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BASIC MATH THE RETURN OF DIVIDENDS IN STOCK MARKET INVESTING

Earlier this year, I wrote a newsletter about gold stocks. I expressed an opinion that they were overvalued, even though they were up 72% for the year. Now they are up 25%. Since I wrote that newsletter, they have declined 47%. Yet another investment bubble seems to be biting the dust. I'm the Jessica Fletcher of irrational exuberance. When I show up, the party's over.

Meanwhile, we continue to receive frequent calls from investors seeking an exit at any price. *The past few months in the mainstream stock market have been defined by hysteria.* The reality of earnings and the tortoise-speak of government have done nothing to calm things down. Once again I am reminded why the Greatest Generation loves the one-story office building. Most investors are assuming that things will stay the way they are now, forever.

Yet, when we look back across the broad sunlit uplands of history, we find that change is always with us. Sometimes things change so slowly that we do not notice. At other times, change is a raging wildfire, destroying the old system and laying the ground bare for new ideas. That's what is happening now and it is normal. This current conflagration has merely burned away the new-economy paradigm and confirmed classic ways of investing. But in other important ways, this is a new experience. One of the more important insights is the way we look at investing for income.

For those of you who have grown up in the go-go days of the stock market, investing in stocks for income is a bit like trying to drive a Porsche 25 miles an hour. Yet, historically, stock investing has been motivated not by the glorious expectation of unending capital gains, but instead by the prospect of steadily rising, consistent dividends.

The stocks which produce these dividends, "widow and orphan" stocks, otherwise known as "blue chip" stocks, are traditionally the highest quality, safest stocks in the entire stock market. These stocks were once purchased with the philosophy of buying and holding. The goal was to buy them and then forever after enjoy a rich harvest of ever increasing cash dividend payouts.

However, the average dividend yield, expressed as a percent of price, has gone down over the past decade, while the stock market has mostly gone up. In fact, we've all been taught in Finance 101 that the cash dividend payout of the stock market, represented by the Standard and Poor's 500, is a clear indicator of the valuation of the stock market.

Dividends, of course, are a periodic payment of cash to shareholders. History tells us repeatedly that low dividend payouts indicate overvalued markets and high dividend payouts indicate bargains. A low dividend payout was central to my own identification, in 2000, of the impending tech stock crash.

But this highly valuable statistical indicator is based on a concept of dividends as a relatively fixed or slightly rising payout. Dividend percentage yields are regarded as a passive indicator, rather than an intrinsic component of stock market enthusiasm. The consensus is that high-growth stocks, which pay lower dividends, are capable of better longer-term returns, while high-dividend stocks are old-economy, basic industry investments that behave more like bonds.

Yet, what happens if dividends are an intentional, consensus-created catalyst rather than the blind and dumb indicator of present value? This is radical thinking. ***I believe that the payout of dividends in the stock market CHANGES in response to market moods.***

After raising such a daring hypothesis, I ventured out for further examination, and guess what? It seems to be true. Dividend payouts seem to be as much a maker of stock market enthusiasm as they are indicators. And what they indicate most of all is the mood of corporate management.

Dividends seem to increase in response to market uncertainty and decrease during periods of confidence. These changes in dividend payout are a direct choice of management and are a reflection of their need to make the stock more attractive to investors.

When times are hard, a dividend, especially a dividend paid consistently for years, is a visceral confirmation of the underlying solidity of the corporation. For example, in the 1930's just after the Great Crash of 1929, the dividend yield of the Dow Jones Industrial Average stock index exceeded the yield on US Treasury bonds. Students of this event have always thought that this was simply a reflection of how badly stocks were damaged. In other words, a fixed dollar payout became a higher percentage of the index as its value went down.

This is what we've been taught. Except that it seems to be wrong. Browsing the Internet and studying histories such as "The Great Crash 1929" by famous economist John Kenneth Galbraith, appear to indicate that financially solvent corporations RAISED their dividends to retain stock value.

