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THE HISTORICAL IMPACT OF HIGHER TAX RATES ON DIVIDEND PAYING STOCKS IS SURPRISING

Brett Slattery, CFA

I recently came across a thoughtful whitepaper from Wisdom Tree Investments titled "What Could President Obama's Plans for Dividend Taxes Mean for Financial Markets?"[1] Their research showed that higher yielding dividend stocks performed quite well during periods of very high dividend tax rates. It seemed counterintuitive on the surface and reminded me of a story that I had heard about bomber planes that had similar parallels. Both offer unique insight into how "conventional wisdom" is often misleading.

INTUITION AND BOMBER PLANES

In an effort to gain a better understanding of how to increase the survivability of airplane bombers from ground fire in World War II, the U.S. Navy and Air Force enlisted help from a mathematics professor from Columbia University named Abraham Wald. They provided him with data from the surviving planes that included tallies of how many "hits" were sustained and the location (engine, fuselage, fuel system, etc.) of each hit. His ultimate goal was to suggest the location(s) on the plane that should be reinforced. The conventional approach at the time was to focus on the part of the plane that was hit most often and put reinforcements there.

Rather than affirming the conventional view, Abraham Wald suggested something radically different, which on the surface seemed completely counterintuitive. He suggested reinforcing the area of the plane that had the *least* damage. The area of the plane that sustained the most damage, yet was still able to fly back safely was not an area of concern to Mr. Wald. Instead, he reasoned that the planes that were shot down were likely hit in the areas that were thought to be the safest; areas not hit in the surviving planes. His methods spawned a new method of studying complex decision making still studied today. [2] Mr. Wald's discovery reminds us that often times, further examination of the facts and circumstances are needed, and in some instances, a rejection of our initial intuitive notion is needed in order to arrive at a prudent decision.

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[1] "What Could President Obama's Plans for Dividend Taxes Mean for Financial Markets?"; Wisdom Tree Research Coauthored by Luciano Siracusano III, Jeremy Schwartz, Christopher Gannatti
[2] "Abraham Wald's Work on Aircraft Survivability"; Mark Mangel and Francisco Samenigo; Journal of the American Statistical Association, Volume 79, Issue 386, June 1984, 259-267.

INTUITION AND HIGHER DIVIDEND TAXES

As investors, we can appreciate Mr. Wald's perspective as we are always fighting our urge to follow our *initial intuitive* response in search of a more reasoned and accurate one. A current "conventional wisdom" in our industry is that the looming dividend tax rate increase from 15% to 39.6% will have a disproportionately negative impact on high-yield stocks relative to low-yield stocks. Wisdom Tree's research, although counterintuitive, reveals that high tax levels did not deter high-yield stock returns from having strong performance over the past 70 years. High-yield stocks actually outperformed low-yield stocks during most periods when the highest dividend tax rate was significantly higher than the current 15% level. They concluded **other market factors were far more important than the tax environment** during those periods.

FURTHER ANALYSIS OF HISTORICALLY HIGHER DIVIDEND TAXES

Their research shows that during the period from 1944-1963 when the highest Dividend Tax Rate was an astounding 91%, high-yield stocks still had slightly better performance than low-yield stocks. Similarly from the period of 1982 to 2002 when the tax rate was 39%, high-yield stocks averaged 13.4% per annum versus 11.7% for low-yield stocks. They only underperformed during the 1963-1981 period. Many would find these overall results counterintuitive, but there is much more beneath the surface to stock performance than tax rates and dividend yields. Companies that pay high and growing dividends typically have solid balance sheets, strong cash flow generation, and have competitive moats that allow them to survive and prosper over complete market cycles.

Another key concern for those interested in investing in high-yielding stocks during high tax rates is whether the dividends will sufficiently grow. A major reason for owning dividend paying stocks is the assumption that growth will at least keep pace with inflation, thereby protecting the "real" payout to shareholders. An additional counterintuitive nugget borne out of historical data is that the **average growth of dividends was the highest during the worst dividend tax rate environments** (91% and 70% rates). If taxes were the only driver of dividend growth, one would expect the opposite to occur.

INSIGHT GAINED FROM THE CURRENT ENVIRONMENT

Wisdom Tree's research also provides some valuable insight about the current environment that further reduces the prevailing and intuitive presumption that high-yield stocks are destined for poor performance.

- **Income-generating alternatives such as corporate and U.S. Treasury bonds have yields that are not attractive** and barely cover inflation. Therefore there is less likelihood that investors will try to swap out of high-dividend payers into low-yielding bonds which also incur high tax rates.
- **Dividend payout rates are nearly half of their historical average** (only 30% now versus the historical level of 57%). This helps mitigate some of the impact to high current payers, but also gives corporate boards the ability to significantly boost payouts to offset the increase in taxes.

- **Nearly 48% of all qualified dividends paid would not be impacted by the dividend tax increase** as their respective filers fall below President Obama's current $250,000 earnings threshold.
- **IRAs and other tax exempt retirement accounts would also not be directly impacted by the tax increase.** Wisdom Tree estimates that nearly 40% of the equities held by U.S. investors are in tax advantaged retirement vehicles.

As is often the case in investing and apparently even in aircraft defense, the first intuitive response to a seemingly obvious relationship – including between perceived economic and stock market trend - usually needs further investigation. Testing *obvious* assumptions and questioning *universal truths* can be time consuming but usually worth the effort as it often provides valuable insight.

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

Contact Information

WILLIS INVESTMENT COUNSEL
Principled Investing
710 Green Street
Gainesville, GA 30501
P: 770.718.0706 | F: 770.718.0805