



Dividend-Paying Stocks:

**The Solution to the Retirement-Aged
Investor's Dilemma**

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Golub Group believes we are on course for a great migration of cash from the sidelines to high-dividend-paying blue-chip stocks. We believe the opportunities to capitalize on this event are truly exceptional for individual investors. We particularly believe this to be true for individuals close to or in retirement who need income.

Abstract

This paper discusses the current landscape facing investors approaching retirement and proposes the solution of using dividend-paying stocks as a key component in a well-structured investment portfolio.

It demonstrates the powerful performance record of dividend-paying stocks and illustrates the dramatic impact of reinvesting dividends on total return.

The paper considers the effect of taxes under present regulations on income received through dividends as compared to interest received from bonds, and presents a case for dividends as a growing source of after-tax income in contrast to fixed interest from a comparable-quality bond instrument.

The paper then cautions the investor to use care and discipline when selecting dividend-paying stocks, since companies do not all have the same ability to sustain or grow dividends, and presents the attributes that one should seek in an issuer with a case study highlighting The Proctor & Gamble Company.

This final section provides insight into the methods used by Golub Group's investment team to build and monitor portfolios for its clients who entrust their wealth to the firm.

Dividend-Paying Stocks: The Solution to the Retirement-Aged Investor's Dilemma

Executive Summary

There are many approaches to investing for families and individuals, but we firmly believe an approach that focuses on high-quality dividend-paying common stocks has a tremendous advantage over the alternatives. This is particularly true today:

- The U.S. population is growing older, and baby boomers are entering retirement;
- Individuals can no longer count on employer pensions and government to finance retirement, but rather need to look to their own savings to support themselves;
- Recent events impacting the financial markets have dramatically diminished private wealth, and these events have disproportionately affected middle-aged and elderly people precisely at the time that they need to tap those resources to fund personal expenditures.

Those who are in retirement or approaching retirement are caught between a rock and a hard place. On one hand, individuals cannot afford to repeat the mistakes made over recent years and have understandably become highly risk averse. On the other hand, a realistic assessment of what remains, and the realization that “risk-free” investments will not provide the necessary income over one’s expected lifespan, should lead to the conclusion that some measure of risk must be accepted to make ends meet.

In our view, dividends are a key answer to individual investor needs. Dividend-paying stocks, carefully selected and managed, have attributes that address these concerns:

- Dividend-paying stocks, as a class, have dramatically outperformed non-dividend-paying stocks over the long run;
- Dividend-paying stocks reduce portfolio volatility;
- Dividends provide cash flow to meet disbursement needs, allowing principal to remain invested;
- Dividend-paying stocks, unlike bonds and other fixed income securities, give the holder the ability to achieve meaningful capital gain, thereby providing inflation protection and growth of principal;
- Dividends can be (and are often) increased by company boards of directors, whereas bond coupons are contractually pre-determined and typically fixed;
- Dividends are tax-advantaged vis-à-vis taxable bond interest; and
- Dividend-paying stocks are generally highly liquid, and therefore can be quickly and inexpensively converted to cash when necessary.

An aging population meets a hostile market

Lengthening life expectancies and a baby-boom generation beginning to enter retirement years are putting strain on the Social Security system as well as on defined benefit pension plans administered by companies, unions and public agencies. Consequently, personal savings and investments are now a more important source of life funding. Defined benefit pension plans are largely a thing of the past (Exhibit I). Since the 1970s, the responsibility for the effective management of retirement funds has

largely transferred from private sector employer to employee.

Unfortunately, the dramatic market declines of 2008 have produced a serious dilemma for the aging public, particularly those closest to retirement (Exhibit II). The people most affected by the stock market crisis are precisely those who have spent years building their 401(k) accounts in preparation for their imminent retirement.

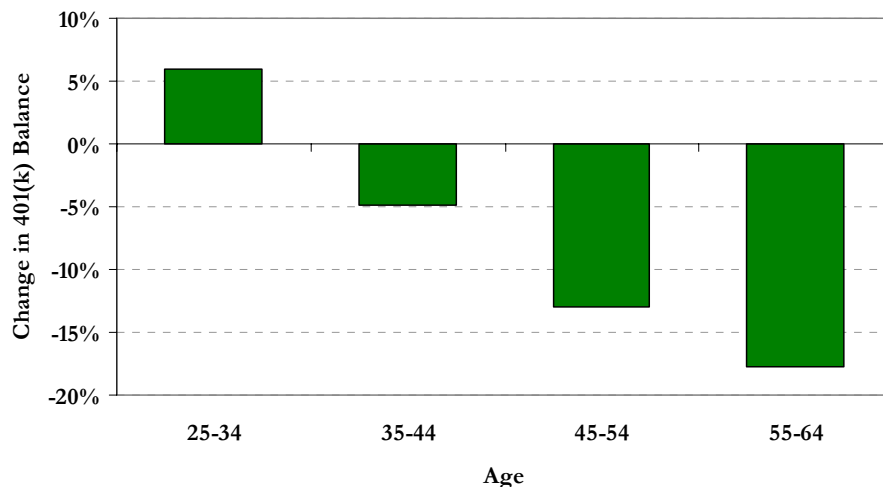
Exhibit I

	<u>1974-1975</u>	<u>2003-2004</u>
Private Sector Workforce (millions)	62.0	109.0
Defined Benefit Plans		
Active Participants in Defined Benefit Plan (millions)	27.2	20.0
Percent of Private Sector Workforce	44%	18%
Defined Contribution Plans		
Active Participants in Defined Contribution Plans (millions)	11.2	64.3
Percent of Private Sector Workforce	18%	59%

