DAVID WENDELL ASSOCIATES, INC.
INVESTMENT COUNSEL

P.O. BOX 6750
325 CORPORATE DRIVE
PORTSMOUTH, N.H. 03802
(603) 427-0200

Third Quarter, 2003

DIVIDEND GROWTH OVER THE LONG HAUL

The most valid reason for owning common stocks has always been to participate in the progress of their underlying ability to generate earnings and pay dividends. It is the growth in earnings and dividends that is eventually reflected in a company's share price.

Just a few years ago, it was common knowledge that the dividend was dead. Paying dividends was old fashioned and strictly a practice of "old economy," typically mature companies. Throughout the late-1990s, dividends largely played second fiddle to capital gains in the bull market crescendo.

Shareholders, so the thinking went, preferred capital gains to dividend payments. At the time, dividends were taxed at ordinary income tax rates, which were much higher than the more favorable tax treatment of capital gains. However, it has since become clear that many of those companies not paying dividends were, in fact, unable to do so because they lacked profits. Many of the "high flying" companies of this period never even began to reach profitability.

To be sure, the dividend track record is just one factor among many in a complete and thorough analysis of a company. Nevertheless, we thought this would be an appropriate time to review dividends and their role in long-term growth stock investing.

Profitability Underlies both Earnings and Dividends

In evaluating the merits of any company as a long-term investment, a key consideration should be the rate of return its management is able to earn on equity capital. No other financial yardstick exerts as much influence on the future progress of earnings as well as dividends. The reason is that return on equity determines the amount of earnings that can be either paid out in dividends or plowed back into the business in order to finance future growth and expansion.

As an example, let's assume that a company has annual net income of $30 million and total equity capital of $200 million. Its return on equity is 15%, or $30 million divided by $200 million.

If management were to distribute $15 million, half of the net income, as dividends to shareholders, then the remaining $15 million would be available to be reinvested in the company. Thus, adding the $15 million to the original $200 million in equity capital would increase equity capital by 7.5%.

This ratio of 7.5% is the company's reinvestment rate. It provides a good indication of the future annual rate of earnings growth that can be financed by the company's profitability and existing capital structure. If the company were to pay all its earnings as dividends to shareholders, it would have a reinvestment rate of 0% and would be unable to grow from internal sources. It would have to borrow money, sell stock, or sell assets.

On the other hand, a company that pays no dividend reinvests all of its earnings back into the company. This expands the base of equity capital and increases the company's expected earnings growth rate. In our example, if all of the net income were reinvested in the company, the reinvestment rate would increase to 15% and would support a similar pace of earnings and, ultimately, dividend expansion.

The following table compares twenty-one companies we have recommended in the recent past to the Standard & Poor's 500 Index. The first column shows the average annual reinvestment rate over the last ten years for the companies and for the S&P 500. The second and third columns show the average annual dividend growth rates over the past five years and the estimated dividend growth rates for the next five years.

	10-Year Average Reinv. Rate	Average Annual Div. Growth Rate Past 5 Years	Next 5 Years
Abbott Labs	22%	12%	10%
Alberto-Culver	12	13	16
American Int'l Group	13	12	14
Anheuser-Busch	21	9	7
Automatic Data Proc.	15	16	10
Cintas	15	20	13
Coca-Cola	27	8	10
Colgate-Palmolive	29*	7	10
Home Depot	15	28	11
Johnson & Johnson	18	14	11
Linear Technology	20	27	9
Medtronic	20	20	18
Merck	21	13	6
Paychex	19	48	15
Pfizer	22	17	17
State Street	14	17	12
Stryker	21	16	20
Sysco Corp.	16	19	18
Wal-Mart	17	19	13
Walgreen	14	5	10
Wrigley, Wm.	14	8	7
Average	18%	17%	12%
S&P 500	10%	2%	5%

*Adjusted for share repurchases.
Source: Value-Line Investment Survey, DWA

As can be seen, the average reinvestment rate for the companies, as a group, was significantly higher over the last ten years than that of the S&P 500. As higher reinvestment rates facilitate higher growth rates in earnings and dividends, the companies, as a group, are likely to grow significantly faster than the S&P 500.

The average annual growth in dividends for the companies as a group was *over eight times* the rate for the S&P 500 over the last five years. For the next five years, it is expected that growth rates for earnings and dividends will likely moderate in line with slower overall expansion in the economy. Even so, the companies as a group are likely to increase their dividends at a rate *more than twice* that of the S&P 500.

Management Teams and Dividend Policy

Investment thinking on Wall Street has changed quite a bit since the late 1990s. Not only have many "high flying" stocks been grounded, some permanently, but the popular perception of dividends also has changed.

