Weekly Market Commentary

December 3, 2012

Shareholders' "Powerball" Payout

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Highlights

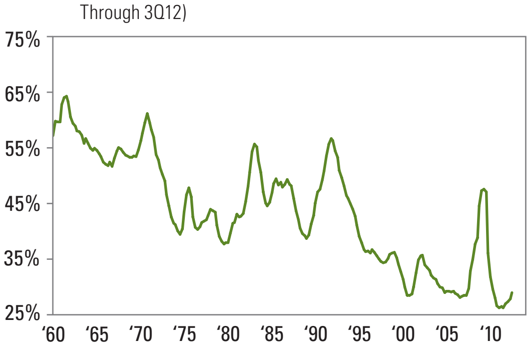
Some shareholders may get their own "Powerball" payout in the next few weeks as companies seek to distribute special dividends ahead of the likely expiration of the 15% top tax rate on dividends at the end of the year.

No matter how much dividend tax rates go up in the quarters ahead, companies may find it more efficient to return capital through share buybacks than dividends.

So if you are looking for yield, stocks are becoming more attractive relative to bonds for both investors and for corporate leaders.

1 Dividend Payout Ratio Did Not Rebound After 2003 Tax Cut

— Percent of S&P 500 Companies' Earnings Distributed in the Form of a Dividend (Quarterly Data Through 3Q12)



Source: Standard & Poor's, Thomson Financial, LPL Financial 12/03/12

Last week's record $587 million Powerball jackpot grabbed headlines. But some shareholders may get their own "Powerball" payout in the next few weeks as companies seek to distribute special dividends that may total a record $100 billion to shareholders ahead of the likely expiration of the Bush-era 15% top tax rate on dividends at the end of the year. Cash has built up with companies hesitant to spend on hiring and new equipment, given fiscal cliff concerns and stalling earnings growth. Companies are paying out a record amount of this cash to shareholders this quarter in the form of regular and special dividends.

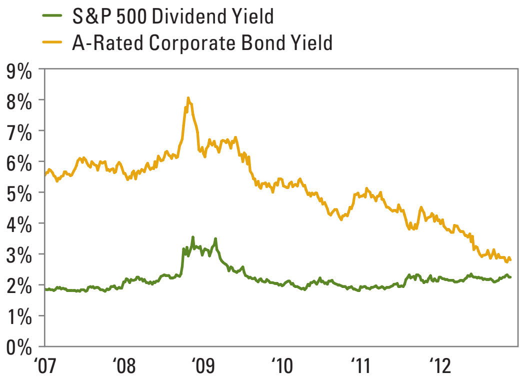
Special dividends are one-time cash distributions companies make to shareholders outside of regular dividend payouts. Dividends are currently taxed at 15% based on the Bush tax cuts passed 10 years ago in 2003. However, dividends will likely revert to the prior 39.6% rate at the end of this year and rise to 43.4% for households earning more than $250,000, due to the added investment tax from the Affordable Care Act (ACA). That potential tripling of tax rates on dividends has prompted a response among corporations.

Last week saw Whole Foods and Las Vegas Sands among the latest companies to announce a special dividend. In addition, some companies, such as Wal-Mart Stores Inc., have moved up their regular quarterly dividend payments to the end of December from the beginning of January to get ahead of the potential tax changes. Companies are scrambling to distribute dividends—even if they do not have the cash to do it. Dividends are typically paid out of earnings, but Costco's $7 per share special dividend is largely funded by a new bond issue.

Will such payouts become rarer after the rates go up? That may depend on where the rates go. The dividend payout ratio (the percent of earnings paid out to shareholders as a dividend) has been volatile due to recessions that cut earnings while companies often maintain dividend payouts. Examining the trend over a long period reveals that the dividend payout ratio appeared to stabilize following a 50-year decline after dividend tax rates were lowered in 2003, but has not started to trend higher [Figure 1]. Much higher tax rates on dividends—going from 15% to 43.4%—would make it less likely that payout ratios will rebound much beyond this quarter.

However, we do not expect dividend tax rates will nearly triple in 2013. Instead, the tax bill that passed the Democratic-led Senate this summer had a top rate for capital gains and dividends of 20% (plus 3.8% for the ACA). If

2 Yield on S&P 500 Stocks and Bonds Has Nearly Converged



Source: Bloomberg Data, LPL Financial 12/03/12

The stock market capitalization weighted debt rating of the S&P 500 companies is as follows:

- **42%** of the market capitalization of the S&P 500 is rated A;
- **23%** rated higher (AAA or AA);
- **26%** rated lower (BBB or worse); and
- **9%** are not rated.

the Republican-led House were to pass this bill — or a similar one in a lame duck session compromise — it could be quickly signed by the President to turn a massive dividend tax surge into a modest rise that may not have much of a discernible effect on corporate or investor behavior in 2013.

No matter how much dividend tax rates go up in the quarters ahead, companies may find it more efficient to return capital through share buybacks than dividends. The dividend yield of the companies in the S&P 500 has nearly intersected with A rated corporate bond yields. The gap has shrunk from 5% to about 0.5% over the past four years, as you can see in Figure 2. If this gap closes further — a possibility if we go over the fiscal cliff — companies may find not only is it more tax efficient to buy back shares in order to return cash to shareholders, but it may actually generate more cash for companies to substitute lower yielding debt for stock. And some companies may be doing just that. Investment-grade bond issuance exceeded $120 billion in November 2012, the second largest on record, as share buybacks are on the rise.

High dividend-yielding U.S. stocks, particularly in the telecommunications services, consumer staples, and utilities sectors, could now take advantage by issuing debt to buy back shares to conserve cash and seek to maximize shareholder returns. So if you are looking for yield, stocks are becoming more attractive relative to bonds for both investors and for corporate leaders. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Stock investing involves risk, including the risk of loss.

Investment-grade corporate bonds: The risks associated with investment-grade corporate bonds are considered significantly higher than those associated with first-class government bonds. The difference between rates for first-class government bonds and investment-grade bonds is called investment-grade spread. The range of this spread is an indicator of the market's belief in the stability of the economy.

Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

Dividend-paying stock payments are not guaranteed. The amount of a dividend payment, if any, can vary over time and issuers may reduce dividends paid on securities in the event of a recession or adverse event affecting a specific industry or issuer.

An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

An obligation rated 'AA' differs from the highest-rated obligations only to a small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.

An obligation rated 'A' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.

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INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

RES 3992 1212
Tracking #1-122505 (Exp. 12/13)