

# FOCUS

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## ***Raise those payouts!***

We are watching the corporate debate about dividends with great interest. Cisco believes it can retain earnings in the form of cash for future growth opportunities. Microsoft succumbed to shareholder pressure and issued a small dividend from its huge hoard of retained earnings. Are the large pools of retained earnings a signal for future earnings growth? A recent article by Robert D. Arnott and Clifford S. Asness, “Surprise! Higher Dividends = Higher Earnings Growth” in the *Financial Analysts Journal* (January/February 2003) investigates whether dividend policy forecasts future earnings growth.

Using data from 1871, the authors analyzed the subsequent 10-year earnings growth as a function of the payout ratio of US stocks. (The payout ratio is the dividend per share divided by the earnings per share.) In the study, they used last year’s trailing dividends divided by last year’s trailing earnings.

The payout ratio in 1946 was very high at 87%. In the next few years, it dropped to 50%, as did the rolling 10-year earnings growth rate. Over the next thirty years, the payout ratio dropped to 40%, reaching a low in 1980. It began to increase in 1981, as did the subsequent 10-year earnings growth. By 1992, the payout ratio had risen to 74%, and earnings growth was substantial. In late 1999, the ratio was back down to unprecedented lows, close to 30%. Since then, earnings have tracked the sharp decline in the payout ratio.

The argument for high price to earnings ratios and low dividends is that there has been a shift toward shareholder tax optimization. The belief is that earnings growth drives stock prices higher, resulting in long-term capital gains that

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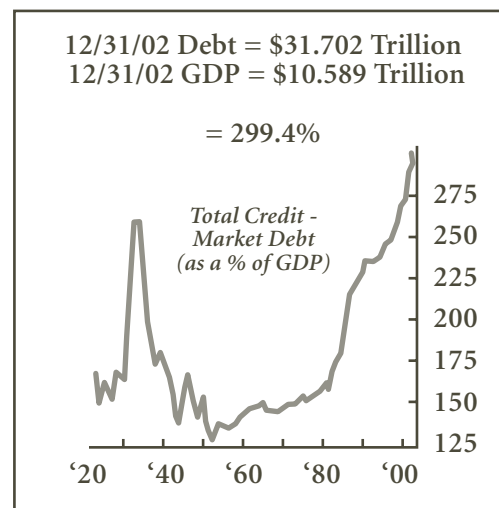
have favorable tax treatment. The optimists' assertion is that today's low payout ratios are a positive signal for future earnings growth. Instead, the Arnott and Asness study implies a period of low earnings growth until at least 2005.

Obviously each company has to evaluate whether it can reinvest or acquire companies that will increase earnings growth. Given the historically low level of interest rates, we have to wonder why any company would have huge stockpiles of cash when it has a positive cash flow. We would expect to see a wave of acquisitions or consolidations, particularly in the hard hit technology and financial sectors, much like the consolidation in the oil companies in the mid-1980s. For companies that are not re-investing or acquiring, our answer to the cash debate seems simple: either pay excess cash to shareholders, pay down debt, or buy back shares.

### *Walking the tightrope*

The Federal Reserve is in a tight spot. Greenspan & Co. need to heat up the economy and get people to keep spending by keeping interest rates low. The tricky part is that if the economy does start to strengthen and interest rates start to move up, our \$32 trillion debt bubble will become less manageable as debt service payments mount. That in turn could force more bankruptcies and move us back into recession and deflation.

In the June 16th issue of *Barron's*, Ned Davis discussed this problem and provided a thought provoking chart:



Our debt levels have soared over the last 20 years, surpassing those of the late 1920s. The debt may have limited our economic growth rate, but our economy did have a great growth period from the early 1980s until 2000. Ned Davis points out that interest rates have declined steadily over the same time period, keeping debt service obligations in check. Moreover, if rates do not stay low or begin to increase, the debt levels could come tumbling down as they did in the Depression because companies or individuals could not keep up with increasing interest payments, thereby triggering foreclosures and bankruptcies and their attendant debt write-offs.

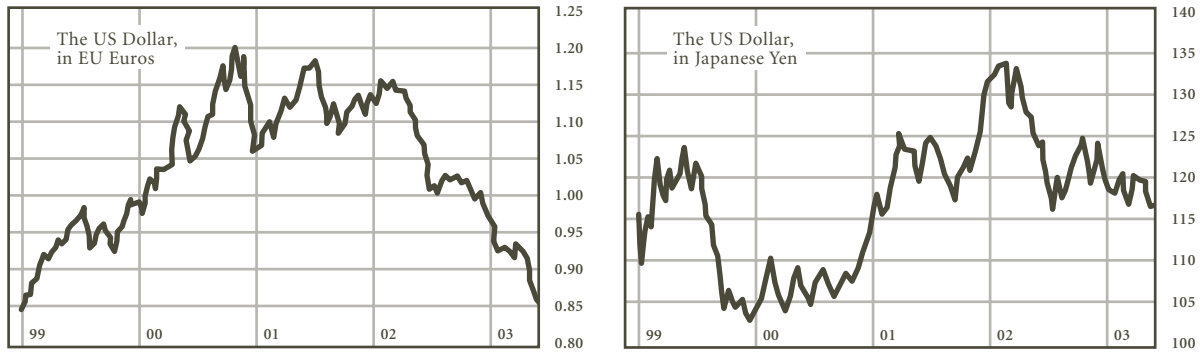
The problem is that while the Federal Reserve is trying to keep the economy moving, it is adding to the overall debt level. That is probably why the Fed Chairman did not want Bush adding to government debt with increased military spending and tax cuts. The Federal Reserve is afraid of a depression and deflation, and it will continue to try to keep rates low. We certainly hope that Mr. Greenspan does not stumble again and that the drop in the dollar does not turn into a rout that would upset the tenuous economic balance.

