



An Update on “Dividend Investing in the Post Bubble Era”

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For Important Disclosures,
see pages 7-9.

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The Dividend Advantage

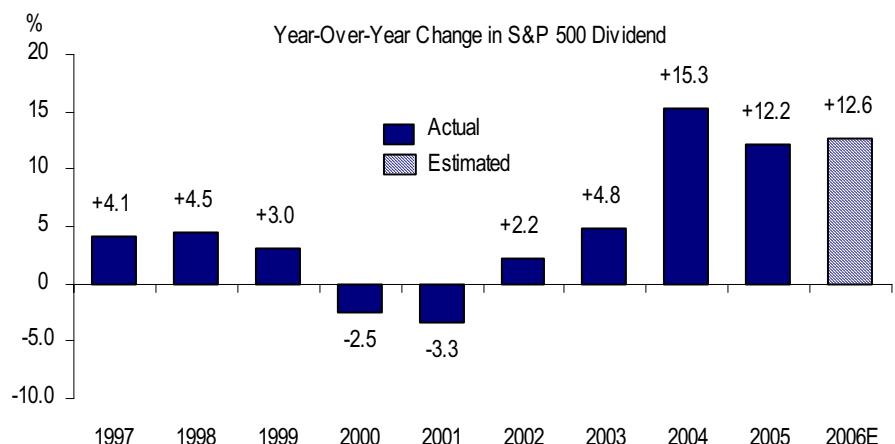
Investors often consider quality dividend-paying companies for the attractive cash flows they provide, but we believe the benefit of owning dividend stocks is much greater than an income stream alone. Dividend stocks have been shown to provide a calm equity port in what can be a volatile market. Recent analysis also suggests that over time, dividend-paying stocks provide returns that exceed that of the overall market as well as their non dividend-paying peers. Most recently, a well-regarded study also seems to show that higher dividend payout ratios may signal higher earnings growth, countering conventional wisdom. That’s a lot of firepower from a group of companies not always known for their headline-making growth stories. But, to paraphrase an Aesop fable, where dividends are concerned, “Slow and steady wins the wealth building race.”

This report hopes to provide some additional perspective on the benefits of dividend stocks. We believe they may be especially appealing to the aging boomer population for the current income they provide plus the capital appreciation potential they represent. Recent market volatility and the transition we believe this volatility reflects should make dividend-paying stocks an especially timely investment.

Another Record Year Projected for Dividends

The large cash reserves on corporate balance sheets continue to find their way into payments to shareholders through dividends. Standard & Poor’s estimates the dividend for the S&P 500 will reach \$25.00 in 2006, a potential increase of 12.6% over the \$22.22 dividend in 2005. Since 2001, the year that marked the low water mark for the dividend payout on the S&P 500, dividend payments have grown at a compounded annual growth rate (CAGR) of 8.01%.

Dividend Growth Remains Strong



Source: Standard & Poor’s

According to Standard and Poor’s, through the first quarter of 2006, nearly \$71 billion was paid to shareholders in the form of dividends, a 5.4% gain over the same period in 2005 and a 23.2% increase over 2004. Negative activity remained low, with only 11 cuts and six omissions. The overall payout increase to decrease ratio remained a strong 36.8 to 1. We believe the 2003 Tax Act, which created a sizable reduction in taxes paid on

dividends and made taking a long-term capital gain or a dividend an agnostic decision, has been at least partially responsible for the desire by corporations to return cash flow to shareholders. Healthy corporate earnings, strong balance sheets and cash flows, and renewed sentiment that shareholders are receptive to dividend payments in the current market environment have also supported this trend.

What caught our attention, however, was the 12% jump in special bonus dividends. Not only did it include companies that would have otherwise had the ability to increase their dividends, but companies without a dividend payment history also chose this move. A one-time payment to return the cash to shareholders preserves the image a company wishes to project and also avoids the long-term commitment that a consistent dividend entails. It's unfortunate that dividend-paying companies entertain the reputation of stodginess and slow growth, compared to its higher beta peers, since that's hardly what they've delivered investors over time.

