

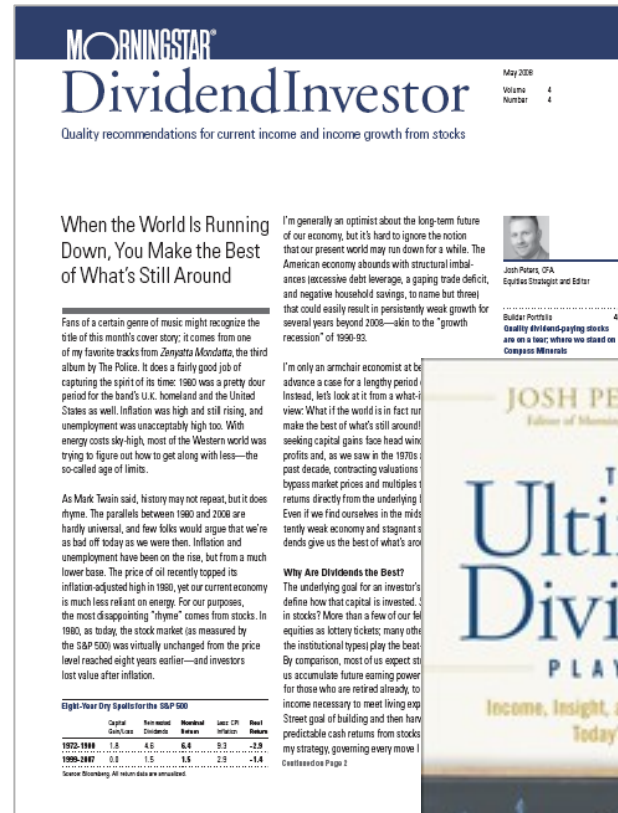
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# Morningstar's Approach to Dividends: A Compelling Case for Cash Returns

- ▶ **Josh Peters, CFA**  
**Editor, Morningstar DividendInvestor**

# Introduction to DividendInvestor

- ▶ *DividendInvestor* enters its fourth year of recommending stocks for “Main Street” financial needs, bypassing the “Wall Street” fads.
- ▶ Dividend increases among recommended holdings now total 115, versus just one dividend cut
- ▶ Released companion book to *DividendInvestor* in January 2008: *The Ultimate Dividend Playbook*



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## Overview: Why Dividends?

### ▶ **Income**

- ▶ High-yield stocks offer both higher current income and preservation of the income's purchasing power over time
- ▶ No maturities, but no reinvestment risk, either

### ▶ **Insight**

- ▶ As a group, dividend-paying stocks are superior long-term investments, as demonstrated by 50+ years of performance
- ▶ Dividends provide valuable clues to financial strength, long-run growth prospects, governance and total return potential

### ▶ **Independence**

- ▶ Bypass Wall Street fads and the *need* for capital gains by earning handsome cash returns directly from the source

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## DividendInvestor: Security Selection

- ▶ All of the information available on a dividend-paying stock can be organized around and condensed to the following three questions:
  - ▶ Is the dividend safe?
  - ▶ Will the dividend grow?
  - ▶ What's the total return?
- ▶ Unlike quantitative strategies (i.e. dividend ETF products), these points of view are forward-looking
- ▶ Financial health, long-term growth prospects, competitive positioning, management stewardship—it's all in there
- ▶ Total return indicated by yield plus likely long-run dividend growth rate

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## The DividendInvestor Model Portfolios

- ▶ Same strategy, distinct applications for different financial goals
- ▶ **Dividend Builder** (Inception: 01/07/2005)
  - ▶ Objective: Build future earning power through dividends, dividend growth, reinvestment and capital gains
  - ▶ Target: 2%-4% portfolio yield, 8%-10% annual income growth through dividend increases, 11%-13% overall total return
- ▶ **Dividend Harvest** (Inception: 12/29/2006)
  - ▶ Objective: Maximize current income without sacrificing safety or the long-term purchasing power of income
  - ▶ Target: 5%-7% portfolio yield, 3%-5% annual income growth through dividend increases, 9%-11% overall total return

