Quiet Counsel

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Investment Outlook

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Cause or Effect? The Role of Dividends in an Outperforming Portfolio

John D. Rockefeller, the world's first billionaire, once famously remarked, "Do you know the only thing that gives me pleasure? It's to see my *dividends* coming in."[1] Dividend-paying stocks represent a key element of a long-term total return approach, so it is important to understand the role they can play in portfolios and review why – or why not – you should invest in them.

Total Return 101

Dividends are cash that a company pays out to its shareholders. For common shares (think "stocks" or "equities") the dividends are entirely discretionary but in order to avoid disappointing investors with a dividend cut, companies tend to be conservative in what they promise. Established companies with stable cash flows thus tend to be more likely payers of dividends and so dividend-paying stocks tend to be associated with maturity and stability.

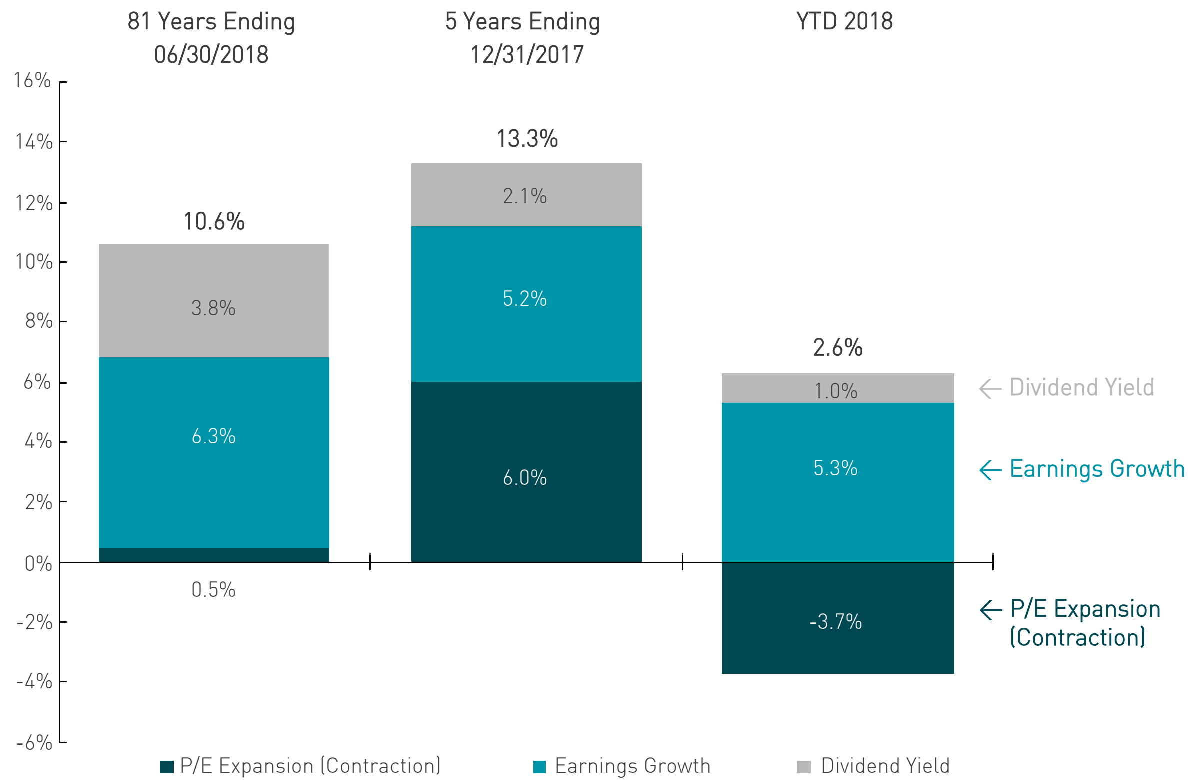
In addition to dividends, the total return to an investor over time includes the increase or decrease in the price of the stock. The stock price will rise or fall based on two key drivers: how much management is able to grow the earnings of the company (observable fact: earnings growth), and how much investors are willing to pay for a stream of those earnings into future, measured by the price-to-earnings ratio (market opinion: P/E). All else being equal, a capable management team generating above-average earnings can use those earnings to reinvest in the business or pay (and possibly grow) dividends. This pattern increases investor confidence, and thus investors' willingness to pay more per dollar of future earnings – resulting in a higher P/E ratio.

