

UBS Investment Research

True Yield Q&A

Americas

Equity Strategy

Equity Strategy

TY = Div Yield + Annual % Decline in Shares

■ True Yield Measures Total Capital Paid to Shareholders

TY = Dividend Yield - (3-yr rate of change in shares outstanding). For a stock with a 3% dividend yield that reduced its share count 1% annually, TY = 3% - (-1%) = 4%. By measuring change in share count, TY avoids the problem that some buybacks merely offset dilution from employee stock options and fail to reduce shares outstanding.

■ High TY: Not the “Usual Suspects”

The sectors with the highest TY are not high dividend payers such as Utilities & Telecom, but Consumer Durables and Consumer Staples at 3.7%, followed by Industrials at 3.4% (Table 1). Semiconductors and Semi Equipment have very high TY of 7.3% and 5.0%, respectively.

■ Improved Payout Policies Are Bullish

We love stocks that pay out no capital **if** they can profitably reinvest all their cash flow. This is not the case for most large, fairly mature companies. Faster dividend growth, and buybacks that *really do* cut share count, are a big improvement over the 1990s, when capex and M&A were excessive, dividends were too low, and buybacks disguised option dilution. More disciplined capex is bullish for margins, strong buybacks boost S&P EPS by cutting the index divisor, and strong dividends enhance total return.

■ Dividend Fountains

They have dividend yields of 2.5%+ and DPS growth of 5%+ (Table 2). Many of these companies are also buying shares; their median TY is 5.0%.

Table 1: Dividend Yield and True Yield by Sector

	Dividend Yield		True Yield	
	Mean	Median	Mean	Median
Consumer Discretionary	1.2%	1.2%	2.9%	3.7%
Consumer Staples	2.5%	2.4%	1.7%	3.7%
Industrials	2.0%	1.8%	2.6%	3.4%
Utilities	4.2%	2.9%	2.6%	2.9%
Materials	1.7%	1.4%	0.2%	2.8%
Information Technology	0.7%	0.0%	2.5%	2.4%
Healthcare	0.8%	0.0%	0.9%	2.3%
Telecom Services	5.5%	6.2%	-0.8%	2.3%
Energy	1.4%	0.9%	0.7%	1.1%
Financials	1.9%	1.5%	-6.6%	-3.5%

Source: FactSet, UBS

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True Yield Q&A

Investor: How do you define True Yield, and why should I care?

Strategist: True Yield equals

(dividend yield) - (3-yr compound growth rate in share count).

So if a company has a 3% dividend yield and is **reducing** its share count 1% per year, its True Yield is $3\% - (-1\%) = 4\%$. But if its share count is **rising** 1% annually its True Yield is $3\% - 1\% = 2\%$.

Investor: But why should I care?

Strategist: Shareholders need to know how much capital they are receiving from the company. True Yield is a handy metric for measuring that accurately.

Investor: Why not just look at the amount spent on dividends and buybacks, in the cash flow statement?

Strategist: You need to consider not just the amount spent but the average price of the shares purchased. More important, buybacks are not returning capital if they don't shrink shares outstanding. Many buybacks fail to do that because they merely offset dilution from employee stock options and / or issuance for acquisitions. This was a big problem in the 1990s. Dividends slowed sharply, supposedly in favor of share buybacks, but share counts didn't decline much; the median share count change for S&P 500 companies was close to zero. Buybacks were effectively being used to disguise dilution from stock options, which were not expensed. It's problematic, to say the least, when CEOs make capital deployment decisions that obscure the magnitude of their own compensation.

Investor: Are you saying that if a company's true yield is less than its dividend yield, it's a sign of poor corporate management?

Strategist. Not necessarily. A low or negative true yield may reflect M&A financed with shares. That's fine if the deal creates value.

Investor. So when is a low True Yield a negative indicator?

Strategist: If a company or industry appears to offer attractive dividends, but the true yield is consistently lower than the dividend yield, it suggests the company is stretching to pay the dividend. In effect it's funding part of its dividend payout by issuing new shares.

Investor: That sounds implausible. Can you give me a real world example?

Strategist: The S&P 500 utility sector has an *average* dividend yield of 4.5%, but an average true yield of just 2.6% (Table 1). The utility sector's *median* dividend yield and true yield are both 2.9%, suggesting few companies are shrinking their share count via buybacks. By contrast, in consumer discretionary, industrial, tech, and (leaving aside four firms that did deals) consumer staples, **true yields are much higher than dividend yields**. Many companies in these sectors are shrinking their share counts and also paying meaningful dividends. Despite its reputation for high yields, the utility sector only ranks fourth in terms of median true yield.

