INVESTMENT INSIGHTS

U.S. EQUITY GROUP

Dividends for the long term

April 2013

OUTLOOK & OPPORTUNITIES

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IN BRIEF

- Stocks that pay dividends have historically outperformed non-dividend-paying stocks over the long term. Not only are total returns driven by dividend growth over the long term, but dividend-payout policies may also help drive smarter capital-allocation decisions by management.
- The tax advantage of dividends over interest income has now been made permanent as a result of the tax deal signed earlier this year, setting the stage for companies to support dividends.
- In what is likely to be an unusual market environment, investors are getting income from companies' bonds comparable to the dividend payouts on the companies' stock, making dividend-paying stocks, which also have the potential for capital appreciation, an attractive option.
- Demographic trends will continue to favor dividend-paying stocks as retiring baby boomers drive demand for income strategies.

AUTHORS

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Clare Hart
Managing Director, Portfolio Manager
U.S. Equity Group
clare.hart@jpmorgan.com

Mariana Connolly
Executive Director, Client Portfolio Manager
U.S. Equity Group
mariana.b.connolly@jpmorgan.com

Equity income strategies and dividend-paying stocks have been in sharp focus in recent years as investors have sought alternatives to low-yielding fixed income instruments. Now that investors have become more comfortable with the equity market overall, we believe it still makes sense to think about dividend-paying stocks as an anchor for their overall equity allocations.

Even if investors are willing to take on more risk, equity income strategies still have the benefit of strong long-term returns with low volatility. While there are pockets of overvaluation—mostly within the traditional yield-oriented sectors, such as utilities and real estate investment trusts (REITs)—there are many tailwinds that make dividend-paying stocks attractive total return vehicles:

- A commitment to a dividend can indicate a strong business and a management priority on returning cash to shareholders, both important drivers of long-term stock appreciation.
- The low-for-long interest-rate environment means that current dividend yields are attractive, while strong corporate cash balances provide companies with room to drive more dividend increases.
- The increased use of stock awards, instead of stock options, as part of executive

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compensation packages means that dividends will be a more important incentive to management teams than they once were.

- The tax advantages of dividends have now been made permanent.
- The increasing number of retiring baby boomers seeking yield will continue to drive demand for dividend-paying stocks.

In this paper, we explore how the combination of dividends, high-quality companies, reinvestment and time can pay off handsomely for long-term investors.

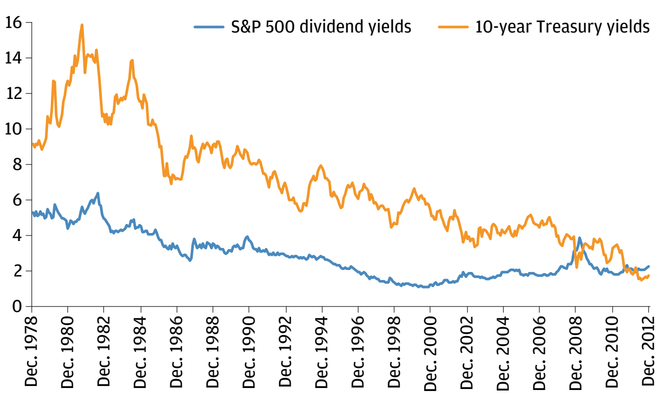
Exceptional times, exceptional valuations

Historically, many investors looking for income have sought the security of risk-free government bonds. But with yields on some government bonds currently below inflation—resulting in negative real yields—many income seekers today are looking to the equity markets to provide an attractive level of income.

Typically, dividend yields across many stocks were below bond yields. Today, however, investors are faced with an exceptional environment where the S&P 500 dividend yield is higher than the 10-year Treasury yield (**Exhibit 1**). With today's low rates and compressed spreads, the yield on a given large-cap company's bond may not be much higher than the dividend yield on its stock, which also carries a possible capital appreciation kicker.

Once in a generation: S&P 500 yields have risen above 10-year Treasury yields.