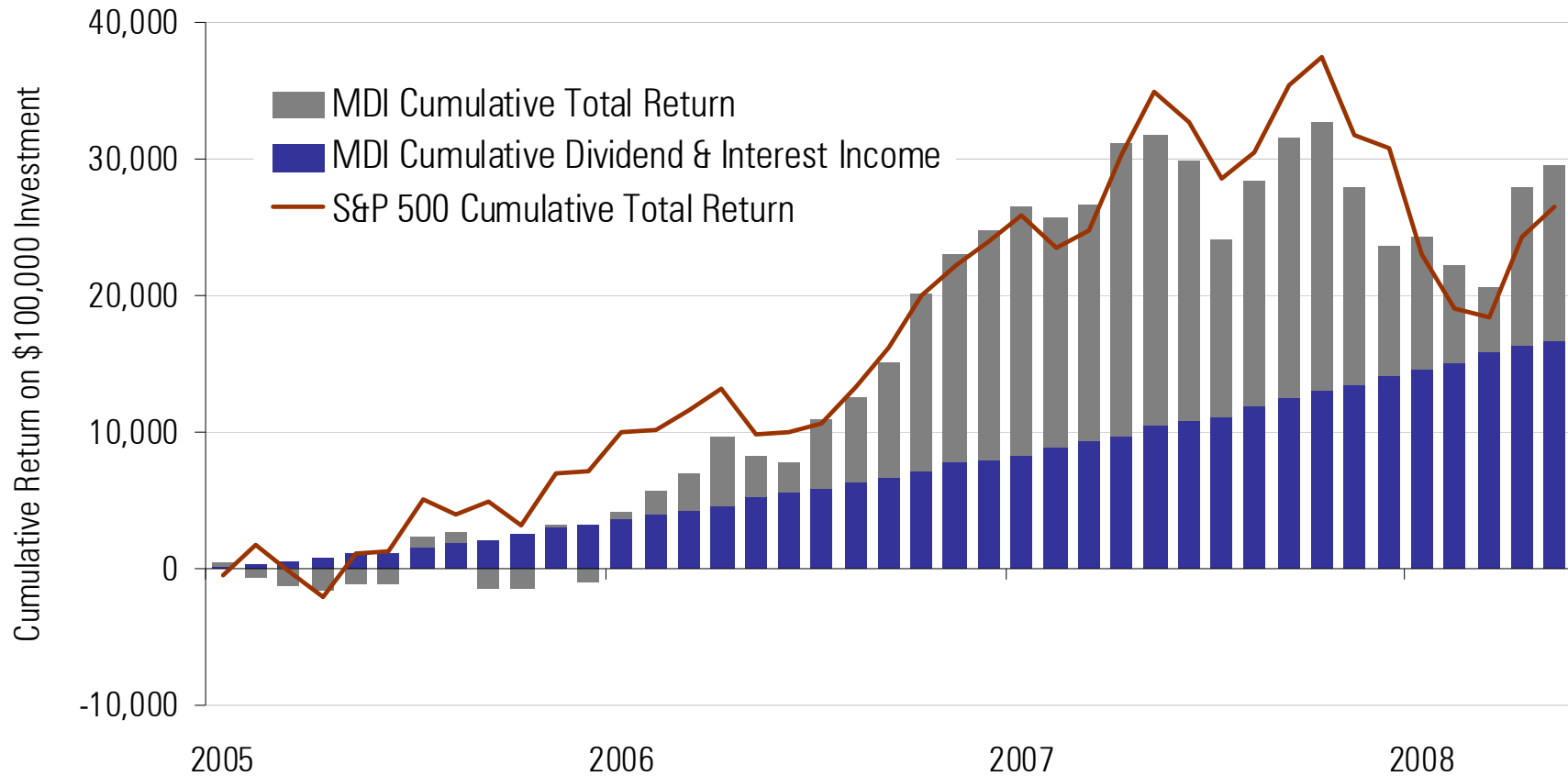
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## The 21<sup>st</sup> Century Investment Challenge

- ▶ As a group, American equity investors count heavily on rising prices to reward them for their shareholdings
- ▶ Yet investors of ordinary means can't change or control market prices
- ▶ **Could it be possible to invest without market prices needing to change – or even needing to matter?**

