

# Uncommon Investment Sense

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KEELEY ASSET MANAGEMENT CORP.

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*“Experience would confirm the established verdict of the stock market that a dollar of earnings is worth more to the stockholder if paid him (her) in dividends than when carried in surplus.”*

*...most investors pay scant attention to whether or not a company pays dividends - among smaller capitalization (cap) stocks.*

GRAHAM AND DODD, SECURITY ANALYSIS (1934 EDITION)

It is said that “a bird in the hand is worth two in the bush”. This old proverb links back to the 13th century and is understood by most people. However, it seems the point is lost on many investors. Corporate dividends are the proverbial “bird” in the investor’s hand, yet not all investors require or even search out dividend paying companies. This becomes even more confusing in light of the empirical data that has shown compounded dividends accounting for over 50 percent of the total returns provided by stocks since 1926. And, while past performance is not necessarily indicative of future results, there is ample reason to believe the dividend story won’t be “flying away” anytime soon.

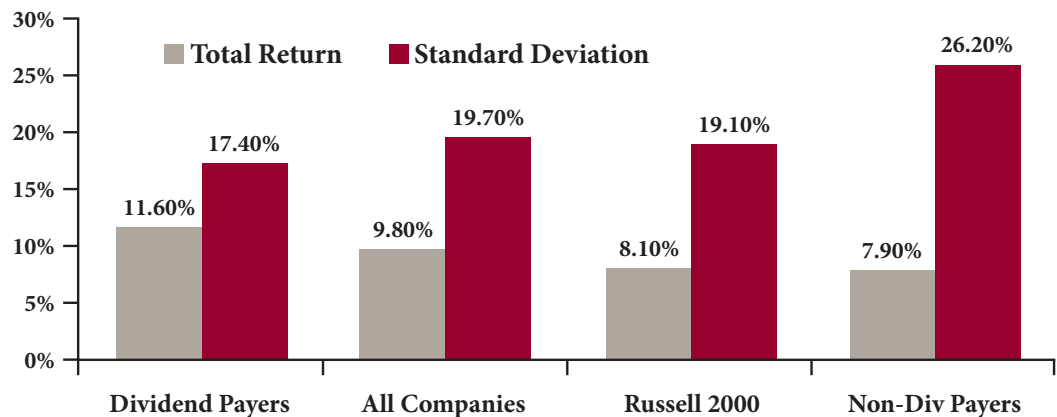
Let’s begin with understanding the empirical data. While an 85-year run is impressive, the period was far from homogenous. There were both secular as well as cyclical bull and bear markets. In fact, the aforementioned roughly 50 percent contribution has ranged from just over 25 percent to over 75 percent and arguably higher (the zero return decades) in the decades since the 20’s<sup>i</sup>. The record shows dividend payers lagged during the bull markets and outperformed during the bear markets. This demonstrates the unmistakable value of losing less during the bear markets because a loss comes with a secondary cost, the time it takes to get back to even. Since time is the enabler of compound returns, less time results in less compounded growth. Consequently, avoidance of losses in the short run can be very accretive in the long run since “... the long run is nothing more than a sequence of short runs<sup>ii</sup>”

Past performance does not guarantee future results. Securities offered through Keeley Investment Corp., an affiliate of KAMCO. Smaller and medium-sized company stocks are more volatile and less liquid than larger more established company securities. The risks associated with dividend investing strategies include a company not paying a dividend or the dividend being less than anticipated.

Where the empirical data becomes oddly interesting is in a segment of the stock market where most investors pay scant attention to whether or not a company pays dividends - among smaller capitalization (cap) stocks. An illustration of scant is the availability of so few smaller cap dividend mutual funds. We define smaller cap as those companies with market capitalizations ranging from U.S. \$200 million to \$3.5 billion.

## The Downside Is The Upside

Looking at the period since 1995, 44 percent of smaller cap companies, on average, have paid dividends. The results from smaller cap dividend-payers are impressive. The following charts illustrate the advantages of smaller cap dividend paying stocks versus other smaller caps from 1996 through June 2011.



