



## The Power of Dividends

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Dividend-paying stocks are best known for their income generation on the one hand and their unfavorable tax treatment on the other. Beyond recognizing these well known features, however, many investors hold a false belief that dividend stocks underperform. High-dividend portfolios are often dismissed as inferior to their high-growth counterparts for several reasons:

- Fear that increasing dividend yield means lower portfolio returns.
- A view that dividend payments are an admission by management that they do not have good reinvestment opportunities.
- A belief that dividends are associated with the end of a company's growth cycle.
- The inferior tax treatment of dividend income relative to capital gains.

The evidence refutes these beliefs. Research shows that the higher a stock portfolio's dividend yield, the greater its return. And just as surprising, the higher the yield, the lower is portfolio volatility.

Building higher-yield portfolios is a straightforward way to improve returns while simultaneously reducing volatility, notwithstanding the conventional, undue focus on income and tax considerations. Investors and advisors should shed this limited view of dividends and let them play a more prominent role in their equity portfolios.

### **Dividend yield, returns and volatility**

At the overall market level, a long line of research shows that higher cash payout and dividend yields lead to higher future market returns. (See, for example, [Surprise! Higher Dividends = Higher Earnings Growth](#), by Rob Arnott and Cliff Asness, and [On the Importance of Measuring Payout Yield](#), by Jacob Boudoukh, et al.) More specifically, this research reveals that dividend yield is a good predictor of future earnings growth, so a period of rising dividend yield bodes well for future market returns. This belies the common belief that executives increase dividend payout when investment and future growth opportunities are poor. Company management, by increasing dividend payout, is actually signaling higher future cash flows, which in turn foretell higher stock returns.

At the individual stock level, too, dividend payout and yield are predictive of future earnings growth and future returns. (See, for example, [Do dividends signal information about future](#)



[earnings?](#), by Khaled Hussainey.) Among other things, this body of research has found that dividend changes contain information about 1) future earnings that cannot be found in other market data, 2) company profitability, and 3) future positive earnings surprises. Other research has found that companies experiencing financial distress rely more heavily on dividends for communicating with investors.

The overall conclusion is that rising dividends signal improved company performance and, in turn, higher individual stock returns.

In order to appreciate the power of dividends, consider the average annual compound returns for S&P 500 stocks over the period 1973 through 2010, which are reported in Figure 1 below. Over this period, S&P 500 stocks that paid growing dividends outperformed dividend-cutting S&P 500 stocks by an astonishing 10% annually. Growing dividends are predictive of strong future stock returns, while zero or reduced dividends are a predictor of poor stock returns.

Even more surprising, volatility declines as dividends increase. Figure 2 below reports the annual standard deviation for the four portfolios reported in Figure 1. In general, volatility decreases as dividends – and accompanying stock returns – increase. In particular, the dividend-growing portfolio experiences roughly a third less volatility than does the dividend-cutting portfolio.