Dispelling Dividend Myths

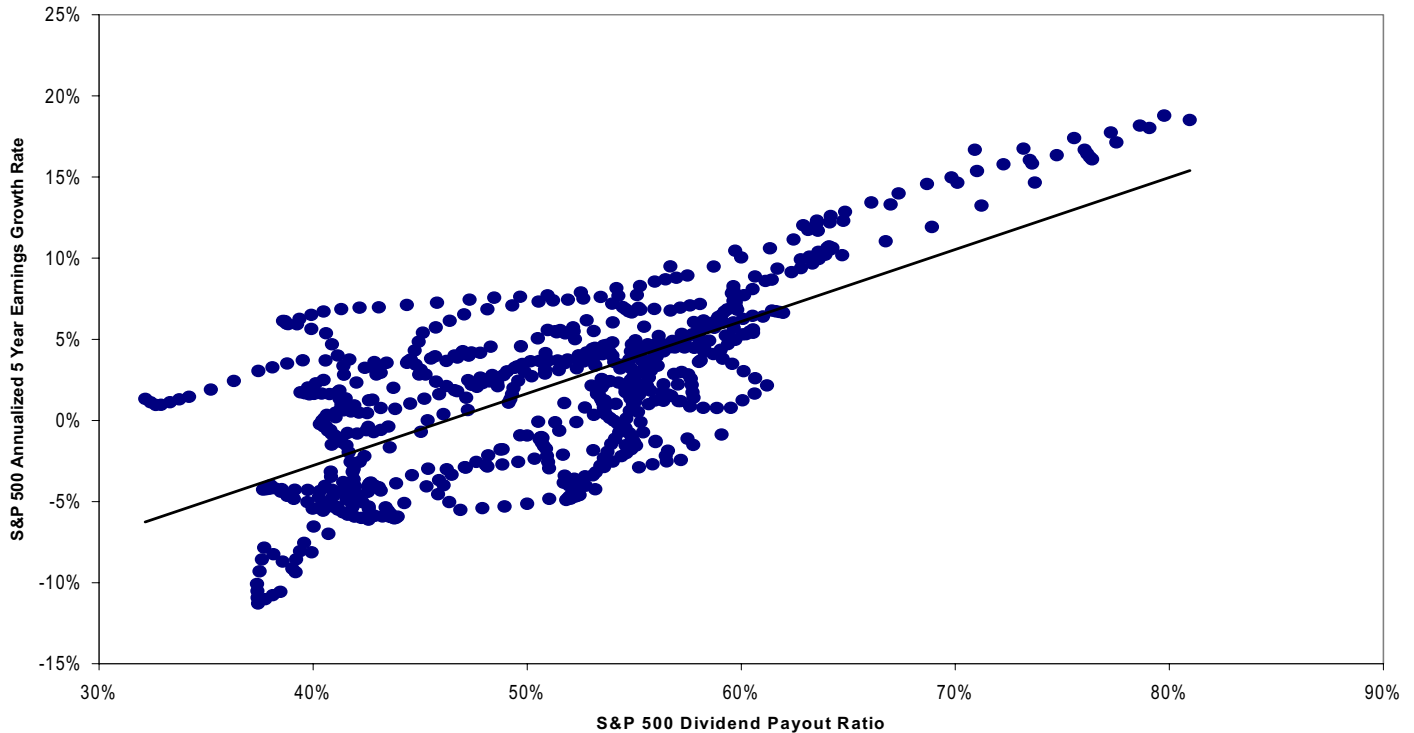
Dividend-paying stocks have been a bit like the Rodney Dangerfield of the equity world. And like Rodney Dangerfield, regarded in the comedy business as a “comic’s comic” who set the tempo for his peers, the reputation of dividend-paying stocks belies the true contribution they provide investor portfolios. Recent studies, highlighted below, refute several myths, and reaffirm our affinity for dividends.

Myth: Investors Accept Dividends in Lieu of Consistent Earnings

Truth: Dividends Signal Earnings Persistence

Professor Jeremy Siegel recently authored an editorial in *The Wall Street Journal* about the benefits of using fundamental metrics to create indices instead of market capitalization. Specifically, he noted that dividends often have predictive power: “Dividends are the only fundamental variable that is completely objective, transparent and unable to be manipulated by managers who tinker with accounting assumptions.” Analysis provided by the quantitative team at Credit Suisse also supports this assertion. The team analyzed the relationship between earnings persistence, which they measured using ROA, or return on assets, and that metric’s correlation to dividends. For the time period of 1951 through 2002, the R-Squared value was just over 0.50, which means that dividends explained more than 50% of a company’s future earnings. That phenomenon also seems to be represented by above average credit quality and earnings/dividend rank of the S&P Dividend Aristocrats, companies that have increased their dividends for 25 straight years. Nearly 64% of “Aristocrat” stocks have a quality rating of A- or better, higher than the average S&P 500 company, where 12.5% garnered the same rating for earnings and dividend consistency.