Russell 2000 and Standard Deviation, definitions at end of paper.  
Source of data: FactSet

*When a business generates cash flow that exceeds its reinvestment requirements to sustain the business, management has opportunity to allocate that capital in ways to benefit shareholders.*

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The higher returns were attributable to the better downside results during market declines, and the lower volatility hints at that very advantage. In a study going back to 1970, on large cap stocks, the dividend payers were shown to outperform the non-dividend payers by 1 to 2 percent more per month in declining markets as compared to advancing markets. And, the results were shown to be economically and statistically significant and robust to many risk adjustments and across industries.<sup>iii</sup> The downside has been the upside, indeed.

### The Smaller Cap Capital Allocation Story

To best understand the dividend story and its durability, it makes sense to understand from where dividends come. When a business generates cash flow that exceeds its reinvestment requirements to sustain the business, management has opportunity to allocate that capital in ways to benefit shareholders. As an alternative to paying dividends, management can acquire companies to complement or diversify its existing business; it can repurchase its own shares; or it can pay down debt or accumulate cash. While the possibilities may seem straightforward, they are both complex and important to long-term shareholder returns. To that point, any analysis of a company should include an understanding of the current management's past and present capital allocation decisions.

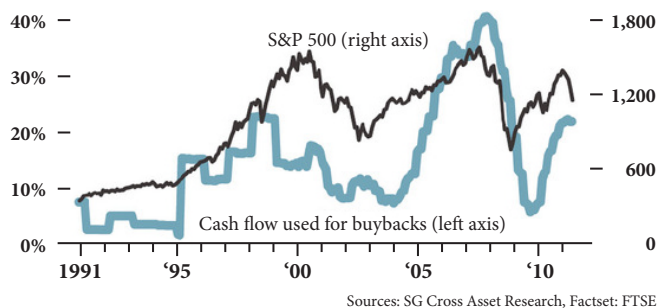
An interesting aspect of many smaller companies is that their requirements to maintain their existing business may be rather modest. Many successful small-cap companies target service and/or product niches. In these cases, there may be natural bounds to growth and accordingly capacity expansion may not make sense. In such instances, there's a unique, durable, proposition for paying dividends. In other instances, management could decide to "acquire, re-purchase or pay-off" in lieu of paying dividends:

- If acquiring a business makes fiscal and strategic sense, then it could be a sound capital allocation decision. However, decades of evidence suggests that most acquisitions don't create value for the acquiring company. While it is not difficult to imagine failure resulting from challenges endemic to successfully integrating a new business, time after time intrinsic value was lost as a result from paying too much<sup>iv</sup>.
- The key question with stock buyback decisions should be whether the stock is undervalued. Interestingly, "during the 20th century, new share issuance in many nations almost always exceeded stock buybacks by an average of over two percent or more a year."<sup>v</sup> Buying back stock to offset dilution resulting from employee stock option grants may not be a particularly good use of corporate resources and is often insensitive to the price of the stock. Just as managers should care about the price

they are paying for raw materials and equipment, they should care about the price they are paying for their stock. Moreover, even when stock buybacks could make sense, they often don't occur. Consider that repurchases would be most accretive when the stock is undervalued. However, undervaluation often coincides with times when there's either too little financial ability or too little confidence in the outlook to initiate or sustain a repurchase program.

### The Buyback Paradox

Companies buy their own stock in good times, and thus pay top dollar for the shares. Common-sense investing says that they should be buying on the dips, but that's just when there maybe shortage of cash, or nerve.



*While paying dividends can most often be a justifiable use of a smaller cap company's free cash flow, the same cannot be written about the other potential uses.*

- Decreasing a debt burden through the retirement of outstanding debt can seemingly be a sound capital allocation decision. However, a company's capital structure may include an optimal amount<sup>vi</sup> of debt as part of overall enterprise value, and this needs to be taken into consideration before assuming this can be a sound decision. Furthermore, the level of interest rates needs to be taken into consideration. Repaying debt at low interest rates is not likely to create much value for most companies.

