The Merits of Dividend Investing

ALTRIUS

Providing Growth.
Preserving Principal.
Managing Risk.

EXECUTIVE SUMMARY

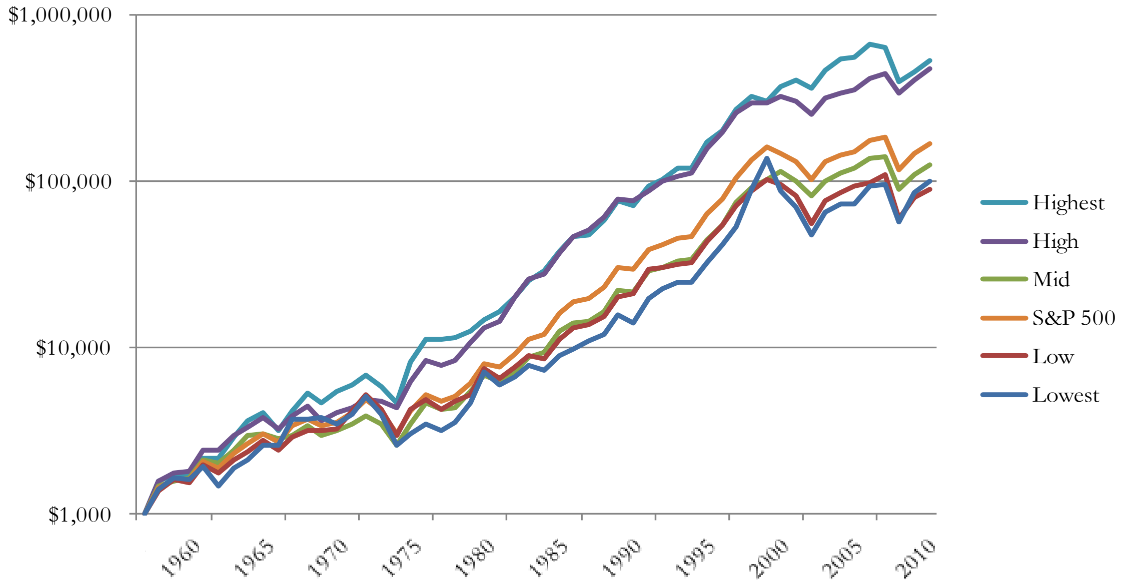
January 15, 2012

Dividends have long been an important source of returns for investors and a way for companies to share profits in a predictable manner. Whereas majority owners of companies effectively have discretionary access to the cash and assets of a firm, one consequence of the wide diffusion of ownership in corporate capital structures is that individual investors have no way of unlocking value from an investment except through dividends, company liquidation, or selling to a future higher bidder.

Furthermore, investors need more transparency and consistency from increasingly complex and globally interconnected business models with varied accounting methodologies. In the wake of the bursting of the technology and housing bubbles and after a lost decade for stock returns, preferences and perceptions of the way in which companies create and distribute profits are changing, and companies will need to adapt to these changes.

This paper will argue that dividends are likely to play an increasingly important role in the investment landscape over the coming decades, by improving the alignment of interests between management and stockholders, catering to shareholder preferences in an era of aging demographics, and as a simple consequence of improved profitability, large cash holdings, and a favorable tax environment. High yielding stocks have tended to outperform substantially over long time horizons, furthering the case for focusing on dividends as a fundamental metric for assessing investments.

Exhibit 1: S&P 500 Total Returns By Dividend Yield Quintile* 1957-2010



Source: Source: Siegel, Jeremy, Future for Investors (2005), With Updates to 2010 © Jeremy J. Siegel

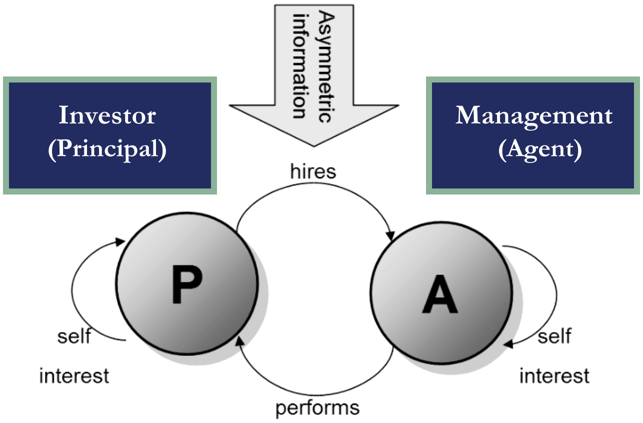
*Each stock in the S&P 500 is ranked from lowest to highest by price to earnings ratio on December 31st of every year and placed into "quintiles" (baskets of 100 stocks). The stocks in each quintile are weighted by their market capitalization. The price/earnings ratio is defined as each stock's net income per share divided by its stock price as of December 31st of that year. Past performance does not guarantee future results.

