In this issue

Giving Back

Dividends have played a significant role in equity returns over the past 50 years. Given the outperformance of dividend-paying stock versus those that do not, should investors solely focus on portfolios that emphasize dividends?

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Getting Paid

The chart below shows the performance of S&P 500 companies from 1972 through 2018, segmented by dividend payment policy. Three conclusions are worth noting:

1. **Dividends Pay**: Investing $100 into stocks that paid consistent dividends (dark blue line) would have been worth $5,227. Investing in stocks that paid no dividends (orange line) would have only been worth $305, or 94% less.

2. **Dividend Growth Pays More**: Owning stocks that grew dividends (light blue line) would have returned $7,499, or 43% more than picking stocks that paid consistent dividends.

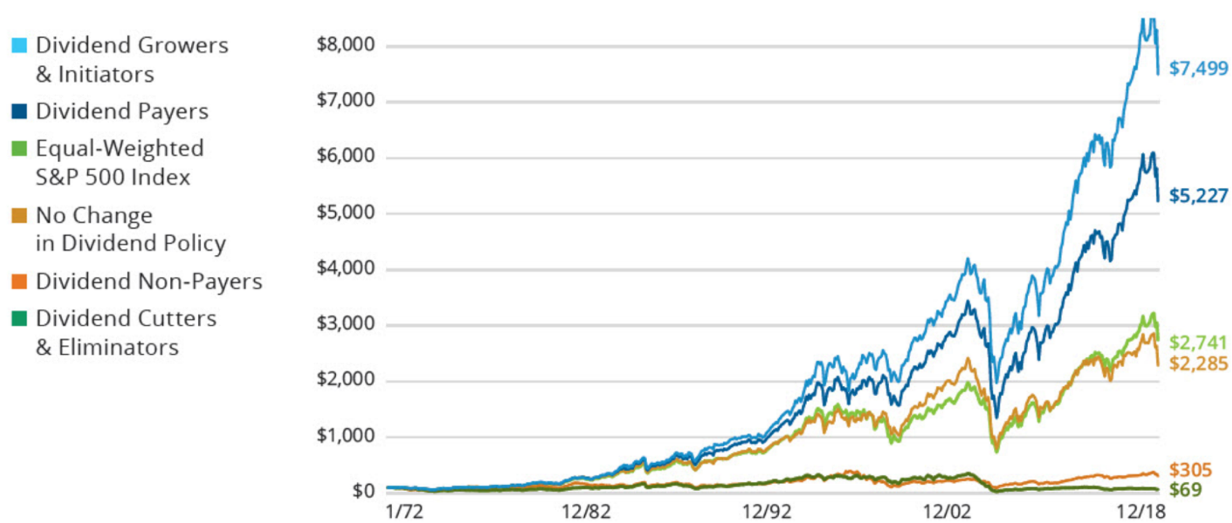
3. **Cutting Dividends Stings**: Owning stocks that cut or eliminated dividends (dark green line) would have been worth $69, indicating the risk of picking stocks that cannot maintain their dividend.

It takes a lot more than just screening for high yielding stocks that have a history of growing their dividend. There are two risks in particular that investors must carefully assess at all times.

The first risk is knowing how to tell the difference between an attractive dividend and a stock under pressure. A high dividend yield can be an indication of a falling stock price more than management rewarding shareholders.

A dividend yield is calculated by taking the dividend payment and dividing it by the stock price. For example, if a stock pays $4 in dividends annually when the stock price is $100, then the dividend yield is 4% ($4 ÷ $100 = 4%).

Returns of S&P 500 Index Stocks by Dividend Policy: Growth of $100 from 1/1972–12/2018



Source: Ned Davis Research, https://www.hartfordfunds.com/market-perspectives/the-power-of-dividends.html

If this stock fell from $100 to $40, then the yield would increase to 10% ($4 ÷ $40 = 10%). This could be an opportunity or a reminder that stocks can be cheap for a reason. Only deeper analysis can help an investor conclude one way or the other.

