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Microsoft's "Starter Dividend"

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Bush's tax-cut plan hasn't even been proposed to Congress yet, but it's already starting to work.

Microsoft's announcement yesterday that it has declared what **CFO John Connors** called "a starter dividend" throws an interesting kink into what is otherwise shaping up to be a sadly familiar technology sector earnings season.

The pattern, once again, is (1) beat your sandbagged earnings numbers by a penny or two (excluding all the non-recurring stuff that recurs every quarter); (2) say that you had a slightly better than expected quarter (not because the business got that much better, but because you're really "executing"); (3) say that going forward you're "comfortable with the street's numbers," or guide just slightly lower (but say it's contingent on the economy not getting any worse); and (4) say you see no signs that the economy is getting any better (but long term, this is really a great business).

Once again, the same old tech earnings season pattern is coming as a disappointing surprise to investors. Their unrealistically rosy expectations were reflected in the fact that since late November the Information Technology Sector has been very overvalued in relation to the rest of the deeply undervalued index -- and that was the basis for a Model Position established in late November to short the NASDAQ 100 against a long position in the S&P 500 (see "Tech Out of Whack, Once Again" November 25, 2002).

But we closed that position profitably earlier this week because we think that once the usual disappointed reaction to this earnings season works itself out, there is now -- finally -- real reason to think that things could begin to turn around for the most growth-sensitive sectors of the economy (see our *Trend Macro Live!* note, January 15, 2003). For the first time since the onset of the present technology depression and bear market, two very positive macro elements have come into play at the same time: **the Fed** has overcome its deflationary bias *and* there is a serious pro-growth fiscal policy proposal on the table. If **Congress** enacts **President Bush's** proposal to end the double-taxation of corporate income (by eliminating shareholder taxes on dividends and excluding retained earnings from taxable capital gains), tech sector recovery will no longer be a matter of *if,* but *when* and *how much* (see "Born-Again Growth Advocacy" January 8, 2003).

How does Microsoft's dividend surprise play into this?

For one thing, it is acting as a lightning rod to catalyze investor disappointment in the technology sector. The fact that **Goldman Sachs' Rick Sherlund** has today removed Microsoft from its place of honor on Goldman's "recommended list" is a sign that some investors will choose to see the dividend as the company's declaration that its best growth years are behind it, and that now it has nothing better to do with its capital than mail it back to shareholders.

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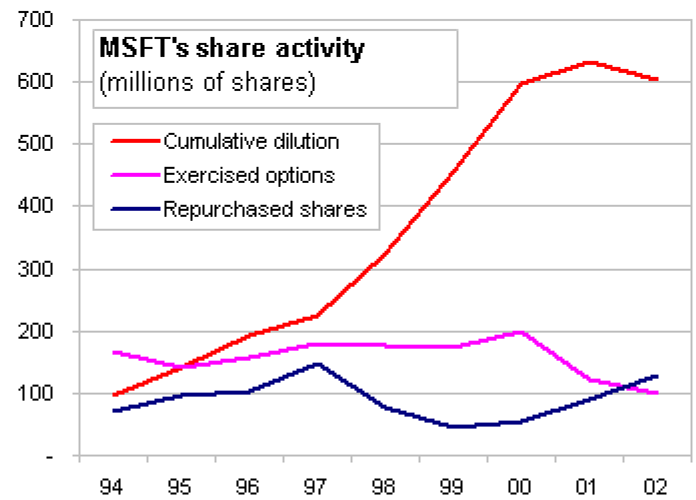
We agree that Microsoft's best growth years are behind it, but find it implausible that investors would need this new dividend to do much more than remind them of that. It has been obvious for many years -- any company that has accumulated $44 billion in cash clearly has had nothing better to do with its capital for quite a while. The reality of Microsoft's maturity is old news -- what's new news is that the public debate about dividends over the last several months, triggered by the prospect of tax reform, has nudged Microsoft into finally doing what it should have done many years ago. A new tax policy initiative designed to make markets more efficient -- a policy that hasn't even been passed into law yet -- is already beginning to work.

Microsoft's dividend really is new -- despite the fact that Microsoft has been paying what might be regarded as a pseudo-dividend all along in the form of its enormous ongoing share repurchase program. There's no doubt that it's been enormous -- the dollar value of it just this fiscal year so far is more than five times the $850 million value of the new dividend. And it's certainly true that share repurchases in general *can* be seen as just a tax-advantaged way to return profits to shareholders.



But in Microsoft's case, the share repurchase program has been all about containing the dilution damage of its vast employee stock options program, and nothing but that. Despite enormous repurchase programs over time, cumulatively share creation due to options exercise has been even greater -- last year was the first in nine in which net dilution actually ticked slightly lower. Seen in this light, the money spent on this repurchase program stands revealed not as a dividend, but as a compensation expense. As CFO Connor said in last night's conference call in response to a smart question from Goldman's Sherlund, "The announcement of the dividend hasn't really changed out view about using cash for buybacks. We will continue to be an absolute large purchaser of our stock. We have as a goal managing our share dilution, and we continue to use buybacks for that."

Microsoft's decision to pay a dividend may even go some way toward convincing **Congress** to agree to the president's proposal. The proposal's critics have argued that, if double-taxation were eliminated, greedy companies would still not raise their dividends (see, for example, *The Administration's Proposal to Cut Dividend and Capital Gains Taxes*, **The Brookings Institution**, January 13, 2003). Now, with America's number one corporate bully doing it before the proposal is even before Congress -- and with other companies young and old -- from **Yahoo!** to **IBM** -- saying that they may well initiate or increase dividends if it is passed into law, the critics may have to think again.

Will other cash-rich, mature technology companies follow suit? The answer will have a lot to do with how the market re-values Microsoft's stock price in light of this development -- Microsoft has stuck its head out of the no-dividends foxhole, and the other companies hidden there will want to see how badly it gets shot. At this exact moment it doesn't look good, with Microsoft and the rest of the tech sector trading lower following the announcement. But it's not at all clear that the dividend announcement is the reason why. It seems more likely to me that the market is reacting to Microsoft's lackluster guidance -- indeed the decline may well have been worse *without* the dividend announcement. Or perhaps the decline is a reaction to the fact that the dividend was *not bigger* -- representing a payout ratio of only 7.7% of Microsoft's mighty money fountain (compared to 28.9% of the overall S&P 500's less capacious earnings), it is indeed a "starter dividend" at best.

We think there's a decent chance that once the usual quarterly tech earnings season disappointment has worked itself out, Microsoft's dividend decision will come to be seen as a positive -- and that soon enough technology investors will finally be able to look across the valley and see something real on the other side.

We like Bush's tax-cut plan because it will, with the stroke of a pen, increase the after-tax incentive to invest and take risk -- and that will call up more investment and risk-taking, and that will lay the foundations for a return to the robust growth required for a technology sector renaissance. But the particular nature of this tax-cut will do something else, as well: it will remove important distortions and transaction costs from the economy's capital allocation process. Microsoft's dividend, arriving as it does in an intellectual climate in which the role of dividends is being actively reassessed by the market, is a signal that the distortions are already beginning to come out. TM