THE CASE FOR DIVIDENDS

According to some academic theories such as Modigliani and Miller's "dividend irrelevance" theorem, whether earnings are retained, spent on stock repurchases, or distributed as dividends should have no impact on shareholder value, as investors could effectively replicate these events through buying and selling shares on the open market. A shareholder should be indifferent to the value of a dollar held on the balance sheet, paid out in cash, or spent reducing the number of outstanding shares as they have a fractional ownership of the entity which retains the same in each case.

In a theoretical world without informational and transactional frictions, this theory appears plausible. However in the "real world" dividends may add value by reducing agency costs of asymmetric information, by improving the reliability of accounting estimates, and by signaling future prospects.

Asymmetric information can lead to conflicts of interests wherein policies which benefit management may not be in the best interest of shareholders, such as the use of extra company funds to splurge on private jets or lavish networking events. A dividend policy can help to align interests by directing resources toward maintaining and growing dividends rather than increasing management benefits and power.



Given the pressure on companies to meet or exceed their quarterly and annual earnings targets, earnings quality and the integrity of other accounting metrics are of serious concern to investors. Management can smooth earnings by postponing or accelerating the recognition of revenues and expenses. Unlike estimates of earnings, cash flows, and the value of assets on a balance sheet, a dividend check is impossible to fake or manipulate. A truly profitable ongoing business venture should generate cash flows that can be distributed as an assurance of its fundamental earnings power. Supporting this, a 2009 study by Douglas Skinner with University of Chicago and Eugene Soltes with Harvard found that earnings consistency from year to year was greater for firms that paid a dividend.

A recent example that reinforces this idea is the China reverse merger phenomenon that came into the media spotlight during 2011 in a variety of accounting scandals. These were Chinese companies which listed on US stock exchanges through a backdoor method of acquisition by a US-based shell company, allowing them to circumvent regulatory and legal scrutiny. Since the end of 2010, a Bloomberg index of these companies has fallen by more than 60%, at least 11 of the firms have had to halt trading, and many were accused of fraud – accounting for a quarter of all securities fraud lawsuits filed in the first half of 2011. Of the 386 listed Chinese Reverse Merger stocks, only 3 currently pay a dividend, compared to 389 of the stocks in the S&P 500.

