

## Boenning Morning Comment

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

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Stocks fell sharply yesterday amid lousy economic news. Weekly jobless claims climbed back over the 500,000 level. The Philadelphia Fed survey of area manufacturing activity showed a decline in July. Finally, although leading economic indicators managed to eke out a gain, the increase was smaller than expected. Investors took the obvious cue and sold persistently throughout the session. Today there is virtually no economic data. Futures suggest the market will start lower. In overseas trading, stocks fell reflecting U.S. economic weakness and the poor trading session yesterday. Futures usually key off of overseas trading so it becomes a big loop. Without any further bad news, I suspect the selling pressure on a summertime Friday will dissipate before the day ends.

I want to get back to the subject of dividends, stock repurchase and taxes. Just to review, companies can use free cash flow and accumulated reserves to reinvest in the business, make acquisitions, buy back stock or pay dividends. That's it. If we are really talking about excess cash, I can actually eliminate the first option in that it is always the first choice and, if not chosen, it means that there aren't any more internal investment opportunities that meet corporate hurdle rates.

This week we saw a pick up in acquisition activity. All the deals were strategic. BHP Billiton initiated a hostile bid for Potash Corp. of Saskatchewan to increase its commodity portfolio. Intel announced a deal to buy McAfee in a strategic effort incorporate more security functionality directly onto the microprocessor. First Niagara Financial announced a \$1.5 billion deal to buy NewAlliance Bancshares in the largest consolidating acquisition in the banking industry since the 2008 financial crisis. The fact that corporate cash, now approaching \$2 trillion, earns next to nothing certainly is a catalyst.

But there are only so many deals. The remaining choices are stock repurchase and dividends. While I am glad to see both, I favor dividends for several reasons, many of which I have written about repeatedly. First, the benefits of dividends are real, obvious, and are felt immediately. From a competitive viewpoint they help stocks compete against fixed income instruments. Second, companies aren't real good buyers of their own stock. Like so many others, they buy most aggressively in good times when their share prices are high. When prices are dirt cheap, normally poor earnings refrain managements from stepping to the plate to buy more shares in earnest. Thus, for many companies, the average repurchase price of Treasury shares is much higher than current market prices. Third, managements of companies that use options as part of compensation (virtually everyone) use share repurchases as a cover to prevent an enormous expansion of share count if they get overly generous with option grants. In a period of cyclical or declining share prices, many options are underwater meaning the exercise price is below the current market price. Therefore, many existing options are worthless, at least at the moment. To compensate, companies often issue even more shares the next time around. It becomes a vicious cycle. Now that accounting rules require firms to charge compensation for option related expenses, fewer companies are flagrant issuers of options. But many companies get around that by announcing what are called non-GAAP earnings (earnings that don't exactly follow the accounting rules), backing out the compensation costs related to options. Evidently, they don't consider all the option dilution real and they try to convince investors that they are right. Many tech companies are the most flagrant abusers of options. Today they moan that their share prices are cheap based on a low multiple of non-GAAP earnings. But

maybe that is because investors aren't fooled by the notion that compensation via stock options is not an expense while cash compensation is. The loser is the employee who gets worthless stock options in lieu of real cash.

Taxes enter the equation when the tax on capital gains and dividends differ. Right now they are the same, 15% as long as you hold your stock for at least 12 months, fairly common for those of us who care about dividends. But next year, if the Bush tax cuts expire, the tax on dividends could go as high as 35% while the tax on capital gains will go no higher than 20%. That, obviously, would put dividends at a disadvantage. Wall Street and corporations don't need much of a reason to shy away from dividends. Wall Street doesn't like them because brokers earn fees on managing and executing stock repurchase programs. They earn nothing when dividends are paid. Management may seem to own a lot of stock in their own company but quite often most of those "beneficially owned" shares are shares controlled via options. When dividends are paid, they only receive cash for the shares actually owned. However, when shares are repurchased, in theory the price of remaining shares rise reflecting a smaller capitalization. Remaining shareholders now own a bigger piece of the pie. But that only makes sense if the stock repurchase price is attractive. They ignore the companion reality that stock prices reflect total return. A higher dividend would lead to a higher share price if growth rates can be maintained.

Regardless of my preference for dividends, here is the stark reality. If the Bush tax cuts expire, two things are likely to happen. Some companies may opt to make one-time payments at the end of this year to take advantage of the 15% dividend rate. But don't expect much of that. Company managements tend to like bigness and cash. It will be a very tough choice to part with true excess cash even if that is the right decision. The second and more important consequence is that in the future, managements will increase stock repurchases at the expense of dividends using the tax differential between capital gains and dividends as the stated reason. The net result is that dividend growth will decrease. If a weak economy ensues, they may even decline.

That's bad for the economy. Here is why. When dividends are paid, the recipient pays taxes whether it be 15%, the rate today, 20%, the rate suggested by President Obama, or up to 35%, where rates would be if the cuts expire. They are likely to spend part or all of those dividends. However, when shares are repurchased no tax is paid. The company buying the stock simply reduces its shares outstanding. The seller almost always will take the cash and buy another stock in its place. There might be a capital gain consequence but there might not be. No spending takes place. Thus, the government gets less tax revenue. The corporation reduces its cash. Yes, that cash would have just sat idle today but maybe tomorrow it would have been used productively. The seller doesn't increase cash; he simply moves it to another asset (e.g. buys a different stock with the proceeds). The dividend recipient is much more likely to spend the money than the seller of stock. Look at the way most trusts are established. Often the beneficiary gets to use the income but can only invade the principal for specific reasons, if ever. Dividends are income. Stocks sold to a company repurchasing stock represent a principal transaction. Funds received are intended to be reinvested.

The bottom line is the following. If Congress wants to stimulate the economy, it should favor dividends over stock repurchases. Allowing the dividend tax to go to almost twice the rate on capital gains is exactly the wrong choice. Democrats and Republicans will do what they always do and blame each other if they fail to legislate a fix. But here is the reality as the tax debate approaches. For the next few months, there is a Democrat in the White House, the House is controlled by Democrats, and the Senate is exactly one vote shy of a super majority for the Democrats. So the Democrats have a unique short term opportunity to sculpt the tax policy it wants. All they need to do is forge enough of a compromise to get one Republican vote in the Senate. That is how health insurance reform and FinReg passed. President Obama is the leader. He has no one to blame but himself if he cannot get the job done. I wish I could say I was optimistic. The alternatives are that the Bush cuts will simply expire and Congress next year will leave them as they will be on 1/1/11. Or Congress next year, probably more conservative, can come up with a new

formula for taxes. If I were in President Obama's shoes, I think I would like my chances today more than six months from now. We'll see what happens.

As noted, stocks should start the morning off trading lower. Instinct says today should be a quiet session but every time I say that, I am wrong.

Today Al Roker is 56. Robert Plant is 62. Sunday is Shell Day and my grandson Alec's eighth birthday.

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