Source: Employee Benefit Research Institute

Exhibit II

**Change in Average 401(k) Account Balances
From Jan. 1, 2008 – Jan. 20, 2009, by Age**



Source: Employee Benefit Research Institute estimates

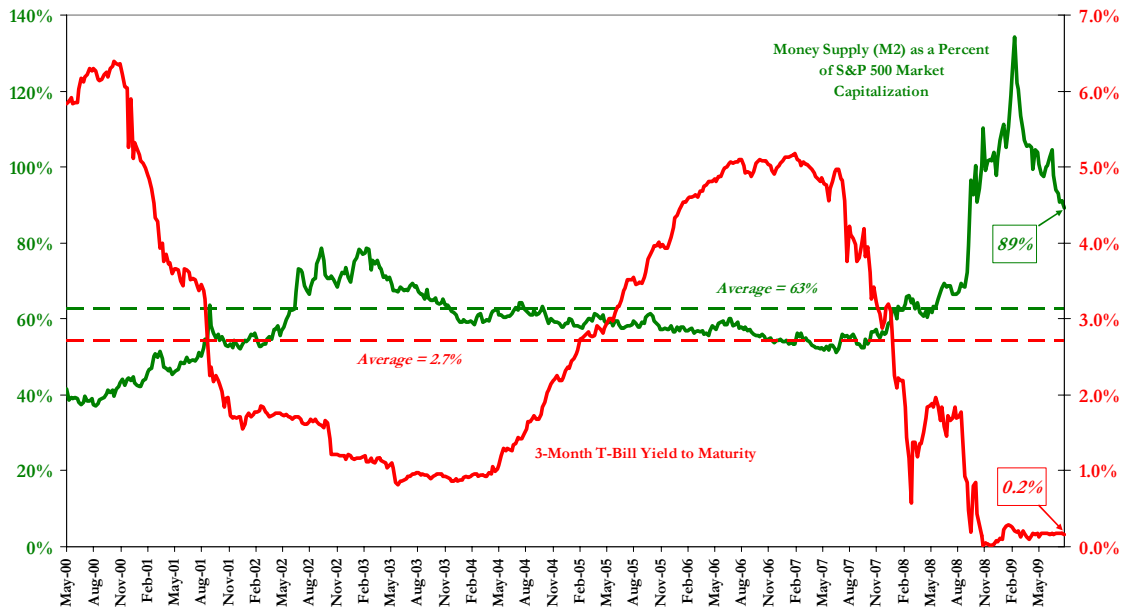
Risk aversion has driven investors to sidelines in record amounts

With this backdrop, it is understandable that aging investors are fearful about their retirement. The immediate reaction has been to shift investment funds to the sideline, out of harm's way (Exhibit III). In 2008, massive amounts of money left the stock market. In fact, judging from the

ratio of money market funds relative to stock market capitalization, investors are now substantially more protective than at any time since money market funds first became a popular investment alternative to bank savings accounts in the early 1980's.

Exhibit III

Investors' Dilemma
Cash on Sidelines (Money Supply v. Stock Market Capitalization) – Left Axis
Yields on "Risk Free" Assets (3-Month T-Bills) – Right Axis



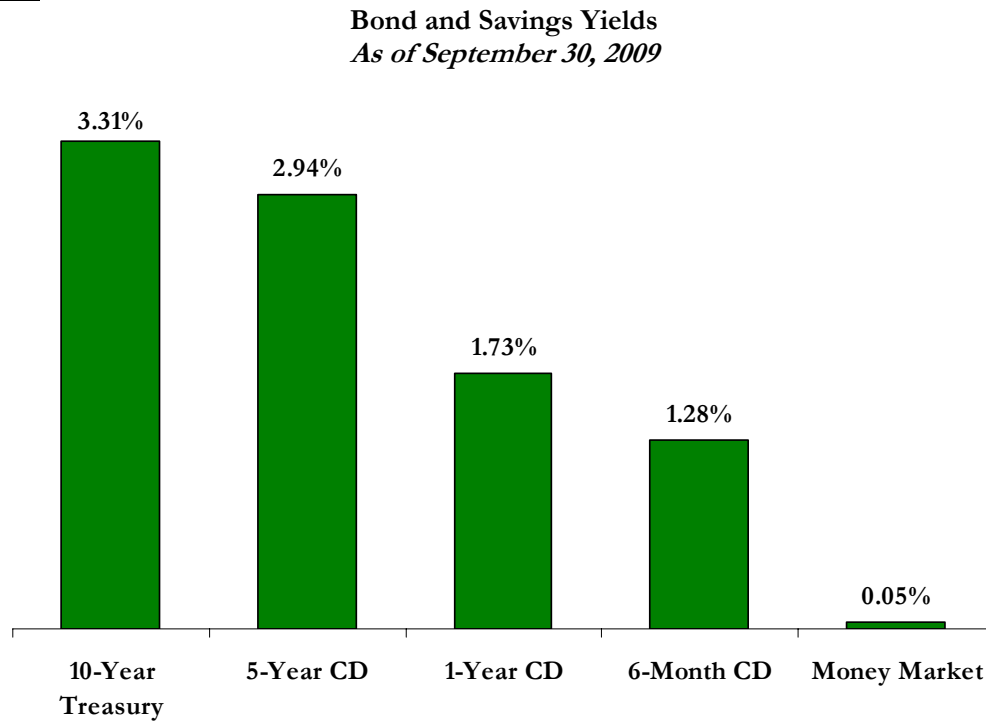
Source: Bloomberg

No risk? No yield.

Unfortunately, rates on these and other similar “risk-free” assets (CDs, savings accounts, US Treasury securities) provide virtually no return today. In fact, these securities are only risk free from the standpoint of their risk of default. Investors still assume the risks of

inflation, liquidity and changes in tax law, to name a few. For example, during the current decade, inflation has averaged approximately 2.7%. Other classes of “investment grade” fixed-income investments, risk-free or not, (Exhibit IV) are similarly “light” on yield.

Exhibit IV



Source: Bankrate.com and imoney.net.com

An alternative: dividend-paying stocks

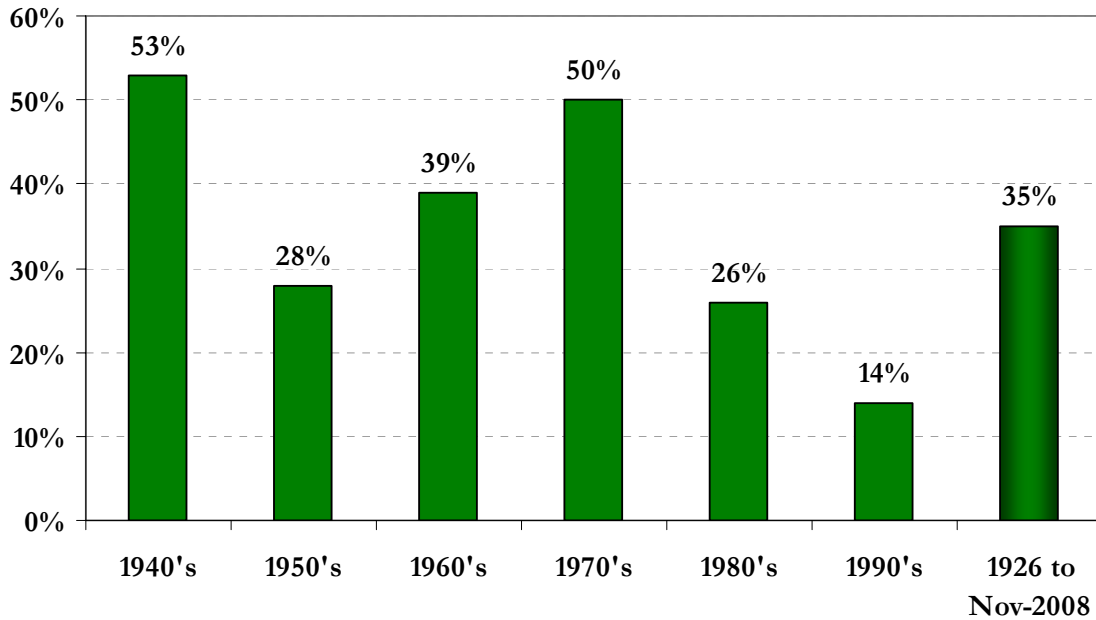
Investors are truly caught between a rock and a hard place – too fearful to venture into “riskier” assets, but dissatisfied with the returns available to them from safer investments. This new risk aversion is likely to be with us for many years, as it was in the aftermath of the Great Depression. We believe the solution to investors who want to follow a conservative path, but who also have a need for current income, is to own dividend-paying stocks.

