

## Boenning Morning Comment

*This report is prepared for us by Tower Bridge Advisors*

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Stocks rose sharply for the second straight session. My two-day rule says we no longer have to play defense. What happened? Good economic news, the correction ran its course in the absence of bad news, and most of the nasty rhetoric started to fade in Washington. Every Obama speech still labels Wall Streeters as the bad guys but it isn't a new tune. Moreover, some of the tax and penalties aimed at the banking and investment worlds already look dead on arrival.

Today I want to look into two topics; the new proposed budget and dividends.

I will start with the proposed budget. To start with, it's big. Over \$3.7 trillion big on the outlay side. Unfortunately, projected income is less than \$2.6 billion. So we face another huge deficit. Breaking down the numbers further reveals the extent of the dilemma. Social Security revenues (taxes) are \$56 billion less than what is going to be paid out in benefits. That gap is peanuts compared to Medicare/Medicaid where \$260 billion comes in and \$763 billion are projected to be paid out. Add it all together and you see that the government is well over \$750 billion in the hole just from entitlements alone. And both sides of the aisle remain unwilling to even begin to put these programs on the table.

There's more. Security spending (mostly for defense) is estimated at \$846 billion, almost 23% of total outlays. It's expensive to be the world's cop. Total non-security discretionary spending is forecasted to be \$530 billion. This is the number everyone wants to chop and slash. It covers everything from overhead, most of the cabinet departments, unemployment claims, running the Federal court system, and infrastructure investment just to name a few components. Take that number all the way to zero and the deficit is still well over \$500 billion.

Next, look at the revenue line. Individual income taxes are estimated at a bit over \$1.1 trillion. Corporate taxes of less than \$300 billion don't seem like very much in comparison. If you double the amount of individual tax revenue, you still can't get to a surplus. Needless to say, no one is suggesting that there is any way the government is going to double taxes. The problems are clear. Hopefully a better economy and some targeted tax increases can close the gap a bit, maybe even by a few hundred billion dollars. But if anyone is serious about getting our country's fiscal house in order, it isn't going to happen until one addresses entitlements. Thus, both sides of the aisle can yell and scream about the merits of tax increases or tax cuts as the trigger for higher total revenues, unless the entitlement situation is addressed, it will only get worse. If you do any longer term projection, it gets really scary. The \$750 billion entitlement hole today only gets larger year by year. In a decade, this gap will add \$8-10 trillion to our cumulative national debt. The addition alone could be 70% of today's GDP. Can the dollar survive as the currency of choice if our national debt approaches 150% of GDP? Probably not. So between now and then either Congress needs to address the entitlements problem head on or face another financial crisis that forces a currency devaluation and a dramatic reduction in the value of the dollar. The incongruity of the whole mess is that the American public is probably a lot more prepared to solve the problem emotionally than Congress. Most members of the House, for instance, simply hope the problem can be deferred for another two years (and then another two years) so that they can get reelected.

Finally, note that net interest expense in the new budget is only \$250 billion because interest rates are so low. Add a few year's worth of deficits to the national debt, bump up the rate a few points and you will quickly see net interest expense doubling from fiscal 2011 projected levels.

We probably can survive as we are for another year or two. As I said, maybe revenues come in a little higher because individuals and corporations will earn more money. Maybe in a few years, we can cut back on defense spending. Maybe some real chopping will save \$100 billion or so in discretionary items. Maybe Congress will freeze its own salaries and expenditures. OK, skip the last one. That's a complete pipe dream. But all that only buys time until either a crisis occurs or Congress has the courage to attack entitlements. It really is that simple.

Now let me completely switch gears and move on to dividends.

As companies mature and growth rates slow, free cash flow increases. The math is fairly simple. Profit margins can stay high but the dollars spent on new stores, new factories, and other capital items decrease leading to a spike in free cash flow. If you were running a lemonade stand, that free cash flow is cash in your pocket. As the owner of a company, it's cash in your bank account. As a stockholder it should mean higher dividends.

Companies can do one of four things with excess cash. They can reinvest in the business as long as the projected returns on new investments exceed the cost of capital by a sufficient amount to cover the risk incurred. If there are not enough such opportunities, the company can make an acquisition using the same criteria measuring costs against projected returns. Once internal and external expansion opportunities are met, if there is still free cash leftover it can be used either to buy back stock or to pay dividends.

For years capital gains were treated more favorably than dividends for tax purposes. But that all changed with the Bush tax cuts. Both dividend payments and long term capital gains were taxed at 15%. If the cuts simply expire at the end of 2010, the capital gains rate returns to 20% but the tax on dividends returns to the taxpayer's highest marginal rate. Somewhat overlooked in President Obama's budget proposal is a nice twist. For families earning less than \$250,000 per year, he suggests leaving the tax rate for both at 15%. No change. For those earning more, the rate for both long term capital gains and dividends would go to 20%. That maintains the parity. It is important relative to my discussion of dividends. Bear with me a moment and I will explain.

