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The Importance of Dividends in a Low-Return Environment

By John Mauldin

In This Issue

Successful investing for the remainder of this decade will mean doing things differently from what people did so profitably in the 1980s and 1990s and from what Wall Street is still telling people to do today.

The rules of successful income investing have changed.

We started the last bull market, in 1980, with high interest rates, very high inflation, and low stock market valuations. All the elements were in place to launch the greatest bull market in history.

The environment now is just the opposite. Stock market valuations are still relatively high, and interest rates are close to zero.

Equity returns have been unrewarding over the past decade; and worse, investors have been subjected to painful drawdowns and wild volatility.

In addition, gold is volatile, as is the dollar against other currencies; and the twin deficits of trade and government debt stare us in the face.

This is a very dangerous time for investors and an extremely unrewarding environment for savers and long-term bond holders. It is, however, a great time for *Yield Shark* income investors.

Long-term bonds? Tying up your money for a decade (or longer) at low, single-digit yields may be one of the most dangerous investments you can make today.

Bank certificates of deposit (CDs)? Your banker would love to lockup your money for a couple years at 1% or 2% (if he is feeling generous).

Absent some new piece of data that I can't see now, we are in for lower bond yields in the US. Rates are going lower and are going to stay low for longer than any of us can imagine. I think I can see out a year or so(in concert with Bernanke), and it looks like continued low rates and deflation.

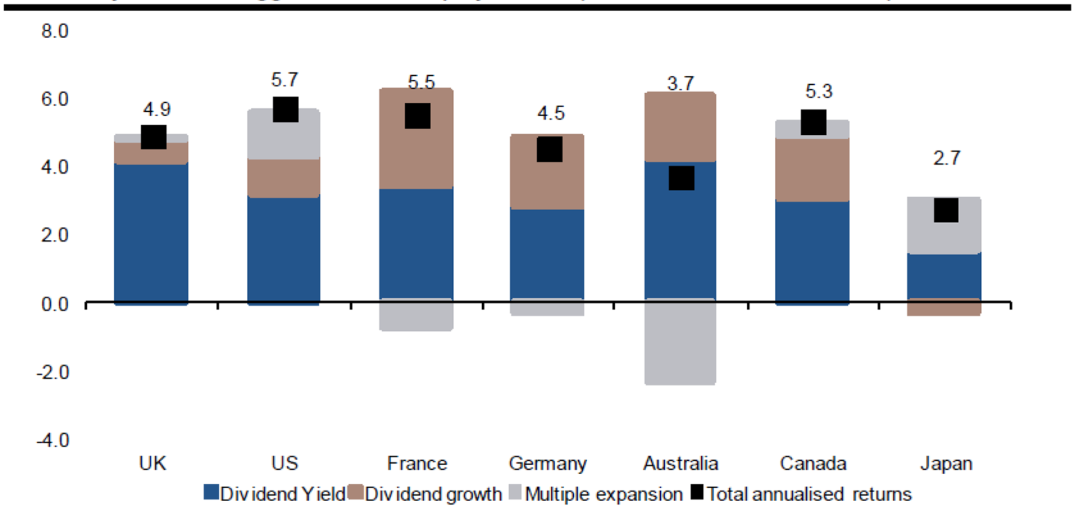
The new and correct way of investing for income today requires putting together a collection of assets such as dividend-paying stocks, bonds, mutual funds, ETFs, and real estate that generates various levels of income at various levels of risk.

> *"The only thing that gives me pleasure is to see my dividend coming in."*
>
> – John D. Rockefeller

The cornerstone of that blend should be secure stocks that pay generous dividends.

This may surprise you, but the bulk of stock market returns since the 1970s have come from dividends and dividend increases.

Dividend yield is the biggest driver of equity returns (real total returns since 1970)



Source: SG Cross Asset Research, MSCI

In God We Trust, All Others Pay Cash

It is hard to fathom, but prior to the 1930s, companies were not required to disclose their financial details. Investors were left largely in the dark and often got stuck with what my father called "a pig in a poke."

Back then, the payment of dividends was one of the few verifications of financial health.

A stock that pays no dividend requires an investor to find a greater fool– someone who is willing to pay more for the stock than he or she did.

With a dividend-paying company, though, investors need not rely solely on a "greater fool" to generate a capital gain but can factor the stream of dividends into their analysis of the company.

