

# DIVIDEND INVESTING: A PRIMER



RICHARD C. YOUNG & CO., LTD.  
INVESTMENT ADVISORS

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“ One of the most persuasive tests of high quality is an uninterrupted record of dividend payments going back over many years. A record of continuous dividend payments for the last 20 years or more is an important plus factor in a company’s quality rating. ”

“ For the vast majority of common stocks, the dividend record and prospects have always been a most important factor in controlling investment quality and value. In the majority of cases, the common has been influenced more markedly by the dividend than by reported earnings. In other words, distributed earnings have had a greater weight in determining market price than have retained earnings. ”

-Benjamin Graham, *The Father of Value Investing*

A difficult lesson learned by many investors since the turn of the century is to not rely solely on capital appreciation for stock-market gains. Investors who pursued speculative gains during the dot-com bubble and in the years leading up to the real-estate collapse were often left with not only smaller portfolios, but with portfolios that produced little annual income.

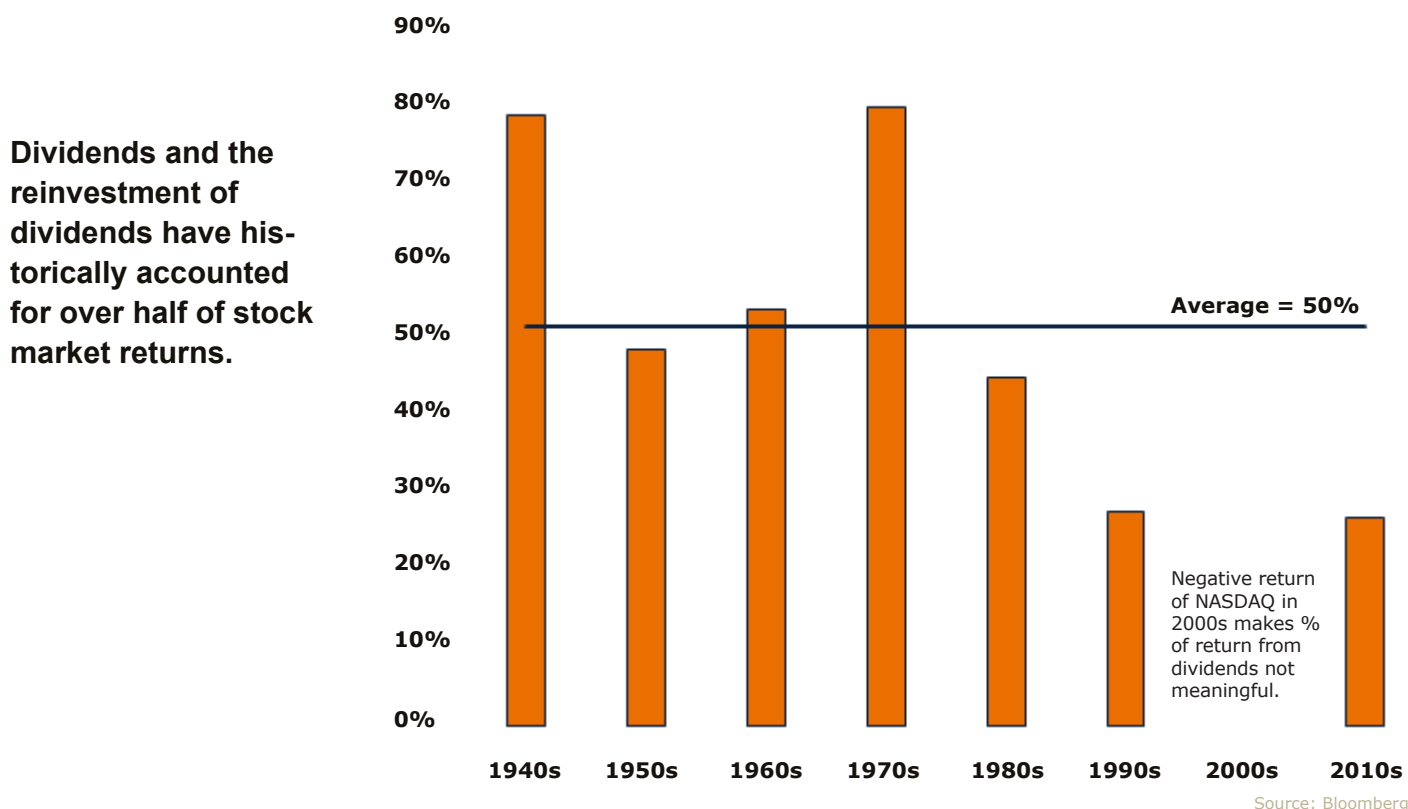
The low-yielding NASDAQ index has more than tripled over the last ten years, but the reality for NASDAQ investors is that for the first 15 years this century, the index underperformed bonds and put investors through two bear markets. That’s a decade and a half with very little return. And if you think you can avoid a similar fate because you buy the “safer” non-dividend-payers, consider this, during a 16-year period from 1965 to 1981, the blue-chip Dow Jones Industrial Average fell 10% in price. Sixteen years is most of a retirement for many investors. The performance of the NASDAQ and the Dow in these two periods is a reminder that stock prices can remain depressed for long periods of time.

