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DIVIDEND PAYING STOCKS
Not Just For Income Any More

Stocks that pay periodic dividends to shareholders have always been a primary allocation in a well-balanced, income-oriented portfolio. Conservative investors and/or those in (or approaching) retirement have long sought out income paying securities to provide a stable cashflow stream and, to a lesser degree, an opportunity for capital appreciation. The demand for these equity securities may fluctuate based on the market environments of other income-producing products. For example, a few years ago, the Fed had been engaged in an interest rate hike cycle and much of the fixed income market grew out of favor. Today, the subprime mortgage debacle has threatened the upside of even the higher quality bonds that investors rely on for that much needed income.

Some investors began seeking new sources of cashflow through alternative products like Master Limited Partnerships (MLPs) and Royalty Trusts, though these lesser known (and understood) securities are often accompanied by their own share of concerns. (Ask investors about their Canadian Income Trusts these days.) With those thoughts in mind, investors began turning more and more to the traditional dividend paying equities, and interestingly enough, many have been surprised at what they have found (and earned).

A Common Misperception

When people think about who buys dividend payers, a prototypical investor comes to mind. They are most often relatively conservative and risk averse. They are more interested in "value" with a consistent income stream and any prospects for "growth" remain a lower priority. After all, many of these investors have moved from capital appreciation to preservation mode and they are more concerned that their portfolios do not lose market value than they experience strong growth. Investors typically buy dividend paying stocks so they can sleep better at night and not because they expect to get rich from their increasing valuations.

In fact, in the high-flying Internet boom days, some equity analysts and investors alike began to steer clear of dividend paying companies and instead sought out the double-digit "certainties" of anything with a dot.com at the end of its name. Dividends became a sign of management's lack of ingenuity and creativity when it came to reinvesting the company's excess cashflow. Why pay out revenues to shareholders when they could instead be poured right back into the profitable company (or, at least, a growth company that would one day become profitable)? Dividend paying stocks were thought to be appropriate only for the most conservative investors who did not care about getting rich like their (day trading) neighbors and officemates.

Utilities, financials, and consumer staples were among the industry sectors most associated with dividend paying companies. On the other hand, technology and telecommunications were often considered growth sectors where management chose instead to reinvest any earnings rather than pay the excess cashflow to shareholders.

Surprising Performances

Well, a funny thing happened when analysts began delving deep inside the numbers. They discovered that these income-oriented securities actually performed quite well on a total return (income and appreciation) basis, even when compared to their growth and core equity counterparts. Since 1968, a dividend oriented portfolio comprised of the top 20% of S&P 500 companies as measured by dividend yield (annual dividend payment divided by stock price) has outperformed the overall benchmark (S&P 500) by three percent. During that extensive period, the dividend portfolio earned a compounded annual return of 13.7%, while the S&P 500 benchmark yielded only 10.7% percent (per S&P Corp/FactSet Research/SCCM).

The data is based on the assumption that the dividend portfolio was rebalanced annually to account for any changes among the top 20% of dividend yielding stocks within the index and assumes that all dividends are reinvested. Bear in mind, many people who invest in dividend payers require a certain amount of cashflow so some of that assumed reinvestment amount may actually be paid to the shareholders. However, three percent is a considerable cushion when comparing the returns of the two portfolios.

Justifying the Numbers

A few reason can be given for the "surprising," enhanced performances of dividend paying stocks through the years…

1) **Market Cycles:** As mentioned earlier, during various economic conditions, certain investments go out of style, so to speak. When interest rates are low, investors seek alternative income sources through securities like dividend payers. Likewise, when the economy is sluggish (and perhaps even recessionary), equity investors choose to participate in value companies that hold up better during these times. Value stocks are more likely to pay dividends than their growth counterparts.

2) **Baby Boomers:** As more people approached those retirement years, they begin shifting from accumulation to preservation and income modes. Portfolios of retirees tend to hold more value stocks, many of which pay that much needed income to replace the periodic paychecks that have ended.

3) **Tax Law Changes:** With the passage of the *Jobs and Growth Tax Relief Reconciliation Act of 2003*, the tax rate on dividend income was reduced to 15%, consistent with the capital gains rate. Suddenly the demand for dividends increased among income sensitive (but tax conscious) investors and more companies, even in traditionally growth sectors, began to oblige. For example, Microsoft was one such technology company that never had paid a dividend prior to 2003, but changed its policy for the benefit of its shareholders.

Don't Just a Book By Its Cover

The point of this insight was not to convince everyone that a portfolio of dividend paying stocks is most appropriate for all investors all of the time. However, perceptions are often inaccurate and those growth-oriented individuals who disregarded dividend payers in the past for being too conservative may have actually cost themselves in the way of total return. Certainly different investment styles may work best during various market cycles, but 39 years is a considerable time frame to prove that these securities actually offer the potential for attractive total returns. As for those investors who sought the safety and income potential of dividend paying stocks, their just rewards may have been greater than expected…probably far greater than their (day trading) neighbors and officemates.