Dividends:
A RETURN TO FUNDAMENTALS

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“In short, a stock is worth only what you can get out of it. Even so spoke the old farmer to his son: A cow for her milk... A hen for her eggs... And a stock, by heck... for her dividends.”

JOHN BURR WILLIAMS  The Theory of Investment Value (1938)

DIVIDENDS INDICATE VALUE

The importance of owning dividend-paying stocks cannot be overstated when it comes to long-term returns. Although much investor focus through the late 1990’s was on stocks trading at stratospheric prices with little or no earnings — and perceived unlimited growth potential — the realities of the market have brought investor perceptions and expectations back to earth. Several recent studies emphasizing dividends illustrate the important contributions dividend-paying stocks can make to well-allocated portfolios.

For example, a recent paper by University of Georgia professor Kathleen Fuller and Babson College professor Michael Goldstein¹ found that, over the 30-year period from 1970 to 2000, dividend-paying stocks outperformed non-dividend paying stocks by a healthy margin. Looking at monthly returns, the professors discovered that stocks that paid a dividend appreciated, on average, 1.4% per month, compared to the 0.9% offered by stocks that did not pay a dividend. Richard Bernstein and Lisa Kirschner of Merrill Lynch conducted a second study on roughly the same time period.² They found that, from the NASDAQ’s inception in 1971 through September 2001, the technology-laden index actually underperformed the stodgy, dividend-paying holdings of the S&P Utilities index, offering an annualized 11.2% return versus 12.0% for their regulated peers.

Given the go-go growth years of the late 1990s, many investors would think it counter-intuitive for dividend-payers to provide competitive long-term returns. Yet just the opposite has proved true — the tortoise has, in fact, bested the hare.

DIVIDENDS’ ROLE IN TOTAL RETURN

A second measure of the value of dividends is in their contribution to the total market’s return, which historically has been significant. Over the 77 years to 2002, dividends contributed, on average, 36.3% of the market’s total return, with a high of 58.9% of the total return during the 1970s.

¹.8%
1.6%
1.2%
1.0%
0.8%
0.6%
0.4%
0.2%

FROM 1926-2002 DIVIDENDS ACCOUNTED FOR MORE THAN ONE-THIRD OF THE S&P 500’S TOTAL RETURN

Average Monthly Total Return
Average Monthly Income Return

The impact of dividends can likewise be seen from an investment at the end of 1925. Excluding dividends, a $1 investment made on January 1, 1926, would have grown to $68.97 by the end of 2002. Over the same period, a stake in only the dividend portion of a $1 investment would have been an even better investment, yielding $122.96 (a $0.06 dividend collected in year one, invested at the market rate in year two, combined with the year two dividend of $0.05 to be invested in year three, etc.). Combining these two strategies would have been dramatic indeed: a $1 investment would have blossomed into $1,775.71.

While past performance does not guarantee future results, the outperformance of dividend-paying stocks and the significant contribution offered by dividends to total returns, presents a strong case for using these types of stocks in any long-term portfolio.

DIVIDENDS DIMINISH VOLATILITY

The issue of trading greater returns for greater risk is well-addressed by dividends, as they have consistently acted as volatility dampeners on total returns. Consider the following: over the last 77 years, the market’s annual return from dividends has ranged only from 1.1% to 8.3%, with no negative return years (obviously). By contrast, the market’s annual return from price changes has ranged from -47.1% to 46.6%, with 27 negative return years. The standard deviation of these annual returns bear these numbers out: the standard deviation of price-only returns was 19.76% over the period, or 2.6 times the mean annual return of 7.60%, while the standard deviation of dividend-only returns was merely 1.56%, or 0.36 times the mean annual return of 4.32%. Dividends not only were a real contributor to total return over these 77 years, but they were relatively stable from year to year — one possible answer to the question of risk versus return.

DIVIDENDS INDICATE FINANCIAL STRENGTH

The payment of dividends serves as an important signal between company managements and their investors, declaring not only that current conditions are good, but also that future prospects are bright. For example, a 2000 paper by Eugene Fama and Kenneth French evaluated the characteristics of dividend-paying companies versus non-dividend paying companies over the 25 years from 1963 to 1998. They concluded that, on average, companies that paid dividends offered a higher return on assets (7.82% vs. 5.37%) and a higher return on equity (12.75% vs. 6.15%) than companies that did not pay a dividend. In other words, the existence of a dividend generally indicated that current profitability was strong.