### **Give Dividends a Meaningful Role**

A possible solution to these potential long dry spells of stock market appreciation is to give dividends a meaningful role in your portfolio. Dividends have historically been an important component of long-term stock-market returns. Over short time

frames and during long bull markets, dividends may seem trivial—but as Figure 1 illustrates, over the last eight decades, dividends have accounted for an average of 50% of each decade's stock-market returns. In the first 15 years of the 21<sup>st</sup> century, when the NASDAQ barely gained any ground, high-dividend-payers (highest yielding quintile) compounded investors' money at 7%. And during that 16-year period from 1965 to 1981, when the Dow fell in price, high-dividend-yielding stocks earned a compounded annual return of 8.1%.

**Figure 1: S&P 500 Share of Return From Dividends**



When you measure over multi-decade periods, the potential impact of dividends on investment returns becomes clearer. Over the last 35 years, dividends and the reinvestment of dividends have accounted for over 53% of the S&P 500's total return.

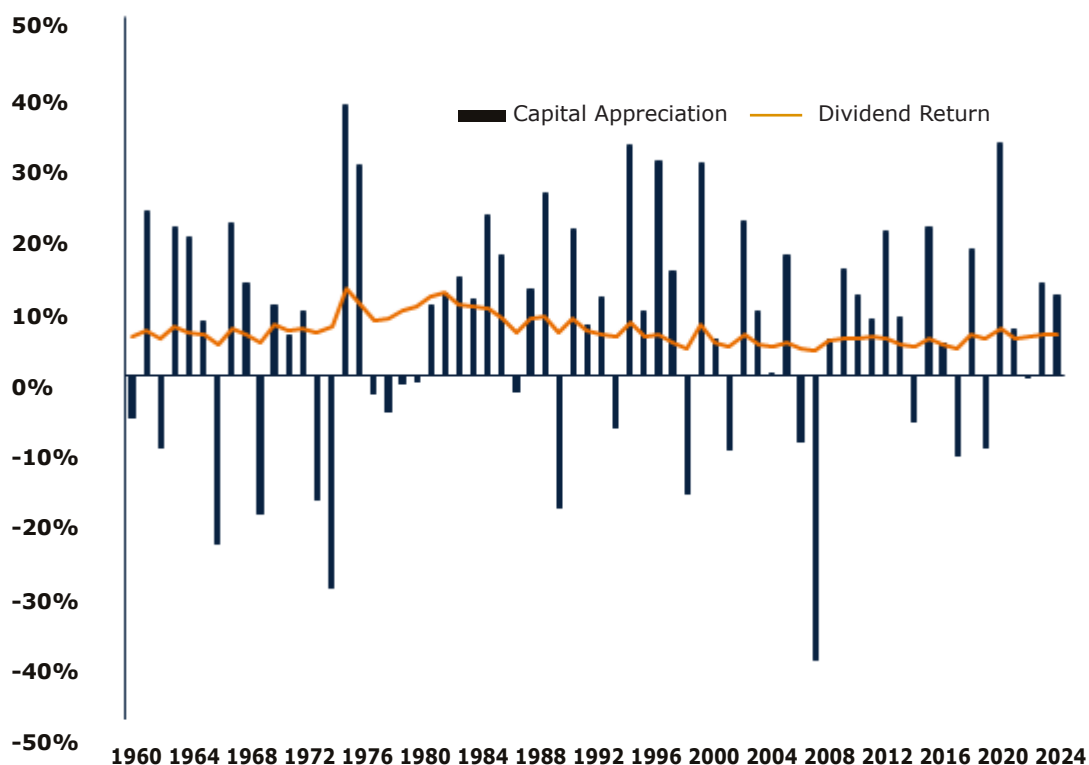
### A Steady Stream of Income

Dividend stocks, and especially high-dividend-yielding stocks, may have appeal for all types of investors. A continuous stream of dividends can be used for living expenses (ideal for retirees) or reinvested at attractive share prices, resulting in higher future-dividend payments (ideal for long-term wealth accumulation). A steady stream of cash can also make it easier for investors to avoid the emotionally charged decisions that often negatively impact portfolios in down markets.

