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Investment Advisors

THE RAY REPORT

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Dividends vs. Stock Buybacks

Investor's Business Daily wrote an excellent piece about the rising cash hoards of non-financial S&P 500 firms. We highlighted this important event in our article, "Cash is King."

At the end of the first quarter of 2004, according to the article, non-financial S&P 500 firms had cash approaching \$520 billion, nearly double the \$260 billion at the end of 1999. Nearly 122 firms in the S&P 500 had more cash and short-term securities than long-term debt. 53 firms had more cash than liabilities. We spoke of the likely unprecedented ability of corporations to return capital to shareholders through share buybacks and dividend increases, as well as, the increased ability of corporations to grow their business through asset purchases and capital expenditures.

Since our highlighting of this phenomenon, Microsoft has returned nearly \$70 billion to shareholders, including a \$30 billion special dividend, ATT Wireless was bought for \$16 billion cash and Kmart will use cash and stock to acquire Sears in an \$11 billion deal. JNJ will use stock and cash for Guidant. Oracle will spend \$10 billion in cash on PeopleSoft. On the surface, it appears that companies are beginning to use some of their cash to the benefit of shareholders.

Unfortunately, despite a few high profile acquisitions, many companies have chosen stock buybacks, as the preferred method of returning capital to its shareholders. In the quarter ending 6/30/04, corporations retired a net \$39.9 billion of stock, the highest level since 2001. While a dwindling

equity supply, especially in light of a modest new issue calendar, is good for the stock markets, the choice of buybacks vs. dividends is an interesting one considering the recent decision to lower the tax rate on dividends.

Despite new tax laws that allow individuals to tax dividends at 15%, dividend payout for S&P 500 companies in the third quarter of 2004 was a near record low of 33.4% of earnings. It is difficult to explain exactly why companies would make the decision to prefer stock buybacks rather than returning the capital to shareholders through dividends. Prior to the change in the tax law, the choice was understandable. Now, it is not so clear.

From the company's standpoint, the decision to institute a share repurchase program rather than a dividend program, allows the company greater control over the timing and amount of the expenditures. Dividends, also are

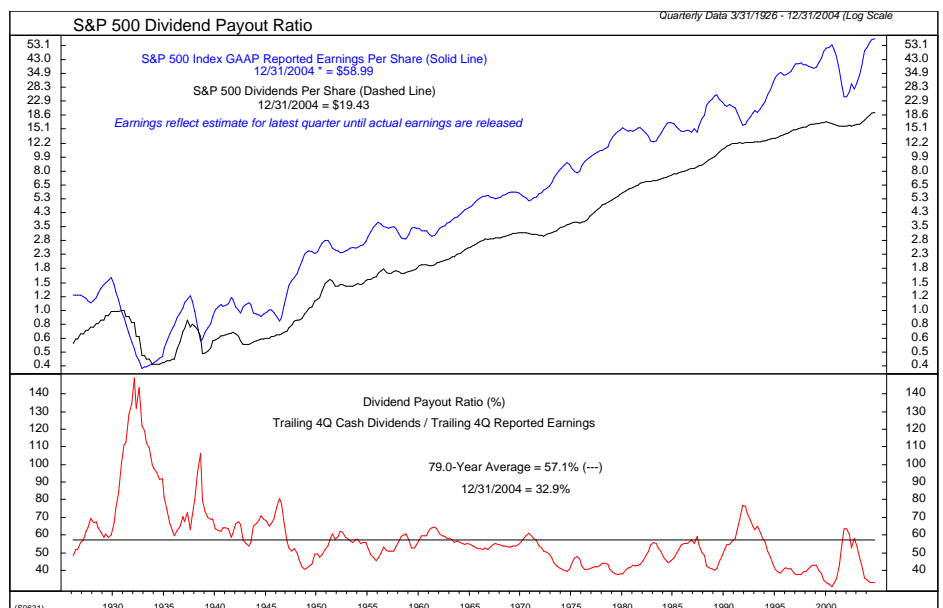
Market Performance For The December 2004 Quarterly Period

<i>Dow Jones Industrials</i>	7.55%
<i>Standard & Poor's 500</i>	9.22%
<i>Russell 1000 Growth</i>	8.88%

generally recurring, so companies must be cautious that cash flow can support its dividend longer-term. In many companies, stock buybacks can help offset the increase in shares from options granted to management, or employees.

Clearly, stock buybacks can have some value to shareholders. When a stock is near a low, or has a low P/E with good cash flow, a stock buyback makes perfect sense. The problem I have with stock repurchase programs, as an investor and shareholder, is when companies institute buybacks when the price of stock is near a high, or when the company's P/E ratio is well above the market. That company is assuming that our capital is best spent

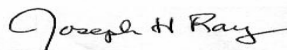
Corporate Dividend Payout Ratio Near Lows



Courtesy of: Ned Davis Research, Inc.

buying their expensive stock rather than allowing us to decide how to spend it. The company is in effect saying, our best idea to use this extra money is to buy our own stock. In this day, when the return of capital costs the investor little in the way of taxes, companies should be more inclined to consider dividend increases rather than stock buybacks, giving the investor the ultimate decision on how to spend the money they invest.

Sincerely,



Joseph H. Ray, President

Looking Forward

2005 will be filled with a number of big events for the stocks we like. Often what are catalysts for a particular security are not the earth shattering events that make FoxNews or CNN, but rather small details that may profoundly affect a company's profitability or competitive position. Here is a list of some of these items to look for in 2005 for various companies or industries.

Amgen — Amgen's first half profitability will be affected by the way doctors adapt to the new Medicare pricing rules for its products. Doctors will now be forced to send some patients to the hospitals for procedures that use to be done in their office, due to new Medicare guidelines. This transition could hurt sales of Amgen's drugs short-term, but a reasonable valuation and a potential new osteoporosis blockbuster should provide support to the stock.

Southwest Airlines — With fuel hedged to a large degree for 2005 and 2006, Southwest needs higher airfares to increase profitability. If airlines should raise fares in 2005, all airlines

should see higher stock prices. If USAir should be shutdown, Southwest would have tremendous opportunities to profit, as would the potential repeal, or modification, of the Wright Amendment.

JPMorgan/Citigroup — Conventional wisdom involved that as interest rates go up, bank stocks went down, but that is not always the case. Bank profitability can actually rise as the economy strengthens. The potential for further settlement of legal issues could also lead these stocks higher.

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