THE BRANDES INSTITUTE

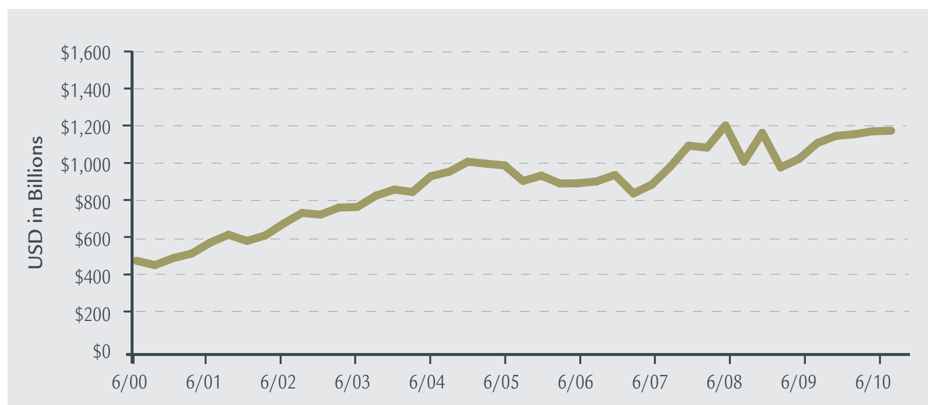
www.brandes.com/institute

Dividend Yield: The Implications of Cash Sitting on Balance Sheets *By Bill Raver*[1]

Fiduciaries and investors, seeking to navigate an uncertain economic environment, would be wise to take note of a key development that is *already certain* – record cash levels that sit on the balance sheets of public companies.

Standard & Poor's reports that non-financial companies in the S&P 500 Index held more than $1 trillion (USD) in cash at the end of first quarter 2010. Exhibit 1 shows the cash and short-term investments for S&P companies over the past 10 years. With companies sitting on large cash positions, Empirical Research notes "the potential to return capital to shareholders is as great as it's been in 125 years."

Exhibit 1: Cash and Short-term Investments on Balance Sheet, S&P 500 Index Companies, 2000-2010



Source: FactSet, as of 9/30/10.

What course of action will companies take with these rich cash balances? As the economic markets continue to recover from the global financial crisis, dividends and share buyback activity have been on the rise (after a dramatic plunge in both during the crisis).

During the first six months of 2010, 135 companies in the S&P 500 Index increased dividends with only two companies reducing dividends, according to S&P senior analyst Howard Silverblatt. That stands in stark contrast to 2009, when during the first six months only 87 companies raised dividends and 65 companies reduced dividends.[2] Also climbing this year are announced stock buybacks, which in the first quarter were up 80% (in USD) over the same period last year. Even if one makes the allowance that a portion of these buybacks are merely reducing shares created by the exercise of employee options, and that not all announced buybacks are fully implemented, this still represents an impressive increase in buyback activity.

Even while corporations are sitting on record amounts of cash, the payout ratio[3] for the S&P 500 lies well below the average for the last 10 years (see Exhibit 2 on following page), and has begun a slight improvement in recent quarters. Taken in context with the high level of cash on hand shown in Exhibit 1, companies have the cash and capacity to raise dividends.

Perhaps the best action for ensuring a positive return on equity is the repurchase of shares trading below book value – in fact, 59 of the companies in the S&P 500 Index traded below book value as of June 30, 2010. This earnings-enhancing course of action assumes companies won't need to raise cash in the future by issuing debt or equity.

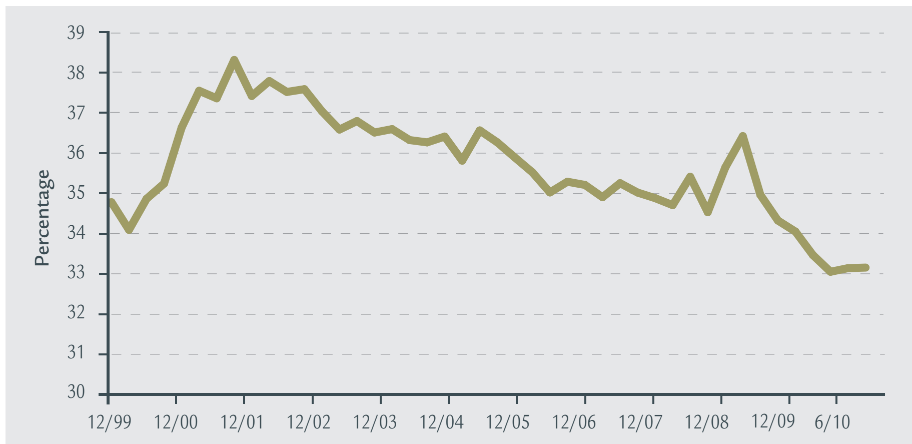
---

[1]Bill Raver, former CEO and CIO of the National Railroad Retirement Investment Trust, is an Advisory Board member of the Brandes Institute, a division of Brandes Investment Partners, L.P.