Psychologically, managements don't want to pay dividends in most cases. Dividends are an admission that they can't find something better to do with shareholder money. Paying money out also shrinks both the company's assets and its equity base. Company CEOs don't like to think of shrinking anything. To them, size matters. Big is better than small. When you see lists of America's biggest companies, they are judged on sales or assets, almost never on more esoteric measures like return on equity or return on invested capital.

Wall Street is another enemy of dividend payments. Wall Street bankers make money when companies make acquisitions and they earn fees when companies buy back stock. They earn nothing when they pay dividends. So they argue against dividends. One long standing argument was the alleged tax advantage of buying back stock but that went away with the Bush tax cuts and Obama is continuing the parity. By the way, Washington likes dividends. It gets paid taxes when shareholders receive dividends. It doesn't earn a penny when companies buy back stock.

Still shareholders who like dividends still seem to have an uphill fight. Managements don't want to admit they are running out of growth opportunities and Wall Street investment houses can make money off of dividends.

But there is a higher calling!

In my very first finance class in business school, the very first line out of the professor's mouth has stayed with me for 45 years. He said, and I quote verbatim, "The primary job of a CEO is to maximize the company's value to its shareholders." That means get the stock price up. Since dividends are an important part of total return and "the bird in hand", a stock's ultimate value is based on dividend yield and earnings per share growth. In a world where cash can only be reinvested at a few basis points, an annual dividend that can rise in line with future growth of free cash flow is more valuable than a dollar locked away in a Treasury bill.

As I started this discussion, I talked about the need for managements to come to grips with the thought that they couldn't find a better use for cash than paying it to shareholders. But as companies get bigger several things happen. Growth rates slow dictated at some point by the law of large numbers. Investment opportunities become harder to find. They need to be big to make a difference and they need to be able to maintain or increase a company's return on capital. In some cases, anti-trust considerations may even preclude the ability of a company to make a big acquisition.

That brings me to Microsoft (MSFT-\$28#\*). I will use it as an example but I could just as easily use Apple or Cisco or Oracle or Google or any of a large number of big tech companies. Microsoft has roughly \$35 billion in the bank. It generates annual free cash flow after all capital expenditures of close to \$20 billion. Currently it pays out about \$4.5 billion in dividends. Not long ago, it didn't pay anything. Management probably feels that it has come a long way. After all, Cisco and Apple don't pay a dime. But maybe it hasn't gone far enough. Its stock has been stuck at its present price plus or minus \$5 per share for close to a decade. Microsoft has a wonderful earnings model requiring almost no capex. It spews cash. It could double its dividend and still add close to \$10 billion to its cash coffers annually. Perhaps a big war chest would allow it to make a wonderful mega-merger. But with who? What company could Microsoft buy that the U.S. and European regulatory authorities would bless? Just to give you an idea of size, Adobe (ADBE-\$33#\*) has a market cap of about \$17 billion and it is dubious whether that deal would be allowed. Clearly a merger with Google or Oracle wouldn't have a chance.

If Microsoft doubled its dividend to \$1.04, it would be my conjecture that its stock price would react positively. At current prices, the yield would be about 3.7%. That's pretty rarified air today. If it were priced to yield just 3%, the stock would have to sell for \$34.66 or roughly \$6 per share higher than today's level. The extra \$4.5 billion only earns a tiny fraction of one cent per share invested in short term instruments. Thus, doubling the dividend wouldn't affect net income growth. It need not affect share repurchases either with \$35 billion of cash in the bank and more coming every day.

For every \$1 per share increase in Microsoft's stock price, the value of Microsoft rises by about \$8.9 billion. That is about a 200% return in one year for doubling the dividend. What's the primary job of a CEO? In this case, I think it is a no brainer. So why doesn't it happen? My guess is that eventually it will. It is just a matter of time. 10 years ago, no one looked at the drug industry and thought about dividend yield. Dividends matter and they matter most at companies with the free cash flow and flexibility to pay them and to raise them. Intel (INTC-\$19#\*) pays 3.2%. ADP (ADP-\$41#) pays 3.3%. Others will follow. The answer is when, not if. To my way of thinking, the sooner the better.

Futures suggest a fairly flat opening today.

Today Morgan Fairchild is 60. Fran Tarkington is 70.

James M. Meyer, CFA 610-260-2220

Additional information is available upon request.

\* - Boenning and Scattergood may act as principal in buying this stock from or selling it to the public.

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