# The 21<sup>st</sup> Century Investment Challenge (continued)

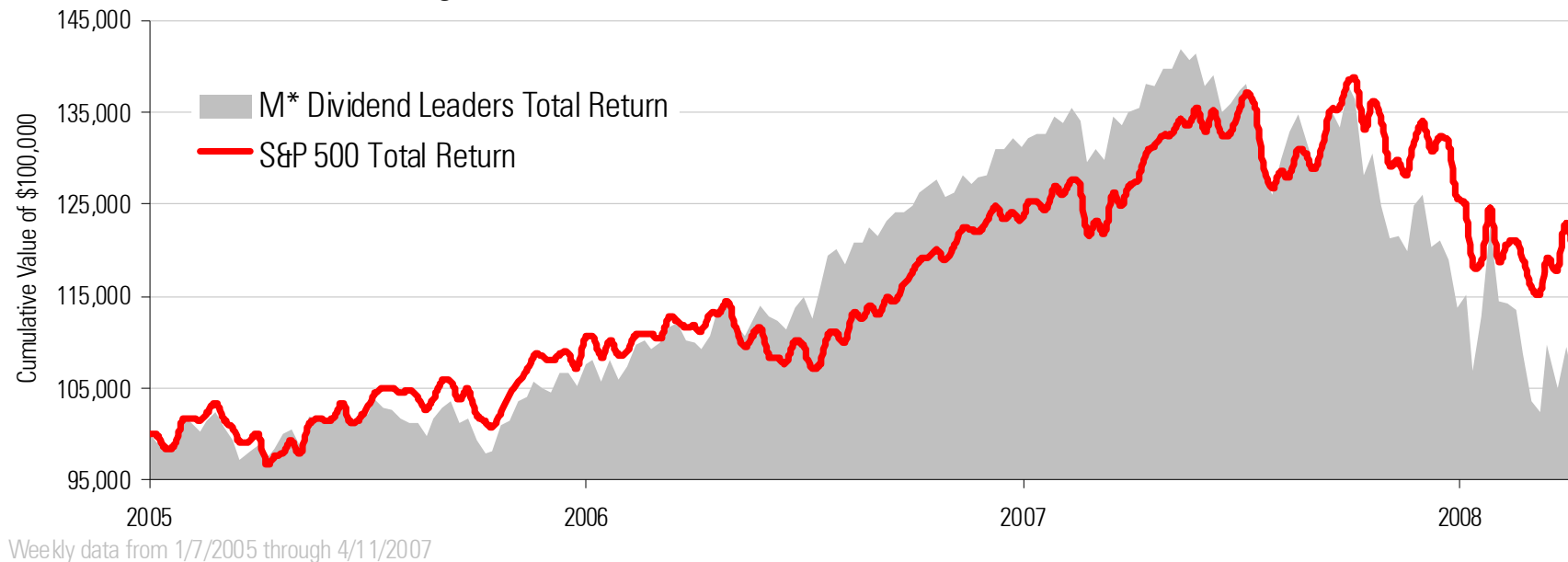
## Dividend Investor Recommendations: Cumulative Performance



## The Current Dividend Landscape

- ▶ With many high-profile, high-yield financial institutions hurting, the past year has been tough on dividend-paying stocks as a group

**Relative Performance of High-Yield Stocks:**  
Morningstar Dividend Leaders Index vs. S&P 500 Total Return





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## The Current Dividend Landscape (continued)

- ▶ A recession looms on the horizon, if it's not already under way
- ▶ Dividends increasingly seen as "risky"
  - ▶ High-profile cuts by Citigroup, Wachovia, etc.
- ▶ Yet the value proposition of high-yield stocks remains very strong
  - ▶ DividendInvestor recommendations yield over 5% as a group; 10-year Treasuries down in the 3.5% range
  - ▶ DividendInvestor recommendations poised for 7% annual income growth on average; Treasuries naturally "zero"
- ▶ Key to success: Choose your holdings carefully!