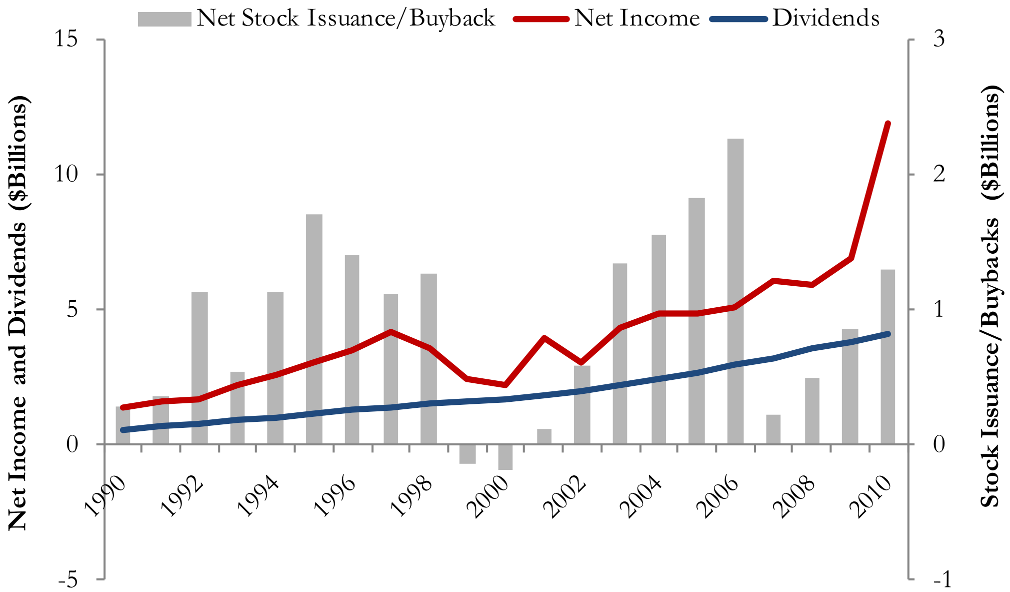
DIVIDEND SIGNALING

Dividends may act as a signal into what management expects the future of a company to look like. Since presumably company insiders have superior insight into business conditions, this signaling effect can impact the degree to which investors feel comfortable about long term investments. Even if a company is going through a temporarily difficult time financially, management may have visibility into changes coming in the future that will restore profitability, reducing cash flow concerns. A dividend cut can be interpreted as a potential red flag concerning the earnings power of the business model.

This effect can be observed empirically in the reaction of stock prices to changes in dividend policy. A 2011 study done by Malcolm Baker and Jeffrey Wurgler documented a difference in price reaction to surprise dividend cuts of about twice the magnitude of the reaction to similar dividend raises. This implies that investors are risk-averse and concerned about the future implications of cuts.

An example of a company with a successful stable dividend policy is Coca Cola (KO), which has raised its dividend for 49 consecutive years. During that time, earnings increased and decreased depending on the year, however the company did not cut their dividend based on these fluctuations but instead adjusted the amount of cash returned to its shareholders through different amounts of share buybacks. In some years (1999 and 2000), Coca Cola actually issued more stock than it bought back on net, while still raising its dividend. Had management been concerned about the future stream of cash flows, they may have been unwilling to temporarily issue additional stock while maintaining the dividend. Instead, their confidence in the viability of the business enabled them to continue increasing payouts even in the absence of strong earnings growth.

Exhibit 2: Coca Cola (KO) Earnings, Stock Buybacks, and Dividends 1990-2010



Source: Company Filings

Dividends versus Share repurchases

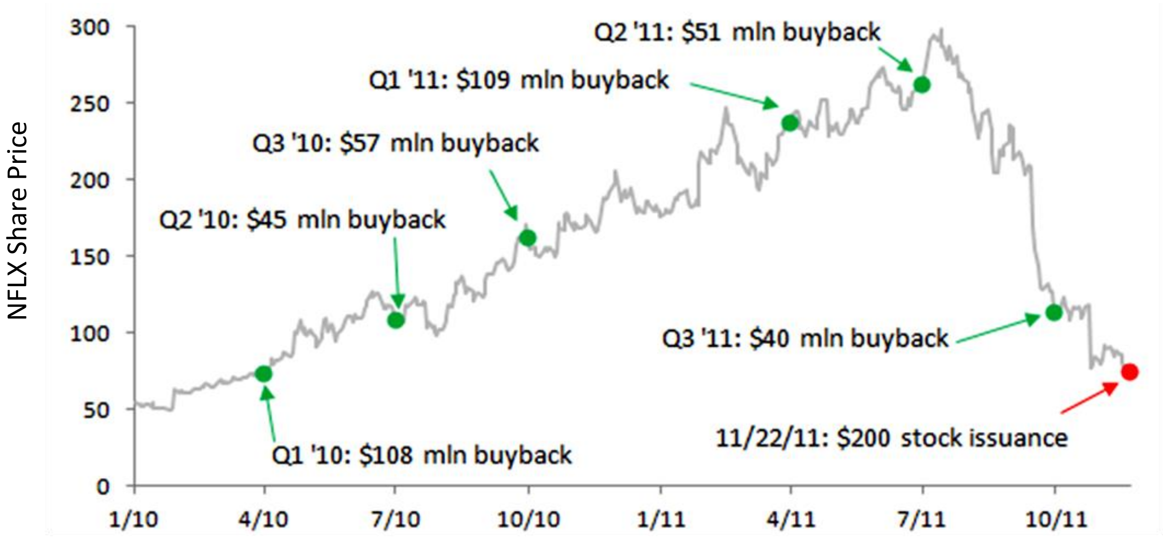
Fama and French documented the decline of dividends and rise in share repurchases in their 2001 study "Disappearing Dividends", showing that the proportion of US-listed firms paying dividends declined from 67% in 1978 to 21% in 2000. In many cases, dividends have been replaced by an increase in stock buybacks, under the argument that the methods are theoretically equivalent.