[2] The declaration and payment of stock dividends are solely at the disrection of the issuer and are subject to change at any time.

[3] The payout ratio is the percentage of earnings paid to shareholders in dividends, or cash dividends per share divided by earnings per share.

Exhibit 2: S&P 500 Index, Payout Ratio, 2000-2010

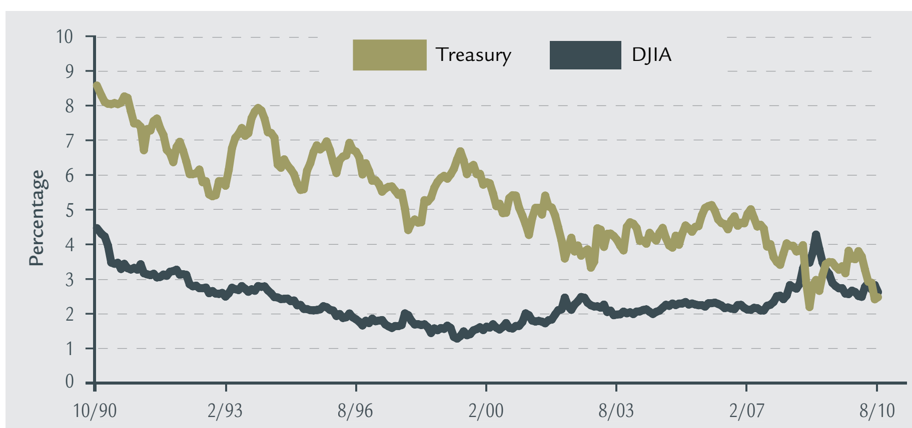


Source: FactSet, as of 9/30/10. Past performance is not a guarantee of future results.

In 2008, the dividend yield for stocks briefly exceeded the yield on 10-year Treasuries for the first time since 1958, and though rising stock prices (and a decline in dividend payouts in 2009) halted this milestone crossover of yields, a large number of blue-chip stocks continue to offer yields well above Treasury bonds.[4]

Beyond increasing dividend payouts and share repurchases, other options remain available to cash-rich corporations. As the euro has recently experienced periods of weakness, some have suggested U.S. companies might be attracted to acquiring European non-financial companies. One option that appears less appealing to corporations is stashing the cash in bonds; U.S. Treasuries are trading near record prices (low yields) – and investment-grade bonds offer little enticement. Perhaps it's not surprising the relationship of dividend yields to Treasury bonds is unprecedented over the last 60 years, as shown in Exhibit 3.

Exhibit 3: Yield Comparison, 10-Year U.S. Treasury vs. Dow Jones Industrial Average, 1990-2010



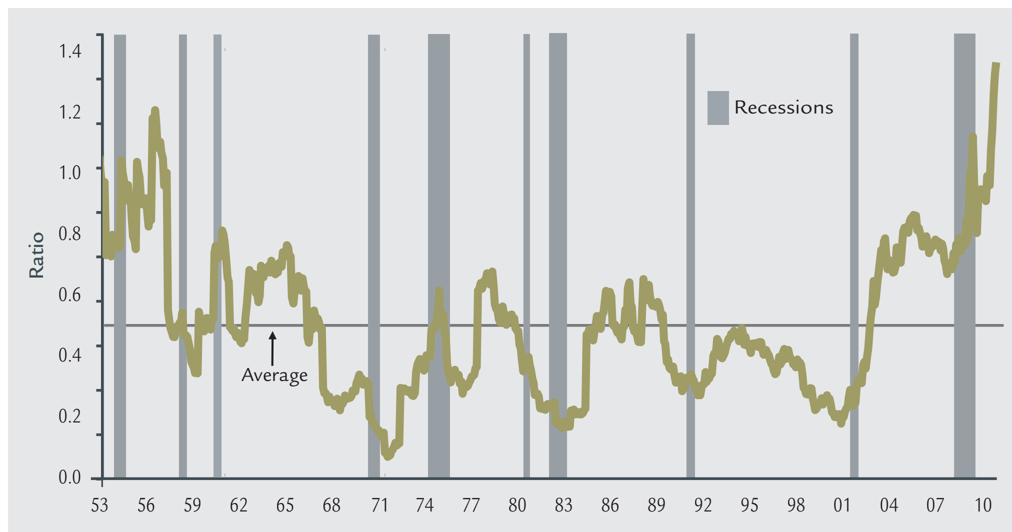
Source: FactSet, as of 9/30/10. Whereas Treasuries are backed by the full faith and credit of the U.S. Government with respect to the timely payment of principal and interest, the declaration and payment of stock dividends are solely at the discretion of the issuer and are subject to change at any time. Past performance is not a guarantee of future results.

