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Sharp Investing

Dividends are In!

By Daniel R. Sharp, Ph.D

Stocks, bonds, real estate. While there are other places to invest your money, these three asset classes are by far the most popular. While all three assets have been used to produce both capital gains and income, only real estate income held any tax advantage. Now with the May 2003 changes in tax law, stock income (dividends) is on equal footing with real estate income in terms of the tax breaks.

Over the last eighty or ninety years dividends have accounted for over 40% of all investment returns from stocks, a fact completely ignored during the speculative boom of the late 90's. In fact, stocks that paid dividends also had *higher* capital gains than those that did not give a dividend payout during this time. At the low point in 2000 the S&P 500 dividend rate was 1.2% compared to a 4% historical rate (we are now back up to 1.7% and rising). With the new tax law, dividends are in again and many companies that historically have never paid out a dividend, such as Microsoft, are now seriously considering adding a dividend.

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Why all the fuss about dividends? Prior to the new law this year dividends were taxed at ordinary income rates, whether 15%, 28% or 39%. But gains on assets held for a year were only taxed at 20% or lower, depending on your tax bracket.

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Market Update September 2003

This quarter saw a strong market rebound based on low interest rates, geopolitical stability, and hopes for a strengthening economy. The stock market moved up virtually non-stop from early March to late June, but has been treading water over the two months. Once again, the six months following a war have proven to be very strong for stocks, as it has in virtually every case over the past 100 years.

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Not only did the new tax law reduce the ordinary income tax rates, and the capital gains rates, but it also allows the dividends on assets held more than sixty days to be taxed the same as long-term capital gains rates.

Here are the details: If your ordinary income falls into the new 15% bracket or below, both your long-term capital gains and dividends are taxed at only 5% from May 5, 2003 to December 31st, 2007. In 2008 only there is *zero* tax on gains and dividends for the 15% bracket and below.

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If you are above the 15% ordinary income bracket, both your dividends and gains are taxed at 15% through 2008, even if you are in the highest 35% ordinary income bracket. In 2009 the tax break expires, but the thinking is that it will be very difficult politically to restore the higher tax rates, and it is expected that between now and 2009 that more legislation may pass to permanently reduce these investment tax rates.

So what does this mean for me if I don't need or want income? Many investors in higher tax brackets that didn't need income actually stayed away from dividend-paying stocks to avoid paying up to a 39% tax rate, and chose companies that did not pay a dividend so that their maximum tax exposure was only 20%. Now all stocks, with or without dividends, are on an equal footing. Investors, whether investing for growth or income, will pay the same tax rates. This should result in a whole new group of investors buying dividend-paying stocks that previously ignored them. This is expected to create a long-term demand for dividend-paying stocks that should benefit owners of such stocks, whether invested for growth or income. I believe dividend-paying blue chip stocks will be the investment of choice for the next five years at least.

What if I do need income? Stocks are now a very attractive way to get income. Bonds are still taxed at ordinary income rates. Bonds are currently paying record low-income yields and are at record high prices (low return with high risk). Higher taxes, higher risk and lower return equal lower demand. For income-oriented investors, REITs (Real Estate Investment Trusts) and dividend-paying blue chip stocks offer tax advantages and much better expected capital gains than the fixed income alternatives. Stocks like General Motors, Albertson's and Bristol-Myers Squibb offer dividends rates of around five percent and should also produce significant capital gains over the next few years. Investors in lower tax brackets can take advantage of the new tax law and would only pay federal taxes of $250 on $5,000 worth of dividend income compared to taxes of $750 to an equivalent amount of bond income. Higher tax brackets garner even more dramatic savings. An investor in the 35% bracket would pay $1,500 in taxes on $10,000 in dividend income, but would pay $3,500 in taxes if the income came from bonds, a difference of $2000.

The Tax Relief Act of 2003 makes stock dividends much more attractive than bond income. This should result in higher long-term investment returns from dividend-paying

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stocks for both growth and income investors. If you are willing to put up with the short-term volatility of stocks, you can now have your cake and eat it too. One way to mitigate the higher risk and volatility of stocks is to not chase the highest dividend, but to invest in large, stable companies with growing significant dividends. Prudent investors are now doing this, which is the reason many companies are now considering adding a dividend payout. Dividends matter again, and the trend of rising dividends should continue through at least 2008.

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Market Update… cont. from page 1

strong this quarter as investors bid up prices on companies most likely to see earnings rebounds from a stronger economy. Over 70% of all companies beat earnings expectations this quarter and there is much optimism about the second half of the year. A quick resolution to the war, continued record-low interest rates, and the start of some encouraging economic trends all put investors in a buying mood.

However, recent market action combined with the historically weak late summer season point towards the market taking a breather for this next quarter. We fully expect to see some healthy consolidation in stock prices as investors wait to see if the upturn in economic data points turn into a sustainable trend. September is the weakest month of the year for stocks, October generally starts weak and ends strong. We pointed out some obvious reasons last quarter why we thought the quarter just completed would be strong, and now the reasons are just as obvious that the next three months will likely be flat with periods of buying opportunities, as there could be some minor 5-10% pullbacks in averages between now and the end of October. This is a necessary pause for a healthy market and will allow strong returns likely starting in the late fall.

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We can help you determine whether you should leave your 401k with your previous employer, roll the 401k to your new employer, or roll your 401k to a self-directed IRA, and most importantly, when to make these moves. Analysis of the companies or funds, the levels at which they were purchased, and their future prospects and reasonable expectations can all be beneficial in getting you back on a steady path to creating wealth. A complimentary investment consultation can be arranged at your convenience in person or over the phone. Fax or mail us your current account statement and our Portfolio Managers will discuss your goals & risk tolerances, and analyze your portfolio.

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Value Investing: The purchase of companies, through the stock market, for less than their economic value due to temporary unpopularity (lack of investor demand). This is the opposite of growth investing, which is buying companies at a premium in the hope that other investors continue to push their prices higher and higher regardless of what the business is actually worth.

Market Update …continued from page 3

The stage is set for further upside fireworks starting around the October timeframe when we expect corporate earnings to really start to shine. The Federal Open Market Committee reduced rates again this quarter from 6.5% in January of 2001 to a current 45-year-low 1%. The Federal Reserve remains committed to keeping interest rates low at least until a sustained economic recovery develops. The Fed's relentless effort to pump up the money supply also continues. The correlation is very high between an accommodative Federal Reserve and higher corporate earnings, and thus stock prices. The latest GNP data point showed the economy growing at an almost robust 2.6%, and this is just the start of stronger economic figures. Corporations have spent the last three years lowering their expenses, working down inventories, becoming lean and mean, and refinancing debt at lower interest rates. The last piece of the puzzle will fall into place as corporations start to finally spend money again, financing new projects and hiring labor. Right now America is filled with timid CEO's just starting to think about getting a little more aggressive – and once that is in full throttle we'll be firmly moving up the growth cycle of economic activity. Consumers and real estate held up the economy while corporate America pulled back, but soon we'll have all three legs back on the economic stool and should be rewarded with several years of 3%+ economic growth. We fully expect that this will result in valuation expansion in the market and average to above-average market returns over the next two to three years.