| SAFECO Dividend Income A | |
|---|---|
| **Fund Facts** | |
| Symbol | SFOAX |
| Website | www.safecofunds.com |
| Address | SAFECO Mutual Funds, P.O. Box 34890, Seattle, WA 98124-1890 |
| Tel. No. | 800-528-6501 |
| Inception | 09/30/96 |

| **Portfolio** | |
|---|---|
| Total Net Assets * | $0.70 |
| Avg Mkt Cap ($ Weighted) * | $34,570.00 |
| Average Price/Earnings Ratio | 20.53 |
| Average Price/Book Ratio | 3.25 |
| Turnover Ratio | 58.00% |

| **Investment Information** | |
|---|---|
| New Investment | Open |
| Min Initial Investment | $2,500 |
| Min Subsequent Investment | $100 |
| Min Initial IRA Investment | $1,000 |

| **Risk (Against Std Index - 3-yr Average)** | SFOAX | Category Avg. |
|---|---|---|
| Alpha | -1.02 | 5.91 |
| Beta | 0.72 | 0.80 |

| **Returns vs. Lipper Equity Income Index** | SFOAX | Index |
|---|---|---|
| 1 Year (Cum.) | -19.20% | -17.95% |
| 3 Year (Ann.) | -9.73% | -4.89% |
| 5 Year (Ann.) | -6.27% | -0.73% |

| **Returns vs. S&P 500** | SFOAX | Index |
|---|---|---|
| 1 Year (Cum.) | -19.20% | -23.02% |
| 3 Year (Ann.) | -9.73% | -13.84% |
| 5 Year (Ann.) | -6.27% | -1.33% |

| **Fees and Expenses** | |
|---|---|
| Max Sales Charge - Front | 5.75% |
| Max Sales Charge - Deferred | 0.00% |
| Redemption Fee | 0.00% |
| Total Expense Ratio | 1.35% |
| * millions | Data through: 01/31/03 |
| Source: Company Documents; Lipper | |

| **Portfolio Manager** | |
|---|---|
| Management Team | --- |

Q&A

TICKER's Choice

# Don't Overlook Those Dividends

*According to Darcy MacLaren, dividend is a word that "should resonate well with conservative investors." Using a team approach, the SAFECO Dividend Income fund yields an average 3% a year. That may not seem like much, but if the Congress agrees to a repeal of the tax on dividends to common shareholders, the implications could be broad and long reaching. Along with the compounding, which is a powerful thing, all long-term investors appreciate.*

**Q: Included in the Bush administration's fiscal stimulus plan was a proposal to repeal the double taxation on corporate dividends, which is has been in effect since 1913. What are the implications for the fund?**

**A:** During the bull market of the 1990s, companies were under pressure from Wall Street and investors to produce earnings per share gains at any cost. Dividends were passé at worst. In the last couple of years of bear market, stocks that pay dividends have already outperformed. I think you probably saw the S&P study last year that showed stocks that paid dividends were down 18% and those that didn't were down 30%.

**Q: That's relative over performance, but a loss is still a loss.**

**A:** A loss is still a loss. In a down year, owning stocks that pay dividends was defensive. Defensive is about all you can do in a down market. I would say that last winter, the topic started to turn among investors and the press toward more interest in dividends. Historically, dividends have provided 40% of the stock market's total return until the beginning of the bull market in the 1990s. So, if you go back to anything resembling a more normal stock market environment where stocks don't go up 25% a year, in any kind of normal environment, companies that pay dividends would be advantaged anyway, because there's that steady compounding that you can count on. If the taxation changes, that income to investors that's advantaged to them would be even more so.

**Q: What about budget strapped legislatures deciding that they can capture this federally exempt income for themselves?**

**A:** That's possible. My understanding is that some states base their income taxation on the federal code. And some aren't. It's variable. When you look at it from the perspective of the individual investor, they're asking what's best for me. If it goes through Congress as planned, when you look at after-tax income, municipal bonds are great, because you don't pay tax on those. Dividends would be great, because you don't pay tax on those either.

**Q: It seems to me that this is the type of fund that one would choose for an IRA or some type of tax-**

© 2003 TICKER **All rights reserved**. The entire contents of the publication are copyrighted. Reproduction in part or in whole is not permitted without written permission of the publisher. Unauthorized reprints are punishable by fines of up to $50,000.
Requests for reprints or permission to copy editorial matter for other purposes, please contact Elizabeth Kadar, email: elizabeth@ticker.com

**deferred plan to take advantage of the accounting. Do you agree or disagree?**

**A:** That takes away some of the conversation concerning the repeal of the law, doesn't it? What is interesting is the two kinds of individual investors that I've talked to, over time. One is real conservative and they'll say, "You know, I was always taught that you only spend income and not principle." Those kinds of people have tended to like dividend-paying funds anyway, and it makes it all the better for the stocks, because the dividends won't be taxed. It's perfect, right? Then there are people who say, "Well, I don't want dividend stocks to pay more tax on. I want the capital gains." I don't see how it couldn't be a plus for companies that pay dividends. I would tell you that one of the things we try to pay attention to is not just the absolute level of dividend yield but also the ability of the companies to grow their dividends over time as they grow their earnings.