The second risk is knowing how to recognize unsustainable payouts. Executives of publicly traded companies often recognize the power of dividends. This can create perverse incentives to grow a dividend at the expense of the greater good of the firm (especially when their bonuses are tied to the stock price).

Stocks must be carefully analyzed to ensure that the company can support the dividend. If a company earns $10 million this year and has committed to pay $15 million in dividends, then management may put the financial health of the company at risk if they continue to pay.

Investors must also be sure that management is not paying dividends at the expense of needed reinvestment back into the business. For example, Pacific Gas & Electric (ticker: PCG) raised their dividend by an impressive 8.2% in July 2017[1]. This California utility had also paid out close to $5 billion in recent years leading up to this dividend increase[2]. These actions drove the stock to an all-time high in September of that year. This was just weeks prior to the fires in Northern California that devastated the wine country and a year prior to the Camp Fire in 2018 that killed 85 people.

These wildfires were sparked from electrical equipment that should have repaired. Allocating billions to dividends rather than critical maintenance created such a large liability for the company that the dividend was suspended, the CEO stepped down, and management ultimately filed for bankruptcy protection. Since its peak, the stock fell just over 86%[3].

Simply put, dividend-paying stocks have delivered strong performance in aggregate, but navigating the risks associated with the sustainability and stability of the dividend requires specialized skill and experience.

Give It Time

When a company pays a dividend, the value of that firm falls by the amount of the dividend paid. For example, if a firm is worth $500 million and they use cash to pay a dividend totaling $50 million, then the resulting value of the firm is $450 million ($500 - $50 = $450).

Since the firm now has $50 million less in the bank, the stock price must reflect this return of capital. The key point here is that shareholders do not gain or lose at the time of payment. The value lost from the decline in the stock price is equal to the amount of cash received from the dividend.

Investors must then wait for the company to rebuild that $50 million in value by selling more goods and/or services. This cycle requires any investor interested in dividend strategies to be patient. A good rule of thumb is to have a minimum three-year time horizon for any portfolio that places an emphasis on dividends or dividend growth.

It's not much different than purchasing real estate for income. Price tends to be cyclical, but as long as rent is paid and there are no major impairments to the property, a dip in the price of the property is often best tolerated since the income being generated remains intact.

Said another way, would you sell a rental property with a good tenant who paid on time simply because local housing prices began to fall? Or would you rather collect the rent check and wait for the housing market to recover?

The Bottom Line

Dividends have played a significant role in equity returns over the past 50 years. Going back to 1960, approximately 82% of the total return of the S&P 500 Index can be attributed to reinvested dividends and the power of compounding[4].

Dividends do more than put money in an investor's pocket. They can also provide insight into the minds of the executives that are committed to paying them. No rational management team would part with cash unless they felt supremely confident that they would not need it going forward.

Meaning, executives know their company better than any analyst on Wall Street. If they feel good enough about their future prospects to return excess cash to shareholders, then this is one "tell" that can be quite useful to a prospective investor.

But Pacific Gas & Electric taught us that it's not adequate to conclude that a company paying dividends is less risky than the broader market. Furthermore, dividend-paying equities tend to have higher interest rate sensitivity than stocks that do not pay dividends. Putting an entire equity allocation into a dividend growth portfolio could create a wild ride if interest rates were to rise.

The bottom line is that like most things in life, moderation is warranted with dividend and dividend growth strategies. If your financial advisor determines that you are a good fit, allocate a modest amount, commit to staying invested, and focus on collecting those rent checks.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer

Sources

1 https://www.streetinsider.com/Dividend+Hike/PG%26E+Corp.+%28PCG%29+Raises+Quarterly+Dividend+8.2%25+to+%240.53%3B+3.1%25+Yield/12964600.html

2 https://www.cbsnews.com/news/pacific-gas-and-electric-camp-fire-ignored-repairs-for-years-on-its-aging-power-lines-report-says/

3 yCharts, Date as of 9/16/2020

4 https://www.hartfordfunds.com/market-perspectives/the-power-of-dividends.html

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