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HEARD ON THE STREET

Market's Ills Won't Be Solved By a Cut in Tax on Dividends

The Bush Proposal Would Change Habits Of Many Investors, Causing Ripple Effect

By KEN BROWN
Staff Reporter of THE WALL STREET JOURNAL

When President Bush proposes a dividend tax cut Tuesday afternoon, investors will let out a cheer. And why not? The president will effectively be putting more money in the pockets of those with enough assets to invest in stocks.

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But what's gotten lost in all of the excitement is that a shift toward buying high-yielding stocks by investors and paying out dividends by companies won't quickly solve the market's problems. The move also could have widespread and potentially negative ramifications on everything from mergers and acquisitions to capital spending to state and local government financing. And if rising dividends come at the expense of lower share buybacks, then the growth in per-share earnings will likely slow, potentially keeping a lid on any market gains over the next few years.

Dividend-paying stocks have outperformed the market since the bubble burst in 2000, as investors have fled highflying stocks that rarely paid dividends and bought stodgier names that hold up well in a downturn and tend to pay dividends. **Eastman Kodak** Co., for example, was the highest-yielding stock in the Dow Jones Industrial Average at the start of 2002. Not surprisingly, it was also the best-performing stock in the index last year, rising 19% on top of its current nearly 5% yield.

Now, with expectations rising that taxes on dividends will be cut this year, investors are becoming even more obsessed with yield. Ultimately, many analysts say, this renewed emphasis on dividends could be healthy for the market, shifting investors and companies away from an emphasis on short-term growth in earnings and

more toward healthy, if slow-growing businesses that can produce sustainable long-term gains.

But they don't think it will be a quick fix. "The change is important in terms of the way it changes both management and shareholders' attitudes about stocks, and it's something that long-term will be very positive for investors in common stocks," says Jason Trennert, a strategist with research firm International Strategy & Investment. Still, "it shouldn't be seen as a short-term panacea for what ails the market."

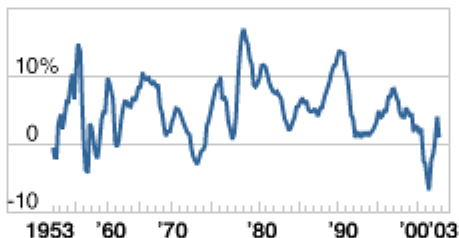
What ails the market, of course, is a weak economy, sluggish corporate profit growth and relatively high stock valuations. A dividend tax cut won't immediately solve any of those problems. Investors won't see the benefit until they file their 2003 taxes in the spring of next year, unless they take the uncommon step of adjusting their withholding to account for the change in dividend taxes.

Companies have been cutting the level of profits paid out in dividends to investors for most of the past century. From 1950 through most of the '90s, companies paid out about half of their profits to investors on average, but the payout ratio was down to 32% in 2000, according to Ibbotson Associates, a Chicago research firm. For the first three quarters of 2002, it stood at 33%, meaning companies held on to two-thirds of their profits to use however their managers saw fit.

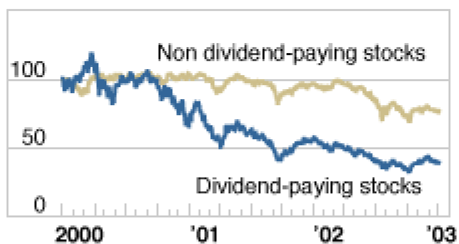
THE BIG DEAL ABOUT DIVIDENDS

President Bush's plan to eliminate the tax individuals that pay on stock dividends has thrown dividends into the spotlight. Meanwhile, dividend-paying stocks have become one of the few remaining sources of income from the stock market.

Unlike earnings, S&P 500 stock dividends are still growing...
Year-to-year growth in the dollar amount of the dividends paid in the trailing four quarters.



And dividend-paying stocks outperform their non-paying counterparts...
Dividend-paying stocks have beaten non-dividend-paying stocks in the S&P 500 for three years.



And companies have become more conservative about paying dividends
The dividend payment ratio, or the percentage of S&P 500 companies' profits, paid out as dividends

In the late '90s, investors were of the belief that fast-growing companies could grow even faster if they reinvested their cash in their own businesses. But investors now believe that cash in the form of a dividend check is more valuable than a promise of future riches. An emphasis on dividends keeps companies from sitting on piles of cash and, critics say, squandering the money on ill-conceived mergers or new products. Instead, companies with less cash on hand are forced to raise money for big initiatives by issuing stocks or bonds, which gives investors something of a check on corporate excesses.