Dividends have provided a substantial percentage of the total return to stock

investors (Exhibit V). In fact, over the past decade dividends provided all of the return to stocks as earnings collapsed and valuation multiples (a measure of investor expectations as to future earnings growth) declined. To quote a recent report from leading research firm International Strategy & Investment Group: “The current decade’s negative 40% price return demonstrates the value of dividends received. Investors owning the S&P 500 would still have earned over 11% from dividends, shrinking their returns deficit to a less painful negative 28%” (ISI: Friday, May 29, 2009).

Exhibit V

Historical Dividend Contributions to Total Equity Returns



Source: Standard & Poor's

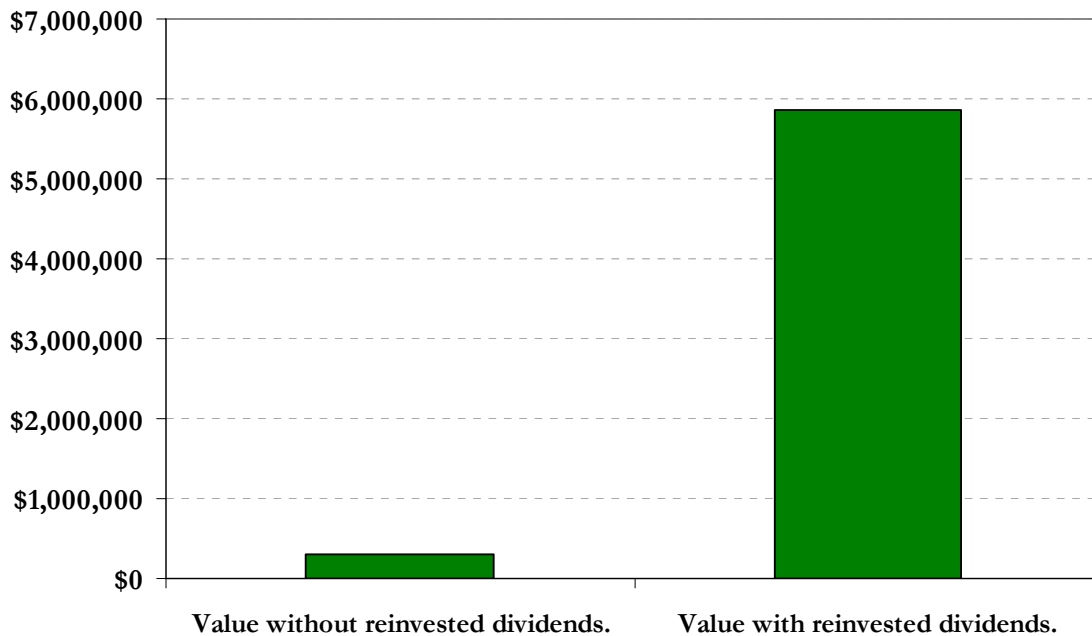
Dividend reinvestment as an avenue for compounding wealth

Dividends over the long run can have a dramatic effect on cumulative investment returns, particularly when dividends are reinvested intelligently, allowing for the compounding of invested funds. A chart borrowed from Richard Young Intelligence Report illustrates this point well (Exhibit VI). If one could have purchased a share of Coca-Cola back in 1919 for \$40 and held it through 1999, one would have made a very wise choice.

Not only has the share price risen dramatically, but in addition, Coke has paid a dividend every year since then, including through the Great Depression. The value of that share, after splits, and of the dividends received would have been \$298,218. If those dividends were reinvested in Coke stock, rather than kept in a piggy bank, the \$40 investment would have grown to \$5,866,413.

Exhibit VI

The Awesome Power of Compounding The Coca-Cola Story



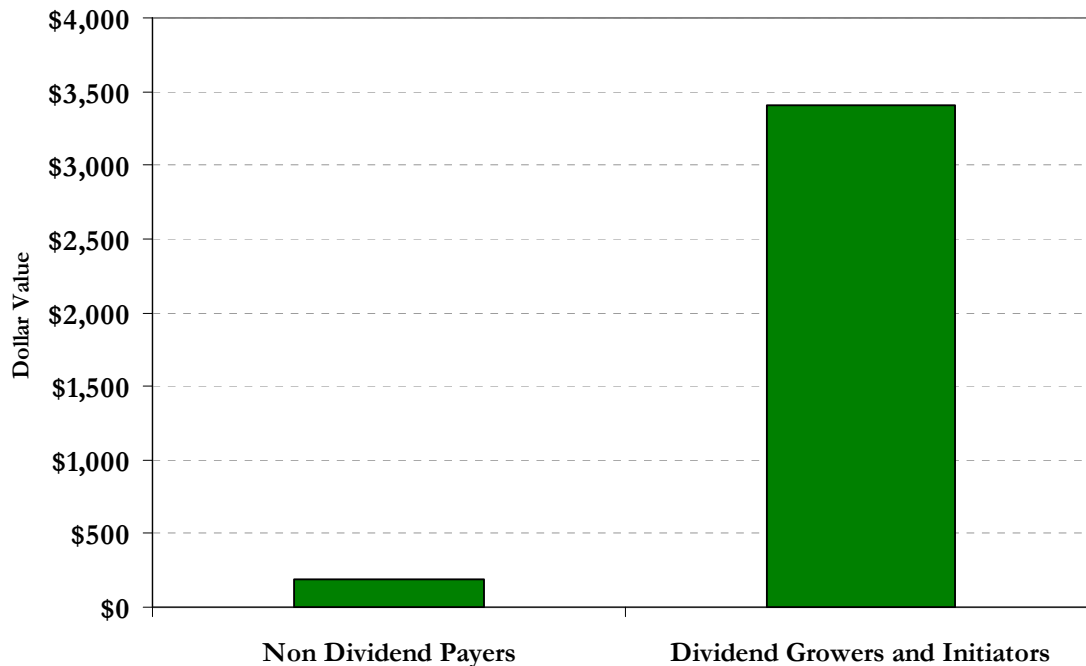
Source: Richard Young Intelligence Report

Coca-Cola is certainly not alone. Dividend paying stocks have outperformed their non-dividend-paying brethren by a substantial margin (Exhibit VII). The evidence shows that the best returns over the years are from those companies that pay and raise dividends (classified as the “Dividend Growers in the exhibit below). This is neither a rare nor temporary circumstance – rather, it holds over the

long term. The implication is this: Dividend stocks are suitable for investors beyond those who are simply seeking income from their account. In addition, the investor seeking growth through capital gains will also be well served with dividend-paying stocks. A migration of capital from the sidelines into dividend paying blue-chip stocks could fuel even greater gains over the coming years.

