

Don't discount dividends

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At a time when many investors are concerned about the uncertain prospects for many global companies, focusing on predictable companies and sectors is appealing. Few aspects of the return of equity markets are as predictable as the income from those companies that deliver a consistent yield. So let's consider the often overlooked, much maligned **dividend**.

Why are dividends maligned?

It has frequently been implied that firms which pay a portion of their earnings out to shareholders are "mature" or even "old" and have become "ex-growth" companies. We disagree, and show later that this argument is not valid for every dividend paying company.

While any balanced, well-diversified portfolio ought to have elements of growth stocks in it, **income should not be disregarded**. In fact, it is a theoretical and empirical truism that the fundamental reason an investor holds shares in a corporation is to have a claim on the firm's earnings. Those claims are ultimately represented by sharing in the profits via dividends. It is for this reason that the workhorse valuation model for a firm's "true" share price is the **dividend discount model**.

True, in many forms, this valuation measure represents the firm's inherent worth by assuming an earnings growth rate into the future, but it is assumed that these future earnings eventually come back to the investor via the **dividend payout rate**.

Equity returns – capital growth or income?

Moving from theory to practice, the simple fact is that over time, the return that an investor makes from holding equities is attributed **more to income than to capital gain**. A 2000 study by Ibbotson and Chen ¹ shows that an investor who purchased the S&P 500 Index in 1926 would have averaged an annual total return of 10.7% through the year 2000 (in USD). Adjusted for inflation (which averaged just under 3.1% per year), real returns came out to be just over 7.6%. Of this real annual return, well over half, or 4.3% of the annual average total return was attributed to income received via dividend payments! The remaining 3.3% was due to capital gains.

¹Ibbotson, R. G. and P. Chen, "Long-Run Stock Returns: Participating in the Real Economy," *Financial Analysts Journal*, January/February 2003, pp. 88-98.

What about more recent history? We know that the 1990s were characterized by a long bull market, which ended in 2000 with the deflation of the technology bubble. The first half of this century has seen the “burst” of that bubble followed by a bull run that lasted from 2003 through to 2007 and was recently characterised by another bear market. With the price action of the last two decades exhibiting such up-and-down behaviour, it would be interesting to know where the gains from holding stocks would be seen. Figure 1 summarises the sources of equity market returns over various periods.

The table below shows that for the nearly-thirty year period from 1980 through this past September, in Europe and globally, income exceeded capital gains for the broad stock market indexes. In the US over the same period, it was just a bit lower. Even in the great bull run of 1980 to 1999, income was still a significant component of returns across all three markets. However, we must note that this period is now recognised as an anomaly. This is especially true for the latter part of this period, which corresponded to the unprecedented increases in valuations and multiple expansion. This re-rating of equities has been almost entirely undone since then, and investors’ capital gains (seen in the two sub-periods between 2000-2003 and 2003 to the present) have been more than fully reversed. In fact, over the eight years of this century, income has so far turned out to be the **only source of positive real return**.

Figure 1. Average annualized equity market returns 1980-present and various sub periods, broken down by component

(annualised)	1980 to Sep-2008			1980 to 1999			2000 to 2003			2004 to Sep-2008		
	US	EU	World	US	EU	World	US	EU	World	US	EU	World
Total Return	11.8%	12.2%	10.8%	18.1%	18.4%	15.9%	-6.4%	-8.5%	-6.0%	3.1%	6.3%	5.3%
Income	3.2%	3.6%	2.8%	4.0%	3.9%	3.2%	1.4%	2.1%	1.6%	1.9%	3.4%	2.5%
Real Capital Gains	4.9%	1.8%	2.1%	10.0%	6.1%	5.6%	-10.2%	-14.9%	-10.5%	-2.3%	-0.1%	-0.2%
Inflation	3.7%	6.8%	5.8%	4.0%	8.3%	7.1%	2.4%	4.3%	3.0%	3.5%	2.9%	3.0%

NOTES: MSCI US, Europe and World, tables shows annualised returns for the following periods, 31-Dec-79 to 30-Sep-08, 31-Dec-79 to 31-Dec-99, 31-Dec-99 to 31-Dec-03 and 31-Dec-03 to 30-Sep-08. US and World in USD, EU in local currencies.

Real capital gain calculated as the difference between capital gain of the price index and inflation.

Income calculated as the residual between total return and real capital gain and inflation.