Table 2: Dividend Fountains: 2.5%+ Yield, 5%+ DPS Growth

Ticker	Company	Div Yld	True Yld	Rating	Ticker	Company	Div Yld	True Yld	Rating
ABT	Abbott Laboratories	2.8%	2.2%	Buy	KFT	Kraft Foods	4.0%	7.3%	Buy
CAT	Caterpillar	2.9%	4.1%	Neutral	LLTC	Linear Technology	3.1%	11.9%	Buy
CVX	Chevron Corp.	3.7%	6.3%	Buy	LO	Lorillard	5.2%	-8.2%	Buy
CB	Chubb Corp.	2.9%	8.7%	Buy	MCD	McDonalds	3.2%	6.7%	Buy
CLX	Clorox	3.1%	5.7%	Buy	NSC	Norfolk Southern	2.8%	5.2%	Buy-Short Term Buy
CAG	ConAgra	3.3%	7.7%	Buy	NOC	Northrop Grumman	2.9%	6.3%	Buy
DRI	Darden Restaurants	2.2%	3.6%	Buy	PCG	PG&E Corp.	4.0%	1.8%	Buy
EMR	Emerson Electric	2.9%	5.0%	Neutral	MO	Altria Group	6.6%	7.0%	Buy
GIS	General Mills	2.5%	4.0%	Buy	PG	Procter & Gamble	2.7%	5.4%	Buy
HON	Honeywell Intl. Inc.	3.1%	5.0%	Neutral	SYN	Sysco Corp.	3.4%	4.8%	Neutral
ITW	Illinois Tool Works	2.8%	6.7%	Buy	VFC	VF Corp.	3.2%	3.6%	Buy
INTC	Intel	2.8%	4.2%	Buy	WEC	Wisconsin Energy	2.7%	2.7%	Neutral
JNJ	Johnson & Johnson	3.0%	4.2%	Buy	XLNX	Xilinx	2.3%	8.3%	Buy
K	Kellogg	2.7%	4.2%	Buy					

Source: Factset, UBS

Investor: Which sector has the highest True Yield?

Strategist: Interestingly, it's consumer durables. With growth prospects poor, lots of companies are aggressively repurchasing shares. A third of the stocks in the sector have True Yields above 5%.

Investor: What about tech? Any notable trends there?

Strategist: Tech dividends are low, but buybacks are strong. Tech's median True Yield is 2.4%, only 50 bps behind Utilities. Even more striking, the semiconductor industry has a median true yield of 7.3%; for semi equipment it is 5.0%. That at or above "usual suspects" cash cows such as "big pharma" at 5.1%, managed care at 5.0%, or "core" consumer staples stocks (household products, food, soft drinks, and tobacco) at 4.0%.

Investor: But don't semiconductors' big share buybacks show the industry has slowed down, and reinvestment opportunities are fewer? That sounds bearish to me.

Strategist: I would rather own a company with a realistic understanding of its growth opportunities than one that overinvests, creating excess capacity that depresses margins. That's what occurred in the late 1990s.

Investor: What's the trend in industrials?

Strategist: True yields are quite high, despite capital hoarding during the recession. Dividend yields average 2.0%, and the median true yield is 3.4%, almost as high as consumer staples.

Investor: No offense, but this entire discussion is irrelevant. I have found over the years that dividends are not important for stock selection. High yield tends to mean high risk. Look at GE in 2008.

Strategist: Two points. For more and more stocks buybacks are a key driver of EPS growth. Second, I agree many stocks with very high yields are value traps,

because the stock market sniffs out dividend cuts long before they occur. But I do like stocks that have decent dividend yields (over 2.5%) and decent growth (over 5%). We call them Dividend Fountains (Table 2). Interestingly, although true yield was **not** a criterion in selecting these stocks, their median true yield is high at 5.0%, which reflects their healthy dividend yields and EPS growth driven by buybacks. Even in a slow-growth economy, a disciplined company generating ample FCF can—by combining organic growth, acquisitions, share buybacks, and a meaningful dividend—deliver ~10% total return, which is not bad when short rates are close to zero and Treasuries yield 3.5%.

Investor: Why do you think companies have become more careful in how they deploy capital?

Strategist: They learned their lesson in the 2000-2002 stock market crash and accounting scandals. In the giddy 1990s, capital spending, M&A, and stock option issuance were too strong while dividends were too low. Now companies are more careful and investors care more about dividends, especially now when rates are so low.

Investor: What's the implication for the stock market as a whole?

Strategist. It's bullish. Even if you as a stock picker are not that interested in dividends and buybacks, it is much better for the performance of the S&P 500 if firms with mediocre growth prospects recognize that, do not overinvest or make imprudent acquisitions, and instead pay out significant sums via dividends and buybacks. Capacity growth was much slower in the last business expansion than in the 1990s, and capacity is actually declining now. That's one reason why margins have snapped back quickly. Don't forget that share buybacks boost S&P 500 EPS growth. In 2007 and 2008 the median S&P 500 company reduced its share count by 1.4% yr/yr and the index divisor declined at a 1.7% annual rate.

Investor. It sounds like companies are under-investing in capex and R&D. That will slow economic growth.

