

# Dividend Growth vs. Absolute Yield

*Despite its name, Cohen & Steers Dividend Value is not a traditional value fund. Its differentiated approach enables it to invest in areas typically avoided by value managers, such as biotech or technology. The key aspects of the fund's strategy are the focus on dividend growth, the long-term outlook, and the emphasis on high quality vs. valuation.*

**Q: Could you explain your philosophy and why dividends are such an important element?**

**A:** We believe that companies with sustainable cash flow and strong dividend growth outperform over long periods of time because they deliver superior returns with less volatility. The basis of our philosophy is to focus on dividend growth, not just on absolute yield, as there's a distinct advantage in that approach.

For example, long-term studies by Ned Davis indicate that since 1972, dividend growers have generated average returns of about 10.6% annually, dividend paying companies have returned about 10.1% per year, while the companies that don't pay dividends at all, have returned about 4.1% per year. So we try to identify companies with historic growth rates and future cash flows that make those growth rates sustainable, or at least better than the overall market.

We also believe that it's very important to buy quality versus cheap valuation, while many of our peers focus on valuation first and then look for the gem that's been discounted too heavily. We apply a bottom-up selection approach in that process.

**Q: What is your strategy for putting that philosophy into practice? How do you screen the universe and select the companies?**

**A:** The strategy is to conduct research on each industry and to identify the most attractive companies based on a qualitative ranking. Our universe largely consists of the stocks in the Russell 1000 Value Index with market cap of more than \$10 billion, or about 200 names. We rank the companies within their industries and identify the specific industry drivers and success factors. Then the analysts rank the companies on several measures, which typically include management, R&D, same-store sales, or some other industry-specific factors.

That ranking allows us to focus on the top names, all other things being equal. Then we look at historic and forward-looking dividend growth rates and apply a dividend discount model to get our valuation.

**Q: Where do you typically find such names? What are the characteristics that would make an industry attractive for your investing style?**

**A:** That has changed over the years. Traditional value managers tend to in-

## FUND FACTS

Symbol	DVFAX
Website	<a href="http://www.cohenandsteers.com">www.cohenandsteers.com</a>
Address	Cohen & Steers Capital Mgt, Inc. 280 Park Avenue New York, NY 10017
Tel. No.	800-437-9912
Inception	8/31/2005

## PORTFOLIO

Total Net Assets *	\$18.6
Avg Mkt Cap (\$ Weighted) *	N/A
Average Price/Earnings Ratio	N/A
Average Price/Book Ratio	N/A
Turnover Ratio	N/A

## INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$1,000
Min Subsequent Investment	\$250
Min Initial IRA Investment	\$0

## RISK (AGAINST S&P 500 - 3 YEARS)

Alpha	N/A
Beta	N/A
R-Squared	N/A
Ann Std Deviation	N/A
Sharpe Ratio	N/A

## RETURNS VS. RUSSELL 1000 VALUE INDEX

	DVFAX	Index
1 Mo. (Cum.)	1.69%	2.43%
3 Mo. (Cum.)	0.58%	0.48%
YTD (Cum.)	6.59%	9.15%

## RETURNS VS. S&P 500

	DVFAX	Index
1 Mo. (Cum.)	1.69%	0.62%
3 Mo. (Cum.)	0.58%	2.15%
YTD (Cum.)	6.59%	3.34%

## FEES AND EXPENSES

Max Sales Charge - Front**	4.50%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee **	1.00%
Total Expense Ratio	1.28%

## PORTFOLIO MANAGER

Richard Helm	Aug-2005
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\* millions \*\* for amount invested less than \$100,000

Data through: 7/31/2006

Source: Company Documents; Lipper



vest in higher-yield, lower price/book, or lower P/E industries, and typically avoid areas like media or technology. With our approach, we find companies across the board and that's another differentiating factor. That's because we're not chasing absolute yield, but we're pursuing dividend growth.

