

# T H E L O N G V I E W

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## *Wake Up and Smell the Coffee – It's All About the Dividends*

Starbucks' CEO, Howard Schultz, recently announced that Starbucks would pay its first-ever dividend. Some analysts, believing that Starbucks had run out of opportunities for growth, recommended selling the stock. Others argued that the Company's decision to return profits to owners would be good for its shareholders.

Although Starbucks stock subsequently rose, the ensuing debate was not really about Starbucks. It turned on a much more important question – whether investors are better off when a company elects to dividend its profits out to shareholders rather than spend the money to grow the business. On this crucial issue, the evidence is clear. Companies that have higher dividend yields have, on average, provided far better total returns to investors.

### *Lion's Share of Real Return*

Dividends matter far more than most investors realize. The conventional wisdom is that while the investment return from bonds is wholly dependent on income, stocks provide growth first and income second. It is true that an investor's total return from a stock investment consists of both a capital gain (or loss) and dividends. However, over time, it is the dividends – *particularly reinvested dividends* – that have made up most of the return.

In an 2002 article in the Financial Analysts' Journal, *Dividends and the Three Dwarfs*, Robert Arnott analysed returns on U.S. stocks from 1802 to 2002. The total return during this period was 7.8% per annum. Of this, 5% – 64% of the total – represented the return from dividends. Arnott's calculation, which assumes dividends are reinvested, demonstrates the powerful effect of compounding over long periods of time.

If we look at real (i.e. after inflation) returns, the result is even more dramatic. Jeremy Siegel, in his book *The Future for Investors*, has calculated that from 1871 through 2003, 97% of the total after-inflation return from stocks came from reinvesting dividends. Only 3% came from capital gains.

Over more recent periods, such as the last 45 years, dividend yields have been lower, but dividends still make up more than half of real returns.

### *Correlation Between Yield and Total Return*

Given the importance of dividends, one would expect that higher yielding stocks would produce a greater total return than lower yielding stocks. A number of independent studies have proven just this. For example, Siegel examined the record of firms in the S&P 500 index from its beginning in 1957 up to 2002. At the end of each year he sorted the companies into five quintiles by dividend yield (dollar amount of dividend per share divided by share price) and then calculated the return over the next calendar year. The portfolios with higher dividend yields offered investors, *in strictly increasing order*, higher total returns. Several other studies have come to the same conclusion.

Of course, dividends must, over time, be paid from earnings. So it is not surprising to learn that, among the highest yielding quintile, those companies with a lower payout ratio (dividend divided by earnings) had the very highest total returns.

### *Show Me the Money*

We can think of at least three possible reasons why higher yielding stocks beat the averages. First, because dividends are paid out of profits, a high yield often signals a company trading at a low multiple of earnings – and there is clear evidence that companies purchased at low earnings multiples have, on average, beaten the index. Second, dividends are proof of real cash earnings. This reduces the risk that management will take advantage of increasingly complex accounting rules to exaggerate (or even fabricate) earnings. Finally, a tradition of returning some portion of earnings to the company's owners each year may prevent managers from overspending on marginal capital projects or engaging in the type of empire building activity that has so often destroyed value.

### *Reducing Downside Risk*

Perhaps more important than providing higher total returns over time, reinvesting dividends can protect investors in falling or range-bound markets. Clearly, a falling stock price allows reinvested dividends to purchase a greater number of shares. And these extra shares will increase future returns when the market recovers.

A classic example of this is the Great Crash. The 1929 bull market peaked on September 3, 1929. The Dow Jones Industrial Average remained below that bull market peak until November 24, 1954 – i.e. for more than a quarter of a century. For many who had borrowed on margin, the stock market crash was a complete disaster. But the long term stock investor who did not buy on margin and stayed the course for those 25 years had a much better result than you might expect. Stockholders who reinvested their dividends realized an annual rate of return over this disastrous period of over 6% a year. The capital gain was zero. But the return solely from receiving and reinvesting dividends was almost twice the return from bonds and four times that from short-term treasury bills.

### *Be Paid to Wait*

North American stocks provided a total return during the 20<sup>th</sup> century of over 9% per annum. However, there were several periods, lasting an average of about 15 years, when the broader index (which measures price appreciation but not dividends) was essentially flat. In these range-bound markets the total return to investors was about 5.5% per annum – and substantially all of this return came from dividends.

If you believe that the greatest bull market in history, lasting from 1982 to 2000, is likely to be followed by an extended range-bound market, you may wish to ensure that the companies you invest in have sufficient free cash flow to pay you dividends while you wait for higher stock prices.

### *Improving the Odds*

There is, of course, far more to investing than picking high dividend-paying companies.

The essence of intelligent investing is finding (from among thousands of publicly traded companies) a reasonable number of predictable businesses with

growing profits and effective management that are selling for significantly less than their expected value.

However, starting by examining companies that pay a higher than average dividend and have a history of growing those dividends will increase your baseline probability of beating the averages. More importantly, the likelihood of higher dividend paying stocks outperforming the averages is greatest *when that outperformance is most needed* – i.e. in a falling or flat stock market.

At Manitou our mandate is, first, to protect our clients' capital from loss, and second, to provide a good long term investment return. One of the ways we do this is to carefully consider a company's ability, over time, to grow its profits and the dividends it pays to its shareholders.