Strategist. Stellar productivity gains argue against the under-investment theory. Companies are getting a productivity payoff from the Internet-based "New Economy" that enthralled investors in the late 1990s. Investment in equipment and software rose at a 13% annual rate in Q4 2009 and is forecast 6-7% in 2010 and 2011.

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Buy	Buy	48%	40%
Neutral	Hold/Neutral	40%	35%
Sell	Sell	13%	26%
UBS Short-Term Rating	Rating Category	Coverage ³	IB Services ⁴
Buy	Buy	less than 1%	17%
Sell	Sell	less than 1%	67%

1:Percentage of companies under coverage globally within the 12-month rating category.

2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

3:Percentage of companies under coverage globally within the Short-Term rating category.

4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS. Rating allocations are as of 31 December 2009.

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UBS 12-Month Rating	Definition
Buy	FSR is > 6% above the MRA.
Neutral	FSR is between -6% and 6% of the MRA.
Sell	FSR is > 6% below the MRA.
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Buy	Buy: Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.
Sell	Sell: Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.

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Company Disclosures

Company Name	Reuters	12-mo rating	Short-term rating	Price	Price date
Abbott Laboratories ^{8, 16}	ABT.N	Buy	N/A	US\$53.93	12 Feb 2010
Altria Group ^{4, 16, 18a, 22}	MO.N	Buy	N/A	US\$19.63	12 Feb 2010
Caterpillar Inc. ^{6b, 7, 16, 18b, 22}	CAT.N	Neutral	N/A	US\$56.20	12 Feb 2010
Chevron Corp. ^{6b, 6c, 7, 16}	CVX.N	Buy	N/A	US\$71.01	12 Feb 2010
Chubb Corporation ^{6b, 7, 16}	CB.N	Buy	N/A	US\$49.07	12 Feb 2010
Clorox ¹⁶	CLX.N	Buy	N/A	US\$59.36	12 Feb 2010
ConAgra Foods Inc. ^{6b, 7, 16}	CAG.N	Buy	N/A	US\$23.40	12 Feb 2010
Darden Restaurants Inc. ¹⁶	DRI.N	Buy	N/A	US\$38.99	12 Feb 2010
Emerson Electric Co. ^{6c, 16, 18c}	EMR.N	Neutral	N/A	US\$46.21	12 Feb 2010
General Mills Inc. ^{6b, 6c, 7, 16, 22}	GIS.N	Buy	N/A	US\$69.49	12 Feb 2010
Honeywell International Inc. ^{2, 4, 5, 6a, 6b, 6c, 7, 16, 18d, 22}	HON.N	Neutral	N/A	US\$37.86	12 Feb 2010
Illinois Tool Works ^{2, 4, 6a, 16}	ITW.N	Buy	N/A	US\$43.64	12 Feb 2010
Intel Corp. ^{6b, 7, 8, 16, 18e}	INTC.O	Buy	N/A	US\$20.43	12 Feb 2010
Johnson & Johnson ^{16, 18f}	JNJ.N	Buy	N/A	US\$62.72	12 Feb 2010
Kellogg Co. ¹⁶	K.N	Buy	N/A	US\$52.34	12 Feb 2010
Kraft Foods Inc. ^{4, 6b, 6c, 7, 16}	KFT.N	Buy	N/A	US\$29.09	12 Feb 2010
Linear Technology Corp. ¹⁶	LLTC.O	Buy	N/A	US\$27.25	12 Feb 2010
Lorillard ¹⁶	LO.N	Buy	N/A	US\$75.35	12 Feb 2010
McDonalds Corp. ^{6b, 7, 16}	MCD.N	Buy	N/A	US\$63.59	12 Feb 2010
Norfolk Southern Corp. ^{4, 6a, 16, 18g, 22}	NSC.N	Buy	Buy	US\$48.48	12 Feb 2010
Northrop Grumman Corp. ^{16, 22}	NOC.N	Buy	N/A	US\$58.89	12 Feb 2010
PG&E Corporation ^{2, 4, 5, 6a, 16}	PCG.N	Buy	N/A	US\$41.02	12 Feb 2010
Procter & Gamble ^{2, 4, 5, 6a, 6b, 6c, 7, 8, 16, 18h}	PG.N	Buy	N/A	US\$61.76	12 Feb 2010
Sysco Corp. ¹⁶	SYN.N	Neutral	N/A	US\$27.54	12 Feb 2010
V.F. Corp. ¹⁶	VFC.N	Buy	N/A	US\$73.94	12 Feb 2010
Wisconsin Energy Corp. ^{4, 5, 6a, 16}	WEC.N	Neutral	N/A	US\$47.87	12 Feb 2010
Xilinx, Inc. ^{6b, 7, 16}	XLNX.O	Buy	N/A	US\$24.56	12 Feb 2010

Source: UBS. All prices as of local market close.

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