Exhibit VII

Dividend Growers and Initiators v. Non-Dividend Payers
Growth of \$100 from 1/31/1972 - 6/30/2008



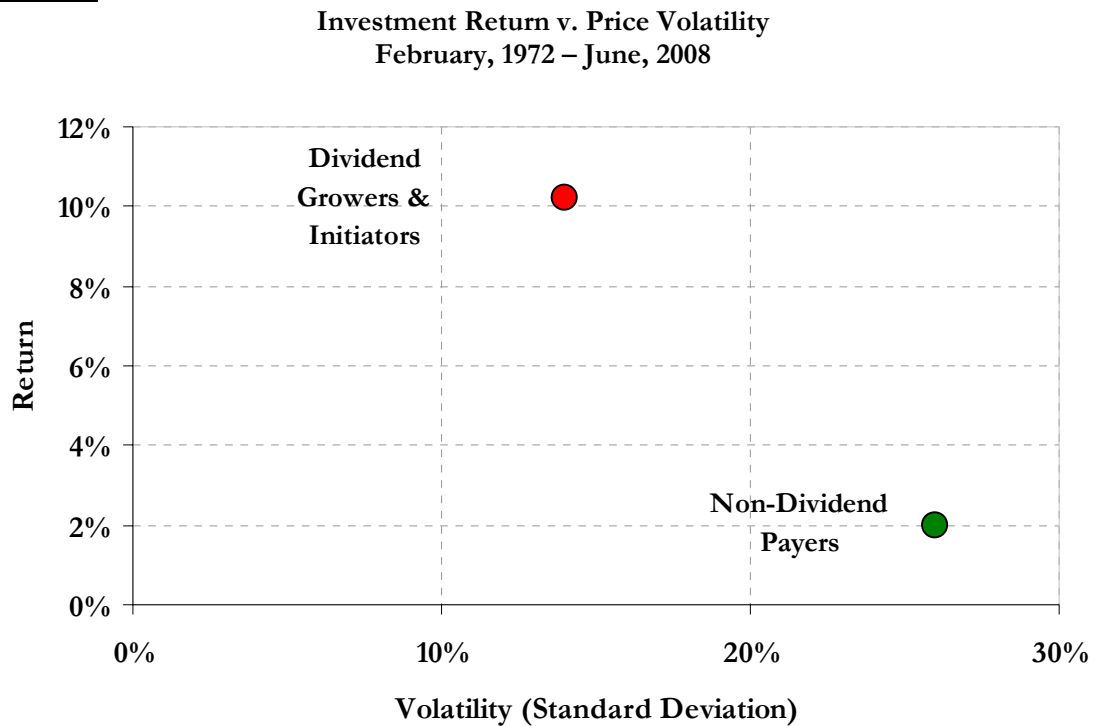
Source: Navellier Applied Research with Ned Davis Research data

Dividend payers dampen portfolio volatility

Further, dividend stocks tend to dampen portfolio volatility. Dividends are typically paid by larger, more stable and financially sound businesses. Recent data from Navellier Research (Exhibit VIII)

indicated that the “dividend growers and initiators” from the above analysis were also less volatile, as measured by standard deviation of stock price changes, while delivering higher returns.

Exhibit VIII



Source: Navellier Applied Research with Ned Davis Research data

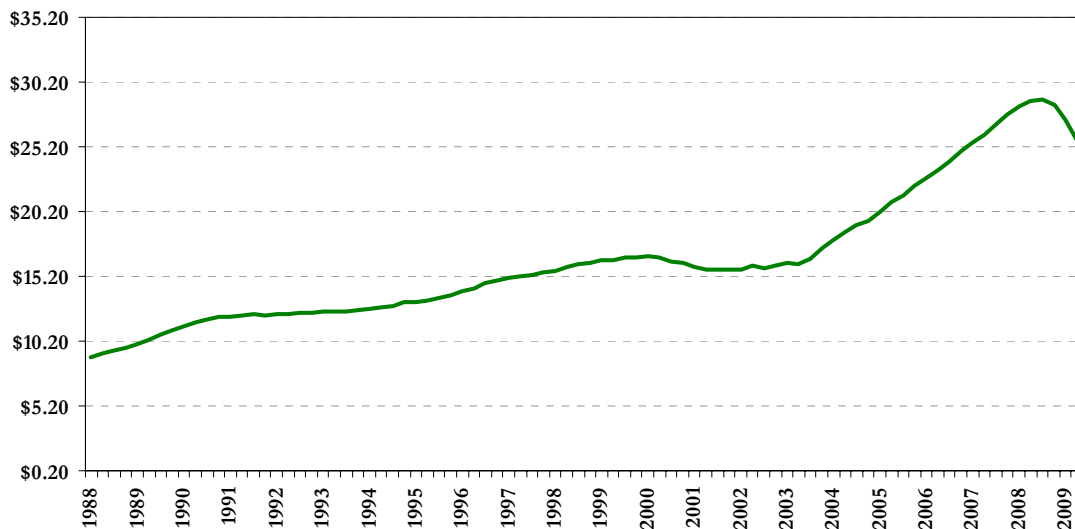
Dividend stocks can provide superior after-tax income in addition to capital gain

While bond interest payments are fixed over the life of the instrument, dividends tend to increase over time. For example, the consumer products giant Procter & Gamble has paid a dividend without interruption since its incorporation, and has increased its dividend in each of the past 52 years. The compound growth rate of its dividend over this time is in excess of 9% (the math of compounding indicates that the current dividend is more than 88x larger than the one paid 52 years ago).