In practice, buybacks have come under criticism as executives often appear to buy stock at the wrong time, perhaps overpaying for shares. This is because when stock prices are low, a business is usually struggling, liquidity is important, and its credit rating may be at risk. Therefore management is likely to repurchase shares only when they are fully or over-valued by the market.

A recent case study is that of Netflix (NFLX), which does not pay a dividend but consistently bought back its stock at a prices above $100/share throughout 2010. Company management indicated that they would stop giving earnings and revenue guidance in 2011 as industry competition and contract renewals clouded their visibility into the future, however they nevertheless continued buying millions of dollars worth of shares. In the summer of 2011 the stock abruptly lost three quarters of its value as content providers demanded a higher share in profits and customers lashed back at a price increase by dropping the service.

Subsequently in the fall of 2011, Netflix finally stopped buying back shares, and actually sold stock to raise cash for its operations (buying high and selling low). This sort of activity can be frustrating to long-term investors who would prefer to be rewarded consistently rather than in booms and busts. Had Netflix issued stock instead of bought it back back when it was priced at $250, the firm would be better capitalized today and would not have had to dilute the value of its existing equity to raise capital.

Exhibit 3: Netflix Buybacks 2010-2011



Source: Bespoke Invest

Changing Investor Preferences

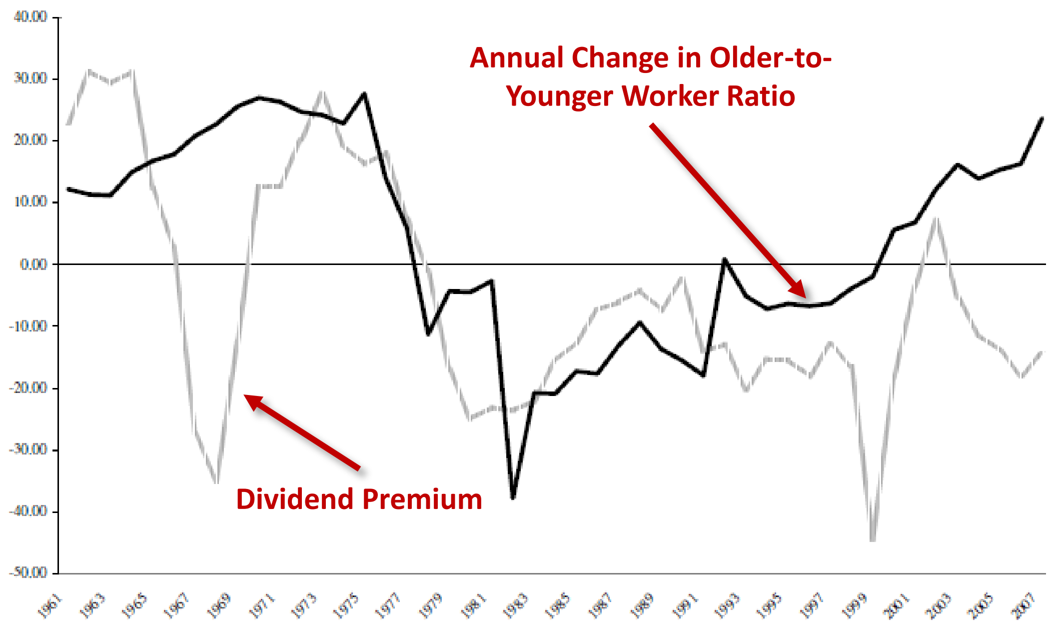
Just as companies go through different phases in the business cycle, so too do investors go through lifecycle changes and periods of time when they prefer different types of returns. These changes can be influenced by age, health, tax status, employment, sentiment, or any of a number of other variables.

In 2004, Malcolm Baker and Jeffrey Wurgler proposed a "Catering Theory of Dividends", wherein managers pay dividends when investors place a premium in the stock market on companies that do so. The idea is that dividends go in and out of style depending on the time period. They found that managers do tend to initiate dividends when investors place a relatively higher value on payers while tending to omit them when nonpayers are preferred.