One of the most effective ways for a company to communicate its financial well-being is to send its shareholders a check, otherwise known as a dividend.

Dividends are the payments of a company's hard-earned profits to its owners. A company's ability to continually pay dividends provides concrete evidence that the company is performing well. And accounting malfeasance is much harder if a large transfer of cash is going to shareholders on a regular basis.

With the Securities & Exchange Act of 1934, new rules of financial transparency forced publicly traded companies to disclose key financial details. Nonetheless, dividends remain a worthwhile yardstick of a company's performance and prospects.

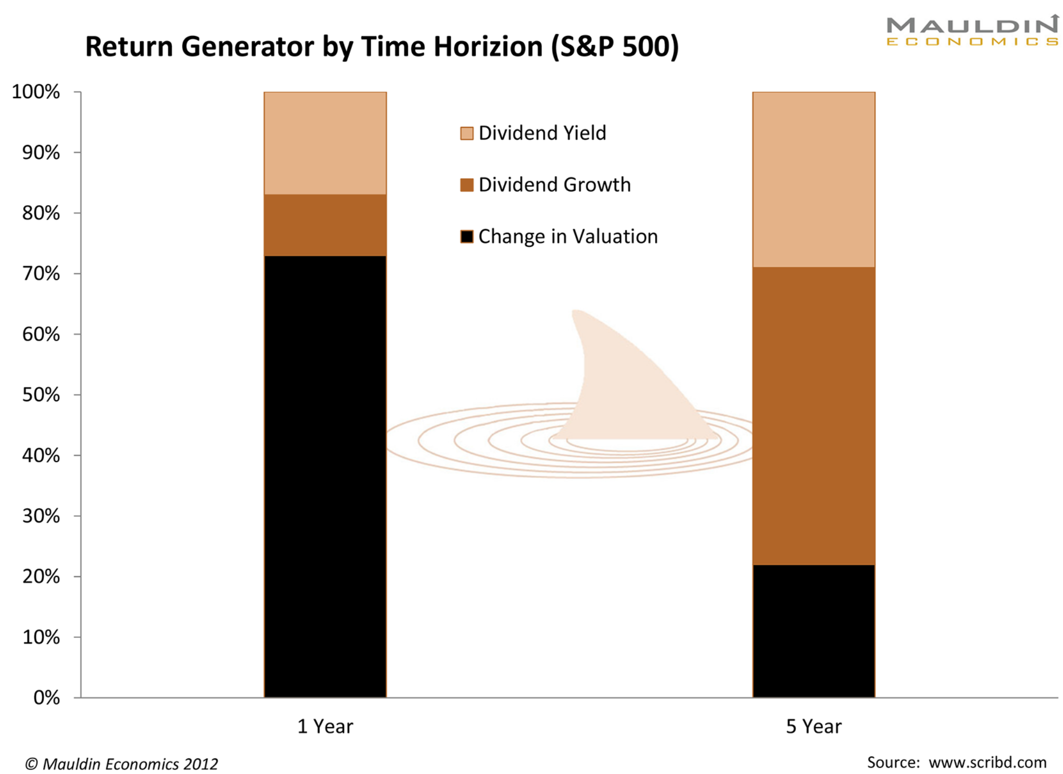
I'm not saying that non-dividend-paying companies are bad investments. Many companies need to retain cash to grow their businesses, but as an income investor, you need *cash* to pay your bills.

The Crucial Role of Dividends

As I mentioned above, dividends have provided a greater share of the stock market's total return, not only recently but also over the very long term.

Going back to 1871, on a year-by-year time horizon, nearly 75% of stock market returns have been generated by ups and downs of the market.

However, as the time horizon is extended, the direction of the stock market loses its importance and dividends become a more important contributor. For example, on a five-year time horizon, dividend yield and dividend growth account for almost 80% of the return.



John Bogle, of Vanguard fame, has an even higher opinion of dividends. Bogle calculates that "over the past 81 years… reinvested dividend income accounted for approximately 95% of the compound long-term return earned by the companies in the S&P 500."

FACT: Dividends make up the lion's share of an investor's total return.

Contrary to what you may think, the wrong way to invest in the stock market is to hope for big price gains. Instead, look for the steady accumulation of dividends.

Over the last eight decades, ending 2010, dividends contributed 44% of S&P 500 total returns, according to Fidelity Investments. And that includes a long, profitable stretch of fantastic stock market returns in the 1980s and 1990s.