[4] Whereas Treasuries are backed by the full faith and credit of the U.S. Government with respect to the timely payment of principal and interest, the declaration and payment of stock dividends are solely at the discretion of the issuer and are subject to change at any time.

Companies are not just sitting on cash – they are also achieving impressive earnings. The robust cash flow yields for large-cap stocks have reached *unprecedented territory* in relation to both investment-grade and junk-bond yields, as Exhibits 4 and 5 demonstrate.

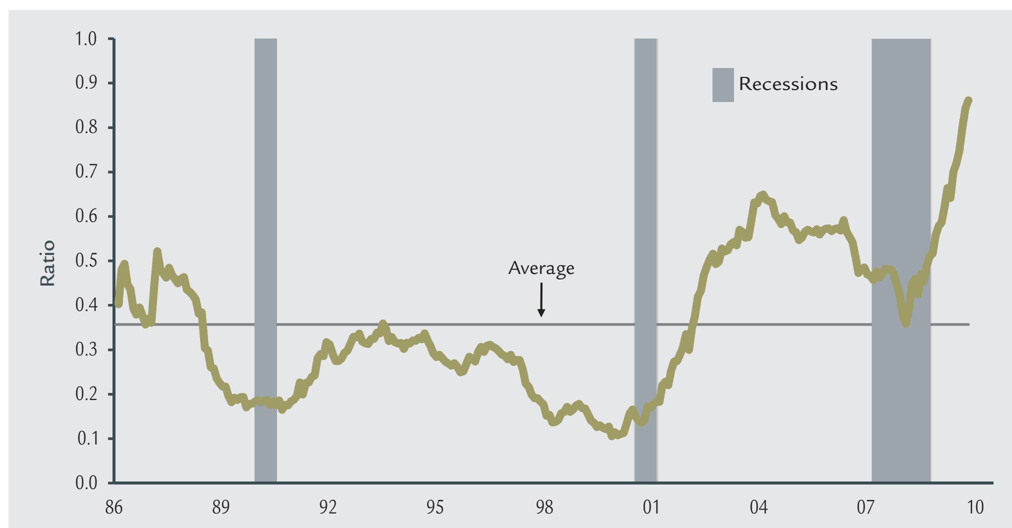
While companies have recently generated high cash flows and enjoyed higher liquidity, they have also achieved impressive earnings.

Exhibit 4: Equity Free Cash Flow Yields as a Ratio to Baa Corporate Bond Yields* 1953 Through Late-August 2010



Source: Empirical Research Partners, using Federal Reserve Board, Corporate Reports, Empirical Research Partners Analysis.
*Capitalization-weighted data. Past performance is not a guarantee of future results.

Exhibit 5: Largest 1,500 Stocks Equity Free Cash Flow Yields as a Ratio to Junk Bond Yields* 1986 Through Late-August 2010



Source: Empirial Research Partners, using Federal Reserve Board, Corporate Reports, Empirical Research Partners Analysis.
*Capitalization-weighted data. Past performance is not a guarantee of future results.