Figure 2 compares the capital-gains component of returns to the dividend component of returns for high-yielding stocks. Note the relative stability of dividend returns compared to capital gains.

**Figure 2: Dividend Return vs. Capital Appreciation**

The stability of dividend returns can offer comfort to retired investors.



Source: Kenneth French data library.

### Reduce Risk with Dividend Stocks

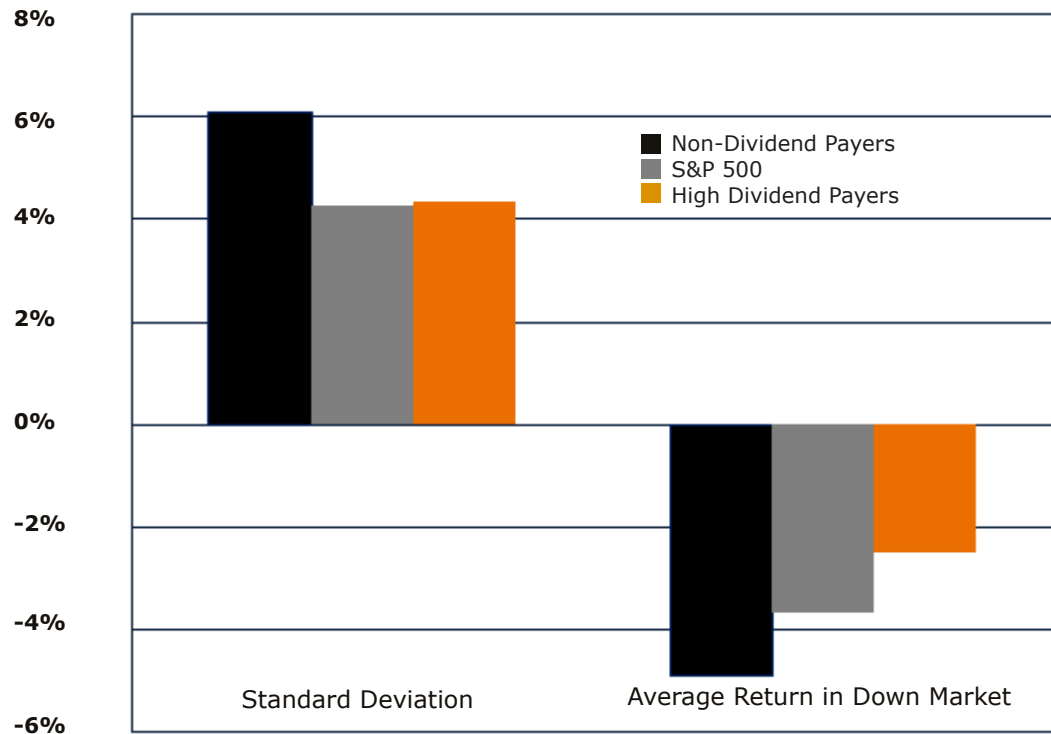
What's more, dividends can help reduce portfolio volatility. Figure 3 (next page) shows that high-yielding stocks have historically been less volatile than non-dividend-paying stocks. And high-yielders have held up better in down markets than both non-dividend-payers and broad-based stock-market indices such as the S&P 500.

### Dividends: A Shortcut to Quality

A dividend strategy may also help you avoid some of the pitfalls that can negatively impact even the most seasoned investors' portfolios. Dividend-paying companies are often more durable businesses than non-dividend-payers. Payers may also be more likely to operate in industries with higher barriers to entry and have stronger balance sheets than non-dividend-payers. And because there is often a stigma associated with cutting

**Figure 3: High Dividend Payers Less Risky**

Historically, high dividend payers lose less in down markets.



Source: Kenneth French data library and S&P Global.

