. These funds are typically structured as closed-end funds with a diversified portfolio of high dividend paying stocks. They employ what's known as a covered-call strategy, buying stocks and then selling call options (the owner of a call option has the right to purchase the underlying stock at a designated price on or before a specified date, at which time the option expires) on those stocks for which they receive a payment. Some of these funds also employ limited leverage (typically up to 30%), borrowing funds at a rate lower than their expected return, further enhancing the total return. While investors sacrifice some of the upside potential due to the call strategy, the yields generated from this strategy range from 8-11%. While the high-income level makes these funds less volatile than most straight equity funds, they are not immune to either stock market corrections or poor stock selection.

Grant/GrossMendelsohn's Value Added Selections

In order to capture the most attractive elements of dividend investing, we have added positions in the Alpine Global Dynamic Dividend Fund and the ING Global Equity Dividend and Premium Opportunity Fund to selected client portfolios. A brief review of these two funds will serve to illustrate the unique characteristics of their strategies.

The Alpine fund employs a three pronged approach which covers all market capitalizations and sectors. The first strategy focuses on high dividend stocks with capital appreciation potential based on turnaround opportunities, depressed earnings that are poised to recover or expectations of a corporate restructuring. With the financial sector generally out of favor in today's market, it is not surprising that both Citigroup and Bank of America are among the fund's holdings. The second leg of the Alpine strategy targets companies with slightly lower dividends, but with a greater focus on capital appreciation potential. Consistent dividend growers like GE fit the mold for this "growth" element of the strategy. The third prong of the strategy, dividend capture, is the piece that distinguishes the fund. By utilizing a paired "rotation strategy," the fund captures six dividends per year rather than the normal four (stocks must be held a minimum of 61 days in order to meet the preferential qualified dividend tax treatment of 15%). The fund also scouts for special dividends where companies are returning large cash balances to shareholders as one-time dividend payments due to a restructuring or recent strong operating performance. The Alpine fund was particularly adept in 2006, distributing roughly 13%, all of which received qualified dividend tax treatment.

The investment strategy of the ING Global Equity Dividend and Premium Opportunity Fund also consists of three component parts. The ING core strategy begins with

the selection of between 65 and 90 stocks from a global universe of companies with a market cap in excess of \$1 billion and a dividend yield above 3%. In keeping with the typical option income strategy detailed above, the fund then sells covered call options (meaning that the options are "covered" by stocks owned by the fund), generating additional revenue. The third part of the ING strategy, purchasing put options (the right to sell or "put" a particular stock to the option seller at a predetermined price below the current level) is the component that makes this offering particularly attractive. This combination option strategy provides a balance between sacrificed upside appreciation potential and downside risk protection. The benefit is a healthy current dividend of 9%.

As an increasing percentage of the population transitions from the workplace into retirement, we also see the need to allocate a larger portion of portfolios into equities to ensure that investors don't outlive their assets. We believe that a high quality, diversified, risk controlled and tax-advantaged dividend strategy will be an attractive investment choice in helping meet this need.

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