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Dividends Do Make a Difference

"I want my $2."
-Johnny the paperboy in *Better Off Dead* (1985)

If you went to high school in or around the 1980s, you will likely remember the classic absurdist comedy, *Better Off Dead.* Perhaps the most memorable comic bit is the ongoing attempt by the paperboy to extract the $2 owed to him by John Cusack's character, Lane Myer. For those of you who don't remember the schtick, or have a couple of minutes to kill, here is a link to a few clips guaranteed to expand your cinematic cultural horizons- https://www.youtube.com/watch?v=RB6wQxugJn4.

As investors with an appreciation for dividends, we can identify with this young entrepreneur's enthusiasm for the power of regular cash payments. Most are familiar with the fact that almost half the long-term return of the S&P 500 has come from dividends. There are plenty of other reasons to love dividends.

- If a company is paying a dividend, it implies it is more established and has a reliable source of cash flow, (although this is not always the case)

- Managements understand the market will not react favorably if the dividend is cut at a future date, which imposes a certain level of financial accountability

- Intuitively, with more of the return coming from dividends, risk as measured by volatility of returns will be lower

In spite of these benefits, dividend investing still gets looked down upon by growth investors who tend to see dividends as a sign a company has no growth prospects. Surely, the logic goes, if management had decent growth prospects on the table, they wouldn't be giving excess capital back to those pesky shareholders. Despite repeated evidence to the contrary, it is often assumed that high-dividend stocks may be fine for income, but if you are looking for total return, better shop somewhere else. High-dividend stocks are also often associated with value stock investing. Academic research has shown that value stocks have outperformed growth stocks over time, and concluded that this outperformance is due to various forms of risk. The implication seems to be that if dividend stocks do outperform, it must be because investors are taking on a higher degree of risk to get that extra performance.

It is therefore with considerable interest that we read one the latest academic contributions to the subject, an article in the November/December 2016 issue of the *Financial Analysts Journal* entitled *What Difference Do Dividends Make?* (spoiler alert- they make a pretty big difference). The authors seek to take a long-term look at not only the risk and return characteristics of dividend paying stocks, but also the impact of adding dividend paying stocks to growth and value portfolios, respectively.

They began with stock return data from 1962 to 2014 and ranked them according to dividend yield. They then created four groups:

No-dividend	Paid no dividend
Extreme-dividend	Top 5% of dividend payers
Low-dividend	bottom half of remaining dividend payers
High-dividend	top half of remaining dividend payers

The extreme-dividend group (top 5% of dividend payers) was segregated in an attempt to weed out companies with financial problems where the dividend yield was unusually high due to anticipated dividend cuts which eroded the stock price.

Return data for the four dividend categories are summarized in the table below. Note that return and yield data are reported monthly:

Table 1

	Mean Return	*Dividend Yield*	*Standard Deviation*	*Sharpe Ratio*
High-dividend	0.897%	0.366%	4.014%	0.21
Extreme-dividend	0.850%	0.526%	4.950%	0.18
Low-dividend	0.797%	0.159%	4.746%	0.16
No-dividend	0.765%	0.012%	7.035%	0.13

Key takeaways:

- The high-dividend category is the clear winner, with not only the highest returns, but also clearly the lowest risk as measured by standard deviation

- Dividend yield accounted for 41% of the high-dividend category's return, which almost certainly contributed to its lower volatility

- The annualized dividend yield for the high-dividend group was 4.4%, a very meaningful level. Note that during the time periods studied, the average yield of the S&P 500 ranged between 1.1% and 5.6%

- The extreme-dividend category, supposedly filled with financially stressed companies, actually had lower volatility than the low-dividend and no-dividend categories

- The no-dividend group, which is presumably composed of high-growth companies, had the lowest total return and by far the highest risk of any category

Table 1 makes a pretty compelling case that by "settling" for income, dividend investors are in no way giving up in the total return race.

The second part of the study examined the impact of increasing dividend yields on growth and value strategies. To do this, the authors ranked the stocks by price-to-book values and made three portfolios:

Growth	Top 30% of price-to-book value
Blend	Middle 40% of price-to-book value
Value	Bottom 30% of price-to-book value

Each portfolio was then broken down into the same dividend categories shown above. The results are shown in the next three tables:

Table 2

High Price to Book Value (Growth)

	Mean Return	*Dividend Yield*	*Standard Deviation*
High-Dividend	0.814%	0.255%	4.186%
Low-Dividend	0.749%	0.105%	5.217%
No-Dividend	0.563%	0.007%	7.515%
Extreme-Dividend	0.558%	0.346%	7.960%

Table 3

Mid-Price to Book (Blend)	*Mean Return*	*Dividend Yield*	*Standard Deviation*
Extreme-Dividend	1.097%	0.498%	5.994%
No-Dividend	0.978%	0.014%	6.705%
High-Dividend	0.910%	0.372%	4.158%
Low-Dividend	0.823%	0.190%	5.064%

Table 4

Low Price to Book (Value)	*Mean Return*	*Dividend Yield*	*Standard Deviation*
No-Dividend	1.148%	0.031%	6.747%
High-Dividend	1.081%	0.419%	4.601%
Low-Dividend	1.070%	0.221%	5.485%
Extreme-Dividend	0.995%	0.543%	5.754%

Key Takeaways:

- Conventional wisdom would hold that growth stock returns should come from capital appreciation. Instead, the study found that in the growth portfolio, the high-dividend category outperformed all others. Growth investors appear to have a good opportunity to increase returns and lower risk with the addition of high-yielding stocks to their portfolios.

- It is a reasonable assumption that many of the stocks in the high-dividend category of the growth portfolio are increasing their dividends from year-to-year, a definite nod to the importance of rising payouts to total return.

- The annual dividend yield in the high-dividend growth portfolio was 3.1%- not too shabby, and decidedly above the current yield of the S&P 500 of 1.9%.

- The high-dividend category has, by far, the lowest risk (standard deviation) in each of the three portfolios.

So, based on the above data, where is the best place to start looking for stocks to build a portfolio with competitive total returns, a low risk profile, and solid income generation? It seems our list should include stocks with dividend yields higher than the general market that are growing their dividends. That happens to be Behind the Numbers' prime hunting ground for new ideas. Like Johnny the paperboy, we want our $2, and next time, we'll expect $2.15.