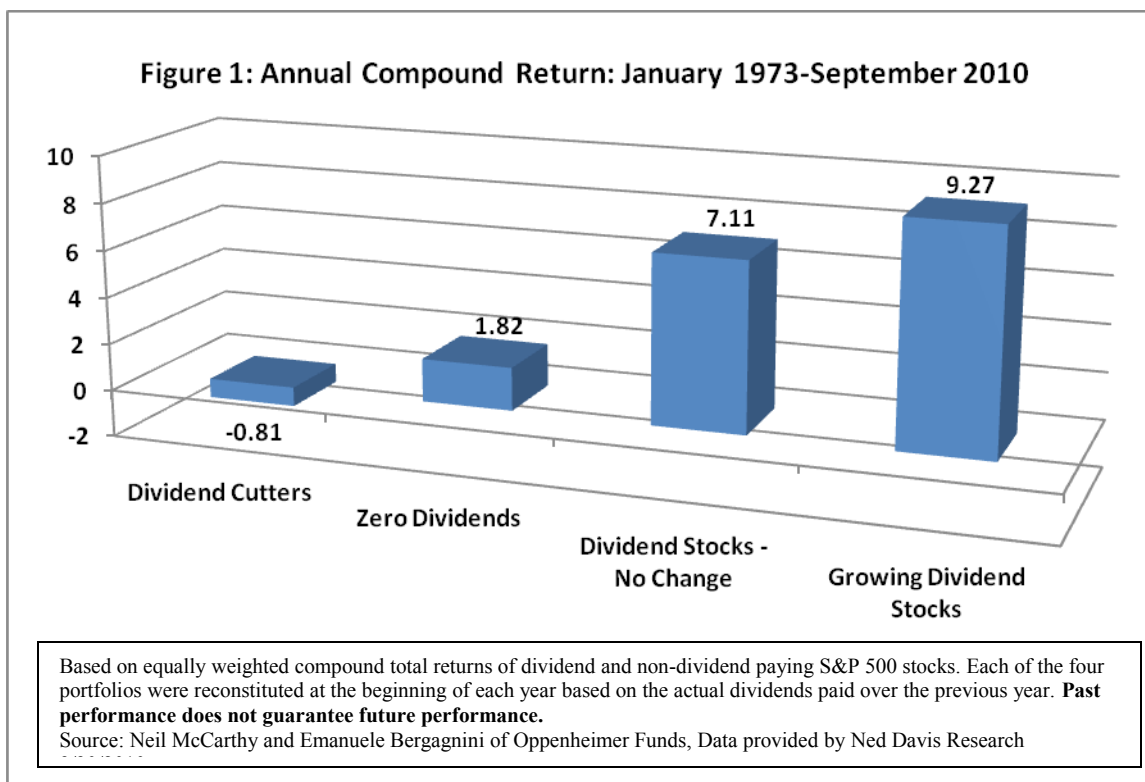
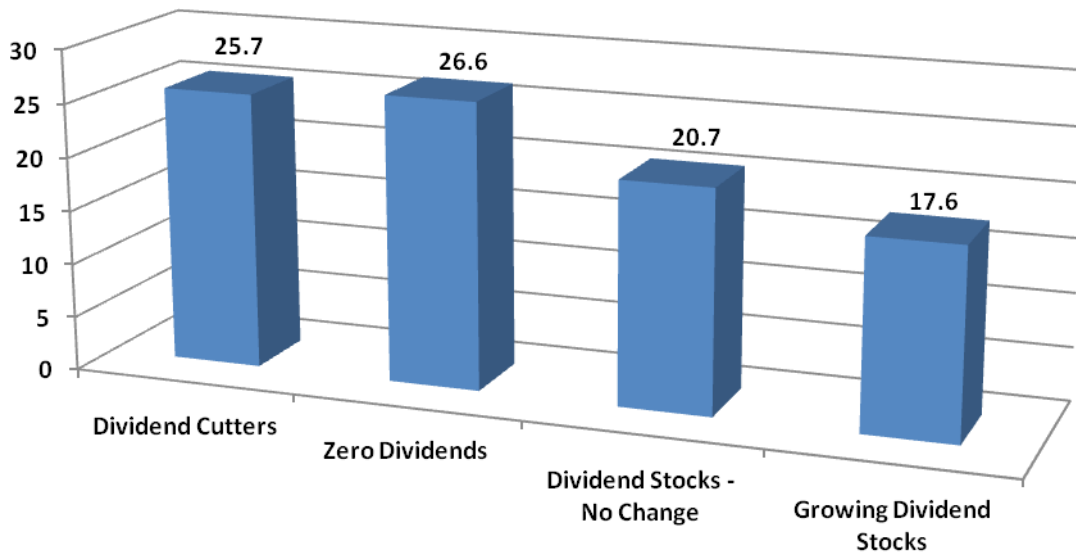


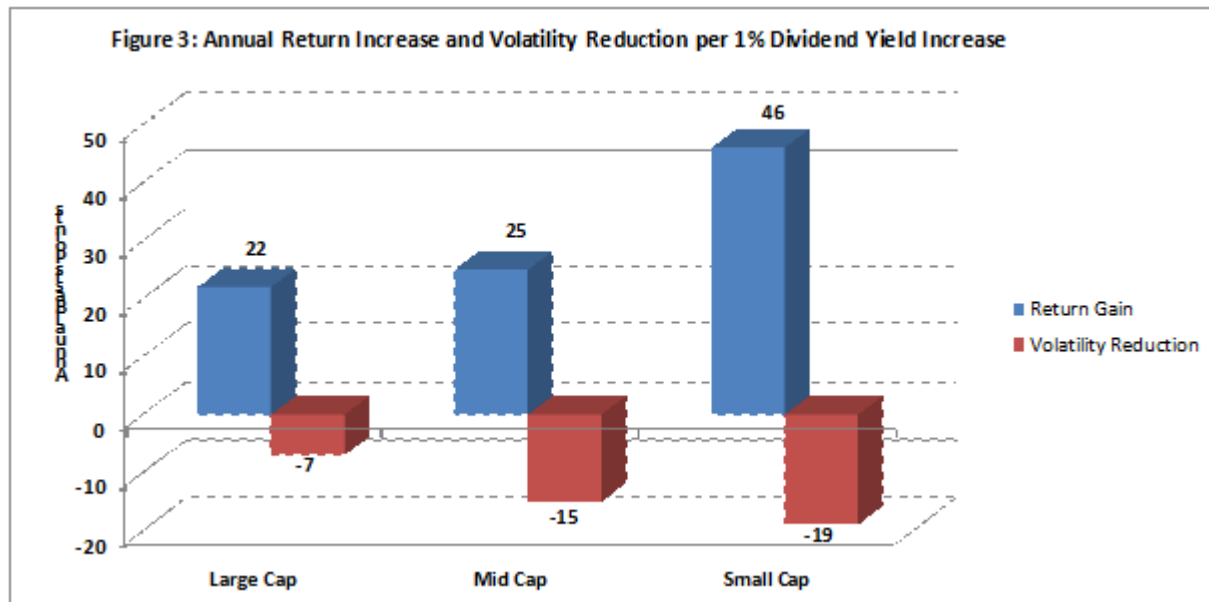
Figure 2: Annual Standard Deviation: January 1973-September 2010



Based on equally weighted compound total returns of dividend and non-dividend paying S&P 500 stocks. Each of the four portfolios are reconstituted at the beginning of each year based on the actual dividends paid over the previous year. **Past performance does not guarantee future performance.**  
 Source: Neil McCarthy and Emanuele Bergagnini of Oppenheimer Funds, data provided by Ned Davis Research 9/30/2010.

