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Did the Tax Cuts Pay Dividends?

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All the evidence is that the tax cuts on dividends and capital gains are performing exactly as predicted.

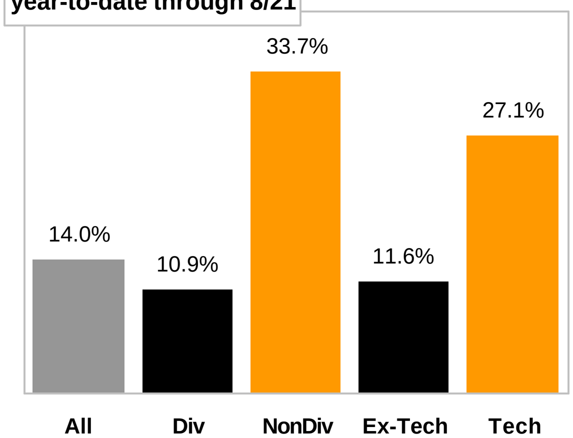
Earlier this month **Standard & Poor's** put out a press release celebrating this year's "massive increases" in dividend issuance, noting that "This reverses a 20-year decline in the number of S&P 500 issues paying a dividend." This dividend renaissance has occurred at the same time as the stock market has recovered to, or near to, its highest levels of more than a year. How could one *not* declare this year's reduction in tax rates on dividend income a success?

Yet some observers have cited statistics in S&P's press release as evidence of precisely the opposite. S&P's analyst **Howard Silverblatt** states, "historically, long-term dividend payers have performed better than non-payers. From 1980-2002 (annual portfolio), dividend issues have done 2.70% better annually (compounded) than non-payers." But a footnote to the press release points out that year-to-date through July, the dividend-paying stocks in the S&P 500 returned only 13.6%, while non-payers have returned 31.7%.

Holman Jenkins says in his ***Wall Street Journal*** column of August 13, "Were they thinking straight, even supporters of the tax cut should have anticipated lagging share-price performance for companies that immediately up their dividends." And **Daniel Gross** goes so far as to say in his ***Slate*** column of August 18 that "the Bushies have managed to turn...a perennial outperformer into a chronic underperformer." Politics aside, these remarks contain serious errors of both observation and judgment.

Let's begin by asking whether it is true that dividend-paying stocks have underperformed non-payers this year. In point of fact, S&P's simple calculation -- which simply sorts stocks into two bins, payers and non-payers, without any correction for any other characteristics such as industry group or beta -- is insufficient to answer the question. As the chart at right demonstrates, we get substantially identical results by sorting stocks into tech and ex-tech bins. S&P's Silverblatt told me that "when you plot this, you are plotting technology. It's like looking at who drives what kind of car. Rich people drive fancy cars. Does the fancy car make them rich?" So, too, with his finding that dividend-payers outperformed from 1980-2002. Silverblatt agreed that the results would be very different if the end-point had been set at 1999, nearer the techstock top than the techstock bottom.

S&P 500 cap-weighted price performance year-to-date through 8/21



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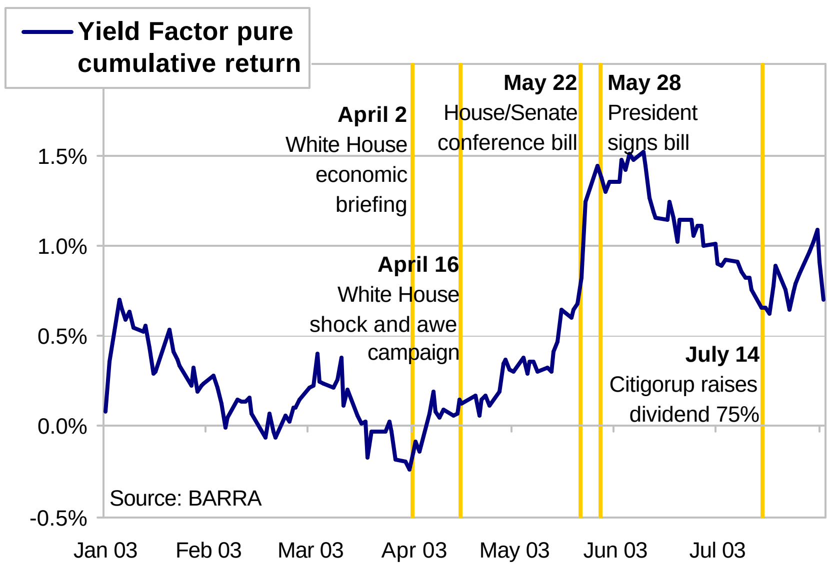
So, yes, strictly speaking it is true that dividend-payers have underperformed year-to-date. But the fact that virtually the entire performance difference between payers and non-payers can be explained by industry group -- and could probably explained by beta, too -- suggests that dividend policy is only a coincidence, not the driver of the result. In fact, a more sophisticated analytical technique proves this conclusively.

"Factor modeling" allows us to examine the effect on returns of various risk factors -- not only the dividend yield factor (whether a company pays a dividend, and if so, how much), but also industry group, beta, volatility, exposure to foreign earnings, price/book ratio, and many more. By holding all risk factors but one constant, we can measure the effect of just a single selected factor. Factor modeling reveals that -- contrary to S&P's simple two-way sorting technique -- there has in fact been an excess return year-to-date associated purely with paying a dividend *per se*.

