There Is More to Dividends Than Just Yield

There is more to building a dividend-oriented portfolio than simply buying high-yielding stocks. In fact, chasing the highest yields can lead investors into serious trouble. There is a lot to consider to successfully invest in dividend-paying stocks. When a disciplined and comprehensive strategy is applied, the benefits of dividend-paying equities can be significant:

- Dividend-paying stocks have outperformed the broader market over long time horizons.
- Dividends can provide a potentially growing income stream, which can help supplement retirement income and keep pace with inflation.
- Dividend-paying stocks have been the backbone of long-term total return.

A smart dividend strategy doesn’t focus on the highest-yielding stocks, but on the fundamentals of the issuing company—the aim is to understand the company’s ability and willingness to pay the dividend. A company that is able to pay a steady or rising dividend generally has a strong business model, is growing its earnings power, and generates consistent cash flows from operations. The company must have a management team and board of directors that know how to allocate capital efficiently to sustain business and dividend growth.

Dissecting the Alternatives to Dividend-Payer Equities

Depending on an investor’s needs, there are circumstances where it may make sense to invest in companies that don’t pay dividends.

Reinvestment

For example, non-payers could increase their earnings power substantially by reinvesting 100% of earnings at attractive rates of return, driving up shareholder value. In this case, the investor is rewarded through eventual appreciation of the stock price. This assumes two critical factors. First, earnings must be reinvested at rates of return greater than the cost of capital; otherwise, the company is not creating value. Second, the market must realize that value is being created for the stock price to rise above a shareholder’s purchase price.

Share Buybacks

Share buyback scenarios represent another instance of potential value in non-payers. Companies that have excess capital may choose to reward shareholders by buying back shares rather than paying dividends. Assuming the company is buying back more shares than it issues to employees through grants and options, the number of outstanding shares will decrease, thus increasing per-share price. This does not increase the value of the overall issuer’s enterprise, but it does increase the value of the now fewer outstanding shares. This is a very attractive and tax-efficient way to return value to shareholders. There is a caveat for this to work well—the company must buy back shares when they are at or below fair value. In practice, most companies institute share buyback programs when business is strong; earnings may be above normal, and that’s why they have excess earnings to distribute. Companies experiencing above-average earnings frequently have stock prices that reflect an
overvaluation. Naturally, few management teams feel their company’s stock is ever overpriced, and even fewer would want to discourage investors from owning their stock at an inflated price. Without regard to the intrinsic value of their firm, they will buy back shares anyway, destroying shareholder value. These are the management teams who are the first to cut their buyback plans at the first sign of trouble. If a temporary change in the business results in lower-than-average earnings, the share price could suffer and may become under-valued. Despite this being the perfect time to buy back shares, most companies eliminate or cease their buyback plans. In theory, buying back shares is a great way to enhance shareholder value without creating a taxable event. In practice, however, the result isn’t always in the best interest of the shareholder.

For either of these alternatives, a significant problem with focusing only on non-payers is that when an investor needs income, securities must be sold to generate the funding for it. The markets, however, can be very volatile. When an investor requires capital to fund spending needs, market prices may be severely depressed. A better investment option would be to have regular income streams that eliminate the need to sell in an unfavorable environment.
The Case for Dividend-Paying Equities

Once we begin considering how to construct a portfolio of companies that have attractive dividend yields, satisfactory growth rates for the underlying businesses, and good business models, it becomes apparent that a significantly smaller universe of companies will meet these criteria.

Positive Performance Impact

History illustrates that dividends are a major contributor to an investor’s total return. Dividends of the S&P 500 companies represent almost one-third of their total return from April 1970 through March 2017. The annualized total return for the S&P 500 Index was 10.44% per year, as shown in Figure 1.

Going even further back in time—another 100 years for example—reinforces that income’s important role is hardly a new concept. Since 1870, dividends have accounted for 46% of total return, which is shown in Figure 2.

An analysis by Credit Suisse demonstrates the performance impact of companies based on dividend yields. They divided the 1,000 largest U.S. stocks by market capitalization into 10 equal-weighted groups with decile 10 being the highest yielding. Figure 3 shows that over the long term, the 8th decile outperformed the 10th decile. While decile 1, the lowest yielding stocks, underperformed the S&P 500 Index.

Capital Discipline & Earnings Growth

We believe paying a dividend instills capital discipline in management teams, aligning the sometimes conflicting interests of management and shareholders. Although this is a more qualitative factor, we consider it a major issue when constructing our portfolios. Since corporate boards, management teams, and investors can never control all potential conflicts, having a dividend policy is helpful for investors. It is not coincidental that over longer time horizons dividend-paying companies tend to be attractive investments. This is because, over time, dividends become a larger component of overall returns, as shown in Figure 4.

It Pays to Pay

One reason we believe investors should be partial to dividend payers is that dividends are sticky. While a company could cease dividend payments at any given time, their stickiness means that management teams are aware that when they reduce their dividend, even by a small amount, stock prices can suffer significantly. This has two results. First, companies want to pay a dividend that is sustainable and not overly burdensome in a recessionary environment. Second, the company must be more aware of its capital allocation decisions. An ideal dividend policy will balance both the needs of the company to fund growth and pay shareholders a meaningful dividend that can grow over time.

Conclusion

Chasing the highest yielding stocks can often lead to trouble. Although not always the case, these are frequently companies that are in financial distress. Low stock prices (hence high yields) could be a harbinger of future dividend cuts. Also, as we saw in Figure 3, the highest yielding stocks are not necessarily the best performing. In order for a company to grow its business and earnings power, it must retain some amount of capital. Because we seek to invest in companies with solid business models, we naturally assume they can grow their values over time.

Moreover, a growing dividend stream is significantly more valuable than a flat or declining one. But there is no guarantee that a company with a growing dividend will continue to increase payments. One must understand the business, its industry, growth expectations, and cash needs to make an educated decision as to whether a company will have the ability and willingness to increase its dividends per share indefinitely.

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**Figure 4 | Dividends Represented More of Total Return over the Long Term**

<table>
<thead>
<tr>
<th></th>
<th>1 Year</th>
<th>3 Years</th>
<th>5 Years</th>
<th>10 Years</th>
<th>20 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend Yield</td>
<td>12.5%</td>
<td>19.8%</td>
<td>21.5%</td>
<td>20.1%</td>
<td>28.5%</td>
</tr>
<tr>
<td>Dividend Growth</td>
<td>34.7%</td>
<td>42.1%</td>
<td>40.9%</td>
<td>57.6%</td>
<td>64.3%</td>
</tr>
<tr>
<td>Valuation Changes</td>
<td>52.8%</td>
<td>38.1%</td>
<td>37.6%</td>
<td>22.3%</td>
<td>7.3%</td>
</tr>
</tbody>
</table>


Investors may not make direct investments into any index.

Past performance does not guarantee future results.
The views expressed by the portfolio managers reflect their professional opinions and should not be considered buy or sell recommendations. These views are subject to change.

Following a dividend-focused strategy does not assure or guarantee better performance and cannot eliminate the risk of investment losses. Dividends are not guaranteed.

**S&P 500 Index** – An unmanaged broad measure of the U.S. stock market.

**MSCI All Country (AC) World Index** – A market capitalization weighted index that is representative of the market structure of 46 developed and emerging market countries in North and South America, Europe, Africa, and the Pacific Rim. The index is calculated with net dividends reinvested in U.S. dollars.

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