EXHIBIT 1: S&P 500 DIVIDEND YIELDS VS. 10-YEAR TREASURY YIELDS

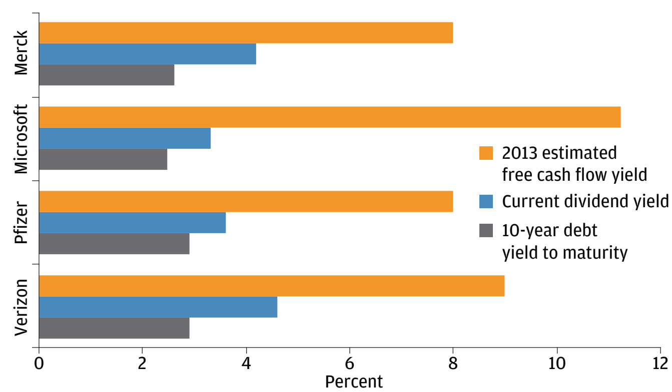


Source: Bloomberg. Data as of December 31, 2012. Dividend Yield: Trailing 12-month gross dividends divided by price. Trailing 12-month dividends for each stock are calculated by adding the gross amounts of all dividends that have gone "EX" in the past 12 months, including special cash dividends. For the index total dividends, Bloomberg takes the sum of all members' last 12-month dividends times shares in the index, divided by the index divisor.

At a stock-specific level, valuations for dividend-paying stocks are also attractive. As **Exhibit 2** illustrates, various companies' free cash flow yields are significantly higher than their 10-year debt yields, and some even have dividend yields that exceed the yields on their 10-year paper. Corporate balance sheets—which remain flush with cash—suggest that these yields are not only likely to be maintained, but also have room to grow further.

Steady stream inviting yields: Ample free cash flows suggest that companies with dividend yields near bond yields can sustain attractive dividend levels.

EXHIBIT 2: 2013 ESTIMATED FREE CASH FLOW YIELDS, CURRENT DIVIDEND YIELDS AND 10-YEAR DEBT YIELD TO MATURITY



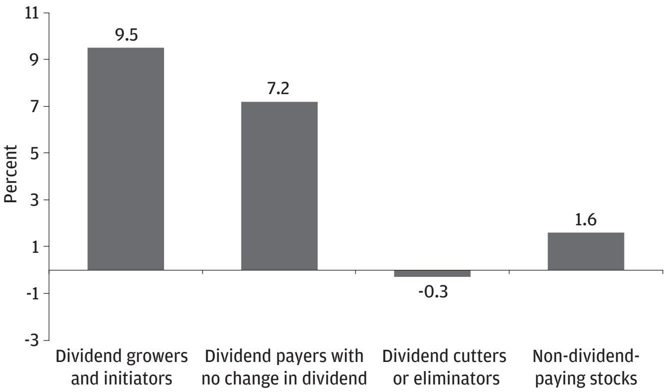
Source: J.P. Morgan; Wolfe Trahan Accounting & Tax Policy Research; company filings; Bloomberg; Standard & Poor's; FactSet; market data as of February 13, 2012.

The lion's share of return

Over the long term, dividend-paying stocks have posted strong long-term returns with lower volatility than the broader market. While some investors may think of dividend payers as stodgy companies in slow-growth businesses—an outdated view from the 1980s and 1990s when capital appreciation dwarfed dividends—dividend payers can be found across a broad range of sectors and industries. Dividends can sometimes serve as a good litmus test for companies with strong businesses and management teams that are committed to returning capital to shareholders. Over the last 40 years or so, dividend-paying stocks within the S&P 500 have outperformed non-dividend-paying stocks—in many cases, by a significant margin. As shown in **Exhibit 3** (next page), companies that initiated and grew their dividends posted average annualized total returns of about 9.5% from 1972 through the end of 2012 compared with 1.6% for non-dividend-paying stocks. This is likely because companies that can commit to a recurring dividend payment in cash are often inherently healthier companies.

Depend on dividends: Over the last 40 years, the S&P 500's dividend payers grew significantly faster than non-dividend payers.

EXHIBIT 3: RETURNS OF S&P 500 DIVIDEND-PAYING STOCKS HAVE SIGNIFICANTLY OUTPERFORMED THOSE OF NON-DIVIDEND-PAYING STOCKS (JANUARY 31, 1972–DECEMBER 31, 2012)



Source: Ned Davis Research, Inc. Returns based on monthly equal-weighted geometric average of total returns of S&P 500 component stocks, with components reconstituted monthly; data as of December 31, 2012.
The above chart is shown for illustrative and discussion purposes only.

Dividends also dominate the components of total return. (Total return in any given measurement period is the combination of the income received in the form of the dividend plus the change in the asset value—the stock price movement—both divided by the starting asset value.)