Dividend payers are often durable businesses with strong balance sheets.

dividend payments, the consistent payment of dividends may be a signal of management's confidence in the future prospects of a company. This is especially true of companies that raise dividends. Management teams seldom commit to higher dividend payments unless they believe the dividends can be maintained.

Cold, hard cash in the form of quarterly dividend payments may also be a sign of strong corporate management. Who can forget the accounting frauds like Enron, WorldCom, and Tyco and their impact on many retirement portfolios? Not a single company in the group paid a meaningful dividend. Companies can manipulate earnings by using creative accounting techniques, but regular dividend payments can't be faked.

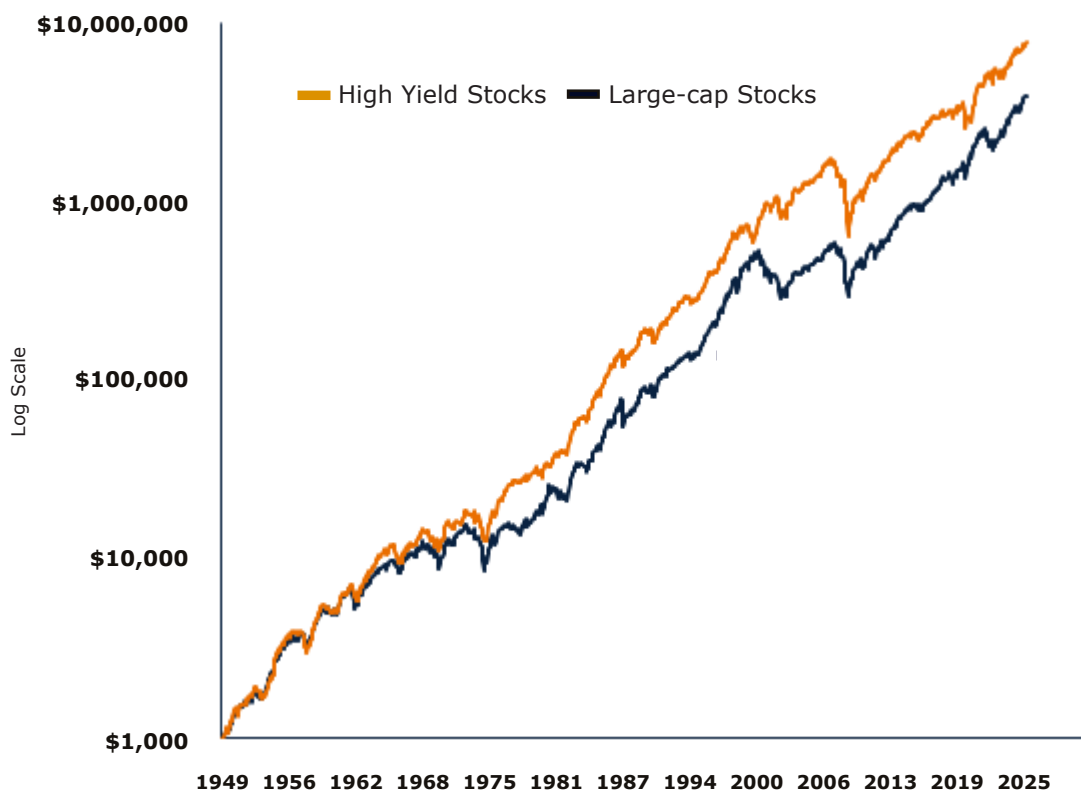
### A Free Lunch?

What is the trade-off for consistent income, potentially lower risk, and higher quality? Would you believe the possibility of higher long-term returns? Although one might expect a high-quality, low-risk strategy to generate lower long-run returns, historically the opposite has been true. Over the long run, high-yielding stocks have outperformed the broader market.

Not every year, of course, but over the past 75 years, the highest-yielding quintile (top 20%) of stocks beat the market by a substantial margin (Figure 4).

**Figure 4: Large-Cap. Stocks vs. High Dividend Paying Stocks**

**High dividend payers turn \$1,000 into \$7.8 million vs. \$4 million for large-cap stocks - a difference of \$3.8 million.**



Source: Kenneth French data library.

### **Faster Earnings Growth from Dividend-Payers**

If you have avoided dividend-payers in the past because you've assumed they are staid businesses with low growth prospects, you may be surprised by the historical facts. Historically, companies that returned more earnings to shareholders in the form of dividend payments had greater earnings growth. Why? Is it not true that the fastest-growing companies often pay no dividends at all? Indeed it is, but high dividend payments limit the amount of cash management teams have at their disposal. The resulting scarcity of capital often forces CEOs to pursue only those projects offering the most promise. At non-dividend-paying companies, where retained earnings are abundant, management teams may be more likely to make questionable acquisitions or invest in marginal expansion projects that hurt profitability.