***Don't worry, be happy!***

As if the debt problem weren't enough to worry about, we've heard a constant drone lately from commentators who point to the decline of the dollar as yet another sign that we're in a heap of trouble. After all, Robert Rubin, Treasury Secretary in the Clinton administration, used to say that "a strong dollar is in America's interest."


Don Luskin of TrendMacrolytics ([www.trendmacro.com](http://www.trendmacro.com)) recently argued the opposite case. Consider the logical extension of Rubin's argument: if the dollar were to continue to gain against all other currencies, sooner or later all other currencies would be worthless. Moreover, he argues, the dollar isn't "crashing," as evidenced by the two charts on the next page. On the contrary, relative to the Euro, it is back where it

was when the Euro was issued in 1999. Relative to the Yen, it is actually up slightly.



Most media pundits blame the decline in the dollar on our trade deficit and worry that eventually holders of dollars and dollar denominated securities will dump them. Luskin argues that the dollar is really in the hands of Alan Greenspan and the Federal Reserve: when it prints more money, the value goes down. When it tightens, the dollar goes up. His conclusion, written just before the new tax law was signed, was as follows:

“...I’ve said over and over that Alan Greenspan and the Fed were responsible for the technology bust and the subsequent recession because of their deflationary monetary policy. One of my strongest pieces of evidence for that was the ‘strength’ of the dollar during the worst years of the bear market. Now that the dollar has been ‘weak’ for a sustained period, that’s evidence for the opposite conclusion: that Greenspan and the Fed have finally relieved the deflationary pressures in the economy.

“That’s nothing but great news. And add on top of it the fact that the President is about to sign the most sweeping and large-scale tax cuts and tax reform since, well, two years ago, and before that since the Reagan administration. So why do investors insist on worrying that the world is ending because the dollar is too ‘weak?’ Gimme a break. Don’t worry. Be happy. It’s all coming together—finally!” 

***From our  
Financial  
Planning  
Department:  
The Trust  
Protector***

The uncertainty surrounding repeal of the estate tax presents a challenge to many wealth-transfer strategies, because the events that trigger a transfer of wealth usually occur many years into the future. Conceivably, the repeal of the federal estate tax could make undesirable, and even unnecessary, the provisions of some irrevocable trusts. With this in mind, meet the “trust protector.”

A trust protector is a person who is given certain powers to adapt trust provisions to accommodate a change in circumstances. Also known as a special trustee or a trust advisor, a trust protector does not replace the trustee, but rather serves in addition to the trustee. The ideal candidate would be a trusted family friend.

Consider the following scenario to understand the role of a trust protector. A married couple creates a trust which provides that, after both have died, a separate trust for each child is to be created. Once each child reaches age 35, he/she is to receive his or her assets outright. Several years after the second parent’s death, the trustee (a bank) learns that one of the beneficiaries has a serious gambling problem. The trustee contacts the trust protector to relay this concern. The trust protector, having the power to change certain trust provisions or revise the age at which a beneficiary receives his/her assets, has the ability to make a decision regarding the distribution of assets for this beneficiary. Assuming the trust protector opts to keep the assets in trust for the rest of the beneficiary’s life, the outcome is the protection of assets.

The distinction between the trustee’s role and the trust protector’s role can be thought of in terms of technical versus personal. Record keeping and the preparation of tax returns are the types of responsibilities that might best be handled by a bank trust department, whereas issues involving a beneficiary’s ability to handle money might benefit from the insights of someone closer to the situation. A trust protector also can be granted the power to replace a corporate trustee

with another institution when such a change is desired, thus alleviating the need to go to court. More and more, the use of a trust protector is also being considered as a way to introduce greater flexibility regarding the uncertainty of the estate tax repeal.

As with all things legal, a healthy dose of caution is warranted. So it is with estate planning. After all, the greater the trust protector's powers, the greater the chance for potential problems. Selecting the right person for the role is critical, too. As always, consult your attorney: estate planning is best handled by professionals.

**Notable  
quotables**

*Suppose you were an idiot. And suppose you were a member of Congress. But I repeat myself.*

—MARK TWAIN

*We contend that for a nation to try to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle.*

—WINSTON CHURCHILL

*A government which robs Peter to pay Paul can always depend on the support of Paul.*

—GEORGE BERNARD SHAW

*A liberal is someone who feels a great debt to his fellow man, which debt he proposes to pay off with your money.*

—G. GORDON LIDDY

*Democracy must be something more than two wolves and a sheep voting on what to have for dinner.*

—JAMES BOVARD

*Foreign aid might be defined as a transfer from poor people in rich countries to rich people in poor countries.*

—DOUGLAS CASEY

*Giving money and power to government is like giving whiskey and car keys to teenage boys.*

—P.J. O’ROURKE

*Government is the great fiction, through which everybody endeavors to live at the expense of everybody else.*

—FREDERIC BASTIAT

*Government’s view of the economy could be summed up in a few short phrases: If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidize it.*

—RONALD REAGAN

*Just because you do not take an interest in politics doesn’t mean politics won’t take an interest in you.*

—PERICLES (430 B.C.)

*I don’t make jokes. I just watch the government and report the facts.*


—WILL ROGERS

### ***Inside Woodside***

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As a reminder, our offices will be closed on Monday, September 1 in observance of Labor Day. 🇺🇸

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