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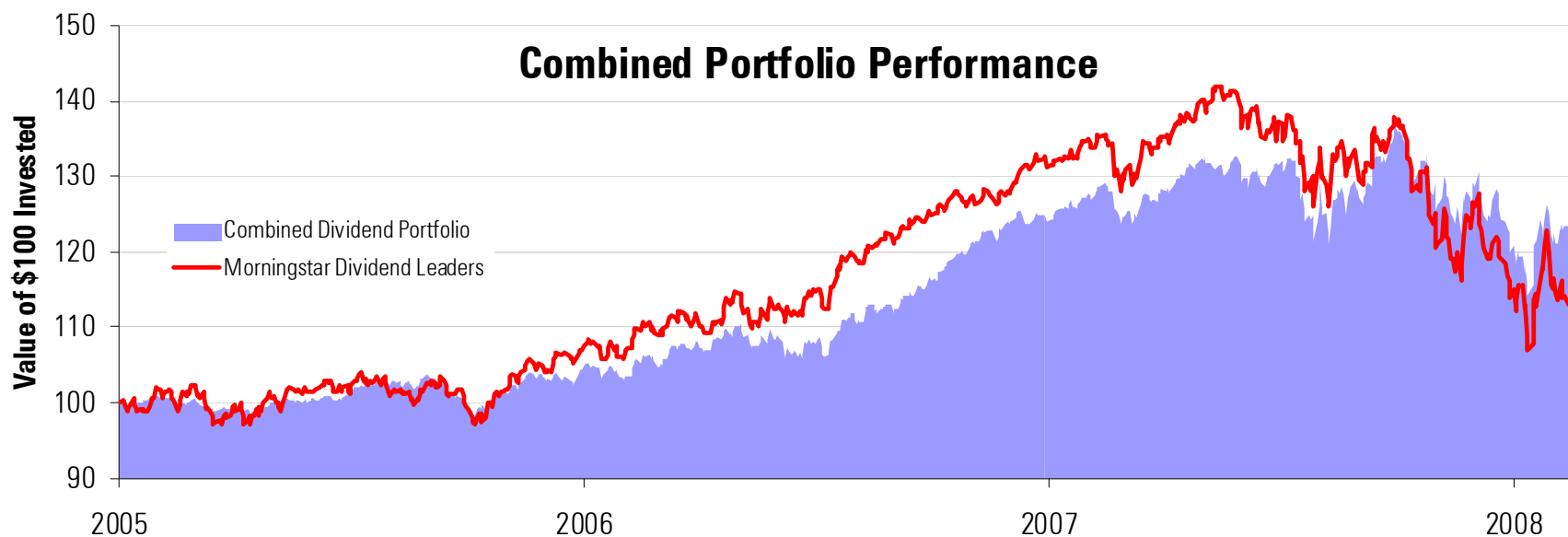
## Where We Are Today (continued)

- ▶ “Is the dividend safe?” is usually the most important question the prospective (or current) investor can ask
- ▶ Many factors to consider, but two shortcuts help greatly:
  - ▶ Be skeptical – make that very skeptical – of yields over 8%
  - ▶ Be skeptical – make that *extremely* skeptical – of dividends that show no propensity to grow
- ▶ Avoid the temptation to reach for yield
  - ▶ A reliable 5% - 7% yield is much likely to prove rewarding—especially with a good growth rate—than the “sucker-yield” stocks paying over 8% with questionable fundamentals

# Model Portfolio Performance

<b>Builder</b>	2005	2006	2007	YTD08	Total*	<b>Harvest</b>	2007	YTD08	Total*
<b>Total Return</b>	<b>2.3%</b>	<b>21.9%</b>	<b>-2.8%</b>	<b>9.7%</b>	<b>8.9%</b>	<b>Total Return</b>	<b>1.8%</b>	<b>-1.3%</b>	<b>0.3%</b>
S&P 500	7.1%	15.8%	5.5%	-3.3%	7.3%	S&P 500	5.5%	-3.3%	1.4%
<i>Builder B/(W)</i>	<i>-4.8%</i>	<i>6.1%</i>	<i>-8.3%</i>	<i>13.0%</i>	<i>1.6%</i>	<i>Harvest B/(W)</i>	<i>-3.7%</i>	<i>2.0%</i>	<i>-1.1%</i>
M* Div. Leaders	5.2%	25.5%	-10.2%	-8.2%	2.6%	M* Div. Leaders	-10.2%	-8.2%	-13.1%
<i>Builder B/(W)</i>	<i>-2.9%</i>	<i>-3.6%</i>	<i>7.4%</i>	<i>17.9%</i>	<i>6.3%</i>	<i>Harvest B/(W)</i>	<i>12.0%</i>	<i>6.9%</i>	<i>13.5%</i>

*\*Totals are annualized since inception*



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## Dividend Bucket #1: Banks

- ▶ Collapse of the “shadow-banking” sector, falling interest rates bodes extremely well for the regulated banking industry
- ▶ Fear of credit losses, dilutive capital issues and even dividend cuts keeping prices low ... and potential future returns high
- ▶ On balance, lots of opportunity – but pick your spots carefully, always with an eye on dividend safety!
- ▶ Top DividendInvestor recommendations
  - ▶ **BB&T Corporation** BBT (5.2% yield, 8% growth)
  - ▶ **US Bancorp** USB (5.0% yield, 8% growth)