During the '80s and '90s, stocks were appreciating so rapidly that dividends were regarded as unimportant. In fact, a company's decision to pay out dividends was often seen as a sign that it had run out of opportunities to invest for future growth!

The 1970s, when returns averaged 5.9% a year, was a more normal decade, and dividends contributed 71% of that 5.9% average annual return.

The case for dividends gets even more compelling when you factor in inflation. Then dividends contribute more than 80% of the real return (return above inflation).

Decade	Price Appreciation	Dividends	Total Return
1930s	-5.26%	5.59%	0.33%
1940s	2.98%	5.95%	8.93%
1950s	13.57%	5.63%	19.20%
1960s	4.39%	3.33%	7.72%
1970s	1.60%	4.12%	5.72%
1980s	12.58%	4.77%	17.35%
1990s	15.31%	2.82%	18.13%
2000s	-2.72%	1.76%	-0.96%

Safety and Stability

I am reminded of the times when I told my children to clean their rooms before they went out to play and was cheerfully told, "I did," as they poured out the door, only to have Dad find that they'd stuffed all the detritus that was on their floors into the closets, drawers, and under the bed. The appearance was of order and calm, while in the shadows and cubbyholes lurked the sad reality.

Dividends are a crucial insurance policy against the sad reality of inevitable bear markets.

A *Wall Street Journal* article from September 15, 2011, titled "The Dividend as a Bulwark Against Global Economic Uncertainty, "showed that dividend-paying stocks had returned 8.92% on average since 1982, compared with just 1.83% for non-dividend-payers.

Wharton Business School professor Jeremy Siegel came to a similar conclusion in a 2010 article titled "Yielding to the Allure of Dividends," where he praised the performance of dividend-paying stocks during the 1929 market crash.

"Investors unlucky enough to get in at the peak (and hang on) would have had to wait about 25 years for prices to make up their losses. Following the strategy of reinvesting dividends would have shortened the wait by roughly 10 years."

> *By the way, this is the same Professor Siegel who published a well-known study that showed that, throughout history, roughly three-quarters of the real return from the stock market came from dividends, with only one-quarter from capital gains.*

That Was Then. What About Now?

Yeah, yeah, yeah, what's the Great Depression have to do with investing today, some of you skeptics may ask.

Times have certainly changed, but the importance of dividends has not.

Since 2000, the companies in the Dow Jones Industrial Average have increased dividends by an average of 7.07% per year, the S&P 500 Index companies by 5.46%, and the NASDAQ Index companies by 45.38%.

That big jump in NASDAQ dividends may surprise you, but dozens of technology companies, including Apple and Microsoft, have initiated dividend programs.

FACT: The technology sector is now the 2nd largest dividend-paying sector in the United States.

Clearly, the importance of dividends cannot be overstated, and that is why I hope you'll pay particular attention to the two new investments my *Yield Shark* research team will recommend this month. Now here they are.

John Mauldin

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Best of Both Worlds Portfolio: Phillip Morris International

We aren't smokers, but we recognize the harm cigarettes have caused. And some people are unwilling to invest in tobacco stocks, good investment or not. If you want to flip to our next high-yield recommendation, thatis completely understandable.

However, the dynamism and profitability of the tobacco industry, and Phillip Morris in particular, are regularly praised by many of the experts in my network of brilliant investors; and that's why PM is this month's Best of Both Worlds recommendation.

Our International Income Portfolio pick is a Norwegian stock, Yara International, that few Americans have ever heard of. But don't let this seeming anonymity bother you.

My research team is constantly on the lookout for undiscovered opportunities. Plus, Yara has been in business for over 100 years, is a multinational giant in the fertilizer industry, and is profiting from rising global demand for agricultural products.

Everybody has heard of the Marlboro Man, but a lot of people hate cigarettes. Nevertheless, there is big, big money in tobacco, and Philip Morris International is simply one of the best stocks in the world.

Phillip Morris (NYSE:PM) is the lucrative owner of seven of the top 15 cigarette brands in the world, including the #1, Marlboro. Marlboro has beenthe unquestioned top cigarette brand in the world for the last 40 years. PM sold over 300 billion Marlboro cigarettes in 2011, more than the next two largest cigarette brands combined.

