

In recent years institutional investors and analysts have become obsessed with *alpha*—a measure of investment performance that used to be called *excess return* or *value added*. Simply put, alpha is the return above a benchmark (beta) after adjusting for volatility (often referred to as “risk”). For example, if an investment return were twice as high as the benchmark but volatility of the investment were also twice as high, there would be no alpha (just higher returns at the price of higher volatility). If a return were twice the benchmark but the volatility was the same as the benchmark, the alpha would be the investment return minus the benchmark, or the excess return over the benchmark for the same degree of volatility.

Call it a parade, or call it a circus, the quest for alpha has produced almost uncountable variations, a new world of characters and performances, attempting to harvest alpha and sell it to investors. Starting from the classic and basic hedge strategy of buying stocks the investor believes will go up and selling short those the investor thinks will go down (a strategy which the PhD’s at no less an institution than Goldman Sachs have demonstrated over the past two years can be subject to catastrophic reversals in adverse conditions), innumerable schemes to reduce volatility or anesthetize beta have emerged, including pairs, swaps, spreads, options, swaptions, forward contracts, etc. Many of these common examples have, through inadequate liquidity or poor planning for unusual events, contributed to the current turmoil in the financial markets: They often generate fine returns with minimal volatility, until they don’t. Meanwhile, some observers believe there is only so much available alpha in the world (not long ago Duke University professor David A. Hsieh suggested only \$30 billion in alpha is realizable annually from the \$30 trillion market value of all stocks and bonds worldwide, an assertion about which we have no comment). Since the alpha available in any case doesn’t generate the absolute returns many investors need (thus they pump up the volume with leverage, and we’ve seen where that leads), most investors are still stuck needing to tolerate at least some degree of beta.

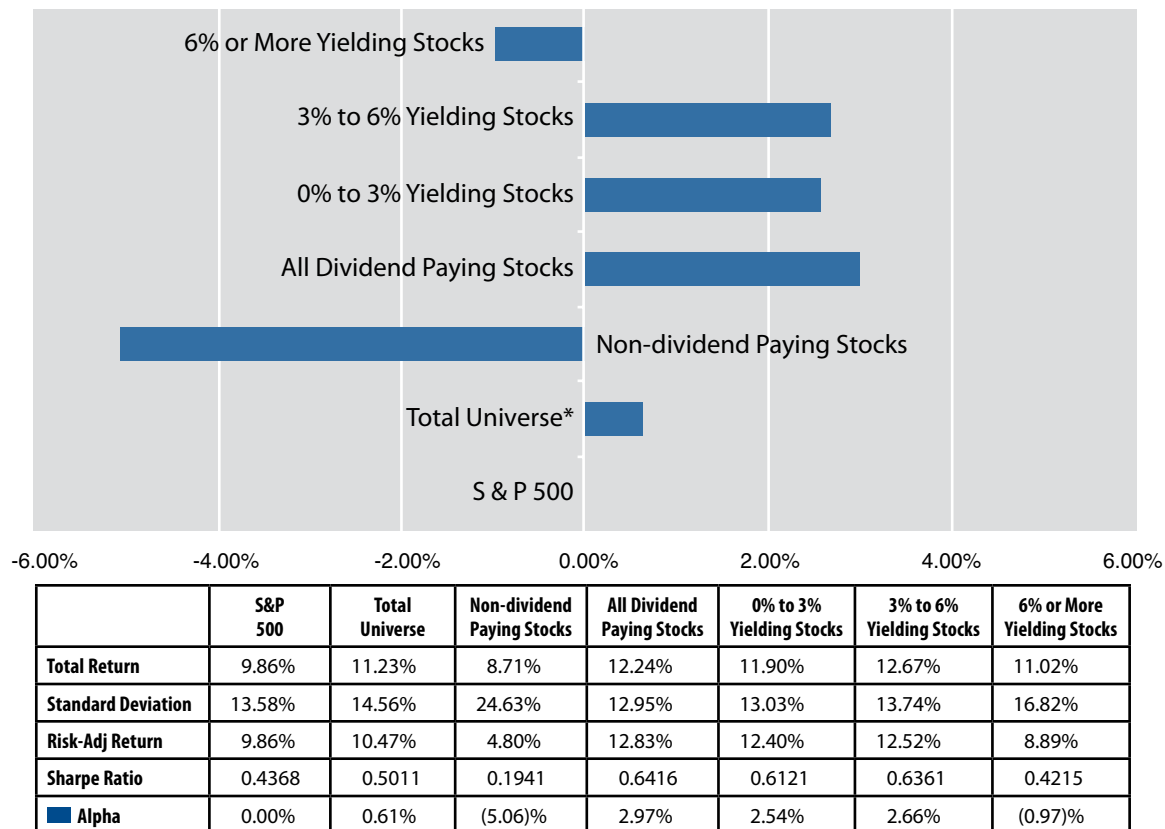
For an investor willing to tolerate some fluctuations in search of better total returns (at the minimum end of the risk spectrum are T-bills as a pure alpha strategy—so any total return better than bills should require at least some volatility), we think there is an alpha-generating strategy that has been with us since the beginning of developed markets.