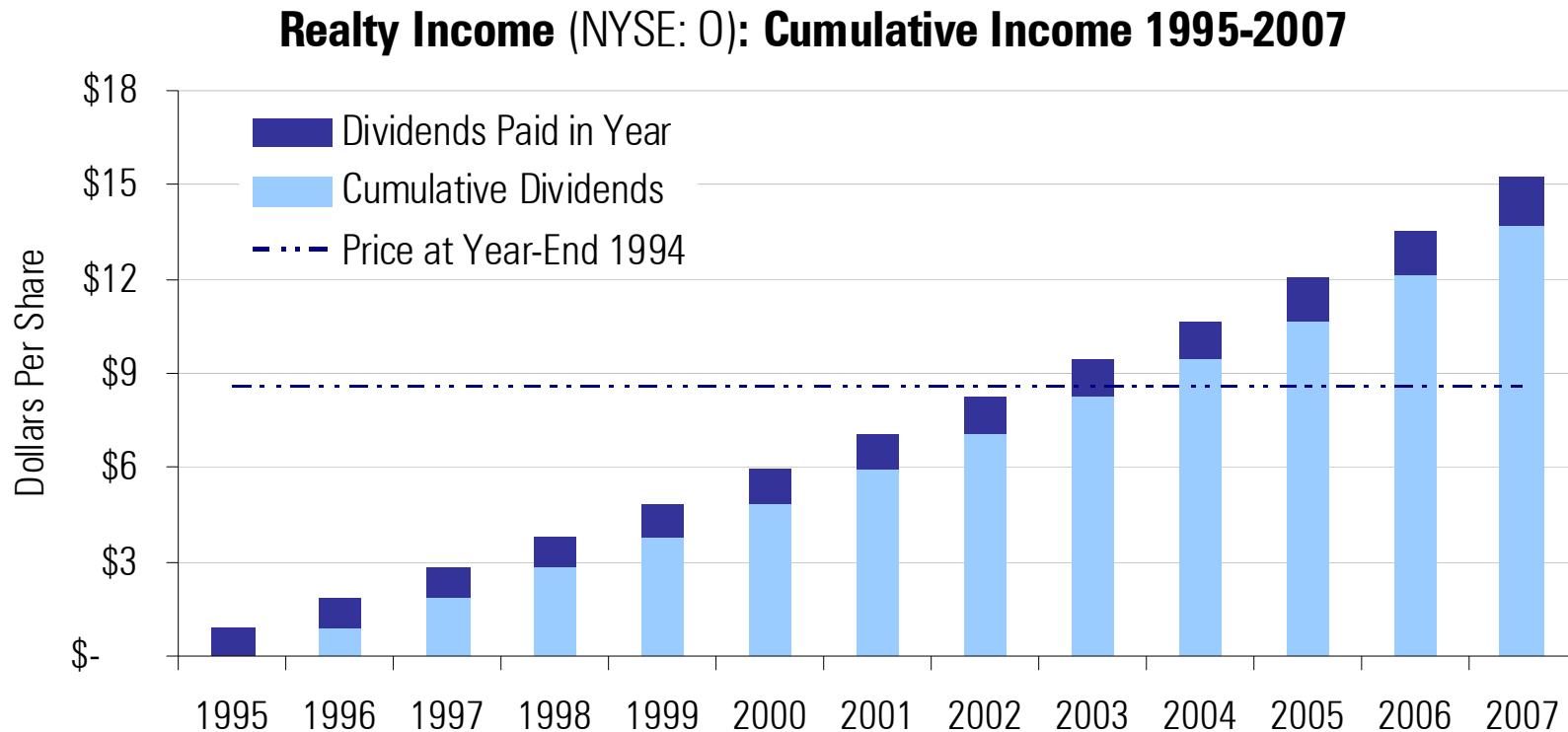
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## Dividend Bucket #2: REITs

- ▶ Morningstar called peak in sector valuations in early 2007; subsequent selloff allowed us to pick up a couple of bargains
- ▶ As interest rates plunged, quality REITs became expensive again
- ▶ Top recommendation: **Realty Income** O (6.7% yield, 4.5% growth)
  - ▶ “Monthly Dividend Company” arguably the standard against which all other dividend payers ought to be judged
  - ▶ A good buy under \$27; a great buy under \$23.50 (7% yield!)
- ▶ Other DividendInvestor REIT holdings
  - ▶ **Developers Diversified** DDR (6.5% yield, 7% growth)
  - ▶ **First Potomac** FPO (7.9% yield, 4% growth)