We will look at technology companies, for example, if they're raising dividends aggressively. Even if their absolute yield is low, they may be growing dividends because their cash flows allow them to. The companies raising their dividends usually have optimistic outlooks for their businesses. No company would raise its dividend if it expects rough seas ahead, so I believe that boosting the dividend is a vote of management confidence.

**Q: Many companies have been raising dividends recently, including Lehman Brothers and Nordstrom. Is your universe expanding?**

**A:** Yes, we expect the S&P 500 companies this year to raise dividends about 12%, which is a significant increase. One of the reasons is that cash and marketable securities on the balance sheets at the end of 2005 were near all-time highs, according to Ned Davis Research. Cash and marketable securities was in excess of \$2.3 trillion, which at the end of 2005 represented about 20% of the S&P 500 market capitalization.

So we look for companies with very high cash balances as they must do something with that cash or it would depress the return on equity. Managements are frequently compensated based on the ROE, so they need either to make an acquisition, buy back stock, repay debt, or boost the dividend. We feel that boosting the dividend is the most efficient use of cash and that's our focus.

**Q: Why do you believe that boosting the dividend is the most efficient use of cash?**

**A:** In a high interest rate environment, it makes sense to buy back debt, but that's not the current situation. Most

companies have refunded their debt at lower levels and don't have high-coupon debt outstanding. Acquisitions don't generate the synergies expected and claimed by management. In fact, most companies are not particularly good at making acquisitions, so these events can have a negative effect.

Repurchases are very popular with investors right now, but we see a number of problems. Most companies are repurchasing shares to offset the dilution from issuing options, and often end up issuing more than they buy back. So the argument that repurchases boost the EPS is not always valid. They may help maintain your EPS, but if you're issuing more shares, you're using a lot of cash just to tread water with your EPS.

In the end, management is weakening the balance sheet by burning off cash. It is buying back shares at relatively higher prices, because the market has done well in the past few years and most prices are up dramatically. So from our standpoint, it is not an efficient use of cash. And while a repurchase at times may boost earnings, that boost is artificial as the business hasn't grown organically or through an acquisition. It's the same business with a weaker balance sheet; the repurchase just prevents the management's shares from diluting.

Another reason some companies favor buybacks is that management's options often don't adjust for the dividend paid, so they become less valuable after the stock price trades ex-dividend. Managements would rather repurchase shares to neutralize that impact than pay a dividend that would lower the share price. So we try to find cases in which managements actually own shares, not option positions.

But we recognize that for most investors buybacks are portrayed as a positive thing, so we're not going to stand against a favorable sentiment. We just don't look for buybacks because we consider them, at best, neutral. Of course, in the case of a stock that's hammered by the market for a short-term reason, there may be a real opportunity to buy back shares at a

20% discount. That's an efficient use of cash, but an ongoing share repurchase program generally doesn't make sense.

**Q: I understand the argument against acquisitions and buybacks, but paying dividends also doesn't strengthen the balance sheet or the business. What's the rationale there?**

**A:** A dividend doesn't strengthen the balance sheet, but it tells investors that management has enough confidence in its business to return cash to investors. Anything that comes back to shareholders as a return on investment is a positive thing for us. Second, it sends a very clear message about putting shareholders' interests first.

Historically, when dividends were taxed at a higher rate, management could argue that this was a less efficient way to return capital than share buybacks. But when the tax rate on dividends is 15%, that's pretty nominal and the tax-efficiency argument is less meaningful.

You're right that paying out dividends doesn't grow the business, but dividends are paid after capital expenditures. We look at the free cash flow after the company has made enough investments to maintain and grow its market position. The question is will this free cash be used for benefit of the management or for the benefit of the shareholder?

**Q: When a company increases the dividend, isn't that a very long-term commitment?**

**A:** Absolutely. It's a long-term commitment as it would be very painful to cut that dividend. That's why management must be confident to do it and we take that as a positive sign. If the company has lots of cash on its balance sheet, but is unwilling to boost the dividend even modestly, that's also a sign.

Some companies argue that they don't want to become a high-dividend type of stock because it would send the wrong message. For example, Microsoft wants to be perceived as a dynamic growth stock, not as a cash-cow investment. I think that Steve Ballmer's big-

gest fear is that everyone will regard Microsoft as a utility. But at the end of the day, if they have good use for that cash, they should be putting it to work, not keeping it on the balance sheet.

