Cash Hoards
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Dear Fellow Investors:

In an article in Saturday's Wall Street Journal, Jason Zweig asked the question, "What will it take for companies to unlock their cash hoards"? At Smead Capital Management, we'd like to expound on his thoughts and examine our own portfolio under the magnifying glass presented.

Zweig dealt with the key facts. First, companies with large cash balances are adding to them. Second, payouts are historically low as he showed through this research:

"Meanwhile, the payout ratio—the proportion of earnings paid out as dividend income to shareholders—fell to 28.9% for the past four quarters. That, says S&P senior index analyst Howard Silverblatt, is the lowest level since 1936."

Third, the point has probably come where the best interests of corporate management and the shareholders are at odds. Zweig zeroed in on Ben Graham's thoughts in regards to why big companies that generate high levels of free-cash flow are hesitant to return cash to shareholders. He intimates that larger business managers seem to think that their slowing growth can be dealt with by acquisitions. With depressed stock prices, the cheap currency is cash. Just look at the money market fund interest rates at major investment firms and banks. The rate is almost zero. Why would you want to make an acquisition with stock at a 6-10% earnings yield when you can give up .01% return on cash?

Graham provided three solutions to this problem. He said that shareholders must pressure management to return the cash to shareholders. He urged companies to set up a formal dividend policy. This would be a certain percentage of profits to be paid out in the form of dividends. Lastly, Graham urged companies to pay out 67% of earnings in dividends. Here is how Zweig explained it:

"Finally, Graham advocated that leading companies should pay out two-thirds of their earnings as dividends. That rate isn't as radical as it might sound, even though it would amount to more than a doubling from today's levels. The dividend payout, as a percentage of total profits, has averaged 52.3% since 1936 and 46% over the past two decades, according to Standard & Poor's."

Silverblatt estimated for Zweig that a 50% payout ratio would put an additional $207 billion into investor's pockets and raise taxable income for the US Treasury. It would be a stimulus package without government intervention and it would happen every year going forward.

How would Zweig's thesis affect our portfolios and some of our individual companies? At the end of the first quarter of 2011, we concluded that 23% of our company's after-tax income was being paid out in dividends. We have three criteria among our eight proprietary criteria which speak directly to this issue. Our companies must generate high levels of free-cash flow, be protected by wide moats for long duration business consistency and have strong balance sheets. Therefore, we believe our companies are in a much better position to raise dividends than the average company. On a portfolio basis, a growth in dividend pay-out ratios to 46% would mean an immediate doubling of our dividends. If our earnings grew by 7% per year for 10 years and our pay-out ratio was 46% at the end of the 10 years, our dividends would quadruple. This is only something to think about in a relatively low turnover portfolio where an investor could be likely to own many of the current holdings for a decade.

We are involved in a number of companies which should be pestered by shareholders. Some have shown improvement by starting a dividend for the first time like Amgen or by raising their dividend significantly like Microsoft or Franklin Resources. One of our portfolio companies, Ebay, was kind enough to take 30% of the $8.5 billion paid to buy Skype that came from Microsoft's balance sheet. In our opinion Ebay could easily pay a dividend with their massive free-cash flow, but so far has chosen to not pay a dividend. Microsoft has been much more interested in pouring our dividends out through losses they manufacture in their online division. They lost more money last quarter in that division ($726 million) than they had in revenue ($648 million). Microsoft tells us dividend hungry investors that they will make those losses up on volume.

We have been impressed by how Starbucks has handled the subject of dividends. When the company's restructuring and slower store growth exposed their massive free-cash flow in 2009-10, Howard Schultz set a substantial initial dividend. He also announced an ongoing dividend policy of a 35-40% payout ratio going forward. Ben Graham would love that kind of attitude toward shareholders.

We believe that our eight proprietary criteria finds companies with the kind of cash hoards that Jason Zweig described. They are in a position to follow Ben Graham's advice. We also believe that income hungry investors have been too scared to trust the attractive income possibilities created by rising pay-out ratios. As this phenomena plays out and pressure to disgorge these cash hoards occurs, we'd like to think that our portfolios will get an above average share of these rising income streams.

Best Wishes,

William Smead

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