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THE KEY TO LONG-TERM EARNINGS AND DIVIDEND GROWTH

A company's reinvestment rate, derived from its return on equity, is a measure of profitability. As such, it plays an important role in our firm's investment selection process. We thought this an appropriate time to update a Letter last published seven years ago.

Given the current market environment, analyzing the investment potential of a company has become increasingly important. Return on equity, or the rate of return management is able to earn on equity capital, is a key consideration. No other financial yardstick exerts as much influence on earnings and dividends over the long haul.

The reason that return on equity is so important is that it determines the amount of earnings that management can either pay out in dividends or plow back into the business in order to fund future growth.

As an example, let's assume that a company has an annual net income of $60 million after taxes. The total equity capital shown on its balance sheet is $400 million. Its return on equity is calcluated by dividing $60 million by $400 million, or 15%.

Now, management has a choice each year of whether or not to distribute dividends and if so, whether or not to increase the existing level of dividends. If management were to distribute half of the net income, or $30 million, to shareholders as dividend payments, then the remaining portion would automatically be reinvested in the business as additional equity capital. Thus, the existing capital base of $400 million would be expanded by $30 million, or 7.5% ($30 million divided by $400 million).

In the above example, this number, 7.5%, is the reinvestment rate. It gives a good indication of the future annual rate of earnings growth that can be financed through the company's existing profitability and capital structure.

If our hypothetical company were to pay all of its earnings to shareholders as dividends, it would have a reinvestment rate of zero and would be unable to grow from internally generated sources. In order to expand its business, it would have to borrow money, sell stock, or sell assets.

On the other hand, if the company were to pay no dividend at all, it would in effect be reinvesting all of its earnings, the entire $60 million, into its business. Thus, its reinvestment rate would be 15% and theoretically it would be able to support an expansion pace of 15% through internal sources without resorting to external financing.

Now let's look more closely at return on equity. In the first example shown below, our company does not pay a dividend. It is able to maintain a consistent reinvestment rate year after year -- thus, the reinvestment rate is essentially the same as the growth trend in earnings per share:

Company with Consistent Returns

	Reinvestment Rate	Equity Capital Per Share	Earnings Per Share
Base Year		$10.00	
Year 1	15%	11.50	$1.50
Year 2	15	13.23	1.73
Year 3	15	15.21	1.98
Year 4	15	17.49	2.28
Year 5	15	20.11	2.62
Year 6	15	23.13	3.02
Average Rate	*15%*		
Compound Growth		*15%*	*15%*

Note that the reinvestment rate of 15% will produce an annual growth rate of 15% in earnings per share. Obviously, if a company pays a dividend, its reinvestment rate will be lower than its return on equity. As a result, its earnings growth rate will be less too. At any given level of profitability, the higher the dividend payout ratio, the slower will be the growth rate.

The rise in earnings per share is also strongly influenced by the trend of the reinvestment rate. If the reinvestment rate increases over time, earnings growth will exceed the average reinvestment rate during the same period. This can be seen in the example below for a company with improving returns:

Company with Improving Returns

	Reinvestment Rate	Equity Capital Per Share	Earnings Per Share
Base Year		$10.00	
Year 1	10%	11.00	$1.00
Year 2	12	12.32	1.32
Year 3	14	14.04	1.72
Year 4	16	16.29	2.25
Year 5	18	19.22	2.93
Year 6	20	23.07	3.84
Average Rate	*15%*		
Compound Growth		*15%*	*31%*

In both of these examples, the reinvestment rate averaged 15% over the entire six-year period. However, for the company with improving returns, the reinvestment rate doubled from 10% in Year 1 to 20% in Year 6. This lifted the compound earnings growth to 31% annually, or twice that of the company with consistent returns.

In contrast, a decline in the reinvestment rate can lead to a major earnings slowdown, even for a highly profitable company. This can be seen below:

Company with Declining Returns

	Reinvestment Rate	Equity Capital Per Share	Earnings Per Share
Base Year		$10.00	
Year 1	20%	12.00	$2.00
Year 2	18	14.16	2.16
Year 3	16	16.43	2.27
Year 4	14	18.73	2.30
Year 5	12	20.97	2.25
Year 6	10	23.07	2.10
Average Rate	*15%*		
Compound Growth		*15%*	*1%*

In addition to looking at reinvestment rates, it is also useful to see how a company compares to other companies as a potential long-term investment.

A widely used benchmark for an *average* high-grade company is the Standard & Poor's 500 Index. During the 1980s, the annual earnings growth rate for the index typically ranged between 7 and 8% and the reinvestment rate was about 7%.

Beginning in the mid-1990s, however, the average annual earnings growth rate for the index picked up to about 9%. This faster pace in earnings growth was supported by an increase in the reinvestment rate to an average of 11% for the same period.

This improvement in the reinvestment rate stemmed from the tremendous cost-cutting efforts of American industry through asset sales, plant closings and layoffs in order to increase profitability and competitiveness. However, common sense suggests there is only so much fat that can be cut.

In fact, the reinvestment rate of the S&P 500 is currently at historically high levels and has just started to pull back a bit. Obviously, it is unlikely to maintain the fast pace of recent years indefinitely into the future.

The table on the following page shows the eighteen companies in our firm's top-rated growth investment category. It compares their reinvestment rates and their earnings and dividend per share growth rates for the last ten years and estimates for the next five years with the S&P 500:

	Reinvestment Rate		Earnings Per Share Growth Rate		Dividends Per Share Growth Rate	
	1995-2004 Avg.	Next 5 Yrs. Est.	Last 10 Yrs.	Next 5 Yrs. Est.	Last 10 Yrs.	Next 5 Yrs. Est.
Abbott Labs	20%	13%	11%	10%	12%	4%
Amer. Int'l Group	13	11	14	12	13	16
Amgen	26	16	20	20	--	--
Auto. Data Proc.	14	13	12	9	15	8
Biomet	18	21	16	17	--	24
Cisco Systems	22	21	35	13	--	--
Home Depot	15	15	24	14	28	11
Johnson & Johnson	18	15	14	12	14	12
Linear Technology	19	19	26	27	--	11
Medtronic	20	16	21	15	21	18
Paychex	17	14	29	14	42	11
PepsiCo	19	21	9	11	9	13
Pfizer	21	14	19	14	16	13
Stryker	21	25	22	22	26	23
Sysco Corp.	18	19	16	15	20	16
Walgreen	14	15	17	17	8	13
Wal-Mart	17	21	15	15	19	16
Wrigley, Wm.	14	13	11	10	10	10
18 Co. Average	18%	17%	18%	15%	18%	14%
S&P 500	11	9	9	7	4	8

Source: Value-Line Investment Survey, Standard & Poor's, DWA

Note that the reinvestment rate of these top-rated growth companies, as a group, is estimated to be almost twice that of the S&P 500 over the next five years. Their earnings per share growth rate will likely be *more* than twice that of the index and their dividend per share growth rate will also be significantly higher. Over time, higher growth rates in earnings and dividends should lead to higher share prices, everything else being equal.

In conclusion, it is fair to say that the reinvestment rate, a strong indicator of a company's future growth, is rarely mentioned in the financial press, to the point that many investors are unaware of its importance. Yet this is an essential yardstick in judging management's ability to achieve a specific rate of long-term earnings growth.

It is also a fact of investment life that relatively few companies have the basic characteristics which enable them to sustain a consistently high return on equity and above-average progress in earnings and dividends. Eventually, this is reflected in the market value of their shares.