Conventional wisdom estimates that slightly less than half the return from equities in any given year comes directly from the dividend, with the rest from the stock movement. But closer to 90% of total returns from the stock market can be attributed directly to dividends when dividend growth is taken into account.[1] Using Robert Shiller's database at Yale University, the market's aggregate dividend distribution has grown at a compound annual growth rate of 4.4% since 1926.[2] That is, of the market's annual total return of 9.7% since 1926, 8.6% of it (which amounts to 89% of the annual figure) came from dividends.

Even in shorter time periods, dividend-paying stocks outperformed. Over rolling 10-year periods, higher dividend-paying stocks outperformed lower- and non-dividend-paying stocks in just about every period since 1970, and did so by about 3% annually.[3] Over rolling three-year periods, the higher-yielding securities beat the low- and non-dividend-yielding securities in about two-thirds of the three-year measurement periods (24 out of 38), with an average outperformance of just less than 1% per year.[4]

Since dividends represent such a large part of total return over time from equities, to ignore them and focus only on capital appreciation often results in subpar returns. Investing for dividends results in real earnings growth because, over the long term, profit growth and dividend growth should be consistent. A company that has substantial earnings that it does not pay out to shareholders should raise red flags.[5]

A better flavor of value?

Many investors think of dividend-oriented strategies as a type of value investing. We believe dividend-oriented strategies can be a better "flavor" of value because they often offer better long-term returns with significantly lower volatility than more broad-based value strategies. As **Exhibit 4** (next page) shows, dividend-paying and dividend-growing stocks have outperformed the overall market and non-dividend payers over the last 40 years, while also exhibiting less historical volatility. As previously discussed, the fact that companies which can support recurring dividend payouts are often inherently healthier companies is likely a driver of this strong long-term performance. In addition, the income stream buffers the effect of market downturns, contributing to the lower observed volatility.

Dividends as a test of management

To understand why dividend-paying stocks perform well over the long run, investors have to look beyond the capital markets to the way companies run their businesses.

1 Daniel Peris, *The Strategic Dividend Investor* (McGraw-Hill Companies, 2011), p. 15-16.

2 Robert Shiller database, Yale University, http://www.econ.yale.edu/~shiller/data.htm. Cowles Commission data from 1871 to 1926; S&P 500 precursor data (sometimes referred to as the Ibbotson data series) from 1926 to 1957; S&P 500 Index data from 1957.

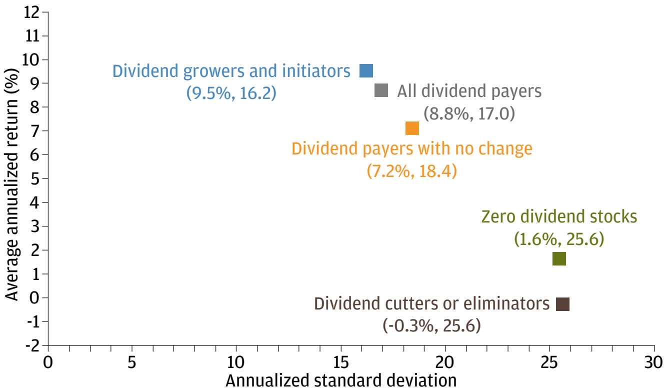
3 Peris, *The Strategic Dividend Investor*, p. 33-35.

4 Ibid.

5 Peris, *The Strategic Dividend Investor*, p. 53-54.

The dividend effect: Dividend-paying and dividend-growing stocks offer strong returns with low volatility.

EXHIBIT 4: S&P 500 INDEX: RISK VS. RETURN BASED ON DIVIDEND POLICY (MONTHLY DATA, JANUARY 31, 1972-DECEMBER 31, 2012)



Source: Ned Davis Research, Inc.; data as of December 31, 2012.

A commitment to a dividend can indicate a strong business and a management priority on returning cash to shareholders.

As a company grows its business and profits, it can increase its distributions to shareholders. While many people might believe that greater reinvestments would lead to greater growth, studies have shown that companies that choose to distribute a reasonable portion of their profits to company shareholders, rather than funnel those profits into other projects, generally do not suffer lower total returns because of those payments.[6]

Having a dividend-payout policy makes managers much less likely to put money into unnecessary projects and keeps them focused on managing costs closely. Companies that are already paying dividends have a strong incentive to go on paying them. Should they stop, cut or suspend their dividends—or divert those dividend payments into, say, a more aggressive acquisition strategy—investors will tend to punish the companies' share prices.

