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The Safest Dividend in the Dow

-- By Andy Obermueller

A number of dividends in the Dow Jones Industrial Average are looking pretty juicy these days. Pundits have been debating whether the highest-yielding Dow component, General Electric, will continue its hefty 10.9% payout. Though the company has promised to stand by its obligation to shareholders, you can see why some investors -- given last year's drubbing -- are less likely to take such a pledge at face value.

So the question is appropriate: Which company has the safest dividend in the Dow? We sorted through the blue-chip index and applied several stringent criteria to arrive at the surprising answer. *(Full Story Below)*

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The Safest Dividend in the Dow

Anyone looking for a motto for 2009 need look no further. The catchphrase for the year, at least for income investors, has to be "safety first." Following last year's dismal performance, investor caution has morphed into anxiety. Wall Street and Main Street are both looking for something they can be sure of.

It used to be that dividend payers themselves were the thing investors could be sure of. Tucked in the shadow of the Wall Street darlings, these venerable firms conducted their business, posted their earnings and paid their dividends. These companies all made money the old-fashioned way. They earned it. High-flying? No. Dependable? Yes.

Well, we all saw what happened -- last year was a terrible year for dividends. So now it's time to apply last year's hard lessons and take a clear-eyed look at risk, performance strength, dividend coverage and, lastly, potential return.

We'll start by setting the bar high, with some of the strongest names in America. The 30 members of the Dow Jones Industrial Average are worth a collective \$2.74 trillion and are considered the strongest in their fields. We'll sift

Income Notes

The yield on the S&P 500 (3.4%) is higher than the yield on 10-year Treasuries (2.9%) for the first time since 1958.

The last time this happened, the market saw +43.4% gains in 1958 and +12.0% gains in 1959.

-- GDO Research Staff

U.S. real estate investment trusts may pay more of their dividends in 2009 in stock rather than cash to save \$10 billion a year.

"Seventy companies out of 100 are likely to do this," said Dean Frankel of Urdang Securities. "It's about liquidity and concerns over debt. Every dollar they have, the better."

REITs, a \$465 billion industry, could save \$10 billion this year by paying 90% of dividends with stock, according to Bloomberg calculations using Merrill Lynch forecasts.

-- Bloomberg

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through these corporate titans to find the absolutely safest dividend.

Safety Criteria No. 1: Yield

The first step in our process is not to look at the Dow at all, but to peek into the debt market, where a 10-year "AAA"-rated bond pays 4.9%. If we can't beat that cash return with a stock, then we might as well stick with the ultra-safe bonds.

This eliminates most of the Dow. Though it pays an average dividend of 3.9%, about 50 basis points higher than the S&P 500 Index, only eight Dow components yield more than the "AAA" bond. They are shown in the chart.

Company Name	Current Yield
Merck (NYSE: MRK)	5.0%
Caterpillar (NYSE: CAT)	5.6%
Verizon (NYSE: VZ)	5.8%
J.P. Morgan Chase (NYSE: JPM)	6.3%
AT&T (NYSE: T)	6.5%
DuPont (NYSE: DD)	7.0%
Pfizer (NYSE: PFE)	8.4%
General Electric (NYSE: GE)	10.9%

Safety Criteria No. 2: Performance Strength

Next, we're going to borrow a page from our colleagues in the value investing world. They recommend focusing on companies with rising, or at least steady, earnings. To that end, we will shy away from any company expected to show more than a -5% decline in earnings this year, based on the consensus Bloomberg estimate.

Company	2008 EPS	'09 Est. EPS	Change
Merck	\$3.29	\$3.29	0%
Caterpillar	\$5.66	\$2.49	-56.0%
Verizon	\$2.54	\$2.54	0%
J.P. Morgan	\$0.98	\$1.80	+83.7%
AT&T	\$2.81	\$2.71	-3.6%
DuPont	\$2.78	\$2.04	-26.6%
Pfizer	\$2.42	\$2.27	-6.2%
General Electric	\$1.93	\$1.27	-34.2%

This eliminates four companies that are estimated to show appreciable declines in earnings this year.

We're left with four firms: Merck, J.P. Morgan, Verizon and AT&T.

Safety Criteria No. 3: Dividend Coverage

Remember, safety is first. With that in mind, we're going to look into the most recently reported quarter for each company and compare net earnings to total dividends paid. This is a tough hurdle to clear: The second half of 2008 presented extremely difficult operating conditions. Any company able to maintain its performance in such a punishing environment clearly has demonstrated a wide economic moat.

Here are the results:

- Merck recorded \$1.1 billion in net earnings and paid \$808 million in dividends.
- J.P. Morgan Chase earned \$702 million and paid \$1.4 billion to its shareholders.
- Verizon came close to meeting its dividend, but couldn't fund it from

her picks are up -- as much as +58.4% in just a few months. And her subscribers are making money hand over fist alongside her. One has made \$10,272... another is up \$46,002.

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By Carla Pasternak
January 14, 2009

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By Andy Obermueller
January 7, 2009

The U.S. is in recession, but there are plenty of places where things are booming. Not only did these countries fare well in 2008, they're going to post strong growth in 2009 and through 2010. Plus, stocks in these countries are cheap, and, best of all, each of these countries sports a higher-than-average dividend.

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operations. It earned \$1.24 billion and dipped into its pocket to come up with part of its \$1.30 billion dividend.

- AT&T earned \$2.40 billion and paid out \$2.35 billion.

We must exclude any company that paid more in dividends than it earned. That sort of arrangement is unsustainable. Any company whose dividend costs exceed its net earnings lacks the margin of safety that conservative income investors in this market must demand.

Safety Criteria No. 4: Upside Potential

We're left with two companies, Merck, the drug maker whose dividend amounted to 73% of its net earnings last quarter, and AT&T, whose earnings covered its dividend with \$50 million to spare.

Certainly at this point it's worthwhile to revisit our initial criterion and simply ask which company has the highest yield. It's AT&T, whose payout exceeds Merck's by 150 basis points. Now, even though that's a wide margin, we want to be sure we aren't missing out on potential upside. We'll use that as our tiebreaker.

AT&T shares are trading at roughly nine times its trailing earnings of \$2.82 per share. A return to its five-year average multiple of 14 would mean a share price of almost \$40 -- +55% higher than the current price. Throw in the 6.5% dividend and the best-case scenario for investors is a total return of +62% based on Tuesday's closing price.

Merck, for its part, typically sells for nearly 14 times earnings. The market is currently valuing the shares at nine times TTM earnings of \$3.35. If Merck returns to its historical valuation, the capital gain would amount to +55% for a total gain above +60%.

Based on these criteria, AT&T can be considered not only the strongest dividend in the Dow, but also the dividend payer with the greatest total upside -- though the race was extremely close. A 6.5% dividend is respectable -- but the real opportunity with AT&T is to be paid an extremely safe rate of return while waiting for a robust capital gain.

Many happy returns!



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