Procter & Gamble is not necessarily an exception, but simply a shining example of a well managed, publicly-owned enterprise. There are many others, of course, and this has led to steady and consistent growth in dividends paid by the diverse set of companies that comprise the Standard & Poor's 500 Index. Over the period from 1988 through June, 2009, dividends paid by the S&P 500 grew at an annual rate of 5.1% (Exhibit IX)

Exhibit IX

S&P 500 Dividends



Source: Standard & Poors data

Further, dividends enjoy a tax preference. At present, the Federal tax code treats “qualified” dividends differently from income derived from other securities (holding period rules apply to determine whether dividends paid from most common stocks are considered “qualified”). Specifically, the individual

taxpayer in the upper brackets pays Federal taxes of only 15%, and lower bracket taxpayers pay are assessed only 5% on qualified dividends. This tax treatment can have a material impact when comparing the return from a dividend stock from a comparable investment in a bond, for example.

Case Study: Procter & Gamble

Consider the following alternatives which reflect current market conditions. Invest an equivalent amount over a 10-year holding period in:

- Procter & Gamble common stock at a price that promises a current dividend yield of 3.4% at the indicated rate.
- Procter & Gamble 10-year senior notes, with a coupon of 4.7%, and priced to a current yield of 4.6%.

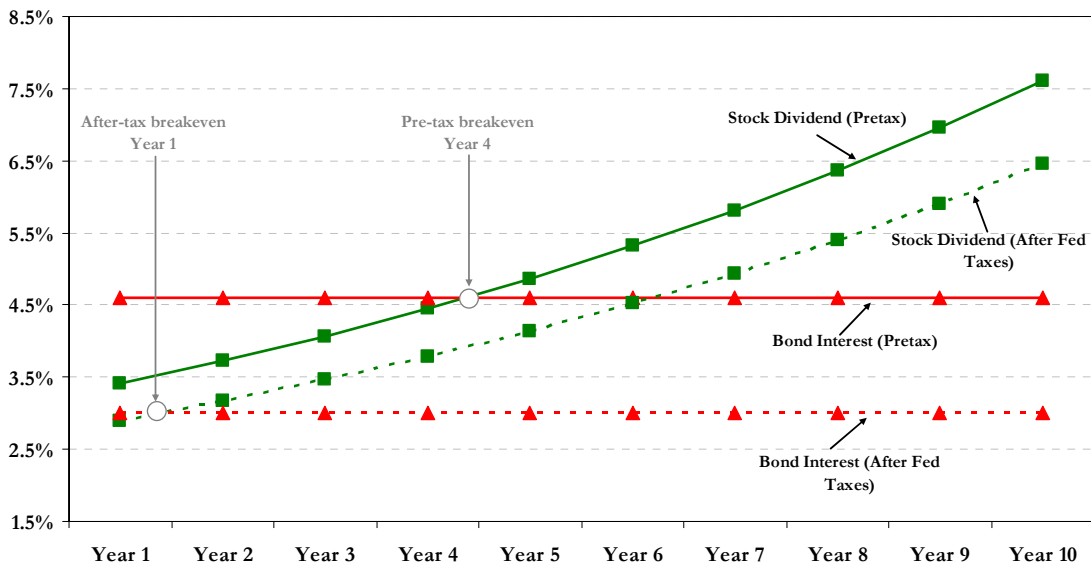
We have assumed for this exercise (the results of which are presented graphically in Exhibit X) that the amount of the dividend declared by P&G's board will grow with company earnings, and we have ignored for now the effect of capital gain (or loss) over the 10-year horizon. P&G has grown its dividend by an annual rate of 11.9% over the past 10-years but Wall Street analysts, on average, project that long-term earnings growth will be a slightly slower rate of 9.3%.

As shown in Exhibit X, under these simple assumptions, the coupons from the P&G senior notes would be higher than the dividends from the P&G common stock for the first four years. In years five and later, the dividends exceed the coupon. The *tax-exempt* investor (or individual retirement account holder) whose *only* concern is income might prefer to receive higher payouts sooner, and opt for the bond.

Taxes change the relative attractiveness of those income streams. To the *taxable* individual investor in the 35% Federal tax bracket, the after-tax yield from the stock holding is higher by the second year. Given these simple assumptions, the cumulative cash flow from dividends over a 10-year holding period would be nearly 50% greater than interest from a bond issued by the same company. Obviously, the taxable investor in need of income should prefer the P&G stock.

Exhibit X

**Procter & Gamble
Comparison of Yield from Investment in Stock versus Bond**



Risk considerations

The investor considering his or her alternatives cannot think only of the expected return from an investment. The risk must be weighed as well. Unfortunately, although returns are easy to measure and the concept is simple to grasp, risk is anything but straightforward. Precisely what is the risk from which one needs to be protected, and how is it measured? The near-term volatility of an investment is one measure of risk, but in our view, the most important consideration is the likelihood that an investment will result in the permanent loss of capital and purchasing power over time.

In the above example, given the underlying creditworthiness of P&G, we believe it is a near certainty that the bond will pay 100% of the principal owed at maturity, not a dollar more or less. Over

the life of the bond, the market price will rise and fall with changes in prevailing interest rates, investor perceptions as to the risk of default, and overall market sentiment, but the ride will be relatively smooth.

For the investor whose principal consideration is protecting against volatility risk, the P&G bond may be the best vehicle. If instead, cash flow and growth of purchasing power are the preeminent considerations, most investors will be better off with the stock. As professional stock analysts, we have great confidence that P&G's earnings will trend upward over the coming ten years (even if not in a smooth, straight line), the condition that will enable dividends to grow and shares to appreciate, providing a total return substantially in excess of a P&G bondholding.

Whom do you trust to make prudent investment decisions—Corporate America or yourself?

We believe that dividend-paying stocks are appropriate for *all classes* of investors, not just those who need the income to meet personal expenditures. Consider the growth of Procter & Gamble stock over the long term, in part because of the inexorable increase in its annual dividend payout funded by its ever-growing business. At the same time that the stock price has climbed over the years, the investor in its stock has accumulated mountains of cash from the dividends received. Receiving cash flow in an investment account bestows upon an investor a very important power—the power to choose how the cash should be re-allocated, taking that decision away

from corporate managements. This cash can be reinvested in the same security from which the dividend was paid, or in an entirely new investment, depending on the relative merits of the alternatives.

While it is hardly a new phenomenon, over the past decade much of the leadership of corporate America has demonstrated its propensity to misallocate corporate wealth by pursuing unwise acquisitions, funding excessive expansions of capacity, devising obscene management compensation packages, managements to binge with corporate wealth is too great to resist for all but the most disciplined.