PM's other top brands are L&M, Fortune, Bond Street, Parliament, Philip Morris, Chesterfield, Sampoerna, Lark, and Dji Sam Soe.

All told, PM sold almost 1 *trillion* cigarettes last year.

Phillip Morris is the second-largest tobacco company in the world (after government-controlled China National Tobacco), and its history stretches back into the 1800s, but it isn't the company that it used to be.

The Phillip Morris of old was called Altria and had several divisions: tobacco, food (Kraft), and alcohol (SAB Miller); but the company chopped itself up into separate corporations.

Altria sold off its beer unit, spun off its Kraft (KFT) division as a standalone company, and split the cigarette division into two companies in 2008: Phillip Morris USA, which retained the name Altria (MO), and Phillip Morris International (PM).

> *I'll tell you why I like the cigarette business. It cost a penny to make.*
> *Sell it for a dollar.*
> *It's addictive. And there's a fantastic brand loyalty.*
> – Warren Buffett

Altria controls the US market, while PM is everything else and therefore does100% of its business outside of the US. That international focus is a big positive, because the US tobacco industry has been dogged by litigation for years. However, the rest of the world doesn't share the US's it's-not-my-fault mentality.

Nobody questions that smoking is bad for you, but the rest of the world thinks the person responsible for lung cancer is the person who voluntarily puts the cigarette in their mouth. PM simply doesn't have the same litigation eating at its profits that Altria does.

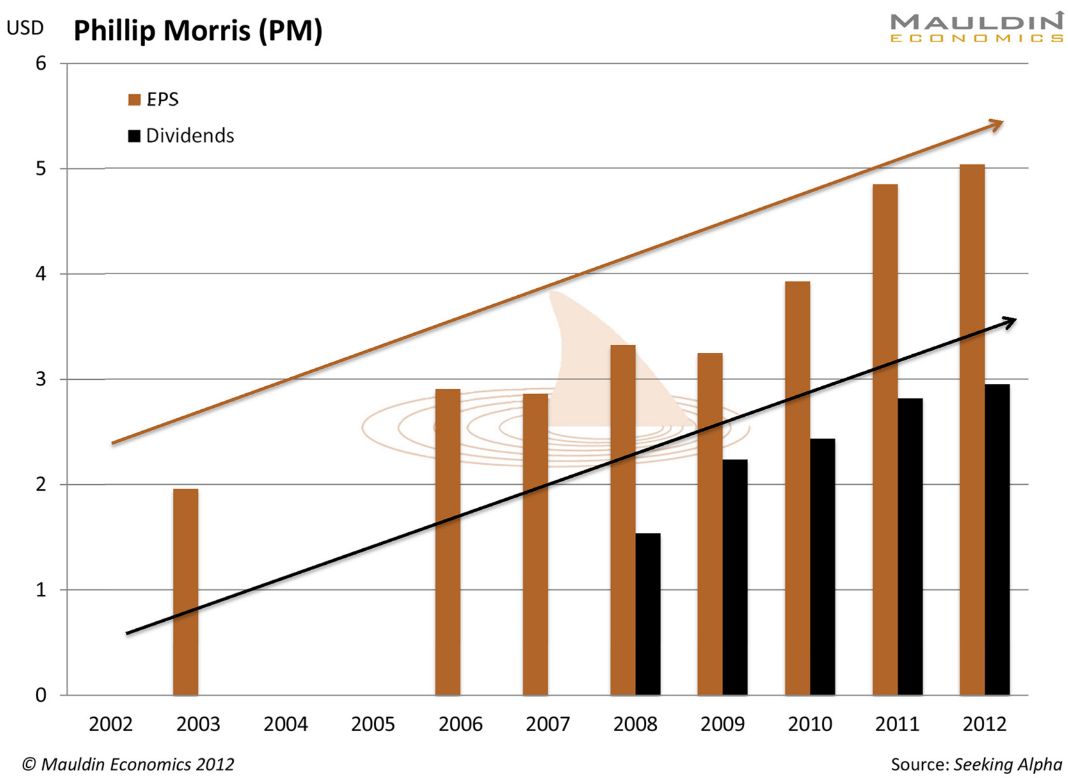
> *"Those who don't smoke and drink aren't real men."*
>
> Chinese saying

There are many reasons to include PM in your portfolio.

BOOMING Sales and Profits: Last year, Philip Morris International made $4.85 a share in profits, which was a 23% increase from the prior year.