Taking Action – Implications for Fiduciaries

Today's low Treasury yields present quandaries that may be unique to different classes of investors. The challenge may be acute for fiduciaries in charge of corporate pension plans, who face a predicament amidst fixed obligations and mark-to-market accounting for solvency ratios. The gap between the assets of the largest company pensions and their projected liabilities widened in August to a $459.8 billion deficit, according to Milliman, an actuarial consulting firm. This deficit may even be understated: AA-rated company bond yields, a benchmark in determining future liabilities, reached the lowest ever in August 2010. The declining bond yields have increased the projected benefit obligations of companies; in fact, the funded ratio for corporate pensions fell to 70.1% in August, the lowest ratio in at least 10 years, from 75.6% the month before, according to the Milliman 100 Pension Funding Index. We note that pension funds have generally recorded healthy gains from their fixed income holdings as Treasury yields plummeted in recent years. However, if the bond "bubble" breaks and Treasury yields rise sharply, pension funds may suffer large losses from their bond positions.

As increasing exposure to government bonds seems ill-timed, where do investors put their capital? In today's low-yield environment, companies may have to consider allocating more of their pension plan assets into equities or, despite the risk-averse environment, may consider "riskier" investments, including alternative asset classes, leveraged investments, and private equity.

If current low-yield conditions make exposure to Treasuries less enticing for investors, the implications for the cash sitting on corporate balance sheets take on higher importance – will dividend yields continue to climb? Will share buybacks prove value-accretive to equity investors? How this record level of cash is put to use could have a large impact on performance and liability obligations going forward.

The Dow Jones Industrial Average is an unmanaged, price-weighted index of 30 blue chip U.S. stocks. The DJIA was created by Charles Dow in 1896 as a general measure of the stock market, and today is compiled by editors of The Wall Street Journal. With over a hundred years of data behind it, the DJIA still serves as a reliable U.S. market's measure. This index captures price movements of the securities.

The S&P 500 Index with gross dividends is an unmanaged, market capitalization weighted index that measures the equity performance of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it can also be a suitable proxy for the total market. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

The Milliman 100 Pension Funding Index projects the funded status for the 100 largest defined benefit pension plans sponsored by U.S. companies. The index reflects the impact of market returns and interest-rate changes on pension funded status, utilizing the actual reported asset values, liabilities, and asset allocations of the companies' pension plans.

This material was prepared by the Brandes Institute, a division of Brandes Investment Partners®, in collaboration with Bill Raver. It is intended for informational purposes only. It is not meant to be an offer, solicitation, or recommendation for any products or services. The foregoing reflects the thoughts and opinions of the Brandes Institute and Bill Raver. Copyright © 2010 Brandes Investment Partners, L.P. ALL RIGHTS RESERVED. Brandes Investment Partners® is a registered trademark of Brandes Investment Partners, L.P. in the United States and Canada. Users agree not to copy, reproduce, distribute, publish, or in any way exploit this material, except that users may make a print copy for their own personal, noncommercial use. Brief passages from any article may be quoted with appropriate credit to the Brandes Institute. Longer passages may be quoted only with prior written approval from the Brandes Institute. For more information about Brandes Institute research projects, visit our website at www.brandes.com/institute.

The information provided in this material should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any security transactions, holdings, or sectors discussed were or will be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance discussed herein. International and emerging markets investing is subject to certain risks such as currency fluctuation and social and political changes; such risks may result in greater share price volatility. Strategies discussed herein are subject to change at any time by the investment manager in its discretion due to market conditions or opportunities. Unlike bonds issued or guaranteed by the U.S, Government or its agencies, stocks and other bonds are not backed by the full faith and credit of the United States. Stock and bond prices will experience market fluctuations, including the potential for loss of principal. Please note that the value of government securities and bonds in general have an inverse relationship to interest rates. Bonds carry the risk of default, or the risk that an issuer will be unable to make income or principal payment. There is no assurance that private guarantors or insurers will meet their obligations. The credit quality of the investments in the portfolio is no guarantee of the safety or stability of the portfolio. High-yield (also known as "junk") bonds can experience sudden and sharp price volatility and involve a greater risk of default than U.S. Government and other high-quality bonds. No investment strategy can assure a profit or protect against loss. Brandes does not guarantee that the information supplied is accurate, complete or timely, or make any warranties with regard to the results obtained from its use. Brandes does not guarantee the suitability or potential value of any particular investment or information source.

Brandes Investment Partners® is a registered trademark of Brandes Investment Partners, L.P. in the United States and Canada.

11988 El Camino Real, Suite 500
P.O. Box 919048
San Diego, CA 92191-9048
858.755.0239 800.237.7119
Fax 858.755.0916
brandesinstitute@brandes.com
www.brandes.com/institute