Quarterly Point of View
The Tax Issue

July 10, 2012

We are four months from a Presidential election, and as we near Tuesday, November 6th, the tax discussion is likely to intensify. This thoroughly boorish topic is not much fun to ponder, let alone write about. However, it is an important topic for investors to consider – if for no other reason than to understand potential changes and avoid the mistakes associated with overreacting.

In February, President Obama submitted his 2013 budget proposal, which contained tax increases on capital gains and dividends. Given that dividends are already taxed at the corporate level – of which any dividend recipient is already a pro-rata corporate owner – the 'double taxation' on those profits is philosophically troubling. Double taxation on dividends has – in varying degrees – been the case for many years, and during many a Presidential administration. It is likely to remain uncorrected. The new rates under the President's proposal would tax upper income earners (single filers exceeding $200,000 in income, or joint filers exceeding $250,000 in income) on capital gains at 19.8%, while dividends would scale to ordinary income rates - with the top current levy at 39.6%. Additionally, the Supreme Court recently upheld the 3.8% surtax on investment income as part of President Obama's health care overhaul. Though the IRS has yet to release guidance on the new tax, it appears to cover most forms of investment income, including capital gains, dividends, rents, royalties and interest. This surtax, when combined with the proposals above, would substantially raise overall taxes on investments, while disproportionately on dividends. The proposal and heightened media coverage about its potential may be contributing to a relatively slower first half of the year for dividend payers in 2012. Further debate - and the election - will go a long way in determining if the proposals are even enacted, but we believe the 'tax discussion' will mean more in short term perception than long term reality. After very strong relative performance for dividend stocks in 2011, the 'taxation' excuse may be used by some as a reason to focus on 'capital appreciation' versus total return dividend income strategies. We acknowledge the perception may have an influence, but we consider it temporary rather than structural, giving investors the opportunity to get involved in high quality, dividend growth stocks.

We are not trying to paint a potential tax increase as a positive development, but it's extremely important to keep it in perspective. Dividends have accounted for a huge part of the stock market's total return for many, many decades. In addition, dividend paying stocks have a long record of outperforming non-payers, and have done so even in periods of oppressive tax regimes. The table below illustrates the performance disparity between

dividend growers, constant dividend payers, non-payers and cutters over the period from 1972 to June of 2011.

Stocks by Dividend Segment	Annualized Return	Cumulative Return
Dividend Growers	9.66%	3722%
Constant Dividend Payers	7.44%	1599%
Non-Dividend Payers	1.83%	105%
Dividend Cutters	-0.56%	-20%

Returns from 1/31/1972 through 6/30/2011[1]

Initially, one might think that periods of very high dividend tax rates (particularly relative to capital gains) would cause investors to gravitate away from dividend payers – but that is not what has happened. In the time frame cited above, dividend tax rates exceeded 38.5% exactly two thirds of the time, with an astounding top rate of 70% levied for a full 10 years of the analysis period! What's more, the average difference between the rate on dividends and capital gains was vast, with capital gains spending 82% of the time at a maximum rate of 28% or under – but often significantly below that. Investors who are worried that a rise in dividend taxes will be commensurately larger than capital gains taxes – and therefore seek to avoid significant dividend payers – may end up being thoroughly surprised by the eventual performance outcome.

This leads us to question what corporate management will do with capital allocation decisions in an environment where dividend taxes might be higher. The individuals likely to take the largest hit with tax increases on investment income are those with influence in the matter - namely, executives and corporate directors. Unfortunately, most executives, in our opinion, are not compensated in a manner aligned with long term share owners, as they are often incentivized through the use of options tied to short term earnings per share growth targets. Because of this, any large difference between dividends and capital gains tax rates may give them an 'excuse' to opt for share buybacks. This reduces the number of shares outstanding, thereby increasing earnings per share (often temporarily) and getting them closer to their incentive 'targets'. For this reason, it will become increasingly important in the period ahead, if a large tax spread does exist, to ferret out the truly committed dividend cultures from the counterfeit.

Interestingly, Morningstar looked at 100 years of tax rates on dividends compared to capital gains and termed the spread between the two the 'dividend tax penalty'. In an environment where a large spread exists, we might once again conclude that corporate management would opt not to pay out a high portion of earnings (referred to as the payout ratio), but this has not been the historical case. In decades where the 'penalty' was highest – in the range around 60% - the three year average payout ratio hovered well above half of all profits being distributed through dividends. Compare this to the last nine years, when the penalty has been 0% (no difference between capital gains and dividend taxes) and yet payout ratios have resided near the historical nadir of roughly 35%. In other words there has been no correlation between a high 'dividend tax penalty', and the inclination of management to reduce commitments to dividends through lower payout ratios.

Meanwhile, corporate directors' actions of late do not appear to foreshadow a destabilizing change in the dividend tax environment. Dividend growth has accelerated recently relative to three and five year averages for companies in the S&P 500. Blue chip global leaders such as Intel, Microsoft, Texas Instruments and BHP Billiton have all announced accelerated dividend payout growth exceeding 20%, on top of already attractive yields. Moreover, after years of not paying a dividend, Apple now plans to start paying a quarterly dividend of $2.65 per share, or almost $10 billion in annual distributions to shareholders.

Finally, most American investors hold a significant portion of their stocks in tax deferred accounts such as Individual Retirement Accounts, both Traditional and Roth, and 401(k) accounts. Frequent reports estimate the percentage of stock holdings in all forms of these tax deferred portfolios to be greater than 60% to 65% of all equity ownership. Given that no tax is paid on investment income earned while inside of these accounts, a change in dividend tax rates has no direct impact.

We clearly don't prefer to see tax increases on investment income, but even if tax burdens do rise, dividends will continue to supply substantial, durable and growing streams of income. We would rather capture a dollar up front, taxed at prevailing rates, than receive the promise of capital gains we may never get the opportunity to pay taxes on. Bonds, already taxed at ordinary income rates, cannot provide growth of income, and at today's rates they hardly even provide interest. Stocks that do not pay dividends provide neither income nor predictable capital gains. With the added support of demographic trends and the absence of material income from bonds, we believe investors will continue to seek consistent dividend payers. We will keep a close eye on the tax developments that materialize through the election cycle and keep our fingers crossed for a common sense approach. Still, the successful application of our dividend growth strategy has never solely been a function of low tax rates, as the intrinsic advantages of durable dividends have allowed shareowners to prosper through a wide variety of tax environments. We don't see any reason why that should change.

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It is a sincere privilege serving those that have entrusted us with their capital.

Respectfully,

Cameron K Martin
Chief Investment Officer
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[1] Source: Ned Davis Research Group

Statistical data provided by Bloomberg Professional

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