In 2011, PM pulled in:

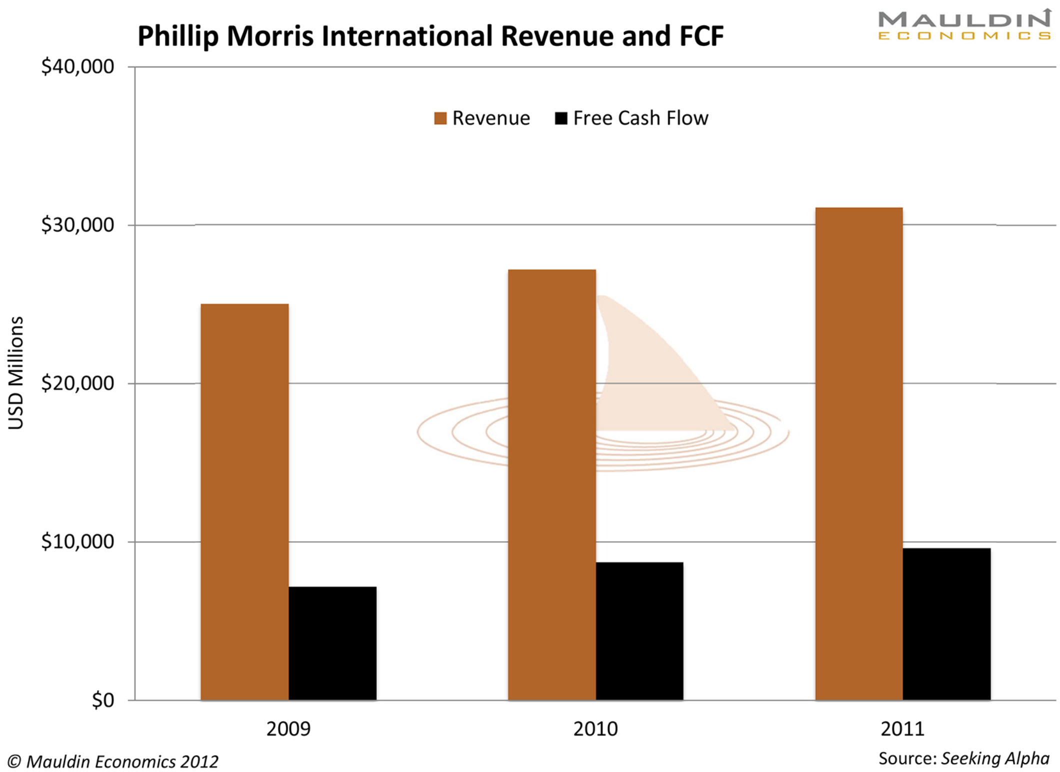
- $10.7 billion from Asia,
- $9.2 billion from Europe,
- $7.9 billion from the Middle East,
- $3.3 billion from Latin America and Canada.



2012 is looking even better. In the most recent quarter, PM pulled in $7.45 billion of sales, which was well above the $7.21 billion forecast and 9.7% higher than the same period last year.

Profit growth was even stronger at$1.27 EPS, an impressive 18% higher than the previous year.

Looking forward, PM is expected to generate $32 billion of sales and $5.30 per share of profits.



Those are impressive numbers, but they are simply par for the course for this steady, all-weather superstar of a stock.

Speaking of All-Weather...

One of the reasons PM is doing so well in spite of the global slowdown is that the tobacco business is largely unaffected by economic slowdowns or rising prices. Economists refer to that phenomenon as" inelastic demand," while the Wall Street crowd characterizes the tobacco industry as "defensive."

Cigarettes are addictive, and it seems that smokers keep on smoking no matter what is going on economically.

Surprising Asian Cigarette Habits

- ✓ Offered like a handshake during social and business introductions
- ✓ Commonly given as gifts for weddings, holidays, and to business associates
- ✓ Patients give cigarettes as gifts to their doctors.
- ✓ Offered to guests next to snacks and drinks at parties
- ✓ Left as offerings on the graves of deceased smokers
- ✓ Given to police when pulled over for driving violations
- ✓ People smoke and eat at the same time, with chopsticks in one hand and a cigarette in the other.
- ✓ Business deals are often sealed with a handshake and a carton of cigarettes

Get this: In the first quarter of 2012, $369 million of PM's$7.45 billion of revenue was from higher cigarette prices.