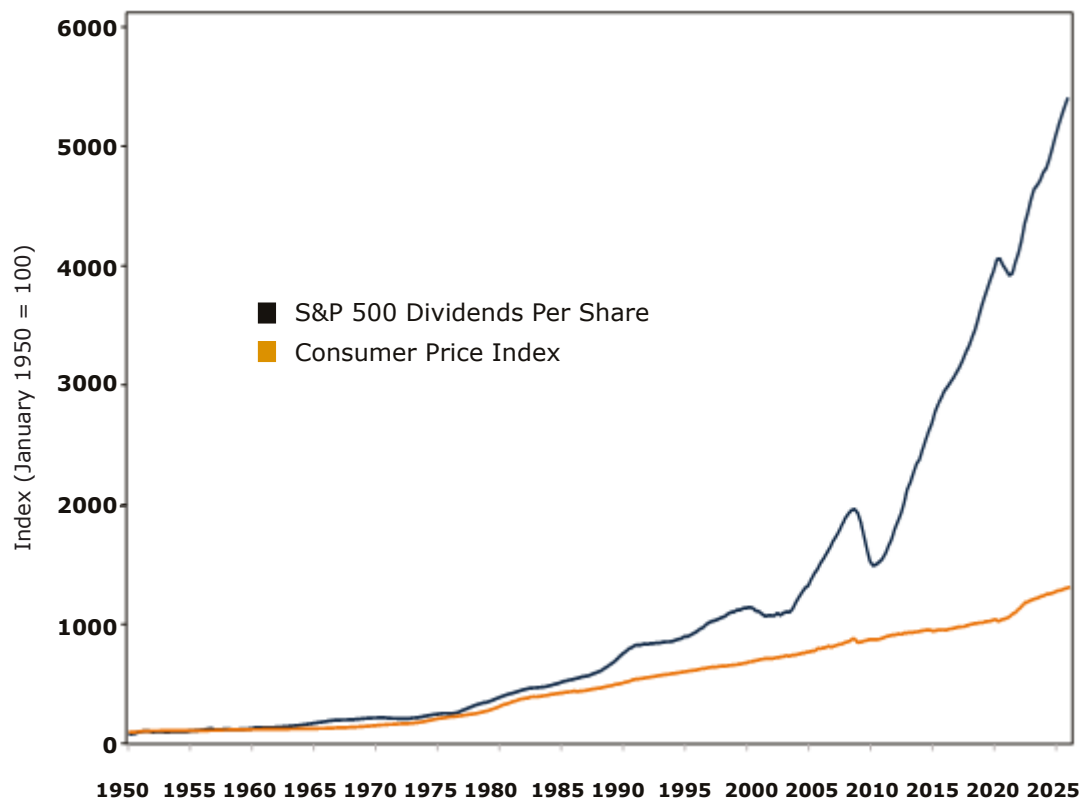
## Dividend-Payers As an Inflation Hedge

With global central banks cutting rates once again, the risk of accelerating inflation is ever-present. Stocks may not be the first asset class you think of for inflation protection, but they can have an important inflation-fighting role to play in your portfolio.

Stocks tend to maintain their purchasing power during inflationary periods because they are real assets. When inflation rises, the revenues, earnings, and dividends of companies tend to rise as well. Figure 5 shows that dividends per share for the S&P 500 have outpaced inflation by a wide margin.

**Figure 5: S&P 500 Dividends per Share vs. CPI**

Dividend payers  
help fight inflation.



Source: Young Research & Publishing, Inc. & Macrobond

## Don't Speculate: Invest

If you've harbored doubts about a dividend strategy, we hope we have established that for investment purposes (as opposed to speculation) a dividend strategy may be a winning approach for you. Dividend stocks can provide a steady stream of income for compounding, they are often higher-quality businesses than non-dividend-payers, they historically have been less volatile in down markets, and for investors who have a longer time horizon, dividend-payers may offer the prospect of market-beating returns.

