Quarterly Point of View

Debt & a Dividend Tipping Point?

January 22, 2013

You are probably just as exhausted as we are with anything relating to the 'fiscal cliff', budget deals, taxes and politics in general. But there is the need to re-hash for a moment some important items that developed from the latest skirmishes in Washington D.C.

First let's summarize the primary highlights of the deal that Congress struck to avert the 'fiscal cliff' - a combination of expiring tax cuts and across-the-board government spending cuts that were due to become effective January 1.

- Top income tax rates will climb to 39.6% for individuals making in excess of $400,000 per year and households making in excess of $450,000. The lower tax rates below those thresholds will be made permanent.
- Capital gains and dividend tax rates will move from 15% to 20% for individuals making more than $400,000 a year and households making more than $450,000 a year. The tax rates remain at 15% below those thresholds.
- There will be a two-month delay in the $109 billion sequestration, which forced discretionary and non-discretionary spending cuts.
- Estate taxes will increase from 35% to 40%, with the first $5 million exempt for individual estates.

The plan, to a small degree, represents a rare bipartisan agreement for lawmakers who have been attempting for years, lurching from deadline to deadline, to reach an accord on taxes and spending. But unfortunately, we believe the following statement captures the feeling of lost opportunity:

Washington missed this magic moment to do something big to reduce the deficit, reform our tax code, and fix our entitlement programs. We have all known for over a year that this fiscal cliff was coming. In fact Washington politicians set it up to force themselves to seriously deal with our Nation's long term fiscal problems. Yet even after taking the Country to the brink of economic disaster, Washington still could not forge a common sense bipartisan consensus on a plan that stabilizes the debt.

This statement was issued by none other than the co-leaders of President Obama's 2010 Fiscal Responsibility and Reform Commission, Democrat Erskine Bowles and Republican Alan Simpson. It succinctly and powerfully declares the issues that still stand before lawmakers.

In simple and straightforward terms -- which is how everyone, and most importantly lawmakers, ought to evaluate this -- our national debt situation currently looks like this:

2911 Tennyson Avenue, The Inkwell Building, Second Floor ▲ Eugene, OR 97408
tel 541.636.4170 ▲ fax 541.636.4815 ▲ www.martincp.com

- U.S. National Debt = $16.4 Trillion

(This does not take into consideration the present value of future liabilities of Social Security, Medicare and Medicaid which are estimated to tack on at least another $50 Trillion!)

- U.S Federal Tax Revenue = $2.5 Trillion
- U.S. Federal Spending = $3.5 Trillion

We've used a similar analogy previously, but this is akin to a family making $250,000 a year with limited ability to grow future income at a pace exceeding low single digit percentages. At the same time this family spends $350,000 a year, which annually increases the burden of $1,640,000 in debt it has already accumulated over the years – not counting any future liabilities to be considered. It seems very clear that this family needs to make some tough decisions. The longer the decisions are delayed, the more painful the solutions become – and ignoring the problem does not count as a solution, nor make it disappear.

This is the bad news, and until serious measures are actually underway to address the debt, it will remain bad news - a mighty headwind to a sustainable recovery, and an economy able to absorb shocks.

Brace yourself though, there is good news. Beneath the surface of this highly imperfect package was beneficial news for investors that will likely have a positive impact for many years to come, particularly for those who prize dividends and understand their significance. As mentioned above, dividend taxes and capital gains will remain at 15% for individuals making less than $400,000 per year and households earning less than $450,000, while those making over these thresholds will be taxed at 20% (these rates exclude the 3.8% ObamaCare surtax, that professedly apply to all forms of investment income and capital gains). Even when we consider the higher 20% rate, there are some meaningful points to appraise.

First of all, these rates are now permanent, meaning there will be no more expirations, sunsets or cliffs. This does not rule out the possibility of a future legislative change, but it now appears highly unlikely in the foreseeable future. The sense of closure on this subject is vital, as is the fact that the rates are much lower than many believed would be adopted.

Secondly, this rate is not only lower than anticipated, but low by historical standards. Dividend taxes have been higher than 20% in 42 of the last 51 years, and for those that will pay 15% this remains the single lowest rate dividends have been taxed in a century.

Finally, Congress has again affirmed that dividends and capital gains should be taxed at the same rate. The level playing field between the two should have positive ramifications for dividend investors as corporate managements make capital allocation decisions. For many years before 2003 capital gains were given preferential treatment to dividends, but that temporarily ended with the Bush tax cuts that were set to expire on New Year's Eve. Wisely this level playing field was made a permanent feature.

These points lead us to believe that a decade from now we may look back at them as the 'tipping point' of a dividend revolution. Until the last several years dividend payments and the philosophy behind them had fallen out of favor on Wall Street. During the heydays of the '80's and '90's with rising price to earnings multiples due to falling interest rates and generally robust economic growth driving stocks higher, investors came to think that companies didn't need to pay dividends.

2911 Tennyson Avenue, The Inkwell Building, Second Floor ▲ Eugene, OR 97408
tel 541.636.4170 ▲ fax 541.636.4815 ▲ www.martincp.com

They were often encouraged by investors to retain and use excess profits in the quest for additional means of growth, either organically or by acquisition, and/or to use those funds to buy back their own stock. 'Buybacks' reduce the number of outstanding shares, consequently boosting earnings of the remaining shares. The concept sounds nice on the surface but history shows that companies regularly buy back their own stock when it's inflated – as the good times help produce the excess cash to buy their shares – and skip buy backs when the stock is cheap, often for the contra reason. Though this strategy is occasionally employed successfully by wise management, it far too often squanders shareholder wealth. Additionally, buybacks reward a shareholder looking to sell, whereas reliable and growing dividends reward long term, loyal shareholders. Undoubtedly buybacks will continue, but with dividends and capital gains now permanently fixed at the same rate, the preference for seeking capital gains (via buybacks) over dividends is likely to diminish.

Without a doubt investors have started to come around to the importance of dividends. After two destructive bear markets since 2000 and interest rates at multi generational lows, both institutional and private investors have started to favor the current income and the relatively low volatility afforded by dividend paying equities. Though the return to dividend fundamentals had already started to take hold, these recent events may end up providing the impetus for a more meaningful movement. If this does in fact take root, a dividend revolution will not only be an affirmative force for those looking for needed income, but for the quality, stability and direction of the stock market as a whole.

Please feel free to call or email with questions you may have regarding our strategies or Martin Capital Partners in general. You can also find information on our website at www.martincp.com.

It is a sincere privilege serving those that have entrusted us with their capital.

Respectfully,

Cameron K Martin
Chief Investment Officer
Martin Capital Partners, LLC

If you would like additional information on how Martin Capital Partners, LLC conducts business, we can provide a copy of our SEC Form ADV part II. As always, past performance provides no indication of future results.

The market views and opinions expressed above reflect the opinions of Martin Capital Partners, LLC and are not intended to predict or forecast the performance of any security, market, or index mentioned.