## Dividend Bucket #2: REITs (continued)

- ▶ Proving my point – market prices don't need to matter



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## Dividend Bucket #3: Utilities

- ▶ Long-run total returns capped at achievable returns on equity; to the extent you pay a premium to book, you'll earn less
- ▶ Rate-base growth story still good, but regulatory price pressure increasing amid low interest rates, cramped consumer budgets
- ▶ Still, there's some value out there:
  - ▶ **NSTAR** NST (4.5% yield, 6% growth) stands out with a low-risk regulatory framework that allows about 2x the industry average dividend growth rate
  - ▶ **Southern Company** (4.6% yield, 5% growth) attractive as well, but I'd hold out for a bit better price.

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## Dividend Bucket #4: Energy MLPs

- ▶ Yet again, MLPs stand as the most attractive high-yield sector
- ▶ Tax constraints, especially on qualified accounts, result in persistently low valuations ... as well as higher yields and total returns
- ▶ Market-dependent for growth capital, but not for existing distributions
- ▶ Top recommendations among straight limited partner interests:
  - ▶ **Kinder Morgan Energy** KMP (6.4% yield, 8% growth)
  - ▶ **Buckeye Partners** BPL (6.9% yield, 5% growth)
  - ▶ **AmeriGas Partners** APU (7.5% yield, 4% growth)
- ▶ No interest in “E&P” partnerships – too much commodity price risk



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## Dividend Bucket #4: Energy MLPs (continued)

- ▶ Typical MLP has two classes of equity
  - ▶ Limited partners (LPs) akin to a participating preferred
  - ▶ General partners (GPs) the final claim on cash flow
- ▶ Most public MLPs grant GPs “incentive distribution rights”
  - ▶ Modestly lower yields, but much faster distribution growth
- ▶ **Magellan Midstream Holdings** MGG (5.1% yield, 15% growth)
- ▶ **Buckeye GP Holdings** BGH (4.8% yield, 13% growth)
- ▶ **Crosstex Energy Inc.** XTXI (4.1% yield, 15% growth)
  - ▶ XTXI noteworthy as a traditional C-corp – anyone can own it!

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## Dividend Bucket #5: Consumer Goods & Healthcare

- ▶ Valuations in consumer staples aren't terribly attractive, but dividend prospects help sort out the best prospects for future cash returns
  - ▶ **Diageo** DEO (3.4% yield, 7%-8% growth)
  - ▶ **Kraft Foods** KFT (3.4% yield, 8% growth)
  - ▶ **Sysco** SYU (2.8% yield, 10% growth)
- ▶ Large healthcare valuations have compressed, but again, favorable dividend prospects define the easy ones
  - ▶ **Abbott Laboratories** (2.6% yield, 10% growth)
  - ▶ **Johnson & Johnson** (2.8% yield, 10% growth)

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## Dividend Bucket #6: Everything Else

- ▶ Improving attractiveness for more cyclical sectors—at least those with well-demonstrated commitments to dividends
  - ▶ **Paychex** PAYX (3.3% yield, 11% growth)
  - ▶ **Waste Management** WMI (2.9% yield, 9% growth)
  - ▶ **Allstate** ALL (3.3% yield, 9% growth)
- ▶ **General Electric** GE an outstanding opportunity with a 3.8% current yield and double-digit long-run growth potential
  - ▶ Business model and future growth prospects not broken
  - ▶ GE hasn't offered a current yield this high since 1985

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## Dividends to Avoid

- ▶ **Rule #1: Don't reach for yield!**
- ▶ Specialty financials and distressed banks
  - ▶ These are for speculation, not long-term investment
- ▶ Commodity plays (Canadian income funds and U.S. royalty trusts)
  - ▶ Dividend payments rely directly on energy prices
- ▶ Shipping plays (tanker and dry bulk carriers)
  - ▶ This is why I require economic moats
- ▶ High-yield telecoms
  - ▶ Zero dividend growth; might as well buy their bonds ...