## Getting Started with Dividend Stocks

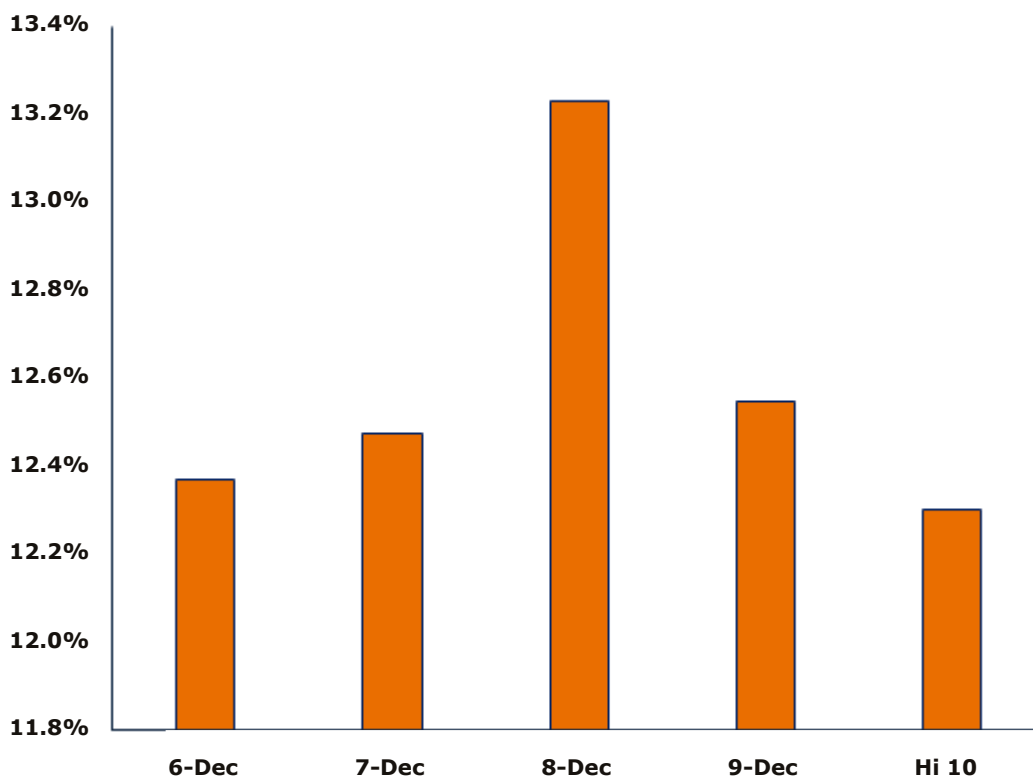
Once you have made the decision to pursue a dividend strategy, how do you choose the best dividend stocks? Should you buy the highest-yielding stocks, or should you favor those with the highest dividend growth? Should you stick to large-capitalization dividend stocks or pursue small-capitalization dividend stocks as well? Should you limit purchases to U.S. stocks or invest abroad?

Since dividend-payers beat non-dividend-payers (Figure 3.), one might assume that the higher the dividend yield, the better. But that isn't always true. Yield alone may not be the best indicator of future stock performance. A high dividend yield can be a warning sign that the dividend may be unsustainable, or that the dividend-paying company is not growing. The historical record shows that an investment strategy that buys the highest-yielding 10% of the stock market and rebalances annually delivers investment returns that trail stocks with high, but not the highest, yields.

Figure 6 shows the compound annual return over the last 48 years of five portfolios formed based on dividend yield. As you can see, the portfolio including stocks from the highest-yielding group actually earned less than did the other four.

**Figure 6: Highest Yielders Not Best**

**Buying high, but not the highest yielders has historically been a better investment strategy than buying the highest yielders.**



Source: Kenneth French data library. The chart shows the performance of the top five decile portfolios that were formed by dividend yield.

**Companies that make regular dividend increases, have historically beaten companies that don't by as much as 51.7%.**

## **Dividend Growth is Key**

At Richard C. Young & Co., Ltd., an important feature of our investment strategy is crafting dividend portfolios that include companies with high dividend yields, a history of regular dividend payments, and a record of consistent dividend increases. Studies by market research firm Ned Davis show that companies that have increased their dividends regularly have outperformed dividend-payers lacking dividend growth by as much as 51.7%. The combination of a high dividend yield today and higher dividend payments tomorrow can potentially be a successful strategy for investment portfolios.

## **A Focus on Dividend Increases**

To build a portfolio of what we believe are dividend paying stocks with upside potential, we focus our domestic stock investing on companies that have increased their annual dividend payment for at least 10 consecutive years.