### *But Then Again, Management Can Always Pay A Dividend...*

Dividends can serve multiple purposes for shareholders beyond being simply a source of income. They are the most transparent exclamation regarding a company's quality as well as a governor on sub-optimal management decisions. Counterintuitive as it may seem "the historical evidence strongly suggests that expected future earnings growth is fastest when current payout ratios are high and slowest when payout ratios are low."<sup>viii</sup>

The payment of dividends disallows other corporate uses of that cash, and as a result there is no clearer signal to shareholders about the company's fiscal health. It also signals the company's expected health into the future since dividend cuts and eliminations are most always very destructive to a company's stock price<sup>ix</sup>.

Dividends also have a unique status as it relates to management governance. For example, as a "call" on company cash flow, management must be more disciplined in allocating cash flow to acquisitions and stock buybacks. The discipline could even be thought to be automatic or free in those instances when cash flows available after dividend payments are too little to do too much. Keep in mind, business history has witnessed many CEO's destroying shareholder value through their poor capital allocation decisions.

While paying dividends can most often be a justifiable use of a smaller cap company's free cash flow, the same cannot be written about the other potential uses. And, among smaller cap managements, discipline around the capital allocation decision may even be a bit "easier" if only due to their more focused businesses.

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## It's All In The Execution

While the strong smaller cap relative history may seem to imply that one could simply filter the investment universe for smaller caps and then further refine that list for dividend payers to obtain an outperforming portfolio, it is not that simple. Smaller cap companies are just like large cap companies: those who either eliminated or cut their dividend have performed much worse than even the non-dividend payers, and those who grew their dividend performed much better than even the stable dividend payers<sup>x</sup>. Fundamental analysis - done right - can make a significant difference in offering the empirical benefits while helping control for risk. The key is to understand factors which affect a company's dividend sustainability:

*...those who grew their dividend performed much better than even the stable dividend payers.*

- The company's cash flow is the most important element as it is the ongoing cash flow that supports the payment of dividends. What is the nature of their business including its cyclical and volatility? How efficient is the company at turning sales into earnings and earnings into cash flow? Are there opportunities for growth and how does growth impact cash flows?
- Due to the potential vagaries of cash flows, the company's balance sheet is also important. In fact, the balance sheet may need to support the dividend payment at times. How indebted is the company? Who has claims on the company's assets and cash flows that are senior to the common shareholder? How liquid are the company's assets?
- The company's dividend history is important. Management's past decisions and current thinking regarding its payout ratio are important. How long has the company been paying dividends? How has the level of the dividend and its relationship with earnings changed over time? What is the likelihood that the payout ratio might change or even need to change keeping in mind that the payout ratio itself is a signal<sup>xi</sup> to investors? Do dividends seem to be a point of pride?

Controlling for risk goes beyond just the fundamental analysis and individual security selection; it also needs to include thoughtful portfolio construction. Since dividend paying companies are not classically and equally represented across all the economic sectors, a policy to maintain a minimum threshold of diversity is important to avoid being too overweight the wrong sector at the wrong time. The number and relative size of individual positions is also very important.

## In Closing

Yes, there are smaller cap companies that pay dividends. Oddly enough, they just may be the best of all dividend paying companies to consider for investment based on their growth prospects and unique payment durability potential. Research in the mid cap dividend universe of companies also suggests that this benefit exists although to a lesser extent.

While the capital allocation decision is both complicated and critical to the future of any corporation (easier for smaller caps?), the dividend option always exists for healthy companies. More return and less risk has been available with dividend paying smaller cap companies. With the historical aspects of both more return and less risk being further enhanced by those companies who have grown their dividends, it will be interesting to see how investors - retirees - in search of income might even begin to incorporate smaller cap dividend payers in their portfolios. The smaller cap dividend story simply seems to make uncommonly good investment sense.

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The Russell 2000 Index is an unmanaged index that measures the performance of the bottom 2,000 companies (based on market capitalization) in the Russell 3000 Index, an index representing approximately 98% of the U.S. equity market. Since inception benchmark returns are from 10/1/93.

Standard deviation is a statistical measurement of historical volatility and can be used to gauge the amount of expected volatility. A large dispersion indicates how much a fund is deviating from the expected normal returns. Number shown reflects the trailing one year standard deviation.

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