## Conclusion: Another Look at Performance

KMP	Jan-05	1.4%	DEO	Feb-06	2.0%	MMAB	Jan-07	1.0%	XTXI	Jul-07	4.5%	BPL	Jan-08	1.5%
MMAB	Jan-05	1.1%	NCC	Apr-06	5.4%	BMS	Feb-07	10.5%	BGH	Jul-07	4.2%	BGH	Jan-08	7.5%
UL	Feb-05	3.7%	KMP	Apr-06	1.3%	UPS	Feb-07	10.5%	BPL	Jul-07	1.6%	MGG	Jan-08	5.9%
NCC	Apr-05	5.7%	APU	Apr-06	3.6%	CMP	Feb-07	4.9%	SPH	Jul-07	1.8%	MMAB	Jan-08	-37.1%
KMP	Apr-05	2.7%	JNJ	Apr-06	13.6%	MMM	Feb-07	4.3%	LYG	Jul-07	1.5%	BMS	Jan-08	4.8%
MMAB	Apr-05	1.1%	MMAB	May-06	1.0%	DEO	Feb-07	1.9%	MMAB	Aug-07	1.0%	UPS	Jan-08	7.1%
JNJ	Apr-05	15.8%	SPH	May-06	4.1%	KO	Feb-07	9.7%	O	Aug-07	6.1%	CMP	Feb-08	4.7%
KMP	Jul-05	2.6%	FITB	Jun-06	5.3%	CSE	Mar-07	5.5%	DEO	Aug-07	3.2%	MMM	Feb-08	4.2%
MMAB	Jul-05	1.0%	WFC	Jun-06	7.7%	O	Mar-07	0.5%	O	Sep-07	0.5%	DEO	Feb-08	2.0%
DEO	Sep-05	4.2%	BAC	Jul-06	12.0%	TPP	Apr-07	1.5%	TPP	Oct-07	1.5%	LYG	Feb-08	3.5%
FITB	Sep-05	8.6%	MMAB	Jul-06	1.0%	APU	Apr-07	5.2%	KMP	Oct-07	3.5%	O	Mar-08	0.5%
FHN	Oct-05	4.7%	SPH	Jul-06	3.9%	ASBC	Apr-07	6.9%	XTEX	Oct-07	3.5%	KMP	Apr-08	4.3%
KMP	Oct-05	1.3%	O	Aug-06	6.6%	BGH	Apr-07	6.7%	XTXI	Oct-07	4.3%	XTEX	Apr-08	1.6%
MMAB	Oct-05	1.0%	DEO	Aug-06	3.2%	BPL	Apr-07	1.6%	BGH	Oct-07	6.0%	XTXI	Apr-08	38.5%
UL	Nov-05	2.3%	MSFT	Sep-06	11.1%	JNJ	Apr-07	10.7%	BPL	Oct-07	1.5%	ASBC	Apr-08	3.2%
MSFT	Dec-05	12.5%	O	Sep-06	0.5%	SPH	Apr-07	1.8%	SPH	Oct-07	5.3%	JNJ	Apr-08	10.8%
USB	Dec-05	10.0%	MMAB	Oct-06	1.0%	MMAB	May-07	1.0%	MMAB	Nov-07	0.5%	MGG	Apr-08	5.0%
KMP	Jan-06	1.3%	SYN	Nov-06	11.8%	CSE	Jun-07	3.4%	SYN	Nov-07	15.8%	APU	Apr-08	4.9%
MMAB	Jan-06	1.0%	USB	Dec-06	21.2%	O	Jun-07	0.5%	USB	Dec-07	6.3%	BGH	Apr-08	5.3%
BMS	Feb-06	5.6%	O	Dec-06	0.5%	BBT	Jun-07	9.5%	O	Dec-07	0.5%	BPL	Apr-08	1.5%
CMP	Feb-06	10.9%	KMP	Jan-07	2.5%	KMP	Jul-07	2.4%	DDR	Jan-08	4.5%			
MMM	Feb-06	9.5%	SPH	Jan-07	3.8%	WFC	Jul-07	10.7%	KMP	Jan-08	4.5%			
UL	Feb-06	4.9%	BGH	Jan-07	3.7%	XTEX	Jul-07	1.8%	XTXI	Jan-08	8.3%			
KO	Feb-06	10.7%	BPL	Jan-07	1.6%	BAC	Jul-07	14.3%	XTEX	Jan-08	3.4%			

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## Questions?

- ▶ All performance, yield and forecast growth data as of 5/14/2008
- ▶ Disclosure: Josh Peters, CFA owns shares of BGH, BMS, FPO, KFT, KMR, MGG, O, SYX and XTXI in his personal accounts