This seems to challenge what we learn in business school, namely that the best growth comes when companies retain a sizable portion of their earnings. RBC Capital Markets’ Chief Institutional Strategist Myles Zyblock, in his work, also cited a powerful paper written in 2003 by Robert Arnott and Clifford Asness, which turned this “conventional wisdom” on its head. In a nutshell, their work, evaluating 130 years of data, showed that higher dividend payouts signal higher earnings growth. This work was further refined recently by Professors Ping Zhou and William Ruland, who showed that this holds true on a company basis as well, after examining data from 1950 through 2003. In this case, a picture is worth a thousand words.

S&P 500: Payout Ratios are Positively Related to Future Earnings Growth

Source: RBC Capital Markets, Robert D. Arnott & Clifford S. Asness - AIMR 2003

We agree with Zyblock's reasoning as to why this may be the case. He reasons that corporations take great care when they set a dividend policy, as a potential dividend cut is almost always received negatively by shareholders. As a result, we believe dividend-paying company management teams' comfort levels are probably high when they declare a dividend, which is part of what a higher dividend payout ratio signals.

We only have to look back to the technology bubble era to witness another possible reason for this seeming disconnect: empire building. Both Arnott/Asness and RBC's Zyblock cited this tendency. Excessive cash levels often encourage managers to build empires, taking outsized risks tempered with possible conflicts of interest that may fall short of the true growth those plans are intended to provide. The real return provided by reinvested cash flows are also much harder to measure than the return to a shareholder provided by a dividend or the returns financed with a stock issuance.

Myth: Dividend-Paying Stocks Deserve their Stodgy Reputation

Truth: Dividend Stocks Have Provided Outsized Performance over Time

The RBC Investment Strategy Weekly report titled "The Tortoise and the Hare" by Myles Zyblock for RBC Capital Markets, outlines the respect dividends should command. He said, "Theory argues that dividend payers are more likely to be slow growers, but the empirical evidence argues to the contrary ... dividend-paying stocks are more likely to outperform both the benchmark and the non-payers over time." Zyblock and his team did a study of S&P 500 companies, comparing the total return of the index to its members that pay a

dividend and those that do not. Taking it a step further, they provide a comparison of dividend-paying stocks that grow their dividends over time as well. The compounded annual returns over the time period analyzed speak for themselves:

Compound Annual Total Returns (Compound Annual Returns to May 30, 2006)	10 Year	5 Year	1 Year	YTD
S&P 500 Total Return (Weighted)	8.3%	2.0%	8.6%	2.6%
S&P 500 Dividend Payers (Weighted)	8.8%	3.0%	9.0%	3.1%
S&P 500 Non-Dividend Payers (Weighted)	6.5%	-1.3%	6.3%	-0.6%
S&P 500 Dividend Growers (Weighted)	9.6%	2.8%	7.4%	2.9%

Source: RBC Capital Markets Quantitative Research

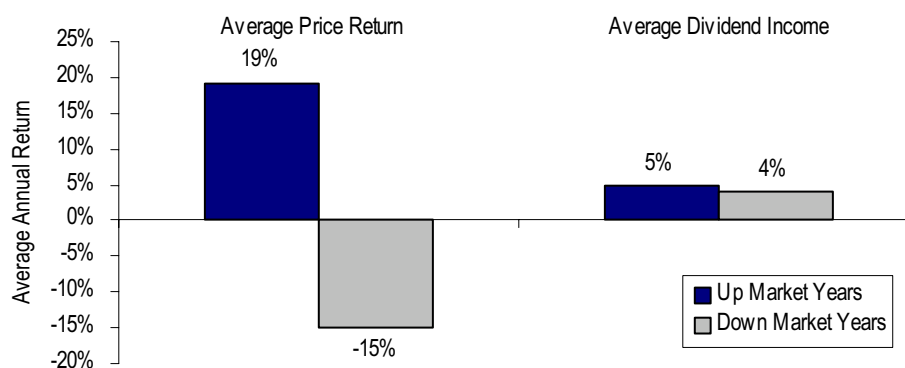
Reaffirming Dividend Truths

While the studies noted above counter some conventional wisdom, the investors who hold dividend-paying stocks experienced the benefits first hand. We reaffirm these “dividend truths” below.