We believe that dividends and dividend growth are the manifestation of the growth and distribution of company profits. Dividend stocks often outperform alternative stock strategies in the long run because they are strongly aligned with the underlying purpose of many public equity investments: The distribution of excess profits to shareholders.

[6] Robert D. Arnott and Clifford S. Asness, "Surprise! Higher Dividends = Higher Earnings Growth," *Financial Analysts Journal*, January/February 2003, pp. 70-87.

Not all dividend-paying stocks are created equal

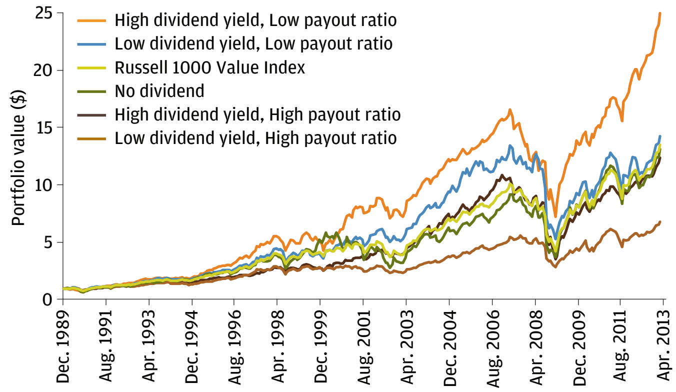
While dividends matter, so does quality. We suggest focusing on companies that not only have attractive dividend yields, but also have sufficient additional cash to maintain and grow their businesses as evidenced by modest payout ratios. Modest payout ratios generally mean that these well-managed companies can reward investors with a dividend today while leaving capital available to grow shareholder value and enhance the dividend for tomorrow.

Analysis over a 20-plus-year period reinforces this approach. In **Exhibit 5**, firms in the Russell 1000 Value Index were divided into groups based on their yields and payout ratios, with the dividend-payout ratio calculated as the ratio of the trailing 12-month dividend over trailing 12-month earnings (before extraordinary items). The best performance over time (using monthly rebalancing) came via equities with both above-average dividends and below-average payout ratios.

The implication of the analysis is clear: Yield alone does not indicate a stock's true value. A high dividend yield can mean many things—some positive, some negative. High absolute yields, for example, may be a sign that the company's share

Prudence pays: Stocks with attractive dividend yields and modest payout ratios enjoyed the highest long-term returns.

EXHIBIT 5: PORTFOLIO VALUE STARTING WITH $1 USING DIFFERENT YIELD/PAYOUT STRATEGIES



Source: J.P. Morgan Asset Management Quantitative Equity Research.
The lines illustrate the portfolio value in dollars through time starting from $1 on January 1, 1990; data as of March 31, 2013. The different portfolios will grow at a compounded rate based on total returns (price appreciation and dividend payment). The benchmark is the equal weighted Russell 1000 Value Index. The dividend yield is the current stated yield projected out 12 months. The Russell 1000 Value constituents were divided into three groups based on whether the stocks' indicated yields were in the highest, middle or lowest third of the universe; the stocks within these groups were further split into three groups based on their historical dividend payout ratios. The lines represent the cumulative returns of these groups. Only the high and low combinations between yield and dividend payout ratios are shown in the chart.

price is sinking and that the company may be in trouble. If the high yield is out of line with its sector, that may be a sign of an impending dividend cut. Investors need to carefully evaluate a company's fundamentals. In some cases, stocks with moderate yields may perform better over time.

We see considerable opportunities among the types of companies we invest in with durable franchises, strong balance sheets, healthy cash flows and disciplined management teams for whom dividend growth is a high capital allocation priority. Such companies should emerge even stronger in an improving economy and be positioned to provide enhanced shareholder value and persistent income streams over time.

Why the dividend trade still has legs

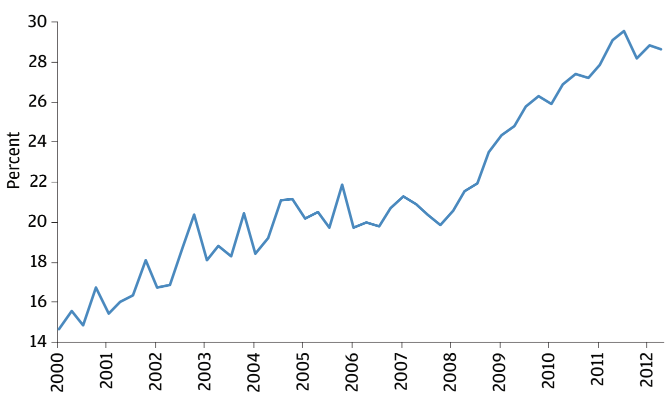
Amid economic uncertainty, high-dividend strategies have become popular with equity investors. As a result, valuations within some high-yield sectors have become expensive relative to their historic averages. But there are some fundamental reasons why the dividend trade still has legs:

- Dividend payout ratios are near historic lows. As **Exhibit 6** illustrates, cash levels on corporate balance sheets remain high, which suggest that companies still have room to increase dividends.