So taken all together, over time a stock's:

Total Return = Dividends Received + Earnings Growth + P/E Expansion

But how important are each of these elements to total return? Charts 1 and 2 below break the annualized total returns to the broad US and Canadian equity markets, respectively, into the component parts of price growth (due to earnings growth and P/E expansion) and dividends.

Chart 1: Annualized Return Components of the S&P 500 Total Return Index – 1937 to 2018



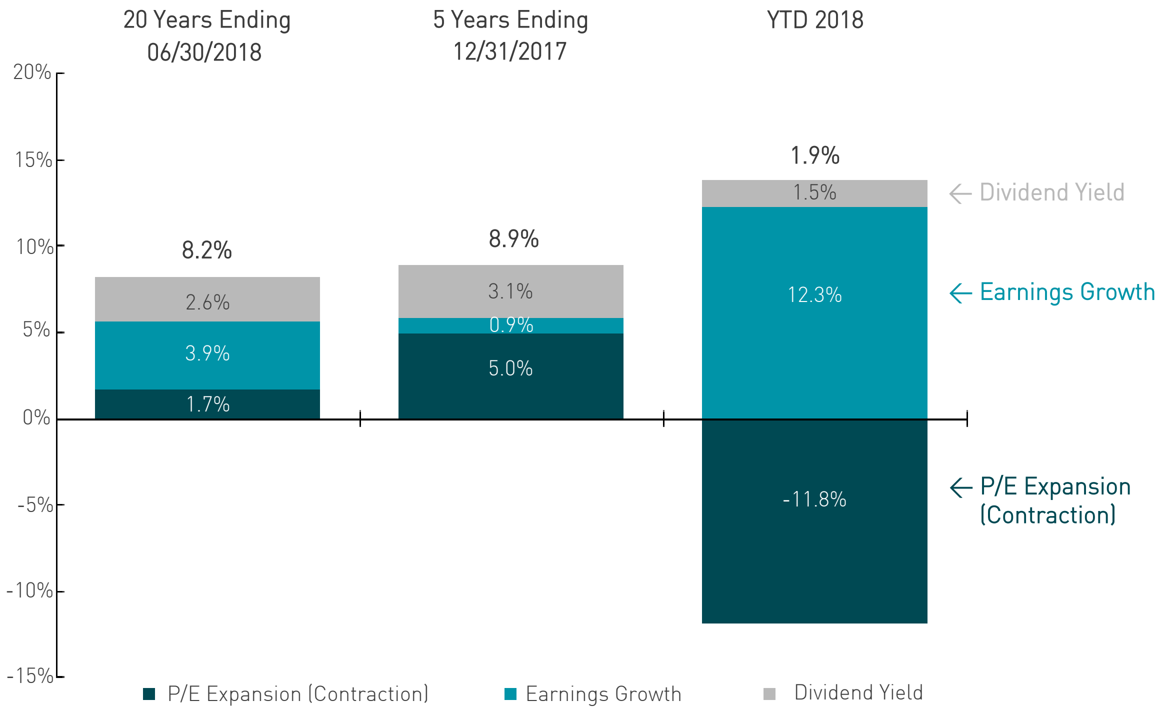
Source: Bank of America Merrill Lynch. All returns in USD.

The left bar of Chart 1 shows that of the 10.6% annualized return the S&P 500 Index earned over the last 81 years, dividends and earnings growth (at 10.1%) accounted for the vast majority of those returns. Only over shorter periods did market sentiment (P/E expansion or contraction) more heavily exert an influence. During the five years to December 31, 2017 (the middle bar), P/E expansion was the largest contributor to total returns, a trend that then reversed in the first half of this year as investor risk tolerances tumbled.