Plus, PM Is Profiting from the Falling Dollar

PM is an American company, but it earns 100% of its revenue from outside the US. That means that it enjoys a boost in those international sales as the dollar falls.

It doesn't matter whether you are selling jet airplanes, bulldozers, or cigarettes, a falling dollar makes your products cheaper.

We expect the US dollar to continue to fall, and PM is an effective way to profit from the decline.

Love These Numbers

There are a lot of numbers to love withPhillip Morris International:

- ✓ PM has $3.6 *billion* in cash in the bank.
- ✓ Sells for 14 times 2012 earnings
- ✓ Generated over $8 billion in free cash flow in 2011 and $1.7 billion of free cash flow in just the first 90 days of 2012
- ✓ PMI spent $1.5 billion in the last quarter to buy back 18.1 million shares. Since its inception in 2008, PM has bought back 432 million shares, which is more than 19% of its stock.PM plans to spend an additional $6 billion in 2012 on stock buybacks.

Cash Cow of Dividends

Of course, PM pays a juicy dividend out of those tremendous profits and the free cash flows it generates.

During 2009, 2010, and 2011, Philip Morris International generated about $25.5 billion in free cash flows.

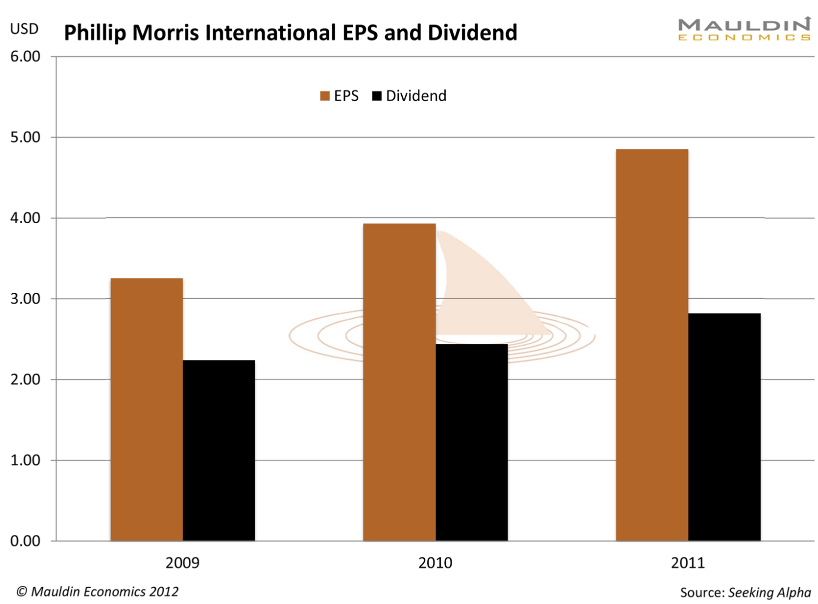
Over that period, the company paid out $13.5 billion in dividends.

Prices

Date	Open	High	Low	Close	Volume	Adj Close*
Mar 27, 2012	0.77 Dividend					
Dec 20, 2011	0.77 Dividend					
Sep 23, 2011	0.77 Dividend					
Jun 21, 2011	0.64 Dividend					
Mar 22, 2011	0.64 Dividend					
Dec 21, 2010	0.64 Dividend					
Sep 22, 2010	0.64 Dividend					
Jun 22, 2010	0.58 Dividend					
Mar 23, 2010	0.58 Dividend					
Dec 23, 2009	0.58 Dividend					
Sep 24, 2009	0.58 Dividend					
Jun 22, 2009	0.54 Dividend					
Mar 23, 2009	0.54 Dividend					
Dec 23, 2008	0.54 Dividend					
Sep 11, 2008	0.54 Dividend					
Jun 26, 2008	0.46 Dividend					

Dividend growth is extremely impressive. Since 2008, PM has increased its dividend by an average of 14% a year, from $1.84 a share in 2008, to $2.56 in 2010, to $3.08 today.

The current dividend of$3.08 a share translates into a 3.7% yield. The payout ratio from earnings is currently around 60%.



You can look long and hard, but there are very, very few companies that offer the combination of (a) strong, steady sales and profit growth; (b) a reliable, high, and growing dividend; and (c) the defensive downside protection that the tobacco industry provides.

