BARRON'S

Q&A | TUESDAY, JANUARY 25, 2011

# The Hunt for the Incredible Expanding Dividend

By JOHANNA BENNETT

Fund veteran Don Taylor likes stocks with rising cash payouts such as Wal-Mart, Abbott Labs and Medtronic.

It's a new year. And it may finally be time for big-cap stocks with a long history of hiking their dividends to shine.

That's according to Don Taylor, manager of the Franklin Rising Dividends Fund. The four-star-rated fund focuses on companies that have consistently raised their dividends and have the juice to keep them rising. From that universe, he gravitates toward out-of-favor, attractively valued stocks.

Taylor's strategy isn't without risk. His fund lagged the market during the stock-market recovery in 2009. It's also heavily concentrated in industrials and health care, and his top holdings consume a big chunk of the portfolio.

Taylor's approach, however, does mitigate volatility. Several of his picks have raised their dividends for decades.

And with annualized returns of better than 6% over the last decade, the fund has beaten the Standard & Poor's 500 over that time period, according to Morningstar.

Below are excerpts from our recent conversation.

Barrons.com: Will big dividend-paying stocks finally start outperforming the broader stock market?

Taylor : There's a pretty good chance of that, though the year hasn't started out that way. During the early phase of a bull market, dividend-paying stocks typically lag smaller, high-risk stocks. The more mature phase of the bull market is when companies with growing dividends outperform the rest of the market. I suspect before long, the bull market will shift into that more mature phase, and we will be very happy with our dividend-paying stocks.

Q: What do you see happening to dividends in 2011?

A: Typically, the six-month period that runs from the beginning of November through the end of April is when most companies announce dividend increases. Last year, dividends paid by the companies in our fund rose 9%, and I see them climbing in the same vicinity this year. But keep something in mind: My companies have long histories of consistent and substantial dividend growth, so they aren't raising their payments off deeply depressed bases, like the banking industry. In the second quarter of 2011, big banks may announce substantial hikes that will help the dividend growth for the broader market.

Q: Explain how you pick stocks?

A: I don't focus on dividend yield. Instead, I look for dividend growth and the prospect for future growth. We look for companies that have raised their dividends for at least eight out of the last 10 years and have doubled those payments over that span. We also look for low payout ratios and strong balance sheets. And finally, we look for value, buying the stocks when they are out of favor, to protect capital and generate long-term returns.

Q: Why isn't dividend yield important to you?

A: It isn't entirely unimportant. I don't want a stock with a 0.05% dividend yield. But I focus on what sort of dividend growth a company can deliver over the next five or 10 years. If your dividend payment never grows, the stock is little more than a junior bond investment, which works well if interest rates fall. There are companies with dividend yields of 3% to 4% with good growth prospects, and from my perspective, that's preferable to a higher yield.

Q: Name one of these companies.

A: Abbott Laboratories (ABT) has a yield of 3.8% and a long history of dividend hikes. In fact, it should keep growing those payments at a rate in the high-single digits or low-double digits.

Q: Given your method for picking stocks, there must be sectors that attract a great deal of attention and some that you avoid.

A: Yes. I find a lot of good rising-dividend names in consumer staples and among diversified industrial companies. I also find them in health care, where valuations are quite cheap. We are underweight in technology (though IBM (IBM), which we own, is a nice rising-dividend company), energy, telecom and utilities.

Q: Your top 10 holdings account for about 45% of your portfolio. You don't seem to be afraid to bet big on your highest conviction stocks.

A: I think most fund managers are way too diversified. Companies that meet our criteria are high-quality companies. Of course, you still need to be very, very careful, but the risk isn't as great compared to lower quality, higher beta names.

Q: What is one of your largest positions?

A: Wal-Mart Stores (WMT). The stock faced some headwinds, but its performance has begun to improve. During the economic downside, Wal-Mart's comparable-store-sales and the stock price held up better than most retailers. As we emerged on the other side, Wal-Mart did not have the low base to grow from and did not generate the same enormous improvement in comparable-store sales as other retailers. Still, the company has plenty of room to grow, especially internationally. There have been a few missteps, but I think those issues are behind us and the market is finally starting to see it. Meanwhile, Wal-Mart has hiked its dividend payment for 36 consecutive years. And with a 27% payout ratio, the dividend has plenty of room to grow, likely at a pace in the low double digits.

Q: What's another pick?

A: Medtronic (MDT) sells medical devices. At roughly 8% to 10%, earnings growth has slowed substantially compared to a decade ago in part because of the company's size. But the market for coronary stents and ICDs [implantable cardioverter defibrillators] has slowed and the economic downturn forced many Americans to defer medical procedures. The stock trades at 10.3 times 2011 earnings, well below the 40 times earnings it fetched a decade ago. But Medtronic has a number of new products. As the economy grows stronger, we will see a gradual improvement in the company's organic earnings growth. That should push the share price from $37 to $45. In the meantime, I expect double-digit dividend increases.

Q: Health care and industrials account for 40% of your portfolio. What is the strongest industrials name in your portfolio right now?

A: I like Dover (DOV). Industrial stocks have performed very well and valuations aren't as attractive. But over the last couple of years, Dover has shifted from a holding company with dozens of individual businesses into an operating company with a few well-integrated business segments. They are gaining efficiencies and revenue synergies, and you can see it in the company's operating results. Dover has also picked up its acquisition activity. Thanks to the company's more integrated operations, synergies from acquisitions will add more value.

Q: What is another stock that you like right now?

A: Procter & Gamble (PG). The dividend yield is just below 3%. But P&G has raised that payment for 54 consecutive years – the latest a 9.5% increased about a year ago -- and they are due to hike it again in the spring. I'm expecting something in the 10% range. The CEO is leveraging the company's size and breadth to get more products established in new geographic markets. Organic sales growth has improved over the last few quarters, and as investors recognize this, the stock is moving back into favor.

Q: Thank you for your time.

Investment Philosophy

Don Taylor focuses on rising dividends. He looks for companies that have increased their dividends in eight of the last 10 years and doubled their total payouts over the same period (with no decreases). The companies must have strong balance sheets and low payout ratios, so they still have money left to invest in their operations. Taylor also looks for out-of-favor valuations. High-growth stocks rarely make the list. The portfolio is fairly concentrated in terms of the number of stocks its holds and the sectors it frequents.

Top 10 Holdings of the Franklin Rising Dividends Fund
(As of December 31, 2010)

Procter & Gamble Company *
Wal-Mart Stores Inc.
Abbott Laboratories *
International Business Machines Corporation *
Roper Industries Inc.
Family Dollar Stores Inc.
PepsiCo Inc. *
Praxair Inc.
Becton Dickinson & Company *
United Technologies Corporation *

* Held in BCV Asset Management Inc. United States Equity Model Portfolio