Dividends Provide Consistency and Cushion in Volatile Markets

In wealth building, it’s not always what you make, but what you keep that denotes those who achieve true success. We believe dividend-paying companies play a significant role here. Stock prices move up and move down, but dividends clearly provide a bird in the hand. One of the reasons dividend-paying stocks have outperformed their non-paying peers is the advantage they provide investors in down markets. This quality was especially evident during the bear market in the early 2000 decade—in the three bear market years 2000-2002, dividend-paying stocks in the S&P 500 Index roughly broke even, S&P said. While the S&P 500 Index declined 39.5% from 2000 through 2002, non-dividend paying stocks fared even worse. A study conducted by Professors Kathleen Fuller and Michael Goldstein show that dividend stocks on the NYSE, AMEX, and Nasdaq returned 1.3% per month, on average, compared with 1.025% for non-payers from January 1970 through December 2000. The study reveals that performance of these stocks was most notable in down markets, where dividend-paying stocks posted an average return of 3.83% vs. 3.79% in capital appreciation alone—and that’s not including the dividends. The S&P folks measured this a bit differently, finding that while the swing in average price returns in up and down markets for 1926 through 2004 are dramatic, the consistency of dividend income for both periods is notable.

Dividend Cushion in Down Markets

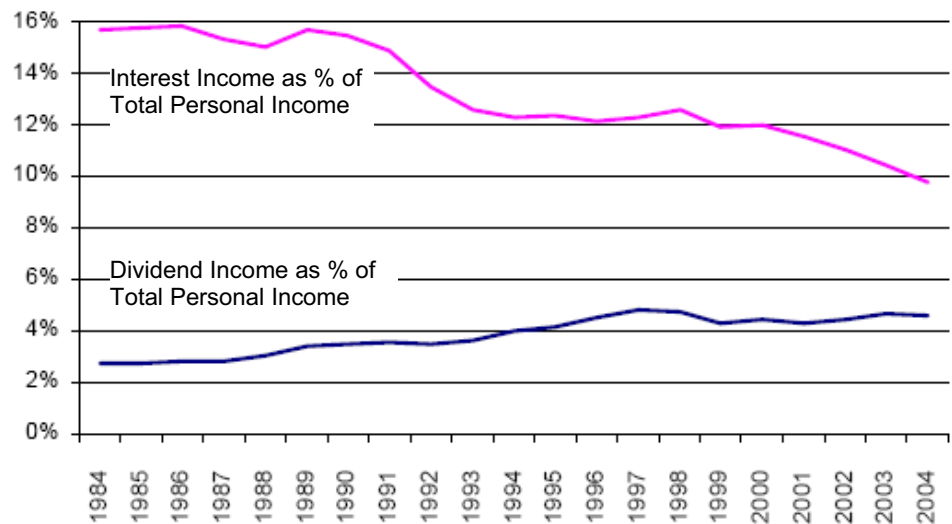


Source: Standard & Poor's

Demographics Should Drive Demand for Dividend Stocks

There's no doubt that as boomers retire and prepare for a retirement period that could be nearly 20 years in duration, on average for many, both growth and income will be required to keep pace with inflation and lifestyle goals. As illustrated by S&P, dividend income represents a growing portion of personal income, nearly 4.6% today compared with 2.7% 20 years ago. When measured in constant dollars, in 2004, personal dividend income represented \$407 billion compared to \$134 billion in 2000, while sources from interest income declined to 9.8% from 15.7%. Equity ownership continues to rise, from 26% of households age 65-74 in 1989 to nearly 40% by 2001. We believe this trend will persist, as retirees seek to maximize the returns from their investment assets. We believe dividend stocks help fill the gap between what's been saved and what will be required to meet retirement income goals.

