EBay and Amgen: Dividends do Matter
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Dear Fellow Investors:

We are owners of both EBay (EBAY) and Amgen (AMGN). We believe the dividend policy and price action in the shares of these two companies can teach us about stock price performance over the next three to five years.

History shows that for a few decades after terrible stock price performance (like we've seen from 1999 to 2011) investors demand more of their return from cash dividends because they do not trust appreciation. In the 1940's and early 1950's, investors demanded a higher cash dividend from stocks than they demanded from Treasury and Corporate Bonds. Treasuries yielded around 2% in 1950 and the Dow had around a 6% yield from dividends. However, in the aftermath of the 1929-32 crushing bear market in stocks and massive bank failures which followed, public companies hoarded cash. Howard Silverblatt at S&P reports that the payout ratio in 1936 of US public companies was 29%. Ironically, in our opinion, we are in the same kind of circumstance and have the same kind of payout ratios today. See our June 1st, 2011 Missive called "Cash Hoards" to understand the history more fully.

Last summer, Amgen was trading in the low $50's on a per share basis and had never paid a dividend as a public company. Amgen declared their first ever cash dividend at $.28 quarterly last summer. Since then, they did a Dutch auction, buying back 9% of their shares and raised the dividend to $.36 per quarter. Amgen's first ever dividend was a higher yield on share price than the 10-year Treasury bond yield! I have been in the investment business for 31 years and can't ever remember an initial dividend offering more than the 10-year Treasury interest rate. We believe it is no coincidence that Amgen is trading above $64 per share on December 29, 2011. At the $1.44 annualized dividend rate, it yields around 2.23%, still significantly above the Treasury bond yield.

Amgen still has a payout ratio below 30% and has massive free-cash flow. They could be an aggressive dividend growth company going forward as we believe their balance sheet is strong and the future earnings look bright. Their newest product Denosumab is selling briskly in the form of Prolia for Osteoporosis and Xgeva for treating cancerous tumors. Management seems to have learned what scared investors want from a company.

At the end of June in 2011, EBay closed at $32.27 per share. We believe they have a fortress balance sheet. Their PayPal division is growing like weeds and throwing off massive free-cash flow. Their legacy Marketplace business has turned the corner and is growing nicely, while continuing to throw off over a billion dollars in free cash flow. EBay is buying back stock, but they don't pay a dividend. The stock was trading between $30 and $31 per share in the last week of 2011. Investors can't help but like the operating results of EBay's management team, but they are too scared from the last 12 years of non-existent price appreciation to bet on it alone.

Silverblatt pointed out that the historical payout ratio over the last 50 years is 52.6% and over the last 20 years it was 46%. At Smead Capital Management, we believe that the companies which raise their dividend payout ratio towards the historical averages from the position of strong balance sheets, wide moats and relatively non-cyclical earnings performance will enjoy the kind of outsized price gains that Amgen has seen in the second half of 2011. Hopefully, EBay will get the memo.

Best Wishes,

William Smead

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