One reason is that during the bear market of the past few years, dividend-paying stocks tended to perform better than stocks paying no dividends. For example, last year -- one of the worst bear markets in recent memory -- dividend-paying stocks declined about 13%, less than half the 30% drop in stocks paying no dividends.

In addition, the Federal tax rate for dividends was significantly reduced earlier this year. Instead of the ordinary income tax rates as before, dividends are now taxed at a 15% rate. This, combined with the decent performance of dividend-paying stocks over the last few years along with low bond yields, has brought dividends back into favor on Wall Street.

Not surprisingly, many companies have taken note of this shift. As our firm's founder was fond of saying, "good managements are not potted palms." That is, a good management team is responsive to changing business prospects, tax regulations, shareholder sentiment, as well as future corporate capital needs. All of these, and other elements, are taken into consideration by management in determining the appropriate amount to pay out in dividends.

A number of companies have dramatically increased their dividend payments since the tax rate was lowered. Others, such as *Microsoft*, have begun to pay dividends for the first time ever. Also, some companies have recently re-affirmed their commitment to long-term dividend growth. For example, Reuben Mark, the Chief Executive Officer of *Colgate-Palmolive*, recently stated his commitment to a progressive dividend policy, as opposed to using the company's strong cash flow to buy back shares.

The Superior Track Record of Growth Companies Over the Long Haul

One characteristic that distinguishes many leading growth companies from merely average companies is the consistent growth in dividends over long periods of time. High reinvestment rates enable these types of companies to generate consistently above-average growth in earnings. This in turn supports a consistently above-average increase in dividends paid out to shareholders.

One method we have found useful for gauging long-term growth in dividends is "yield at cost." This is calculated by comparing the dividends received currently to the initial cost of the stock. That is, the dividend per share is divided by the cost per share and this produces an indication of how much the original investment is yielding. This figure can then be compared to other investments and to current interest rates.

The table below shows the same group of companies as shown on page two. The first set of columns shows the cost of one share of stock, the dividend per share, and the resulting initial dividend yield in 1993. The second set of columns shows the same data ten years later, in mid-October 2003. The last column shows today's dividend yield at cost.

	1993			2003		
	Mean Cost Per Share	Dividend Per Share	Dividend Yield at Cost	Approx. Cost Per Share	Dividend Per Share	Dividend Yield at Cost
Abbott Labs	$ 13	$ 0.33	2.5%	$ 42	$ 0.98	7.5%
Alberto-Culver	12	0.14	1.2	62	0.56	4.7
American Int'l Group	14	0.06	0.4	62	0.26	1.9
Anheuser-Busch	13	0.34	2.6	49	0.88	6.8
Automatic Data Proc.	13	0.11	0.8	38	0.48	3.7
Cintas	10	0.05	0.5	43	0.27	2.8
Coca-Cola	21	0.34	1.6	45	0.88	4.2
Colgate-Palmolive	14	0.34	2.4	58	0.96	6.9
Home Depot	10	0.03	0.3	36	0.28	2.8
Johnson & Johnson	11	0.26	2.4	51	0.96	8.7
Linear Technology	4	0.02	0.5	42	0.24	6.0
Medtronic	5	0.04	0.8	46	0.29	5.8
Merck	18	0.52	2.9	49	1.44	8.0
Paychex	3	0.01	0.3	37	0.48	16.0
Pfizer	5	0.14	2.8	31	0.60	12.0
State Street	10	0.13	1.3	53	0.56	5.6
Stryker	8	0.02	0.3	79	0.12	1.5
Sysco Corp.	7	0.07	1.0	33	0.44	6.3
Wal-Mart	14	0.06	0.4	59	0.36	2.6
Walgreen	5	0.07	1.4	33	0.17	3.4
Wrigley, Wm.	19	0.38	2.0	56	0.88	4.6
Average			1.4%			5.8%
S&P 500	$450	$12.58	2.8%	$1,050	$16.90	3.8%

Sources: Value- Line Investment Survey, The Wall Street Journal, Standard and Poor's

Ten years ago, this group of companies had a dividend yield one-half that of the S&P 500. However, over the last ten years the dividend yield at cost for the group *quadrupled* whereas the dividend yield at cost for the S&P 500 increased only about 36%.

Over the long haul, high-quality companies demonstrating superior progress in earnings and dividends are likely to outperform the merely average company. While the foundation of long-term growth stock investing is based on earnings growth and reinvestment rates, growth rates in dividends are also important and likely to produce above-average yields in the long-term.