Dividend and Interest Income as % of U.S. Personal Income



Source: U.S. Department of Commerce, National Economic Accounts

Extended Favorable Tax Rates Should Keep Dividend Stocks in Favor

Dividend investors breathed a sigh of relief as the TIPRA, the Tax Increase and Prevention and Reconciliation Act of 2005, provided for an extension of the favorable tax rate on long-term capital gains and most corporate dividends through 2010. These rates would have expired in 2008. According to Standard & Poor's, investors could save an additional \$49.4 billion in federal taxes over that two-year period, and \$149.7 billion over the full eight-year period. These calculations are based on the "federal statutory tax rate and the qualified 15% tax rate for shares held directly by individuals, excluding pensions, mutual funds and tax deferred retirement accounts." This extension of the tax benefit should give individual investors increased confidence to purchase dividend-paying stocks.

Corporations should also benefit from the extension of this tax benefit, as dividend stock investors are often prized for their long-term ownership profile. This feature may offer a heightened degree of stability in the shareholder base, a feature many companies desire.

Dividend Stock Screen

Stocks with Superior Income, Profitability, and Stability Attributes

In his report extolling the admirable qualities of dividend-paying stocks, “The Tortoise and the Hare,” our colleague Myles Zyblock, screened the S&P 500 companies for qualities that could provide a calmer port during a market storm. The stocks included below rank above their peers for the following qualities:

- Dividend yield (a bird in the hand ...).
- Dividend growth (growing dividends suggest growing earnings).
- Normalized return on equity (ROE) (profitability over a cycle).
- Five-year standard error of earnings (measures earnings stability).
- Standard deviation of 12-month earning estimates (consistency of earnings expectations by industry analysts).

S&P 500 Screened for Superior Income, Profitability, and Stability Attributes

Ticker	Company	Price 6/22/2006	Dividend Yield	5-Year			Std. Dev of 12-Mo. Est.
				Div. Growth	Mean ROE	S.E. of EPS	
MMM	3M Company	\$79.59	2.3%	8.4%	32.0%	15.0%	1.2%
MO	Altria Group Inc.	\$72.22	4.4%	8.5%	36.6%	16.0%	1.2%
KO	Coca-Cola Co.	\$42.87	2.9%	7.9%	33.1%	9.0%	1.3%
CL	Colgate-Palmolive Co.	\$60.30	2.1%	13.5%	169.9%	13.9%	1.0%
CBSS	Compass Bancshares Inc.	\$55.13	2.8%	10.4%	17.9%	6.8%	0.8%
HDI	Harley-Davidson Inc.	\$53.22	1.6%	49.6%	29.4%	6.0%	2.5%
HSY	The Hershey Company	\$54.86	1.8%	12.4%	46.2%	4.0%	0.9%
JNJ	Johnson & Johnson	\$61.18	2.4%	16.0%	28.2%	9.9%	0.7%
KMB	Kimberly-Clark Corp.	\$60.92	3.2%	9.0%	28.2%	11.1%	1.4%
MKC	McCormick & Co.	\$32.54	2.2%	12.5%	28.0%	5.7%	0.9%
PAYX	Paychex Inc.	\$39.19	1.6%	11.2%	29.0%	6.9%	1.1%
PEP	Pepsico Inc.	\$60.02	2.0%	13.9%	32.9%	6.3%	1.5%
PFE	Pfizer Inc.	\$22.65	4.2%	15.9%	24.5%	22.0%	1.5%
PPL	PPL Corporation	\$31.18	3.5%	13.4%	20.6%	15.3%	1.1%
PG	Procter & Gamble Co.	\$55.85	2.2%	10.6%	29.7%	7.9%	0.6%
UTX	United Technologies Corp.	\$61.89	1.7%	17.3%	21.9%	8.4%	1.4%
USB	US Bancorp	\$31.16	4.2%	13.1%	21.1%	11.3%	1.7%
UST	UST Inc.	\$44.26	5.1%	8.8%	265.3%	7.1%	2.6%
WMT	Wal-Mart Stores	\$48.48	1.4%	20.4%	21.6%	3.3%	1.3%
WFC	Wells Fargo & Co.	\$66.41	3.1%	19.4%	19.1%	7.1%	0.9%
Median of S&P 500			1.3%	7.6%	15.7%	27.6%	3.1%

Source: RBC Capital Markets Quantitative Research, RBC Dain Rauscher

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			Count	Percent
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