The argument against dividends is that you're sending a signal that you don't have a better option for that cash. But what are the other options? Are you going to continue building a war chest that will depress your ROE, or pay out that money as dividends or repurchases? Some companies strike a good balance between those options and some don't, but at the end of the day, they want to get that excess cash off the balance sheet.

**Q: What are the most important aspects of your research process?**

**A:** My analysts spend their time on what we own in the portfolio, not on producing new ideas. We're mostly a buy and hold fund with three to five-year outlook, so we're not trying to find the next earnings pop. I basically believe that absolute performance is driven by what you own, while relative performance is driven by what you don't own. I want to make sure that we can deliver good absolute numbers, then the relative numbers will take care of themselves.

To keep the absolute numbers up, we try to avoid the land mines, so I want my analysts to know the companies well. That helps us gauge the company risk on an ongoing basis. We take advantage of occurring shifts, such as emerging leaders moving up due to management changes or product launches, etc. The key is understanding the company and the competitive landscape.

Valuation doesn't come in until later in the process. About 75% of our time is spent on the businesses and only about 25% on valuation because valuation is the easier part of the equation. It's not easy to tell if a stock will go up or down, but it's easy to tell whether a stock is cheap relative to its industry, its history, and the overall market by traditional valuation measures. It helps to understand the dynamics of the company and the industry.


**Q: Would you explain your portfolio construction process?**

**A:** Three-fourths of our assets are in what we call core value types of names, such as Wells Fargo, FPL, Lockheed Martin, or large companies that offer traditional type of value. For these names we have an outlook of three to five years. Then we have 25% in a more opportunistic portion of the fund, where we're looking one to three years out. These

names may include a broken down growth stock, a deep cyclical turnaround story, a mid-cap name, or something that isn't traditional value, but offers compelling value over a shorter period.

Overall, we have about 60 names that we consider the nucleus of the portfolio. At any point in time, there are about fifteen companies that we're scaling in and out of, and this process is related to risk control. We build our positions slowly, buying 25 basis points now and 25 basis points later when we like the price. We also come out of positions gradually, so there's an ongoing rotation rather than big position changes. Our annual turnover rate is about 20%, which means only about 12 new names a year, or one new name a month.

We have limits of 25% in any industry and 3% in any holding to ensure proper diversification and risk control. The only exception is the financial industry as it represents a huge part of the Russell 1000 Value Index, about 35% to 40%. That's a lot of concentration and it makes us nervous, but we recognize that this is the benchmark to which we're compared, so we've made an exception. We have about 30% in financials and another 3% in REITs, which are considered financials by the index, but we treat them as a separate asset class. But in general, we try to stay at less than two times the S&P weighting in most sectors.

We also use convertible bonds and convertible preferred bonds in areas where we can't find dividends. If we find a name in biotech that we really like, we'll look for a convertible because the common shares don't pay dividends. That approach allows us to participate in the upside of the common stock and earn a nice yield while we wait for that upside. It also gives us exposure to areas that are not traditional value, so there's an asset allocation component that we consider very effective. It's another way to spread risk, increase return and differentiate ourselves. 

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**RICHARD E. HELM, CFA**, senior vice president, is a senior portfolio manager for Cohen & Steers and head of the firm's large cap value strategy. He has 21 years of investment experience in the US and abroad. Prior to joining the firm in 2005, Mr. Helm was senior portfolio manager at WM Advisors for four years managing the WM Equity Income Fund, a five-star Morningstar rated fund. While at WM he was twice ranked in Barron's as one of the top 100 fund managers in 2004 and 2005. Previously, he was a portfolio manager at Northwestern Trust, TD Asset Management (Canada), Parametric Portfolio Associates, and Morgan Stanley Asset Management in the US, UK and Japan. Mr. Helm has a BS degree from University of Colorado, an MBA degree from University of Denver, and is a CFA charter holder.

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