## Dividends, market cap and taxes

For a clearer picture of the return and volatility benefits of rising dividend yield (DY), Figure 3 below shows the after-the-fact, survivor-bias free annual return gain and volatility reduction (as measured by standard deviation) for a 1% increase in dividend yield. This 1997 through 2009 sample incorporates 157,625 stock-month observations. The results reveal that for a large-cap stock portfolio, a 1% DY increase produces an average gain of 22 basis points in annual compound return, along with a 7bp reduction in annual portfolio standard deviation. For example, if DY increases by 3%, then an investor can expect the large-cap portfolio return to increase by 66bp and portfolio volatility to decrease by 21bp. You can have your cake and eat it too: higher dividend yields lead to quantifiably higher returns and quantifiably lower volatility.



Based on a total of 157,625 stock, month survivor-bias free sample over the March 1997 through December 2009 time period. Dividend yield quintiles and market cap deciles are recalculated at the beginning of each month. Dividend yield is calculated as 12 times the average monthly dividend over the previous 12 months divided by current price and is not calculated when the stock's price is less than \$5 or the most recent quarterly dividend is zero. Large Cap stocks are market cap deciles 1-3, Mid Cap stocks are 4-7, and Small Cap stocks are 8-10. Subsequent monthly returns are net of S&P 500. The annual return gain per 1% DY increase is the slope of annual compound return on average DY over the 5 DY deciles. The annual standard deviation reduction per 1% DY increase is the slope of annual SD on average DY across the 5 DY deciles. Past performance does not guarantee future performance. Data sources: CRSP and Thomson Reuters Financial.

Figure 3 reveals other interesting results. First, the power of dividends increases as stock size decreases. The return gain increases from 22bp to 25bp to 46bp as one moves from large- to mid- to small-cap stocks, while the volatility reduction improves from 7bp to 15bp to 19bp. Thus, dividend power is not limited to the large-cap S&P 500 stock universe that is the basis of Figures 1 and 2.

The other interesting result is that the observed return gains are large enough to offset the current tax disadvantage of dividends. Since dividends are currently taxed at a 15% rate, their marginal tax cost is 15bp, which is less than each of the expected return gains reported above. Indeed, many investors face tax situations in which their marginal dividend tax cost is less than 15bp. For both tax-deferred portfolios and portfolios subject to capital gains taxes, the incremental tax cost would be less, and in some cases substantially less, than 15bp. Tax law is complicated, so I cannot rule out the possibility that increasing DY could lead to lower after-tax expected returns for some investors. Be that as it may, the vast majority of investors will experience increasing after-tax expected returns with increasing dividend yield.

### Why dividends matter

Companies regularly provide information to investors regarding the state of the company. The value investors should place on such information depends upon the incentives facing management when they issue that data. In providing projections regarding a new venture, for example, management has an incentive to present as rosy a picture as possible. If a



new venture is perceived as overly bold or expensive, management may experience push-back from sell-side analysts and others, but the cost to management of too optimistic a projection is relatively low.

Some company information, such as quarterly and annual financial statements, is audited. Here investors have additional assurances that the information is accurate, and there are legal penalties for both the company and the auditor for material misrepresentations. Investors will place greater value on such announcements, but, as we know, the auditing process is far from perfect, with some firms able to fool auditors and investors for long periods of time.

The most valuable signals come when company management “puts their money where their mouth is” – specifically, announcements that are directly tied to changes in current and future investor cash flows. The best examples of such signals are cash dividends, share repurchases, and financing decisions. The false signal costs of such announcements are high. For example, raising dividends to an unsustainable level is costly, since cutting dividends leads to steep price declines. Management, in fact, has incentives to avoid false signals in either direction when it comes to dividends, making dividends a strong two-way signal. Similarly, share repurchases involve promises of current and future cash flows and can lead to disappointment if not fulfilled, and issuing too much debt can put the company at risk of bankruptcy. So management decisions that, like these, bear significant false-signal costs should receive maximum weight from investors.

### **The power of dividends**

Dividends should not be viewed simply as a source of current income, but as one of the most important stock signals provided by a company’s management. Dividends provide valuable information regarding future company performance and, as a result, stock performance, while at the same time providing signals about future volatility. These are good reasons to consider dividends when analyzing, buying, and selling stocks, and dividends should play a prominent role in an advisor’s equity strategy.

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