- While companies will use some of their cash for stock buyback programs and acquisitions, demand for income and yield will make dividends a priority for many corporations.

Deploying corporate cash.

EXHIBIT 6: CORPORATE CASH AS A % OF CURRENT ASSETS; S&P 500 COMPANIES—CASH AND CASH EQUIVALENTS, QUARTERLY



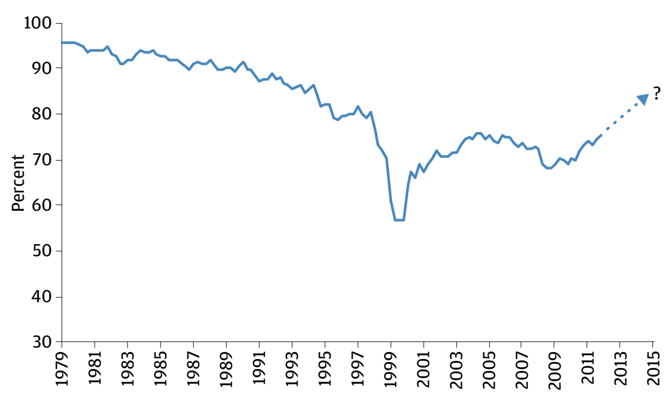
Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management; data as of December 31, 2012.

Dividend initiations across the broader market reached an 18-year high in 2012,[7] while 333 companies in the S&P 500 increased their dividends in 2012, up from 320 companies that did so in 2011. The number of special dividends—which are payments that companies make to shareholders that occur outside the normal payout cycle—issued last year also jumped sharply as corporations rushed to take advantage of lower tax rates prior to the "fiscal cliff." While we generally like companies that view special dividends as a good potential use of excess cash, we do not view special dividends as a viable investment strategy, in part because returns from special dividends fade over time. Rather, we believe companies with long, uninterrupted records of increasing profits and consistent dividend payments are better long-term investments.

- Over the next few years, we expect companies to continue to initiate and increase their dividends. As shown in **Exhibit 7**, the percentage of large companies paying dividends, currently 76%, has been increasing and is projected to reach 90% within three years. But the jump in companies paying dividends is more than just a recent trend. Rather, as the chart illustrates, we believe companies are returning to their long-term dividend-payout levels. The dramatic drop in the number of dividend-paying companies, which occurred in the late 1990s, coincided with the dot-com boom and investors' focus on capital appreciation.

Return to the long-term "normal"?

EXHIBIT 7: % OF LARGE U.S. COMPANIES THAT PAY A REGULAR DIVIDEND



Note: 500 largest U.S. companies.

Source: Wolfe Trahan Accounting & Tax Policy Research; company filings; Bloomberg; Standard & Poor's; FactSet; data and estimates as of September 28, 2012.

[7] According to analysis by Wolfe Trahan Accounting & Tax Policy Research.

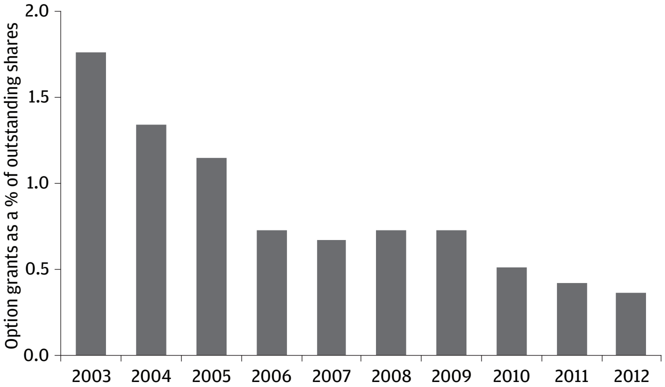
- Dividend yields look attractive in what is likely to remain a low-for-long yield environment. While investors have flocked to the relatively high yields of about 4% to 5% offered by utility stocks, REITs and master limited partnerships (MLPs)—causing valuations in these sectors to often be stretched—there are good values in other sectors. For example, some stocks in the technology and consumer discretionary sectors—not having been the "go-to" sectors for yield—still offer reasonable valuations, along with attractive yields and capital appreciation potential.