Further research by King Fuei in 2011 demonstrated that periods with high dividend premiums were associated with demographic variation as represented by changes in the ratio of older to younger members of the population. Essentially the more people entering old age relative to youths the higher the premium placed on the stock prices of dividend-payers.

2011 marked the first year of Baby Boomers entering retirement and also saw the top three deciles of dividend-paying stocks return between 5% and 10% each, while the bottom 7 deciles all had negative returns. With 10,000+ Baby Boomers turning 65 each day for the next 19 years, the current push toward income seems likely to be a long-term secular trend rather than a temporary one.

Exhibit 4: Dividend Premium and Annual Change of Older/Younger worker ratio

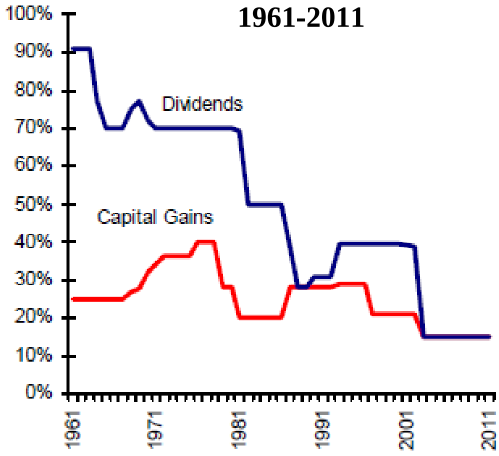


Source: Demographics, Dividend Clienteles, and the Dividend Premium, King Fuei Lee, Schroder Investment Management

EVOLVING INVESTMENT LANDSCAPE

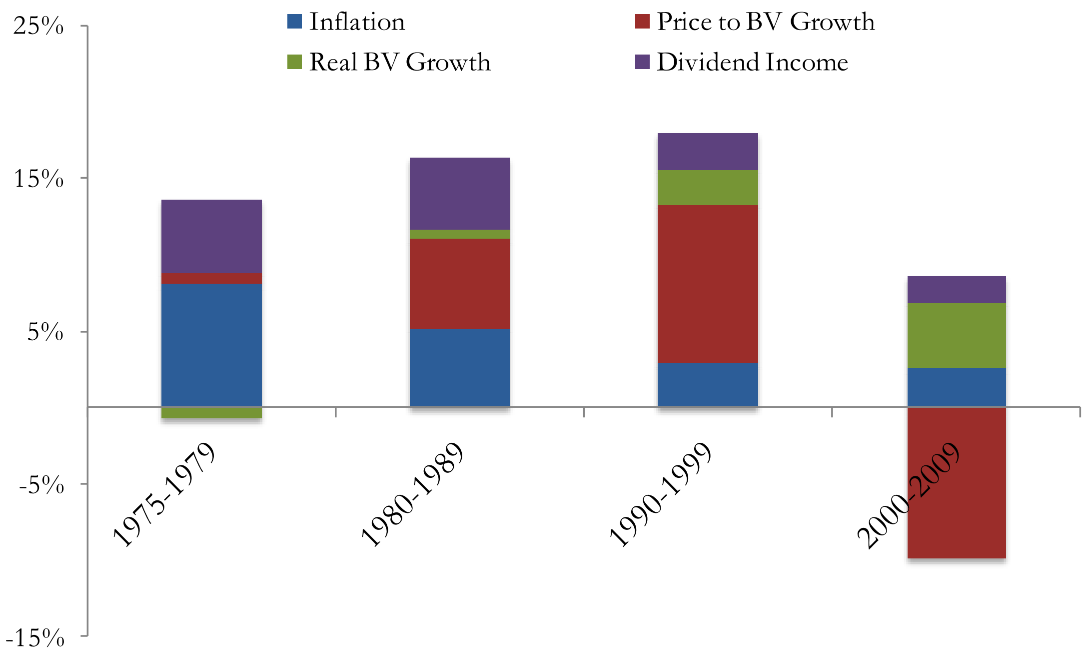
Even as investor preferences are gravitating toward a stable return yield-focused approach to investing, corporations have never been better-positioned to raise dividends. Capital gains no longer receive preferential tax treatment, eliminating a major argument for retaining earnings. US corporations have over $2 trillion in idle cash, twice what they have historically held as a percentage of capital expenditures. Companies are running lean from technological innovation and cost-cutting through the recent years of tight credit conditions.