[1] Rockefeller accumulated the majority of his fortune through his ownership of Standard Oil Company and before we judge him too harshly for this frankly rather sad statement, it should be noted that he gave away most of his wealth through philanthropy, exerting a profound influence on medicine, education and scientific research. Notwithstanding the quote, evidently dividends were not the only thing that gave Rockefeller pleasure.

In Chart 2, we turn our focus to Canada.

Chart 2: Annualized Return Components of the S&P/TSX Total Return Index – 1988 to 2018



Source: Bloomberg and Leith Wheeler estimates. Figures may not sum due to rounding.

Dividends have played a similarly important role for Canadian investors, representing approximately one third of the total return for the S&P/TSX Total Return Index from Aug 1988 to June 2018, the most recent available data. In the first half of 2018 – when earnings were strong but valuations were falling – the 1.5% return from dividends dwarfed the net price growth of 0.4%.

Both charts show that long-term investment returns flow from paying fair prices for quality companies that can grow their earnings (and possibly dividends) over time. Sentiment may provide transitory headwinds or tailwinds to P/E multiples, but you can't take sentiment to the bank. Put another way by storied value investor, Benjamin Graham: "In the short-term, the market is a voting machine but in the long-term it is a weighing machine."

A contrarian view: Should companies pay dividends at all?

If a company's management is able to identify profitable ways to spend all the cash generated in the company – for example, paying down debt, funding research and development, or investing in profitable projects – they should be able to do so and not have to earmark cash for dividends. This is especially true if shareholders do not need the dividend to support their income requirements and so are just taking the cash and reinvesting it back into shares of the company anyway - as the dividend is taxed in the hands of investors when it's received and the company receives no tax break for paying it. "Oracle of Omaha" Berkshire Hathaway founder Warren Buffett famously rejects the payment of dividends to shareholders as he believes that the management of Berkshire can allocate the cash better than shareholders. The company held $116 billion in cash at the end of 2017.

Dividends for Dividends' Sake are Not Enough

As a long-term, total return-oriented value investor, Leith Wheeler pays attention to dividend yield but we do not seek dividends for their own sake – as a stock with a stable and growing dividend represents investment merit only to the extent those dividends reflect stable and growing underlying earnings and cash flows. In Rockefeller's case, Standard Oil would not have been able to pay him those dividends unless it was a profitable and growing business.

In managing Canadian equities, we do not focus on the level of the dividend a company pays. Rather, we look first for sound businesses with strong balance sheets, run by capable operators that are trading at attractive prices.

We want companies that can grow their earnings and exhibit a high return on equity, low leverage, and low payout ratios. The growth of a firm's dividends over time can then be a by-product of these key attributes.

Our current positioning in Canadian portfolios reflects this philosophy, where we currently favour certain Financials over other "traditional income stocks," such as pipelines, which we find expensive. Table 1 shows some recent analysis, when intra-sector valuations were particularly stretched. At the end of the first quarter of this year, banks' lower valuations (P/E ratios), moderate dividend yields (dividend / stock price), and lower payout ratios (the percent of earnings being paid as dividends) clearly showed their superior growth potential relative to the two major pipeline companies. In short, we decided we would rather own CIBC at half the valuation (9.8x versus 20.3x) and lower payout ratio (47% versus 137%) – even though its dividend yield trailed that of Enbridge (4.8% versus 6.7%).

In recent months, interest rate-sensitive stocks have been hurt by rising interest rates, and the worst hit among them have been stocks trading at high multiples. It is yet another reminder that when investing, a dividend is only as attractive as the earnings stream that supports it.

Table 1: Not All Dividend Paying Stocks Are Created Equal

Company	Trailing 12M Earnings per Share	P/E Ratio (Trailing)	Dividend per Share	Annualized Dividend Yield	Payout Ratio (%)
TD	$5.77	12.4x	$2.68	3.8%	46%
RBC	$7.74	12.6x	$3.64	3.7%	47%
CIBC	$11.40	9.8x	$5.32	4.8%	47%
TransCanada	$3.09	17.1x	$2.76	5.2%	89%
Enbridge	$1.96	20.3x	$2.68	6.7%	137%

Source: Company reports, Ste/Capital IQ

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