We expect that those managements who did exercise discipline and prudently passed along corporate wealth to their owners in the form of a dividend, rather than participate in the above-mentioned practices, will survive the current economic malaise better than their counterparts. We also believe their shares will gain favor among the increasingly

conservative investing public. The key point is that the investor has a choice of where to place his or her wealth; the receipt of dividends allows the investor an easy way to exercise this choice, and speculating in the various asset classes—such as real estate—that caused the crisis in which we find ourselves. The temptation for

Selecting dividend paying stocks

Of course dividends don't materialize out of thin air; they must be drawn from corporate resources. It is therefore important for the investor to look beyond the dividend itself, to the financial attributes of the company paying it in order to determine whether the dividend is sustainable and likely to grow over time. Companies can draw the funds needed to pay the dividend from (among other sources) investment accounts, new borrowings, the sale of its own stock to the public, the sale of an asset, or cash currently being generated from its operations. All of these sources are legitimate, viable, and at times even optimal from a corporate finance perspective, but the best source under most conditions is the last one—the company's operating cash flow. When selecting dividend-paying stocks for our client portfolios, the key elements we review include:

- The firm's ability to generate high-quality, consistent earnings and operating cash flow (historical and projected future flows, with a focus on consistency and predictability);
- Balance sheet strength (low/manageable debt, access to external sources of cash at reasonable cost, balance sheet liquidity);
- Capital allocation practices of management and the Board (i.e., historical and expected future distribution of dividends, share repurchases, acquisitions, expansions).

This analysis enables Golub Group's investment committee to make informed judgments when building client portfolios. We will again use Procter & Gamble as a case study.

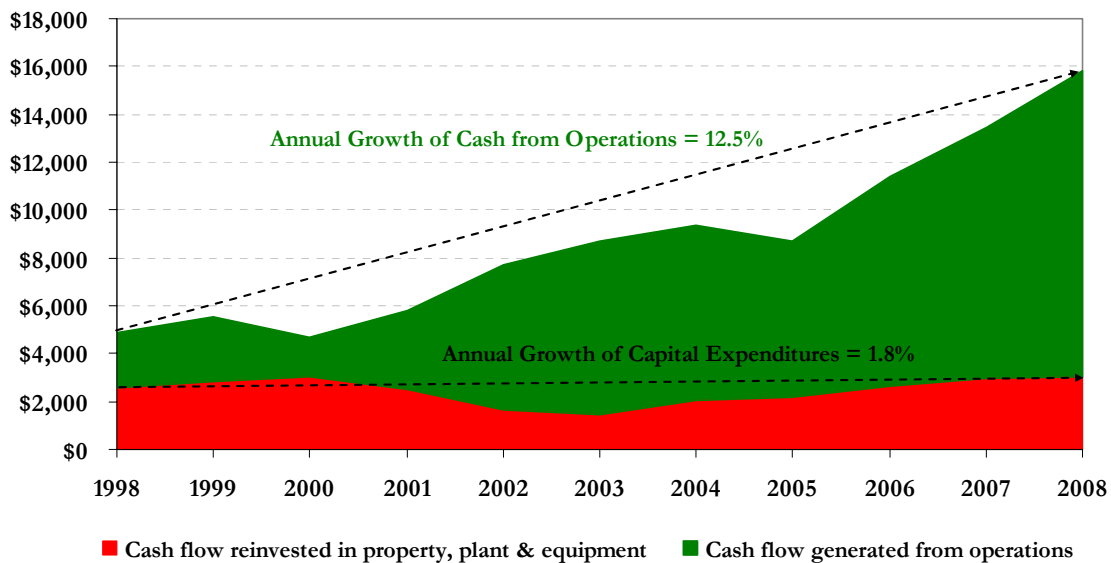
Record of growing free cash flow

First (Exhibit XI), we note that Procter & Gamble has been an extraordinarily profitable enterprise, generating net income for shareholders totaling \$68 billion over the past 10 years. Further, we note the consistency of the results (due to the nature of its business as a developer

and marketer of innovative and affordable consumer products), and the ability of P&G to receive those reported earnings in the form of cash. Cash flow from operations totaled \$96 billion over the same period (141% of earnings), and grew at a rate of 12.5% per year.

Exhibit XI

Procter & Gamble: Cash from Operations v. Capital Expenditures
(\$-millions)



Management reinvested for the future, of course, plowing \$27 billion of this cash flow back into the business to buy, for example, factories, distribution centers, equipment and information systems. As shown in the exhibit above, however, such expenditures have grown at a much slower rate than cash flow, leaving P&G with a growing surplus of cash flow over the years (the area in green represents this surplus). We call this surplus of cash flow generated from operations over the amount used for capital expenditures

free cash flow. In the case of P&G, free cash flow grew at a rate of over 18% per year. This is a record matched by few companies.

This phenomenal track record will provide us, as investors, with the context for making our own assumptions about the future for this company as we build financial projections. The track record inspires confidence as to the future strength and consistency of P&G's cash flows.

Record of financial strength and liquidity

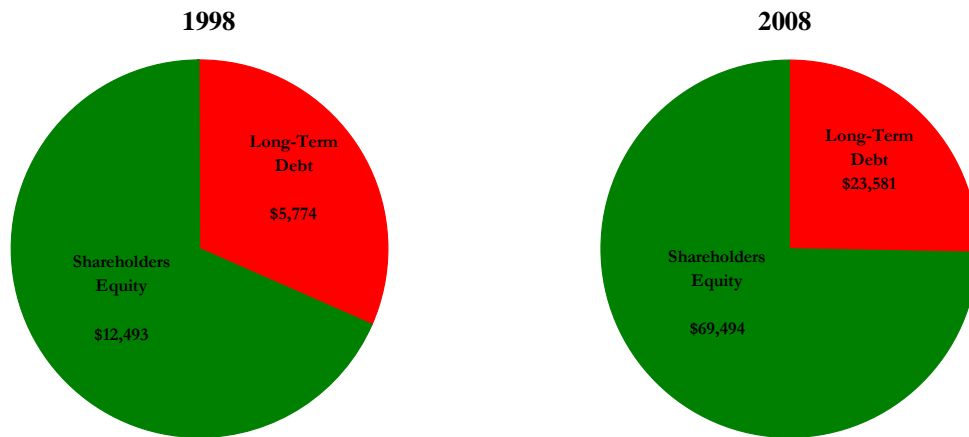
Managements who follow conservative financial policies are best able to pay a growing stream of dividends to shareholders. Loan covenants must not be breached; debt service requirements (interest and principal payments) must be manageable within the cash flow produced by the company. Maintaining high cash balances provides the liquidity needed to repay these debt obligations and fund dividends.

In our analysis of Procter & Gamble, we focus on several measures of balance sheet strength and liquidity (Exhibit XII).

