Q. How important are dividends to the return of stocks these days?

Hersh Cohen: Let me answer that with a story. Some years ago, I met a young fellow who hadn’t ever listened to Johnny Cash, the late country star. Being a fan, I couldn’t let that pass, and I gave him a CD with a note that said “Johnny Cash was a great singer 50 years ago, he’s a great singer today and he’ll be a great singer 50 years from now.”

I feel the same way about dividends. Like Johnny Cash, they may go in and out of style, but the income they provide is always valuable. I can’t imagine a reason to not hold dividend stocks in a long-term portfolio.

Harry “Hersh” Cohen
Chief Investment Officer,
Senior Portfolio Manager
ClearBridge Advisors

Today, dividends are clearly regaining their prominence in stock investing. Remember that before the 1990s, dividends were a critically important component of total return for investors and contributed on the order of 45 percent of the overall return of the stock market.

But in the 1990s, dividends fell out of favor, dropping from an after-tax payout ratio of 50 percent down to 25 percent in 2002, for a variety of reasons. Many corporate executives opted to take generous stock options and use their companies’ free cash flow to support the stock price. Then, when there was a change in the tax treatment of dividends with the tax cuts of 2003, companies began to raise dividends again. Of course, many companies have been raising them all along. Now others are joining their ranks, and the movement has gathered steam.

So dividends have become important again – first, because many companies are increasing them. And second, because investors are being forced to find different ways to find income than they used to do.

Q. Investors are increasingly turning to dividend-paying equities to add income to their
portfolios. Does that mean stocks are the new bonds?

Mike Clarfeld, CFA
Portfolio Manager
ClearBridge Advisors

Mike Clarfeld: From an income perspective, the answer is yes. In recent history, people haven’t looked to stocks for income. But going forward, they’re going to have to. In this low-rate environment, where bonds aren’t generating the kind of income they used to, we think stocks have to be part of the equation for income.

But from a volatility perspective, the answer is no. In the short term at least, stocks can be more volatile than bonds, and investors need to be aware of that while considering their asset allocation decisions. Of course, stocks have attractive qualities that historically have made holding stocks a great idea in the longer term. And at this point, people need to increase their exposures to equities broadly speaking, because of their attractive characteristics overall as investments. And one of those is clearly income. But you need to be aware that stocks do have higher volatility.

Q. Where are the best opportunities for investors looking for income?

Mike Clarfeld: Large cap high-quality dividend payers look very attractive. Certainly the current yield compares very favorably to what one can get elsewhere in the current environment.

We also believe long-term growth is a key factor. As we look out several years, we expect the kinds of stocks we like to grow their dividends at mid-to-high-single digit rates, which we consider to be pretty attractive in today’s world. And we expect that not only will this drive income in terms of higher dividends, but it should ultimately drive higher stock prices as well, giving investors the dual benefits of attractive current yield and stock appreciation.

Of course, in the short term, these are still stocks, and stocks can be volatile. But in the long term, we think that these high-quality stocks, at attractive valuations and with compelling dividends, are at relatively little risk of being impaired over a longer period of time.

Q. What are the characteristics that you look for in dividend-paying companies?

Hersh Cohen: First, a business model that is superior – reflected in a high-quality balance sheet and dominance in their industry. We prefer companies that make products that people truly want or need, and which tend to be used up and replaced regularly – what used to be called the “razor blade effect”.

Second, we want companies with strong free cash flow, which is deployed to generate sustainable growth and to reward shareholders. Those rewards can come in two forms: either share buybacks to shrink the float, therefore increasing earnings per share. But our strong preference is for using free cash flow to pay a growing dividend. We make that clear to companies that visit us.

Why do we prefer dividends to buybacks? So my clients can do what they want with the money. They
can reinvest it or spend it. And having that choice is especially important now, when investors clearly could use the income, especially for retirement.

**Q. Are there companies whose dividends are attractive, but which don’t make sense as investments for you?**

**Mike Clarfeld:** There definitely are. We call that stretching for yield. You see that a lot as people try to improve on the relatively low yield of bond portfolios now. Stretching ends up taking people further and further out on the risk curve, plowing into higher yielding but higher-risk instruments.

Within our investment mandates, we try very much not to stretch for yield, for two reasons. First, higher-yielding instruments invariably have significantly higher risk, and we don't take that lightly. Second, when you buy stocks, you're not buying them just for the dividend. Growth is a key component, too. When investors overemphasize the current dividend and buy the highest yielding stocks, they're ignoring the fact that the real power of dividends over time is their ability to grow as a result of a company's long-term growth.

There are sectors we think should be viewed with skepticism as a result of yield. Frequently, the higher yielding areas are also lower growth. Utilities and telecoms are two examples. There’s nothing wrong with either of these sectors overall. They're very stable, broadly speaking, but they're not great growers.

What we're really looking for are companies that optimize that combination of current income and growth. Whether in consumer staples, high-quality diversified industrial sectors or in technology, we're likely to find very attractive investments that are not overvalued.

**Q. What happens if the tax rate on dividends goes up?**

**Hersh Cohen:** It would certainly be a negative if it happens. But let's put some historical perspective on this. Marginal tax rates have varied widely over the years – ranging from 90 to 28 percent. But many companies have continued to increase their dividends throughout those periods. Some, like Proctor and Gamble, have been raising their dividend for decades.

The point is companies pay dividends for reasons that go beyond current tax policies. It’s quite conceivable that certain firms might adjust dividend payouts higher even if the tax laws change, because their shareholders have come to rely on it.

**Q. How much more volatile do you think the markets are going to be over the next three to five years? Is volatility here to stay?**

**Mike Clarfeld:** Yes, unfortunately, for the intermediate term. Until some key political issues in the US and elsewhere are resolved, especially in Europe, markets will remain unsettled.

As fundamental, bottom-up stock investors, we tend to focus mostly on what's going on at the company level. So, if we're looking at Coca-Cola, for example, we're really going to focus on their
business model. How are they doing competitively against Pepsi? Are people drinking soda, or are they not? What is pricing like? But what we're finding today in the market is that for most companies, as well as stocks, that's almost of secondary importance. The much bigger drivers of returns, both for the market overall and for individual companies, are these bigger macro factors. This is the infamous “risk on, risk off” phenomenon, where a shred of good news out of Europe causes investors to buy stocks broadly, overwhelming what may be happening at the individual company level.

We hope to get back to a time when we can focus on the fundamentals, when these political issues are behind us, and there's a more stable, underlying footing for the world’s economy. Until we get there, the markets will be characterized by a lot of volatility.

Q. How does the dividend strategy at ClearBridge help with market volatility in your portfolios?

Mike Clarfeld: There are two factors. First, in times of higher market volatility, investors tend to gravitate toward stocks with healthy dividends because that dividend acts as a guidepost, signaling the health of the company. Even if we're a little worried about the broader world, we'll feel a little less afraid if a stock that has a 4% yield, for instance.

The second factor has more to do with our investing approach. We're focused on high-quality large-cap companies with strong, well-capitalized balanced sheets and recurring revenues. These companies tend to be less cyclical than others. That combination of higher dividend yield, which investors flock to, coupled with the focus on companies that are more stable and more predictable than average could provide increased stability in a more volatile world.

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