Simply put, we believe that Phillip Morris International should be a cornerstone of every income investor's portfolio. Here's what to do:

> **Assuming a $100,000 portfolio, BUY 50 shares of Phillip Morris International, symbol PM, at the market. Place a protective stop to sell ALL your shares at $67.**

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International Income Portfolio:
Food as a Ripe Investment

Few investors think of Norway as a place to look for investment opportunities, but the Norwegian economy is prosperous and highly diversified, with companies that deserve your consideration.

Norway is a capitalist economy, but the government owns large stakes in corporations in key sectors, including energy.

Those energy riches have made Norway the second-largest natural gas exporter and sixth-largest oil exporter in the world. Energy is Norway's largest export and accounts for 20% of the government's total revenues.

High prices for its natural resources have allowed Norway to accumulate billions in financial reserves; but instead of spending those riches on entitlements, Norway passed legislation that required oil revenue to go straight into its sovereign wealth fund, which is one of the largest in the world, with $500 billion.

The national currency is the krone, which is considered extremely stable and safe by most.

Lastly, Norway opted to stay out of the European Union, which has helped it to largely avoid infection from the European sovereign debt crisis.

In short, Norway is a fantastic place to invest your money during these troubled times. The question is, in what?

Our top pick is Yara International, the largest fertilizer company in the world.

Established as Norsk Hydro in 1905, it changed its name to Yara International in 2004.

Yara is the largest producer of ammonia, nitrates, and fertilizer in the world. In fact, Yara supplies more than 25% of the world's supply of ammonia.

Most of us know ammonia because of its pungent odor, but 80% of ammonia is used for fertilizer. It has many other uses, too:

- Explosives
- Surface cleaners and oven cleaners
- Industrial refrigeration
- Used to scrub sulfur dioxide from the fossil fuels burned in power plants
- Animal feed, as an antimicrobial
- Textiles

Yara has production and sales operations on every continent, and has two primary divisions:

Agriculture: Yara produces a variety of fertilizers, from single-nutrient fertilizers to complex compounds and micronutrients for feeding plants. Yara is a global leader in ammonium nitrate and specialty fertilizers.

Industrial Solutions: Yara creates chemicals that are primarily used for water treatment and air-pollution management, including NO_X abatement solutions for industrial plants, vehicles, and vessels.

Fatten Up Your Portfolio with Agricultural Profits

The long-term dynamics of the global demand for food are a very good reason to own Yara International.

According to Oxfam International, an international humanitarian relief organization, the price of food is expected to double by 2030, as demand outpaces production capacity.

Says Oxfam, "The food system is buckling under intense pressure from climate change, ecological degradation, population growth, rising energy prices, rising demand for meat and dairy products, and competition for land from biofuels, industry, and urbanization. Feeding the world will get harder still."

According to the United Nations, the world's population hit seven billion in October 2011 and is expected to hit eight billion by 2027.

Eight billion is a lot of mouths to feed, but the amount of food that every human is consuming is also increasing. The average person currently consumes about 2,600 calories a day, but that number is projected to climb to 3,000 by 2030.

That may not sound like much, but it becomes a mammoth number when multiplied by billions of people. In terms of calories, our total daily caloric intake is going to increase from 17.1 trillion calories to 24.6 trillion.

TAX ALERT: Norway withholds tax on dividends at the rate of 15% for nonresident investors. An individual investor can file for a tax credit on US Form 1040 if the shares are held in a regular brokerage account. Amounts up to $300 ($600 for joint returns) can be claimed directly on the 1040. Amounts greater than that will create a little extra paperwork (Form 1116).