- Dividends enjoy a sizeable tax advantage over interest income at the federal level, with a tax rate of 20% versus up to 39.6%. Importantly, these tax rates have now been made permanent as a result of the tax deal signed at the start of the year. The latest tax deal represents, in our view, a nearly best-case scenario for dividend-paying stocks, since it preserves the tax-rate advantage of dividends over interest income as well as parity between the dividend and the capital gains tax rates. The fact that we have parity between dividends and capital gains means that companies won't be incented to make poor capital allocation decisions for tax reasons.

- The use of stock options in executive compensation packages is down. As a result, management teams have less incentive to return to a 1990s mentality focused predominantly on capital gains (**Exhibit 8**).

Decline in employee stock option grants: More incentive for dividend initiations and increases.

EXHIBIT 8: AVERAGE OPTION GRANTS AS A % OF OUTSTANDING SHARES

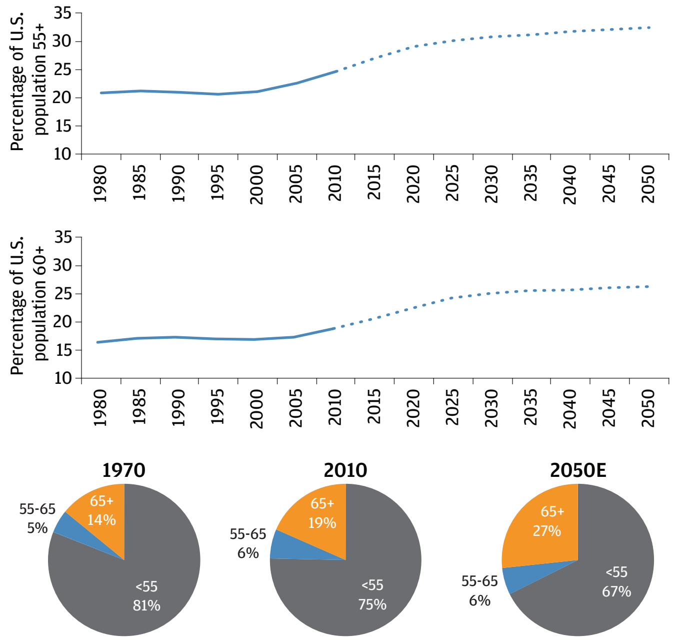


Source: Wolfe Trahan Accounting & Tax Policy Research; company filings; Bloomberg; Standard & Poor's; FactSet; data as of December 2012. Note: S&P 1,500 companies.

- Demographics also support the notion that dividend-oriented investing is a more secular trend. An increasing number of retirees means more of an investor emphasis on dividend-paying stocks, especially for younger retirees in their 60s and early 70s who may live for many more years and, as a result, need both income and capital appreciation potential in their portfolios (**Exhibit 9**).

Aging U.S. population spurs demand for yield.

EXHIBIT 9: PERCENTAGE OF U.S. POPULATION OVER 55+ AND 60+*



Source: Wolfe Trahan Accounting & Tax Policy Research; United Nations: World Population Prospects, April 2011; reflects data available as of February 2013. *Population percentages after 2010 are estimated.

Summary

Dividend investing may have once been seen as a slow-growth, sleepy strategy that typically gains popularity during market sell-offs. But such conventional thinking understates the long-term case for dividend investing.

As we have seen, dividends dominate the components of total return over the long term, while dividend-paying stocks have historically outperformed non-dividend-paying stocks. Part of the reason stems from the fact that companies with dividend policies in place tend to be better stewards of capital. At the same time, not all dividend-paying stocks are the same. Companies that are paying the highest yields may not offer the best value over the long run. Considering dividend yields together with other investment metrics, such as dividend-payout ratios, can offer a better indication of total return potential.

Against that backdrop, three converging factors—an aging population, burgeoning corporate cash coffers and a historically low-interest-rate environment—are setting the stage for continued demand for dividend strategies. When one considers that dividend-paying stocks typically exhibit less volatility than non-dividend-paying stocks, we believe equity income strategies can be an attractive approach to investing in the large-cap value space over the long run.

270 Park Avenue, New York, NY 10017