



Carla Pasternak's

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## Overlooking Today's Single-Digit Yields Can Cost You Triple-Digit Gains

-- By Andy Obermueller

A recent assessment of dividend yields and stock prices in *The Economist* caught my eye -- and crystallized the amazing buying opportunities for income investors in this market. In today's issue, we'll take a look at what *The Economist* said about dividends and illustrate why the opportunities are so rich and the future is so bright for income investors who are willing to take the long view.

To illustrate our point, we'll use a company whose dividend cut recently made headlines -- and show how this could just be the start of a double-digit yield and triple-digit capital gain story in the making. *(Full Story Below)*

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### Overlooking Today's Single-Digit Yields Can Cost You Triple-Digit Gains

I read something utterly fascinating about dividends last week. "A share's value," wrote *The Economist*, "must be the present value of all future dividends."

Is this true?

Maybe, maybe not. Let's consider it. We'll borrow an example from the headlines and look at General Electric (NYSE: GE), which recently cut its dividend for the first time in more than 70 years. We'll evaluate GE from the perspective of a conservative, long-term income investor.

### Income Notes

The worst is over for junk bonds. In early February, Chesapeake Energy, a debt-laden natural-gas producer, decided to issue \$500 million worth of bonds to repay bank loans.

As late as November, Chesapeake had no hope of selling bonds at any price. Yet on Feb. 2, Chesapeake not only brought a debt offering to market but also managed to sell \$1 billion worth of bonds -- twice what it had originally proposed. The bonds yield 10.625% to maturity in six years.

That 10.625% is more than eight percentage points higher than the yield of Treasury securities with a comparable maturity, and it's five percentage points more than what you can get from an A-rated six-year bond from MetLife.

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The shares, priced at roughly \$9, now pay a dime each quarter. That's a 4.4% yield, about a point ahead of the broader S&P's average yield. By *The Economist's* reckoning, the only upside for these shares would occur after 17 years of GE ownership, when an investor would have recouped the initial cost of the shares through dividends. At that point, the shares would have paid for themselves and any additional cash flow from them would be gravy.

That's one way of looking at it.

But that valuation model excludes some critical facts, and not least among them is a company's ability to deliver long-term results. In GE's case, the conglomerate is typically the No. 1 or No. 2 competitor in every field in which it does business, and this domination is evident in the bottom line. "You're talking (about a company)," GE chief Jeffrey Immelt said March 5th, "that earned \$18 billion last year on \$183 billion in revenue, that's outperformed the S&P 500 from a revenue and earnings standpoint over the last five years."

Or, to put an even finer point on it, a profitable and highly rated company that's worth an average 17.2 times earnings but whose P/E has slipped to an anemic 4.6.

Was what *The Economist* wrote wrong?

Not necessarily. The article's point may be considered by-the-book accurate, and taken as a whole the reporting and analysis in the piece were well done. But the statement above might not be the whole truth. In my view, this characterization of stock prices and dividends omits a critical qualifier. Were I an editor of that esteemed publication, I'd have suggested the sentence be recast to read, "A share's *price* represents *the market's view of the present value of all future dividends as well as its collective judgment about its current prospects.*"

It is, after all, the market that decides what a stock is worth. And markets, made up as they are of millions of frantic individual investors, are not functioning in a logical way. All one needs to prove that point is to look at the CBOE's Volatility Index, which, at 45, remains leaps and bounds above its 200-day moving average. Markets are not simply responding to dividend payout levels: They hinge as they always do on a variety of factors, fundamental, technical and, most importantly, psychological.

Now, a manic market does not mean that there aren't ways for income investors to make money -- it only changes the nature of those opportunities. That's why it is a good idea to be reminded of what dividends mean.

Dividends are more than a simple cash payment to shareholders. They are a symbol of strength and stability of both the company and the economy it operates in. As confidence has eroded in the economy and in some specific sectors like finance, stock prices have plummeted across the board. As the business climate has depressed results, so too has the willingness of companies to part with cash. *The Economist* was dead-on in its assessment of this reality: "There is no point in starving a business and endangering a firm's balance sheet in order to meet macho dividend commitments."

In other words, would you rather have a dividend cut or a business that can no longer continue as a going concern? Do you want a bird in the hand if it means decimating the bush?

The publication continued: "...[I]n theory, shareholders should not care whether dividends are paid out today or later. Just as taking money out of a cash machine does not make you richer, nor does extracting cash from a firm you own."

The point to remember is that the a company's cash belongs to its shareholders whether it is put to work rebuilding the balance sheet or sent to you in the form of a dividend check. A prudent investor may well opt for a

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By Andy Obermueller

lesser result to insure the enterprise's long-term success. This works financially as well as medically: If doctors must re-break a bone in order to set it properly, it will grow back as strong as it was. If it is left to grow back on its own, it may never regain its former ability.

With that in mind, let's return to our consideration of GE, which is probably as good a proxy for blue-chip dividend payers as any. If we assume that an investor can purchase shares and hold them for 10 years, and we further assume that GE can achieve a +15% annual growth in its share price -- slightly ahead of the long-term average for the S&P 500 -- then the value of those shares goes from \$9 to \$36.40. Assuming that the results are scalable, the dividend would also rise from a dime to \$0.35. That's more than a 15.6% yield on your initial invested capital to say nothing of a capital gain of +304.6%.

Market signals overall are tough to read and volatility is high. When the market stops making sense, as I have written before, then it is time to stop trying to make sense of the market. We have all taken trips where the road seemed treacherous for a while, only to become straighter and smoother as the miles progress. The trick in these situations is to focus not on the road but on the car.

The stock price represents the market's perception of the value of future dividends and all future business results (which may not be reflected in dividends for some time as companies prudently conserve cash). That view is less than rosy; some payouts are being cut. That course will reverse. Some measure of logic will return to the market's valuation; mania and volatility always fade. For investors willing to exercise patience -- and to commit to collect their returns over time -- the current market opportunities offer the deal of a lifetime.

Many happy returns!



-- Andy Obermueller  
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