Likewise, during the booming '80's, the richest man alive Bill Gates and his acolyte Warren Buffet publicly and loudly condemned dividends as inefficient. Since, at the time, the whole world recognized such CEO's as Live Geniuses Walking, it was assumed that they, not us, could best decide what to do with that dividend money. So it became corporate-hip to decrease or eliminate cash dividends.

Of course this was as much a reflection of societal confidence as it was an expression of rational thought. It reached its apogee with the Amazon.com model set forth by web-guru Jeff Bezos: not only were dividends regarded as unnecessary, but also net profits were superfluous.

It speaks volumes about our national optimism that we as a society bought such an overt impossibility. And now we're here, after a giant market decline brought about by just such a willingness to take leave of our senses.

And, like roses in snow, the clamor for dividends is quietly but irresistibly re-emerging after a 20-year hibernation. The Wall Street Journal published an editorial on August 6th calling for making dividends tax-deductible to corporations. CEO's seeking to avoid a barrage of ripe tomatoes and cat-calls are making pro-dividend sounds that are suspiciously like the words of old-fashioned lead-from-the-front managers.

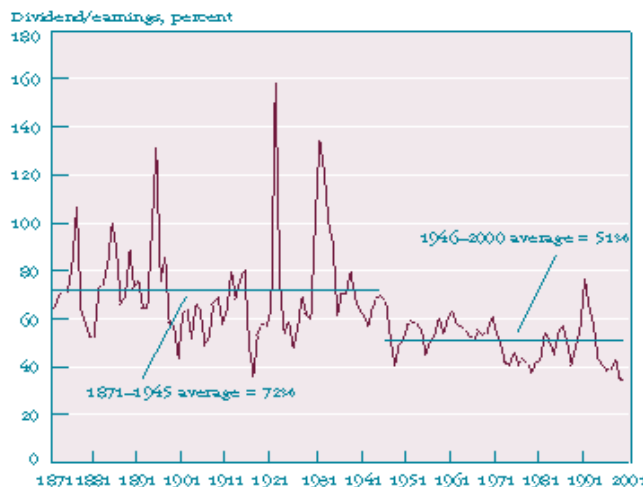
Many of the companies whose stocks have been most damaged, such as Microsoft, Cisco, and Oracle, are actually awash in cash. If they decide to pay dividends today, the checks will go out tomorrow.

I cannot say what the future holds. I can only say that a rediscovery of dividends is historically likely and clearly a sensible way to restore confidence rapidly. Meanwhile I'm keeping portfolios well stocked with the balanced stock and bond funds, and the value-biased funds that would profit from such a market change. Continue to ride this out, and watch for dividends to go up! ♣

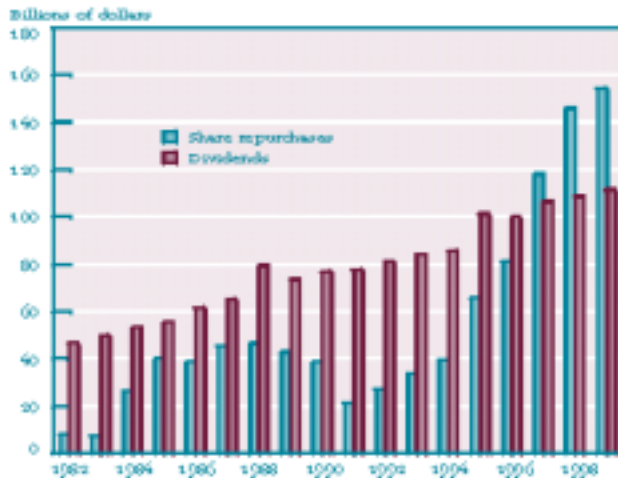
Dividend yield expressed as a percent of the value of the stock market has declined in recent years....



But dividends as a percentage of earnings has also declined. So the decline in yield is not just about stock market valuations.



Meanwhile, the bulk payout of dividends has continued to rise, confirming the value of a strategy of investing for income.



Graphs provided by the Federal Reserve Bank of Cleveland