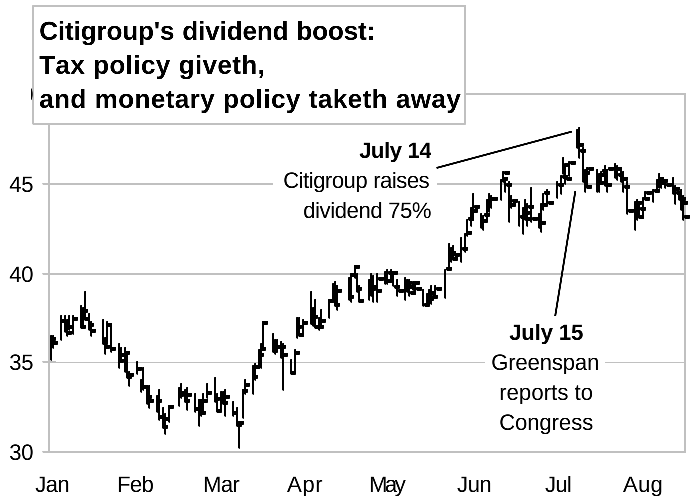


BARRA's E3 US Equity Model -- the most widely used and well-respected factor model -- shows a positive 70 basis points return to the yield risk factor year-to-date through July, when all other factors are filtered out. After a fitful first quarter, the yield factor began to climb following the April 2 **White House** briefing for economists at which **President Bush** revealed his plans for getting his dividend tax cut through **Congress** (see "Notes from the West Wing" April 3, 2003). It ran up sharply as the **House** and **Senate** reached a compromise bill, and the President signed it -- **Guy Miller** at BARRA told me that this is not the absolutely largest, but the most statistically significant, move in the history of the yield factor. Since then it has drifted back down somewhat, and now appears to have become notably more volatile immediately following **Citigroup's** celebrated announcement on July 14 that it would increase its dividend by 75%.

70 basis points year-to-date cumulative return for the yield factor may not seem like much, but BARRA's Miller notes that it runs counter to decades of steady decline. And it clearly demonstrates the falsity of the overly simplistic claim that dividend payers have underperformed this year. We hold the latter point to be the more significant, since we have argued all along that a cut in the tax rate on dividends would "affect most stocks approximately in equal proportion, regardless of their present dividend policies" (see "Assessing the Tax-Cut: The Dividend Windfall" January 22, 2003). We note that Bush administration statements always took the same view as we, although many Wall Street economists and media pundits argued that dividend payers would be disproportionate winners.

We would also point out that taxes on dividends were not the only taxes that were cut this year. Notably, the maximum tax rate on capital gains was cut, as well. So even granting a theory that a dividend tax cut should positively affect only dividend paying stocks -- a theory with which we would not agree -- any examination of relative stock returns this could not fail to acknowledge the fact that non-dividend paying stocks may have been boosted by the capital gains tax cut.

Jenkins' point that we are seeing "lagging share-price performance for companies that immediately up their dividends" is a different matter entirely, and one not even addressed by the S&P report -- nor are the performance statistics contained in the report relevant, though Jenkins nevertheless cites them as evidence. Jenkins might, instead, have cited the fact that Citigroup's stock topped out the day after June 14 when it announced its 75% dividend increase, and that the financial sector -- 76% of whose stocks have increased their dividend rate so far this year, according to S&P -- has fallen 3.8% since then (while the S&P 500 has fallen 1.1%).



Yet why would this be the result of increased dividend payments? Jenkins, though he speaks of "lagging share-price performance," never offers any explanation for why increases in dividend payments would be anything worse than irrelevant. In our view it's far more likely that Citigroup's and the financial sector's performance problems stem from something else entirely. The very day after Citigroup announced its dividend increase, **Alan Greenspan's** semiannual report to Congress signaled the unsustainability of low interest rates in the face of accelerating economic growth. This gave rise to all manner of risk concerns connected with a sudden interest rate regime change, and no doubt triggered significant trading losses for the money-center banks who had piled into the "carry trade" in the previous month, in credulous reliance on Greenspan's previous assurances, borrowing in the overnight market to finance long-term Treasury positions (see "Fed Cred" August 13, 2003).

Under certain states of nature, Jenkins is right that dividends are irrelevant. That would be the case when the shareholder's reinvestment opportunities for the money, outside the company, are no better or worse than that of company management's opportunities for it, inside the company. In the real world, it's situation-specific. But in general we would argue that, at least for mature companies, the money is better situated outside. Some have argued that dividend payouts should be high even for companies with good uses for the money -- if management really has something good to do with it, the argument goes, let them go to the capital markets and make their case.

Cause-and-effect relationships are nearly impossible to conclusively prove when stock prices are involved. But considering that stock prices *overall* are so much higher since the tax cuts *overall* became a reality, we would say at the very least that the burden of proof is on anyone who wants to argue that the tax cuts have *not* had a positive effect along the lines that we predicted. This is the first order "windfall" effect we have been talking about all year. We are satisfied that we were right -- it happened.

And whether or not increasing dividends ought to boost a given stock's price in the short-term, we would say the burden of proof is on anyone who says that equity values have *not* been improved *overall* by lowering a tax barrier that gets in the way of each company's realizing its own optimal payout rate. This gets to the second-order longer-term effects of the tax cuts. As companies become free to pay out money that had previously been held captive behind a tax barrier, economy-wide resource allocation is improved for the long term.

By both making resource allocation more efficient, and by raising the after-tax expected returns to risky investing, the economy's capital stock will begin to increase and improve. And therein lies the most powerful and longest lasting benefits of the tax cuts. Increase and improvement in the capital stock is, in the last analysis, the one and only path to sustainable economic growth. And it's the path we're on. TM