**Q: How do you determine which companies are in your investment universe?**

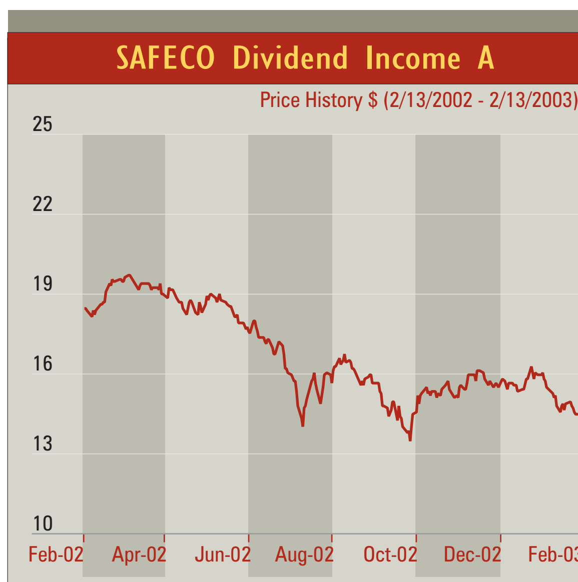
**A:** This is primarily a large-cap fund. We look at a couple of things. One in particular is the dividend payout ratio. If it's too high, chances are they can't keep raising the dividend to stay in line with earnings growth.

**Q: What threshold guidelines do you use concerning debt levels?**

**A:** I like to see debt to capital under 50%. We'll sometimes have companies that go over that, for specific reasons. All other things being under 50% is good; 40% is good.

**Q: There has been a change in the fund's management. Has there been a change in investment strategy?**

**A:** We went to a team management approach. Actually, it's interesting. The way we do it is every person in the equity portfolio department, whether they're a portfolio manager or analyst is responsible for certain industries. In their capacity as industry analysts, we put together a model. The model says, for example, we want x percentage in chemical stocks and the chemical analysts says, "This is my first choice. This is my second choice. This is my third choice." This fund is managed to that model. Everyone in the equity department has input. If all you do is analyze financial services, sometimes there's a period where you get tired of them, because you don't care anymore. That's one part. The other part is that when you cover new things, you learn different ways of analysis. We think that's additive to the process. It may be a little bit unusual. I'm willing to admit that. If someone has five industries, I wouldn't switch all of them, but I might switch one. What I find is that people gravitate toward industries they like, and they'll trade off the ones that they don't like for whatever reason. But also, if you're a good analyst, almost anything is interesting. For the longest time, my areas of expertise were things like media and retail. For 15 years, I did both of those. For a couple of years here I did do the REITs, and I really liked it. When someone asked to take on another industry, I said, "Fine. I'll take on industrial commodities." It's very different from anything I've done before, but I find it interesting to make those switches. I think it makes you a better portfolio manager because you have a broader background. And it makes you a better analyst.




**Q: How does it come into play in the dividend income fund?**

**A:** Another thing that we look at is the number of times in, say, the last 10 years that a company has raised its dividend. It's not a hard rule that they all have to be 10-for-10, but the higher the number, the better.

**Q: That is telling me that as part of your research process, you're compiling a dynamic database.**

**A:** That's right. Each analyst for each stock sets a buy target and a sell target. They can change them as they feel it is appropriate. You wouldn't use the same price target for five years. PACCAR is an example. We bought it in the third quarter. It had a nice run. It went close to the analyst's price target. We said, "This is great. We've made money much faster than we expected, lets take some profits. So we cut it back. The second reason you sell something is if you've got a better idea where you think there is more potential to put the money into. Another reason you sell is if something adverse has changed for this company, something that we didn't expect. We just have to let it go and move on because we determined that what we thought was going to happen isn't going to happen, for whatever reason.

**Q: Moving from dividend performance measures to capital appreciation expectations, what factors come into play?**

**A:** We want several things. We want a good quality company. By that I mean it has to have a good balance sheet. It has to have exceptionally good management, decent. We like to buy them when

© 2003 TICKER **All rights reserved**. The entire contents of the publication are copyrighted. Reproduction in part or in whole is not permitted without written permission of the publisher. Unauthorized reprints are punishable by fines of up to $50,000.
Requests for reprints or permission to copy editorial matter for other purposes, please contact Elizabeth Kadar, email: elizabeth@ticker.com

they're a little out of favor so that we can get a better price. We're willing to go against the stream a little bit. The trick then, is to make sure it's a temporary problem and not a permanent problem.