We spent time this past quarter working with two well-known databases covering essentially all of the most important and largest of stocks, databases we prefer because the data has been reviewed by analysts and are the only databases we know of where that is true. Nearly every other database we’ve explored was sufficiently “dirty” and raised questions about any conclusions derived from it. We had data available from 1986, which covers a litany of tribulations, from the 1987 futures-induced crash to the S&L crisis, to the 1990s period of one-decision consumer non-durable leadership, to the rise of technology companies, to the tech bubble and crash, to Enron et al, two wars in Iraq, the flood-induced vanishing of an American city, the rise of the Euro, the fall and reconstitution of Russia, the rise of China and the BRIC countries—it’s almost too much to think about. But there were certainly enough rallies and declines to think that many moments of what’s to come in our unknowable future have been at least vaguely represented in the period.

“As the dividend increases, eventually the price of the stock producing that dividend will increase as well. The principle here is critical, both for investors seeking to accumulate wealth, and even more importantly today, for investors hoping that investment assets will support their later years.”

“...note that both absolute returns and risk-adjusted returns are superior for stocks that pay dividends.”

Risk & Returns (Alpha) 1993 to 2007



* Total Universe includes 1000 largest stocks in Zacks database rebalanced quarterly. Returns and volatility are annualized three-month holding period data.

The 1993–2007 period covered in our table (our most accurate data and statistics started in 1993), which includes the historic rally of the 1990s—1991–1999 all positive years—offered investors in the S&P 500 index a 9.86% return with a standard deviation (the common measure of volatility) of 13.58. The “total database” (largest 1,000 rebalanced every three months) return was 11.23%, though the standard deviation was higher as well, at 14.6. Some degree of this slightly higher return and risk is a result of the equal weighting of each security and the inclusion of more mid- and smaller-sized stocks, while the S&P 500 is size-weighted, and larger stocks are in general both less volatile and offer slightly less return, in most periods.

Given our firm’s focus on dividends, we did the obvious, simplest thing. We compared dividend-paying stocks to the overall database. As readers of this report know, we have provided various research from others, including Credit Suisse, Ned Davis Research, Standard and Poor’s, Ibbotson and Associates (now owned by Morningstar) among others, in support of the proposition that dividend stocks provide better long-term returns than other kinds of stocks, and we have often suggested that dividends should be considered a *factor* in analyzing investment returns, just as size, style, PE, and book value have traditionally been considered *factors* to which large-group returns may be attributed. One element the other studies have omitted has been *risk-adjusted returns*, taking into account volatility as well as return. Where long-term returns from dividend stocks have universally been perceived as superior by other observers, most have neglected to note that the superior returns have generally come from sharply reduced volatility during down periods, and have not noted that overall performance reflects lower volatility than benchmarks. That is why both absolute and risk-adjusted returns are better for dividend-paying stocks than for the overall market, and that is why *alpha is actually embedded in dividend-paying stocks* even before an investor attempts to sort through the best and worst of the category.

In reviewing the table (previous page), note that both absolute returns and risk-adjusted returns are superior for stocks that pay dividends. Note the “total” database and the S&P also *included* dividend-paying stocks, as you can see by reviewing the “no dividend” results, actually lifting the average against which they are being compared. The truest comparison is between any of the “dividend” versus the “no dividend” categories—and it is not much of a contest.

To be sure, years 2000 and 2001 helped to degrade the no-dividend results, but 1998 and 1999 were underperforming times for dividend stocks. No analysis of the past is science for the future, but it may give us a sense of what to expect over a reasonably long period that will offer many different kinds of markets. Certainly when looking at the past we can see that *dividend stocks, in the absence of any other analysis or quality separation, provided alpha even when part of an undifferentiated cohort.*

For investors who care about alpha, or risk-adjusted returns superior to the market and/or to a very large equal-weighted database of mostly US equities, dividend-paying stocks’ absolute and risk-adjusted returns would seem to make them a compelling first stop on the journey. They will not always sit at the top of the risk-adjusted heap—just witness the second half of 2007 and year-to-date 2008 (excepting our own portfolios) to certify that—but we believe the best place to start in seeking superior risk-adjusted returns is with a universe of stocks that has already demonstrated at least some degree of the characteristics that we hope will predominantly describe our investment future.

“...dividend stocks, in the absence of any other analysis or quality separation, provided alpha...”

Lowell G. Miller is the founder, president, and chief investment officer for Miller/Howard Investments. He is the author of three acclaimed books on investing including the recently revised *The Single Best Investment* (Print Project 2006). This article represents our current opinion, which is subject to change without notice. Securities are mentioned for illustration purposes only. This is not a recommendation to buy, hold or sell.

Miller/Howard Investments, Inc. manages dividend-focused portfolios.

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