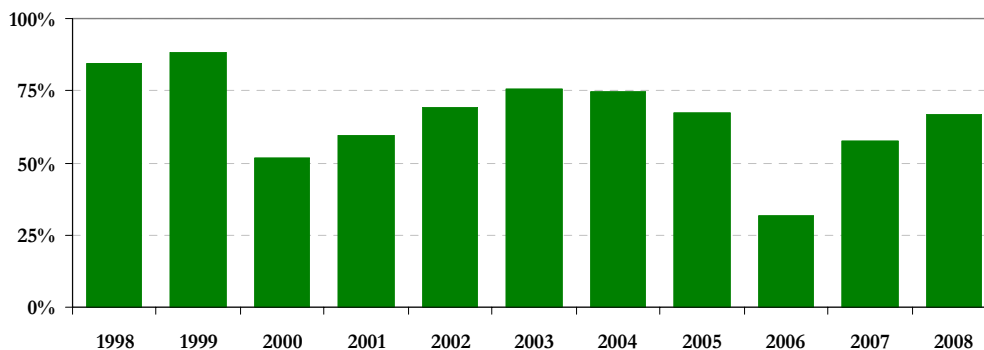
First, the company has always weighted its capital structure heavily toward “permanent” shareholders’ equity. As years have progressed, this preponderance of equity financing has only increased. Second, annual cash generated from operations has averaged 66% of all outstanding long-term debt, suggesting that management could quickly repay its indebtedness if it so chose. Finally, we note that the company has held through this period at minimum \$1.6 billion in cash and investments, providing the liquidity to quickly meet any substantial outlays.

Exhibit XII

Procter & Gamble: Measures of Financial Conservatism: 1. Low Debt in Capital Structure



2. Strong Cash from Operations Relative to Outstanding Debt



Record of prudent capital allocation decisions by management

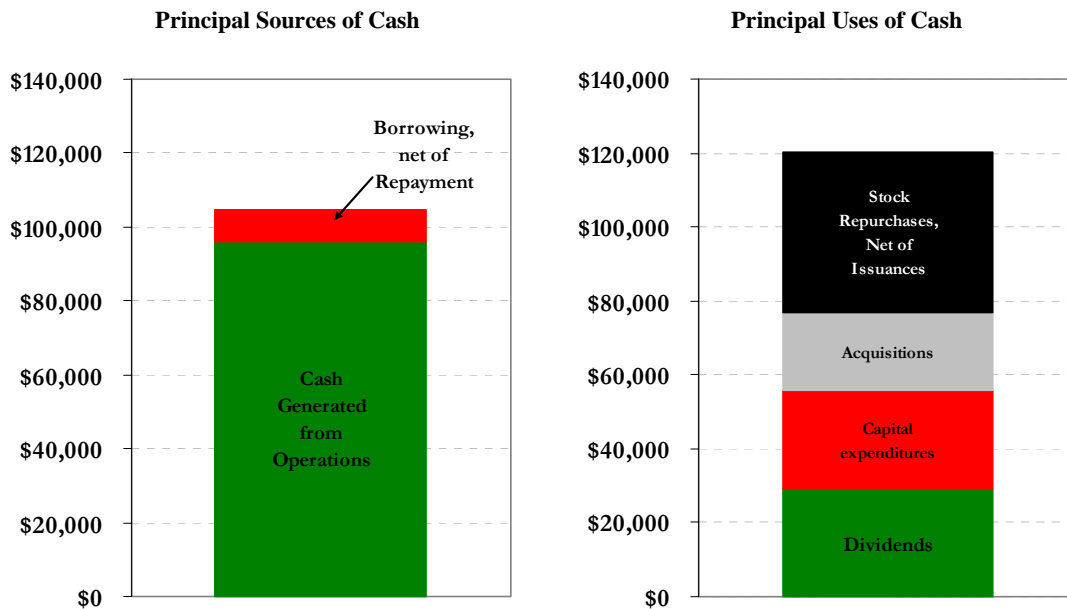
Management has broad discretion as to the use of its financial resources. An analysis of the cash flow statement contained within a company’s annual report sheds a great deal of light onto the capital allocation practices and skill of management (Exhibit XIII).

In the case of Procter & Gamble, dividends are certainly a key use of cash generated from operations. Over the period reviewed, the board of directors declared and paid \$29 billion in common shareholder dividends, using on average 42% of available free cash flow. The company also made several cash acquisitions, particularly in the period from 1998-2004. These cash acquisitions were large, but of a size that is digestible by the company. They appear to have been staged in regular intervals of two

years, allowing enough time in-between to fold the acquired businesses into P&G’s core operations (P&G’s largest acquisition—of Gillette in 2006—was funded through the issuance of P&G common stock to Gillette shareholders in exchange for their stock in Gillette). The company also spent a substantial amount of money acquiring itself, in effect, through the repurchases of its own shares. Stock repurchases such as these are quite common, and can be a very productive use of surplus cash, provided the stock presents a good value at the time of the repurchase. Additional funding for the acquisitions and stock repurchases came from additional borrowings, which totaled \$8.8 billion over the period. As noted before, the increasing debt load is easily managed by the growing cash flows of the business.

Exhibit XIII

Procter & Gamble: Principal Sources and Uses of Cash (1998-2008)
(\$-millions)



A review similar to the one presented above of P&G will expose many of the key fundamental strengths and weaknesses of any business, and shed light on its ability to offer a dividend to its shareholders. All of the necessary information to conduct the review is part of the public record, contained in annual reports and other financial disclosures. A look at the past can provide clues into the future. In the case of P&G, we see a financial juggernaut with a promising future; a company for which rewarding its shareholders with a growing dividend has been a key part of management's corporate financial strategy.

There are two other key considerations that are essential to a successful program of investing in dividend-paying common stocks. The first is *valuation*—before purchasing the stock, an investor must know that he or she is paying a fair price. Disciplined valuation work is critical to successful investing in stocks. Great businesses can be poor investments if an investor overpays to own them. The second is *diversification*—shifts in a company's fortunes and mistakes in judgment (by managements and by the investor) are virtually inevitable; a well-diversified portfolio is the first line of defense against adverse events.

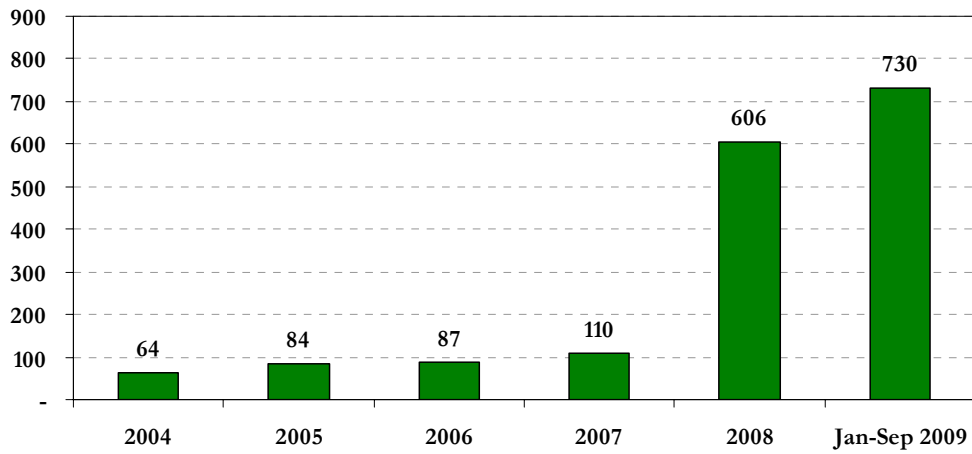
The importance of dividend sustainability

Unlike bond interest – which must be paid pursuant to a contract (the indenture) stipulating the timing and amount of coupon and which is secured by a claim on the assets of the guarantor – dividends are declared and paid at the discretion of a board of directors. They may be withheld for any reason, should the board choose to retain the cash at the company. Often-times, there is a good reason for a board to cut or eliminate a dividend, leaving stock investors without the cash flow they had expected to receive. Dividend investing requires analysis and vigilance to ensure it works to an investor's favor.