Likewise, the continued declaration of a level stream of dividends or an increase in the level of dividends has come to convey management’s sense of the future — that is, that future cash flows will be sufficiently high to meet those obligations. Correspondingly, management announcements of increased dividends have been rewarded by the market with a higher stock price. On the
other hand, dividend omissions or decreases have come to indicate belief by management that future cash flows are too uncertain or insufficient to meet existing dividend obligations. Not surprisingly, those stocks tend to be punished by the market with lower valuations. J.R. Woolridge, for example, points out in *The Revolution in Corporate Finance* that companies announcing a dividend cut experienced a 6% stock price decline in the days surrounding the decrease.4 This carrot-and-stick tradeoff gives management an incentive to be conservative with increases in the dividend, so that upward moves truly are signals that business conditions are good.

This contention is seen most clearly in a 2001 working paper by Robert D. Arnott and Clifford S. Asness. Beginning in 1950 and ending in 2001, Arnott and Asness divided the S&P 500 into quartiles by trailing dividend payout ratio to determine if high payout rates were useful indicators of future earnings growth. They found that average real earnings growth over the succeeding ten years is positively correlated with payout rates — in other words, the higher the current dividend payout rate, the higher the subsequent real earnings growth. The difference is quite remarkable: those companies with the highest payout rates enjoyed real earnings growth of 3.2% over the following ten years, versus a negative 0.7% for those companies with the lowest payout rates.

**DIVIDENDS IMPOSE GREATER DISCIPLINE ON MANAGEMENT**

The above statistics also illustrate how dividends impose discipline on managements with cash on hand. With a dividend policy intact, management has an annual (quarterly) obligation to pay out cash to shareholders, which reduces the level of capital left to invest in new projects. In order to meet the needs of those capital projects, managers are forced to strictly prioritize all potential investments and only accept those with the highest levels of expected returns. If managers faced the same situation with more capital (no dividend requirements), they would be free to invest not only in the most profitable projects, but also in the more marginal projects with the lower expected returns. This would lower the returns for shareholders to levels where, if low enough, shareholder wealth is destroyed, or more likely, shareholders would have been better off receiving the capital through dividends to reinvest themselves. Dividends therefore can help impose greater financial discipline.

A common question to these conclusions revolves around the substitutability of share repurchases for dividends since they both take cash out of management’s hands and return it to shareholders. However, a 1999 paper by Murali Jagannathan, Clifford Stephens, and Michael Weisbach offers evidence against the signaling value of share repurchases. In their study of the 1985 to 1996 period, Jagannathan et al. found that dividend payments typically were paid out of operating cash flows, while share repurchases typically came from non-operating cash flows.6 This is significant in that many investors believe the two are interchangeable with both signaling that business is bright. However, only dividends are paid from the day-to-day recurring cash generated by operations, which is truly indicative of business strength. Share repurchases, on the other hand, are paid from non-operating sources such as sales of assets, and reflect more a temporary cash bulge than a steady flow. As one would expect, the paper suggests that companies that repurchase shares have more volatile cash flows than those paying dividends — another sign that dividends indicate the underlying good health of the business.

**DIVIDENDS PROVIDE DOWNSIDE PROTECTION**

Because dividends act as signals of financial strength, then, it is not surprising that they tend to buttress portfolios in volatile, down markets. Again looking at data from 1926 through 2002, the average return offered by dividends over the period amounts to 4.32%, versus the average total market return of 12.20% (including dividends). Separating the numbers, however, paints a much more definitive picture. In the 23 years when the market experienced a decline, the return attributable to dividends actually rose, to 4.45%, versus the overall market average of -12.60%. In effect, dividends acted as a counterbalance, offering an adjusted higher
return at just the time the suffering investor needed it most (this is, of course, intuitive, as dividend returns will increase if the same level of cash is paid out relative to a lower share price).

A RETURN TO FUNDAMENTALS
Over the years, the arguments against owning dividend-paying stocks have lost their potency when one considers the positive contribution of dividends to returns, mitigation of risk, and usefulness as a signal of a company’s financial health. Yet only in the last year have portfolio managers and the media begun to pay attention to this neglected source of investor returns. In the bubble years of 1998 and 1999, conventional wisdom pointed towards the irrelevance of dividends, balance sheets and, most telling, even profits. A return to fundamentals seems now to have taken hold, and with it, a return to the well-worn research of years past (now dusted off, updated, and revised), that inextricably links equity returns to companies’ ability to invest capital into profitable projects and generate excess cash returns for their shareholders. And as the payment of dividends demonstrates that capacity, both in good markets and in bad, investors today would be wise to refocus and revisit the inherent value of owning dividend-paying stocks.

A RETURN TO FUNDAMENTALS

In the portfolios managed by Northern Trust Value Investors, every stock pays a dividend. It is an important aspect of our management style. We’ve found, through many years of experience, that by buying only dividend-paying stocks, we gain special benefits as outlined in this paper. Our dividend-yield based value approach complements other styles of investing and can play an important role in a well-rounded portfolio.

References

1. Kathleen Fuller and Michael Goldstein, Do Dividends Matter?
2. Richard Bernstein and Lisa Kirschner of Merrill Lynch

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