The Amazing Power of Dividend Growth

SYNOPSIS

- Those who own stocks that pay dividends have voiced concern over the volatility experienced over the last few months.
- The real benefit to owning dividend-paying stocks takes years to materialize.
- The most boring companies are often the most profitable investments.

DIVIDEND PAYING STOCKS DOMINATE

Those who own stocks that pay dividends have voiced concern over the volatility experienced over the last few months, and some have even asked if they should move out of them until things calm down a bit.

Before we discuss the merits of such a strategy, let's get a sense of why dividend-paying stocks are owned by analyzing their returns over the long run. The chart below shows the performance of S&P 500 companies since 1972, broken down by dividend payment policy:

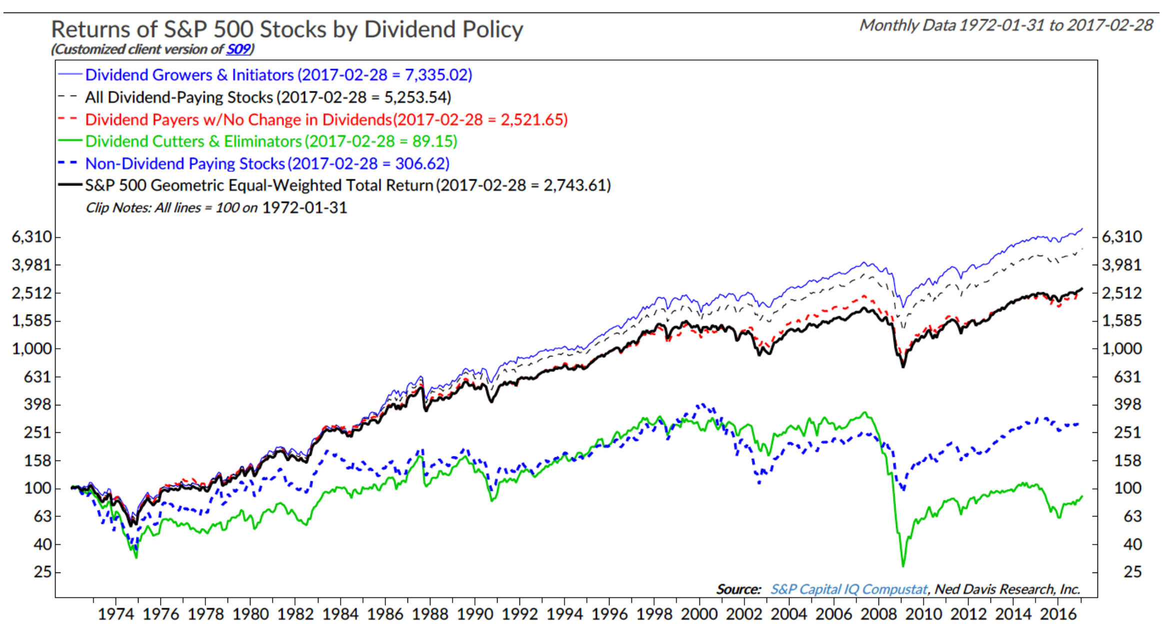
Three very important conclusions worth noting:

1. **Dividends Matter:** Putting $100 into those S&P 500 stocks that pay dividends consistently (black dotted line) in 1972 would be worth $5,235 on February 28, 2017. A portfolio of stocks that did not pay dividends (blue dotted line) would only be worth $306, or 94% less.

2. **Dividend Growth Matters More:** Owning stocks that grew their dividends over time (solid blue line) would return $7,335 over the same period, or 40% more than picking those stocks that paid consistent dividends (black dotted line).

…a stronger economy means higher profitability and ultimately safer dividends.

3. **Cutting Dividends Stings:** Owning stocks that cut dividends (green line) would have lost $11, which shows the risk of having the wrong stocks in a portfolio.