Not every company is Procter & Gamble, a well-managed multinational corporation with strong market presence in growing economies and a fortress balance sheet to support its growth. For all investments in dividend-paying stocks, proper care must be taken to ensure that the dividend is sustainable. Building a portfolio with high dividend payers is not enough, because if those dividends cannot be funded by the company, boards of directors will have no choice but to cut or eliminate them. Data about recent dividend cuts provides real evidence of this risk (Exhibit XIV, following page).

Exhibit XIV

**Announced Dividend Cuts
2004 - August, 2009**



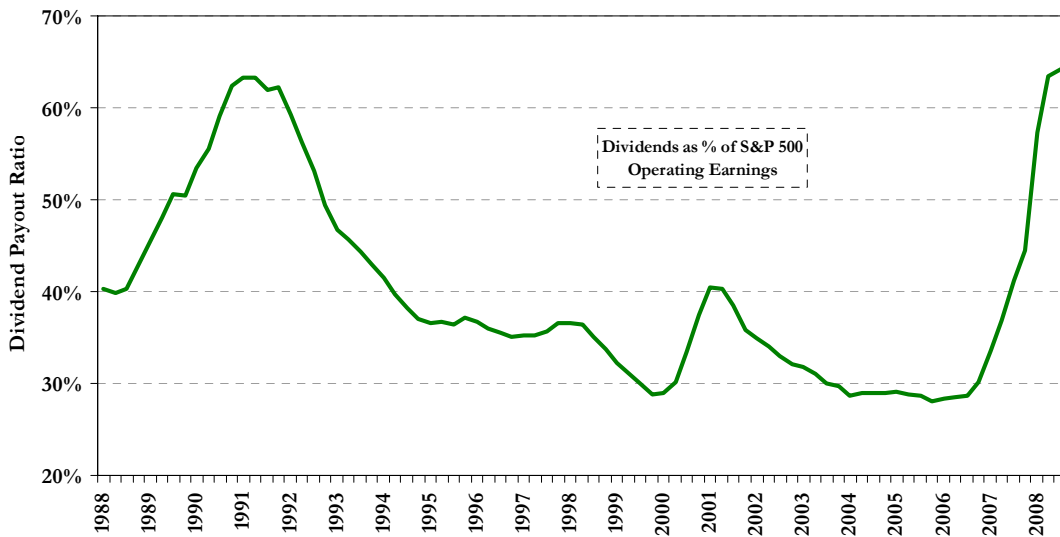
Source: Standard & Poor's Monthly Dividend Action Report

The reason for the recent bad news on dividends is fairly obvious. Managements and boards of directors can choose to retain earnings in the firm to maintain and grow the franchise, or use these earnings for other purposes, such as the repayment of debt, the repurchase of shares or the payment of dividends. In recent years

(Exhibit XV), managements have typically paid out between 30% and 40% of company earnings to shareholders in the form of a dividend. As earnings collapsed in 2008, the payout ratio grew to over 57%, forcing many managements to weigh dividend cuts to preserve capital.

Exhibit XV

S&P 500 Dividend Payout Ratio



Source: Standard & Poor's

Not all companies suffered the same fate. The constant challenge for the dividend investor is to select those businesses that can sustain their dividends, and ideally, find those that have the capacity to grow them. The key attributes of a sustainable dividend payer are those we explored with Procter & Gamble, including:

- Strong and consistent free cash flow from operations;
- Manageable balance sheet leverage and financial liquidity; and
- Sound and consistent management practices as to capital allocation.

The good news is that these attributes are largely measurable by the diligent analyst, using information that is readily available. Neither inside information nor market timing skills are required to make reasonable judgments. Rather, the analyst needs to employ business and market perspective drawn from years of experience, a fair amount of common sense, and patience.

Conclusion

Dividend paying stocks, particularly those that have a record of increasing their payouts, have outperformed their non-dividend-paying brethren by a substantial margin over the long term, making them suitable for investors seeking capital gains as well as those seeking income. In addition to share performance, investors will favor these securities for their lower relative volatility, and for the strength and security of their underlying businesses.

At Golub Group we employ our decades of experience in the analysis of businesses and investment in securities to uncover the dividend growers and sustainers, with the objective of delivering great value to individuals coping with retirement and to all others who come to us with their trust.

We feel our job will be easier over the next several years, whether our client is seeking income or capital appreciation, as wealth migrates from the sidelines into precisely the kind of securities we favor.

We believe that investors who take the lead in this migration will be rewarded with both income and capital gain well beyond what is available from cash and other alternatives, without subjecting themselves to outsized risk. The retirement-aged investor will then have a far better chance of maintaining a standard of living while preserving purchasing power for future years, and the more aggressive investor will improve the probability of achieving the consistent compounding of his or her wealth.

Golub Group's investment advisory services

Golub Group provides investment advisory services to families, individuals and small institutions. Our principals have decades of experience building and managing portfolios of stocks, bonds and other marketable securities. We are value investors who believe that a disciplined analysis of markets, the economy and individual companies, and attention to quality, valuation, diversification and patience can yield exceptional investment results for our clients. We believe that our clients who are approaching retirement need Golub Group to come through for them in four respects, which we call Golub Group's Four Pillars of client success:

- **Investment Performance:** To ensure a comfortable retirement, Golub Group must actively and competently manage our clients' wealth, and generate returns that exceed both inflation and the need for cash distributions.
- **Retirement Planning:** Golub Group must assist clients in properly designing an appropriate investment strategy that considers their needs over a multi-year period, as can be determined through planning and cash flow modeling.
- **Sustainable Income:** Golub Group must serve its clients by investing in a way that produces consistent and predictable streams of cash flow, which will be disbursed or reinvested into the account.
- **Thoughtful Service:** Golub Group owes its clients the attentive and courteous service they deserve from a well-informed financial specialist.

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