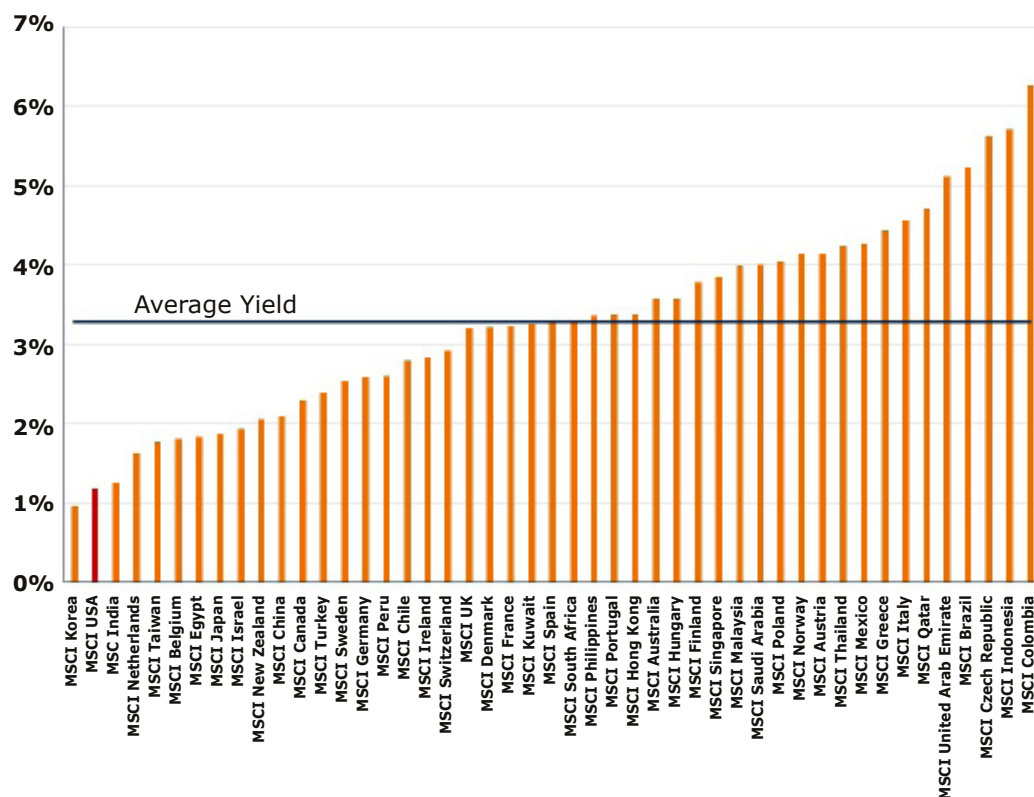
When appropriate, we also invest in international dividend payers for our clients. Foreign companies don't always adhere to the same dividend conventions as U.S. companies, so restricting the investment universe to companies that have increased their dividend for 10 consecutive years isn't practical. Instead we look for foreign firms that have a dividend policy calling for regular dividend hikes even if they don't occur every year.

For the dividend investor, foreign markets can offer compelling opportunities. There are many foreign markets where stocks consistently yield more than those in the U.S. Some even set minimum dividend-payout ratios for companies. Figure 7 shows that of the 47 countries in the MSCI All-Country World Index, the U.S. ranks 46<sup>th</sup> in dividend yields. Many investors recognize that a global dividend portfolio can yield a much greater level of income than a domestic portfolio.

As you can see in the chart on the next page, a well-crafted global dividend portfolio can significantly increase an investor's dividend income when compared to an investment in a broad U.S. stock market index.

**Figure 7: MSCI Country Dividend Yields**

Savvy investors can boost income by investing abroad.



Source: Bloomberg

### Take The Burden of Portfolio Management Off Your Shoulders

The strategies and insights we have shared with you in this report form the foundation of the equity investment strategy at Richard C. Young & Co., Ltd. We hope you have found this report informative. Our goal is to help our clients achieve long-term investment success with comfort and confidence. If you like the sound of what a global dividend portfolio has to offer, [Richard C. Young & Co., Ltd.](#) may be able to help. We manage dividend focused portfolios for individuals, families, and businesses throughout the United States. Our portfolio minimum is \$500,000.

To schedule an appointment with one of our investment specialists, please [click here](#) or give us a call at **800-843-7273**. Thank you for reading.

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