That lack of ready cash could have a downside. Companies could curtail their capital spending and cut back on mergers because they don't want to ask skittish investors for the funding they need. For example, if **Boeing** Co. -- which yields 2%, about the market average -- decided to double its dividend, the move would cost it an extra $543 million a year. That would wipe out almost half the free cash flow the company generated over the past 12 months, meaning that if the company embarked on a costly new jet-development program, it might have to go to the capital markets to get the financing. If investors were unhappy with the company at that moment, Boeing executives could decide to defer the project until they could raise money on better terms.

A rebound in capital spending by companies is seen as a key factor in any sustainable rebound, so a dividend tax cut could actually slow a recovery, though few expect the impact to be more than marginal. Still, "it is interesting that some investors believe that there will be an imminent investment spending cycle and a wave of increases to dividends paid by corporations as a result of changes to the tax law and better credit conditions in the economy," Merrill Lynch strategist Richard Bernstein writes in a new report. "It seems to us that there can only be so many demands on corporate cash flow."

The economic downturn has slammed state and local governments, which have seen tax receipts fall just as demand for services has risen, as it always does in a weak economy. To make ends meet, many governments have sold municipal bonds. These bonds typically carry low interest rates that make it cheap for governments to borrow. Investors are willing to put up with those slim yields because they are generally tax-free.

But if dividends are also tax-free, munis lose some appeal, though in most cases they are less risky than stocks, even those with healthy dividends. This shift could force cash-strapped governments to pay higher rates when they borrow to compete with payouts from companies.

"It'll be interesting to see whether state and local governments scream bloody murder about how the eliminating of the double taxation of dividends raises their cost of capital," Mr. Trennert says.

Both investors and companies will have to rethink the way they value stocks if a dividend cut goes through. In recent years, most everyone was focused, rightly or wrongly, on the growth of per-share earnings as a measure of corporate health. Per-share earnings growth led to share-price growth, which made everyone -- investors and company executives with big options packages -- very happy. Many companies used their excess cash to buy back shares rather than pay dividends, which boosted per-share earnings. The fact that capital gains were generally taxed at lower rates than dividends made share buybacks even more attractive.

Consider the case of **International Business Machines** Corp. Back in 1993, when it was struggling to remake itself, IBM slashed its dividend by nearly 80% to 25 cents a share, a shift that saved the company about $2 billion in cash a year.

When IBM got healthy again, it slowly raised the dividend to 60 cents a share, still half of what it was a decade ago, but more importantly it began aggressively buying back its own shares -- $48 billion worth since 1995. And investors have done well. Since IBM's shares bottomed in 1993, they have risen more than 600%, even after a 36% swoon last year, outpacing the overall market by nearly 100 percentage points.

One reason they have done so well is IBM's earnings per share have risen strongly. But without the share buybacks, the rise wouldn't have been as big. In the 1994 third quarter, IBM earned 30 cents a share, adjusting for stock splits. In the 2002 third quarter, IBM earned 99 cents a share from continuing operations. But if IBM hadn't bought back those 634 million shares, that figure would have been 73 cents a share. (IBM notes that it would have earned interest on all that cash it didn't pay out, putting its earnings at 87 cents a share.) The question is, would investors have bid up IBM shares as much as they did if the company's earnings hadn't risen as strongly as they did?

Far from doing something wrong, IBM has handled this aspect of its finances well. The company returned excess cash to investors just as it would have done if it had paid a dividend, and, by buying back shares, IBM gave itself flexibility to stop the buybacks when it needed the cash. Generally companies are loath to cut a dividend once in place.

In the second half of last year, IBM acquired the information-technology consulting arm of accounting firm PricewaterhouseCoopers and beefed up its pension plan. IBM cut back on share repurchases and was able to cover much of the expense with available cash.

If buybacks are replaced by dividends and the growth in per-share earnings slows, that could also have an impact on employee stock-option plans, which depend on rising share prices to benefit employees. And if companies don't buy back stock, their shares outstanding will continue to increase as employees exercise their options, putting further pressure on per-share earnings.

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