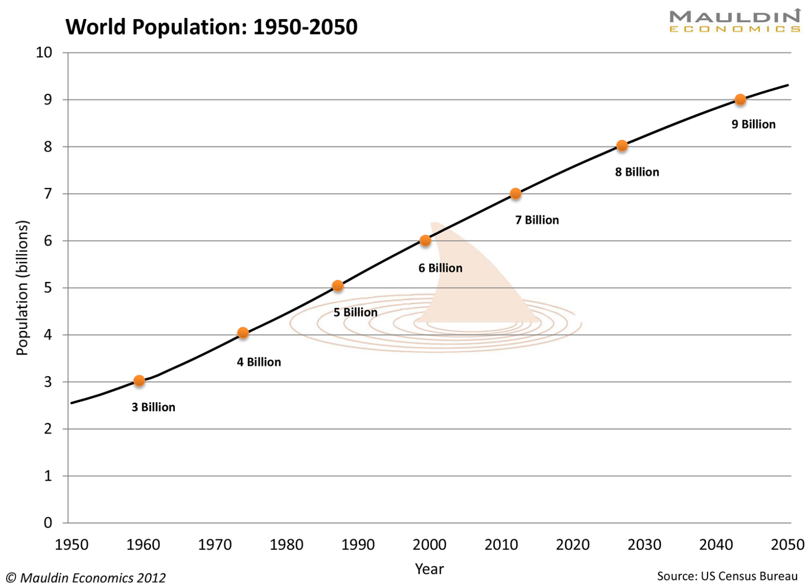
WARNING: If the shares are held in a tax-deferred account like an IRA or 401(k), then there is no mechanism to recover the withheld foreign tax and it is lost, thereby reducing the effective dividend yield. As always, consult your tax advisor on all tax-related matters, since each individual case is different.

Adding to the problem, the amount of arable land available for farming isn't able to keep pace. Example: Over the past 50 years, grain production has doubled while arable land use has increased only 9%.

In China, 1.4 billion people are trying to live off 270 million acres of farmland!

The result is that food prices have risen dramatically. The average annual increase for grocery prices between 1990 and 2011 was a reasonable 2.8%, but since 2005, the International Monetary Fund's food price index has increased by 90%.

That means boosting agricultural yield is the most viable way to increase production, and that means big profits for fertilizer companies, like Yara.

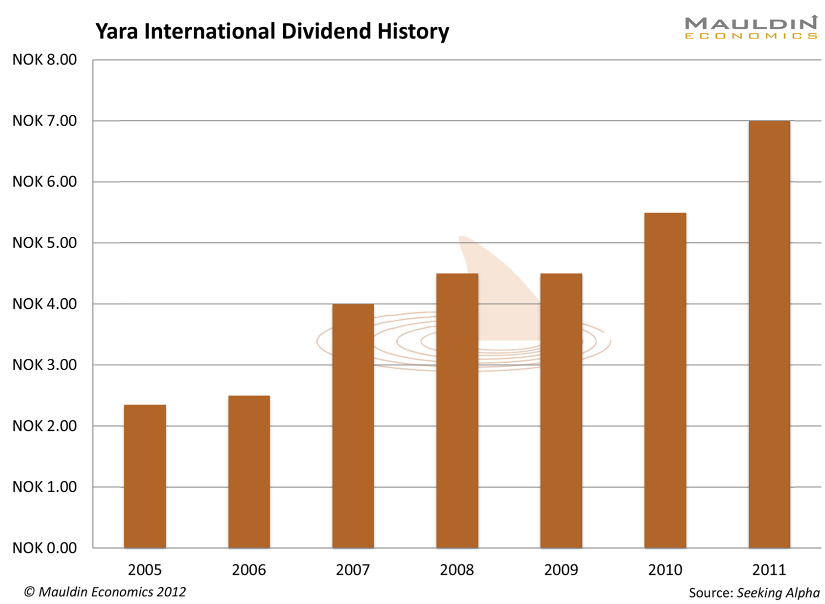


The business of feeding all those hungry mouths is already profitable, but it is going to get much more so as the demand swells, and that makes food one of the most profitable sectors you can invest in.

Yara has a great dividend history.

The company states that its objective is to deliver steady growth in dividend payments by paying out at least 30% of its profits to shareholders.

At $1.22 per ADR share, that works out to roughly a 3% dividend yield. That may not sound high, but that dividend is expected to grow rapidly, as the accompanying chart suggests.



One caveat. Yara pays out its dividend just once a year, and the last dividend was paid on May 23, 2012. That means that you'll have to wait about 10 months to collect the next dividend, *but it still makes sense to buy Yara today*.

Why? First, Yara has historically dropped in price after it pays its dividend, so now is the time to buy.

Lastly, Yara is cheap! The P/E is less than seven times 2011 earnings and even cheaper when you compare it to competitors like Potash and Mosaic, which trade at 12 and 10 times earnings, respectively.

Here's what to do:

> **Assuming a $100,000 portfolio, BUY 50 shares of Yara International, symbol YARIY, at the market. Place a protective stop to sell ALL your shares at $29.**

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