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THE IMPACT OF PROPOSED TAX RATES ON DIVIDENDS

Willis Investment Counsel (WIC) employs a managed volatility and income equity strategy that seeks superior, predictable, and consistent total and risk-adjusted returns in a wide range of equity market environments. The strategy invests in a portfolio of larger cap U.S.-traded common equities with a diversified set of covered call options written on 90%+ of individual portfolio holdings. The strategy aims to compound capital by maintaining lower downside absorption while layering in higher than average dividend yields, covered call option "yields," and principal upside during favorable equity market environments. Dividend yields are a significant return component of the strategy.

Last week, the *Wall Street Journal* reported on the Obama Administration's 2013 budget proposal as it pertains to increasing the rate of taxation on corporate dividends (Review and Outlook, "Obama's Dividend Assault," February 22, 2012)), which theoretically presents a risk to dividend yield-oriented investment strategies. The proposal calls for raising the dividend tax rate in 2013 from the current 15% rate to the projected personal income tax rate of 39.60% for top wage earners. With the planned phase-out of a host of deductions and exemptions, coupled with the 3.8% ObamaCare tax surcharge, the new dividend tax rate would be just under 45%.

While the Obama budget proposal has little to no chance of passing as presented, *if* passed in some fashion, the implications to the WIC Managed Volatility and Income Strategy described above could be meaningful, but certainly manageable, for taxable clients.

The table below provides a simple example of the possible implications using a low and higher dividend yield position, assuming that the effective tax rate on dividends increases from 15% to 36%. For the lower-yielding Monsanto Co. (MON), annualized after tax cash flow from option premium and dividends would be reduced by 30 basis points. With Merck & Co. Inc. (MRK), the dividend component represents a higher percentage of the pre-tax cash flow. Consequently, the after-tax impact would be a higher 82 basis points. Assuming a "normalized" portfolio core run rate of a 3.75% dividend yield and a 3.75% option premium "yield," an increase in the effective dividend tax rate to 36% would result in a 79-basis point decline in the after-tax portfolio cash flow return – from 5.59% to 4.80%.

Table 1

	MON			MRK		
Tax Rate Div.	15.00%	36.00%	**Diff**	0.15	0.36	**Diff**
Option	Jan-12	Jan-12		Jan-12	Jan-12	
Strike	$82.50	$82.50		39.66	39.66	
Premium	$3.20	$3.20		0.54	0.54	
Prem Ret	4.26%	4.26%		1.49%	1.49%	
Ann Prem Ret	8.01%	8.01%		2.81%	2.81%	
Ann Prem $	$6.02	$6.02		$1.02	$1.02	
Stock Price	$75.17	$75.17		$36.14	$36.14	
Dividend	$1.12	$1.12		$1.52	$1.52	
Yield	1.49%	1.49%		4.21%	4.21%	
Up beta	1.22	1.22		0.69	0.69	
Down beta	0.82	0.82		0.61	0.61	
Ann CF yield	9.50%	9.50%		7.02%	7.02%	
% dividend yield	15.68%	15.68%		59.94%	59.94%	
Ann PT CF $	$7.14	$7.14		$2.54	$2.54	
Taxes						
ST on Prem Inc	$2.17	$2.17	$0.00	$0.37	$0.37	$0.00
15% of Div	$0.17	$0.40	$0.24	$0.23	$0.55	$0.32
Total Taxes	$2.34	$2.57	$0.24	$0.59	$0.91	$0.32
Tax as % Stk	2.83%	3.12%	0.29%	1.50%	2.30%	0.80%
AT CF $	$4.81	$4.57	-$0.24	$1.94	$1.62	-$0.32
AT CF ROI	6.06%	5.76%	-0.30%	4.96%	4.15%	-0.82%

Of course, there are unknown variables:

- *The stock price impact to higher yielding dividend stocks*. One could plausibly assume that a tax hike would result in a decline in the price of a stock to bring the pre-tax dividend yield back to a "normalized" rate. For example, MRK's adjusted pre-tax yield of 4.21% in the table could increase to 5.59% to produce the same after-tax yield in a 15% environment. MRK's stock price could fall from $36.14 to $27.19 (a 24% decline) to produce the equivalent after-tax yield.
- *Impact on volatility* for dividend-paying stocks and the resulting impact to premium yield. It is unlikely that we would witness a drop in volatility from already low levels.
- *Corporate strategy* in a new world may place more emphasis on share repurchases than on dividend increases, thus limiting the strategy's ability for cash flow to keep pace with inflation. It would be a quantum leap to assume that a shift to share repurchases would result in an increase in the shares to offset the lack of dividend growth.

Obviously, this is all hypothetical and the market adjustments, if any, would likely be far less, as owners of higher yielding equities are both taxable and non-taxable shareholders. It is simply impossible to predict how the market might reflect higher tax rates on dividends.

Given the above possibilities, the WIC Managed Volatility and Income Strategy described above nevertheless remains relevant for the following reasons:

- Dividend tax changes will likely not negatively impact the strategy's longer term ability to manage volatility/loss mitigation; it may even enhance the opportunities.
- For taxable investors seeking a higher level of cash flow, the strategy may be even more important, as such investors seek alternatives to replace cash flow lost to a higher tax burden.
- For non-taxable investors, a change in tax rates may be of benefit if the market "adjusts" the price of higher yielding securities.

Please contact Bob Willis (bwillis@wicinvest.com) or Jay Kilroy (jkilroy@wicinvest.com) with questions or comments.

For more commentary, we invite you to visit our website at www.wicinvest.com.

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ABOUT WILLIS INVESTMENT COUNSEL

Founded in 1979, Willis Investment Counsel (WIC) is an independent investment management firm, specializing in the management of equity, fixed income, and balanced portfolios for a wide variety of private and institutional clients. We structure and individually manage equity, fixed income, and balanced portfolios in accordance with a policy of investment guidelines and requirements that is developed collaboratively with our clients and their advisers.

The members of the WIC investment team average 28 years in the investment industry, with broad, diverse, and complementary experience in private wealth and institutional investment management. For more than 32 years, WIC has consistently applied a disciplined, time-tested investment process in growing its clients' capital with less risk.

WIC is based in Gainesville, Georgia, less than an hour's drive from downtown Atlanta. For more information on WIC, we invite you to visit our website at www.wicinvest.com.

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