



DECEMBER 17, 2002

THE PETE ANDRESEN INVESTMENT NEWS ANDRESEN & ASSOCIATES

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TURTLE HOUSE RULES

As I write this, the Standard and Poor's index of 500 large-cap stocks is up 7% from its September 30th numbers. The NASDAQ Index is up 18% and someone has made a killing in CSCO (Cisco Systems) stock. Most of the technology sector is rebounding like crazy. (GRAPH 1)

The average investor could be forgiven for missing this rebound. After all, the bigger picture is still bleak. Year to date, as you can see, the Standard and Poor's 500 and the NASDAQ are both negative (GRAPH 2), and the three year numbers are still less than attractive (GRAPH 3).

Yes, we can understand why the average investor is frozen like a deer in the headlights. Their paralysis is all the more unfortunate, for there *do exist* classes of stock that have followed the path of neither the NASDAQ nor the S&P 500. Instead of two different discrete stock markets, as commonly understood, there is actually a spectrum of investments, a continuum of stock market risk and return. Many of these stocks actually do not correlate effectively with either of the big indexes, yet they produce decent returns.

This time I'll report on one obvious venue that has withstood the test of time for over a century. As I reported in my newsletter of August 15, 2002 titled "*Basic Math*", dividend-paying stocks are traditional investment choices that wax and wane in popularity inversely to market optimism. Since the newest Bush tax cuts are likely to include a much needed provision for eliminating the double taxation of dividends, we are likely to see a renewed interest in dividend-paying stocks, as well as discussion about their relative risks and rewards.

Graph 4 (on the following page) includes both the October 1987 stock market decline, when some stocks declined more than 40%, and the great millennium meltdown of 2000-2002. This graph is a tremendously valid study of long-term risk and return. Notice that growth and aggressive funds tend to carry greater risk and yet, unless you have the preternatural sense to sell out at the market top, NOT vastly higher returns. I've seen this amazing phenomenon repeated many times: *Greater risk is often associated with more entertainment, but not necessarily higher returns.*



GRAPH 1 SEPTEMBER 30, 2002 TO DECEMBER 16, 2002



GRAPH 2 YEAR TO DATE 2002



GRAPH 3 JANUARY 1, 2000 TO DECEMBER 16, 2002

Dividend-paying stocks tend to have several shared characteristics. Obviously, they produce a lot of taxable income relative to other stocks. This means that they are most at home in tax-deferred accounts such as IRA's, 403(B)'s, 401(k)'s, or pensions, where cash flow is not subject to tax. They also tend to be more stable in price, both on the upside and the downside. It is rare to see a stock that pays out a lot of dividend soar, and it is equally unlikely to see it collapse, although both have happened.

Dividend paying stocks also usually share a more open accounting structure since they must make genuine cash payments. Unlike more growth-oriented shares that might manipulate profits to suit their strategic goals, dividend-paying stocks have to produce hard cash to pay the dividend, which implies profitability. Cutting the dividend usually causes the stock price to fall, so income streams tend to ratchet upwards as the company grows. Thus, dividends tend to keep pace with inflation more effectively than bonds. Since there cannot be as many surprises in such an open financial architecture, stocks which pay dividends have less earnings surprises as a group, and thus are less likely to make sharp price moves in any direction.

However, even dividend stocks do have surprises. (The collapse of Pacific Gas & Electric in the 80's comes to mind.) For that reason, and to smooth dividend streams, I usually buy my high-dividend stocks in mutual fund form. Both balanced funds, comprised of both stocks and bonds, and value funds, which feature cheaper stocks, are usually full of these high-payout stocks.

As you can see in the graph below, in the long run, these funds tend to provide very decent gains for very little relative risk. For example, the correlated stock market risk of the Dodge and Cox Balanced Fund is 42%. The risk of Vanguard Wellesley Income fund is 14% and the current income is 4.7%. The payout for Longleaf Partners is only 1%, but its correlated risk is 50% of the stock market.

What is the downside to investing in high-dividend stock? There are three issues of concern to the average investor. First, a portfolio or a mutual fund of high dividend stocks generates a lot of income, which is taxed at your regular rate. If you are reinvesting these dividends rather than spending them, you are altering the original tax basis of your investment, which is a concern if you do your own taxes. If you are concerned about your tax bracket and you do not have a tax-deferred account in which to shelter income, these tax-inducing investments may not be for you. Instead you might try some low-risk international or small stock investments that derive most of their performance from capital gains.

Second, these investments lag terribly in a bull market. In fact, they can even go down in a market boom since investors sell them to buy more racy choices. For example, in 1999, Vanguard Wellesley produced a NEGATIVE return of -4.14% in the midst of one of the giant bull markets in history, while the NASDAQ went up 86%. In the longer term, it did not matter at all, but it was quite distressing at the time. However, this shortcoming is easily remedied by diversification within your portfolio.

Third, these are some of the most boring investments you will ever know. You will lose status with your hip, fast-moving peers, you will have no reason to watch CNBC, and you will be regarded as a gray-headed has-been at the athletic club or the golf course. You will have to give up lottery-style big-win expectations. This is harder than many investors realize.

A giant lesson lies within that collection of colors and lines in the graph below. You do not have to fully participate in market booms and busts. Less risk can equal more return. As I discussed in "Basic Math", political moves in the next few months are likely to increase these stocks' attractiveness, as well as increase dividends themselves.

You won't have to sprint like a rabbit to win the race. 🐇

GRAPH 4