Return Tax Treatment 1961-2011



The chart below shows returns broken down by their components of inflation, growth in book value, changes in the price multiple, and income from dividends. The stock market bubble in the 1990s is visible in the large increase in the multiple with little in the way of returns from the other components. Given the importance of recent events on investor and management psychology, this experience may start to shift the focus away from growing the market valuation of investments and toward their income-generating capabilities.

Exhibit 5: Components of Annual Returns of the MSCI US Index



Source: What Drives Long-Term Equity Returns? MSCI Barra Research

Conclusion

Any experienced investment analyst knows the importance of trying to see through the huge amounts of data, reports, and commentary published on a company to get to the core of what is happening at the transaction level and try to determine the handful of critical issues concerning its competitive value proposition. Peter Lynch made famous the approach of becoming familiar with a company's story by simply visiting its stores and using its products. A number of successful investors spend more of their time on the phone and meeting with company management than digging through 10-ks.

Similarly, the money management industry can also be over-complicated and distorted by the seemingly infinite number of ways of analyzing and tracking investments. Many fund managers who make the ultimate decisions of which companies to allocate capital to are disconnected from their investors by multiple layers of due diligence and research through funds of funds, consultants, open architecture platforms, and approval committees, distribution and client service employees, and a variety of other structures. Often these fund managers may under-appreciate the psychological and informational benefit that consistent income to a portfolio provides to the end beneficiary. Even in a down market, stocks that generate consistent cash flows can provide peace of mind to investors who may not follow the financial markets regularly and who may be subject to numerous behavioral biases such as loss aversion, anchoring, myopia, and others that make investing an emotional endeavor.

In light of the role that dividends play in aligning interests in our increasingly complex and interconnected world, the ongoing demographic shift towards a preference for income as opposed to gains on capital, and changing perceptions of value post financial crisis and in a profitable, cash flush, and tax-advantaged business environment, it seems prudent to re-evaluate firms' dividend policies and the emphasis that fund managers place on those policies when making investment decisions.

About The Author

Nathan G. Byrd
Managing Director
Portfolio Manager

Mr. Byrd is a member of the Portfolio Management team at Altrius, responsible for the day to day management of portfolios. His responsibilities include fundamental research, security analysis, portfolio construction and monitoring. Prior to joining Altrius Capital Management in 2011, Mr. Byrd worked at Wachovia Bank as a Portfolio Manager, and as an Equity Research Analyst at Oak Value Capital Management. Mr. Byrd has completed the CFA exams and is a member of the CFA NC Society. Mr. Byrd earned his Bachelor of Science degree in Mathematical Economics from Wake Forest University. He received a Masters in Business Administration from the University of North Carolina's Kenan-Flagler School of Business.

References

Malcolm Baker and Jeffrey Wurgler (2004): "A Catering Theory of Dividends"

Eric Floyd, Nan Li, and Douglas J. Skinner (2011): "Payout policy through the financial crisis: The growth of repurchases and the resilience of dividends"

Eugene F. Fama and Kenneth R. French (2000): "Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?"

Douglas J. Skinner (2006): "The Evolving Relation between Earnings, Dividends, and Stock Repurchases"

King Fuei (2011): "Demographics, Dividend Clienteles and the Dividend Premium"

Douglas J. Skinnerand Eugene Soltes (2009): "What do dividends tell us about earnings quality?"

Bart M. Lambrecht (2010): A Litner Model of Dividends and Managerial Rents

Cho-Min Lin, Chia-Hung Teng, and Cheng-Hui Chang (2012): "Motives of Stock Repurchases and Payout Policy", *International Research Journal of Finance and Economics – Issue 82*

Malcolm Baker and Jeffrey Wurgler (2011): "Dividends as Reference Points: A Behavioral Signaling Model"

Feng Gao, Fengming Song, and Xiang Zhang (2011): "The Unique Role of Cash Dividends: Evidence from the Volatility of Stock Returns"

Chun-Chia (Amy) Chang, Praveen Kumar, and K. Sivaramakrishnan (2006): "Dividend Changes, Cash Flow Predictability, and Signaling of Future Cash Flows"

Franco Modigliani and Merton Miller (1958): "The Cost of Capital, Corporation Finance and the Theory of Investment", *The American Economic Review, Volume XLVIII*

Disclosures