**Q: That approach is similar to the value fund manager's approach.**

**A:** That would be a fair description. We are willing to go against Wall Street a little bit. The way I like to describe it for us is that we like to buy A companies when they're trading like B companies and buy B companies when they're trading like C companies. But we don't buy the D's and E's.

**Q: There was a change in your charter in July 2002 that allows for an exposure to preferred stocks. Do you own any?**

**A:** We have the ability to buy them, but there aren't any in the portfolio right now. We have three stocks that don't pay dividends, all in technology: Microsoft, Dell Computer and Agilent Technologies. I want to have a diversified portfolio. We keep the yield on the portfolio high enough that I'm not worried about it. I think that the more pressure they get from investors and the press, the greater a chance that the directors will approve a dividend. Actually, whenever we meet with the company management, we bring that up to them.

**Q: Since the fund is so old, there must be stocks in the fund that have been there for a long time. Is it hard to find these stocks and stick with them?**

**A:** No, it's not as hard as you think. The oldest stocks in this fund go back to 1987. I also managed some money for SAFECO Insurance Company, and I know we've got stocks that go back to the 1940s. There are some local companies we bought that were purchased by another company and were then purchased by Bank of America. And we still own it, for example. I don't tire of companies if they continue to do a good job.

**Q: Companies that pay dividends have a harder time hiding flaws, what kind of red flags do you look for in the balance sheet?**

**A:** One of the things I think has become clear over the past couple of years, that maybe was once there before, is that simpler may be better. If something seems too complex and they have to work extra hard to keep it running, we have to figure out if we want to put in the time to dig a little deeper to understand why? I think there is lot to be said for companies that make real products and sell them for real cash. It sounds strange, but it may not be.

## About:

**Darcy MacLaren** is vice president of SAFECO Insurance Companies. In addition to managing $1.7 billion in stocks for the various insurance companies, she oversees the equity department, its portfolio managers, analysts and traders. MacLaren joined SAFECO in 1980 as an equity analyst and left to become a portfolio manager at First Interstate Bank of Washington. Before returning to SAFECO in 1994 as director of equity research and vice president of SAFECO Asset Management Company, she was a manager and principal of Meridian Capital Management. She became vice president of SAFECO's property/casualty companies in 1996. MacLaren holds a BA from the University of Colorado in Boulder, an MA degree from the University of Denver, and an MBA from the University of Washington. She is a Chartered Financial Analyst and a member of the Association for Investment Management and Research. She is a past president of the Seattle Society of Financial Analysts.

**Q: Although you avoid the technology sector, Intel pays a dividend — but it sells for 40 times 12-month trailing earnings, is it still expensive?**

**A:** I'll give you an answer that may not be what you're expecting. We talked earlier about if you've been an analyst in one area, you might be able to apply it into a different area. I spent an unreasonable length of time as a metals analyst of steel and copper, for example. It's typical in those industries that in a recession they'll lose money. In a good environment, they'll make a lot of money and be really proud of themselves. In a bad environment, they'll think that the world is coming to an end. That is if you believe that. Well, it turns out, much to the surprise of everybody a couple of years ago, that technology is cyclical. One of the things you learn when you cover cyclical industries is that the stocks are cheap on a dollar price when their earnings are depressed and the multiple is high on those earnings. It's called peak multiple and trough earnings. When Alcoa is going to make five bucks and it's going to trade at 16 times five bucks, it's going to be a $45 stock instead of a $12 stock. You make a lot of money when it goes from 12 to 45 while the multiple makes it look cheaper and cheaper the whole time. Right now, I think you could apply that lesson to technology stocks. They're at trough earnings, but the multiples look expensive. In a couple of years, whenever the environment is better for their products, the stocks will be a lot higher and the PE will be a lot lower.

**Q: Whether the dividend tax repeal legislation passes or not, there is still the issue of compounding, which is a powerful thing for investors. What is your view of compounding?**

**A:** I'll tell you how I feel about compounding. My grandfather lived to be 1031/2. If he had figured, well, I'm going to die when I'm this number of years and hadn't saved money, somebody else would have had to pay his bills. And they didn't. Sixty-plus years of savings really added up. So, I think there is lot to be said for an individual taking the real long-term horizon, because you might very well have it. ▮

**Dave Jennings**

© 2003 TICKER **All rights reserved**. The entire contents of the publication are copyrighted. Reproduction in part or in whole is not permitted without written permission of the publisher. Unauthorized reprints are punishable by fines of up to $50,000.
Requests for reprints or permission to copy editorial matter for other purposes, please contact Elizabeth Kadar, email: elizabeth@ticker.com