Source: Ned Davis Research

In an ideal world, keeping a portfolio concentrated on the top two lines would be easy. However, it's not as simple as picking stocks that pay the highest dividend yields, so two rules should be observed before considering owning these investments.

First, investors need an active manager who knows how to avoid two risks that stocks with abnormally high yields often pose:

1. **Stock Under Pressure:** A dividend yield is calculated by taking the amount of the dividend payment and dividing it by the stock price. For example, if a stock pays $4 in dividends each year when the stock price is $100, then the dividend yield is 4% ($4 ÷ $100 = 4%). Stocks with unusually high yields are often the result of the stock price getting hit. If the stock price went from $100 down to $40, then the yield would increase to 10% ($4 ÷ $40 = 10%).

2. **Unsustainable Payouts:** Stocks that pay high yields must be carefully analyzed to ensure that the company can continue to support the dividend payment. If a company earns $10 million this year and has committed to pay $15 million in dividends, then management may put the financial health of the company at risk if they continue to pay.

Second, investors must have a minimum 2-year time horizon due to the inherent nature of how a dividend payment impacts a company's stock price.

When a company pays a dividend, the value of that firm falls by the amount of the dividend paid. For example, if a firm is worth $500 million and they use cash to pay a dividend totaling $50 million, then the resulting value of the firm is $450 million ($500 - $50 = $450).

Since the firm now has $50 million less in the bank, the stock price must be reduced by that amount. The key point to remember here is that shareholders do not gain or lose at the time of payment. The value lost from the decline in the stock price is equal to the amount of cash received from the dividend.

Investors must then wait for the company to rebuild that $50 million in value by selling more goods and/or services. Over time, this cycle causes the stock price to go up and down. This behavior is perfectly normal but also means that the real benefit to owning dividend-paying stocks takes years to materialize.

IMPLICATIONS FOR INVESTORS

I recently attended a presentation by an equity strategist for Federated Investors, where the table below was presented to the audience:

Apple Computer (AAPL) vs. Altria (MO),
12/31/1982 – 12/31/2016

Stock Ticker	Price Return	Total Return	Volatility of Returns
AAPL	21,610%	35,958%	45.5%
MO	11,586%	56,794%	24.7%

Source: Federated Investors. Volatility is annualized standard deviation of monthly returns

This table compares the performance of Apple Computers against Altria, a cigarette company formerly known as Phillip Morris, from right around the time when Apple sold its stock to the public for the first time in the early 1980s.

The price return (second column) of both stocks has been truly amazing, but those investors who picked Apple nearly doubled what Altria generated. Given Apple changed the world more than once while Altria was fending off the government's efforts to put them out of business, this should come as no surprise.

However, this is only a component of an investor's total return. Imagine selling a rental income property for 20% more than what you originally paid five years later. At the time of sale, your total profit would be that 20% *plus* the income you received over the years.

The same applies here, and once we factor in the dividends, the total return of Altria is more than double what Apple has generated (third column).

Not only is the total return of Altria so much higher than Apple, its volatility is around half (fourth column).

Dividends are paid by more mature companies, so their profitability is usually consistent over time. This consistency creates a smoother ride for investors.

Add it all up, and Altria has delivered twice the return with half the volatility of one of the most iconic and loved companies of all time.

This may fly in the face of recent volatility, but don't forget why we own income-generating investments. Would you throw out a good renter and sell the condo if the housing market softened?

Dividend-paying stocks will likely remain volatile as the Fed moves interest rates higher over the next year, but as long as dividends keep coming in, there is no reason to give up on a strategy that has massively outperformed nearly all other equity strategies out there.

If anything, Fed rate hikes only strengthens the case to own these stocks. Rising rates remains one of the best indications that our economy continues to strengthen, and a stronger economy means higher profitability and ultimately safer dividends.

The bottom line is that boring companies are often the most profitable investments, so resist the urge to trade in and out of dividend-paying stocks and just let them do their job.

Sincerely,

Mike Sorrentino, CFA
Chief Strategist,
Global Financial Private Capital
mikeonmarkets.com