SOURCE: OECD, Bloomberg

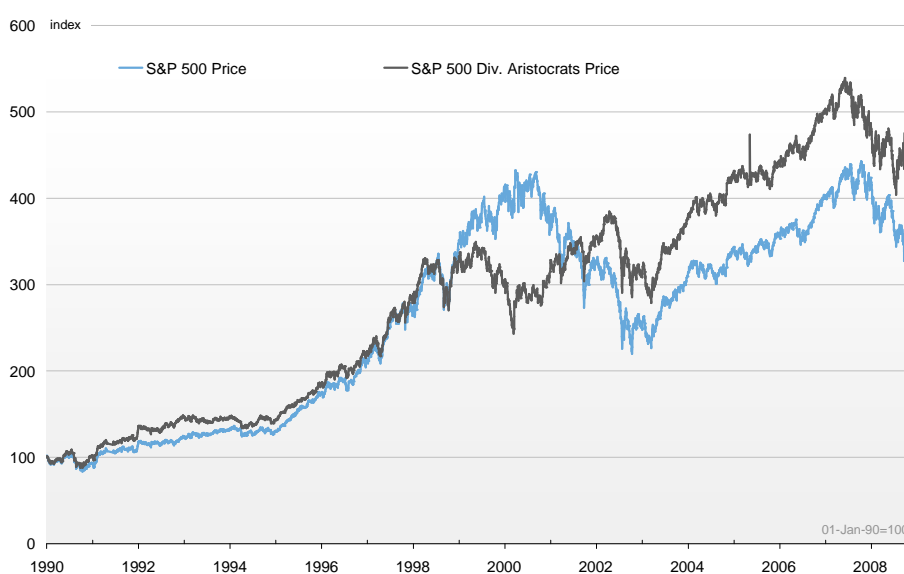
“Old growth” companies?

The idea that high-yield companies are attractive mainly for their income generating potential more than for their potential capital gain is also rejected by the empirical data. Standard and Poors has created a list of so-called “Aristocrats”. The S&P 500 Aristocrats are US companies listed in the S&P 500 index which have **paid and increased their dividends** for at least the past 25 consecutive years. Figure 2a shows, perhaps not unsurprisingly, that in terms of total return (i.e. income from dividend plus capital gain) the Aristocrats index has outperformed its broader index counterparts for a significant period, the only exception being the bubble period between 1998 and 2000. But more interestingly figure 2b shows that if you strip away income, and only look at capital gain (in the form of the simple price index), the Aristocrats also outperform the broader market! Dividend payers give you a higher total return because they pay significant income, but they also give you a better capital gain!

FIGURE 2a. S&P 500 Aristocrats versus S&P 500, Total Return Indexes



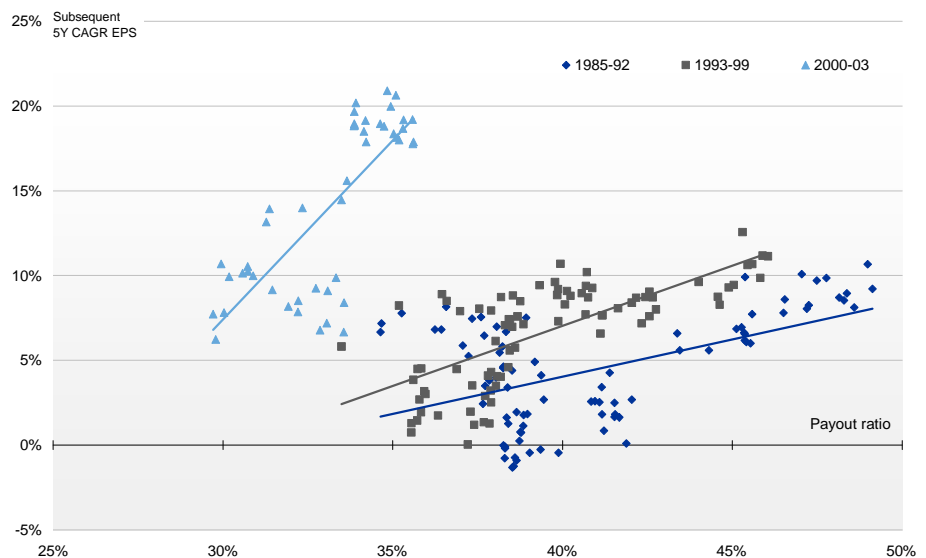
FIGURE 2b. S&P 500 Aristocrats versus S&P 500, Price Indexes



NOTES: S&P500 & S&P500 Dividends Aristocrats, Price, USD, 01-Jan-90=100
SOURCE: Bloomberg as of 03-Dec-08

Above we summarised the conventional wisdom that high-yielding firms are not “growth” firms in the traditional sense. Once a company starts paying its shareholders an annual dividend, it is doing so because it apparently has less than attractive growth opportunities to be exploited by retaining and reinvesting its profits. Yet even this seemingly intuitive result is rejected by the data. Below, we plot the dividend payout ratio for the global equity market in any given month on the horizontal axis versus the annual compound earnings growth over the subsequent five-year period. If conventional wisdom is correct, this relationship would be negative: the higher a portion of earnings paid out to shareholders, the less likely future EPS growth should be. However, looking at three different sub-periods (corresponding to three different market regimes), we see that each sub-period shows a positive relationship. The higher the payout, the more likely the average firm realizes higher earnings growth over the next half-decade.

Figure 3. Global Equity Dividend Payout Rate and Subsequent Five-year Compound Annual Returns



NOTES: Scatter diagram shows FactSet Aggregates World Index Payout ratio vs nominal annualised EPS growth over the subsequent five years.

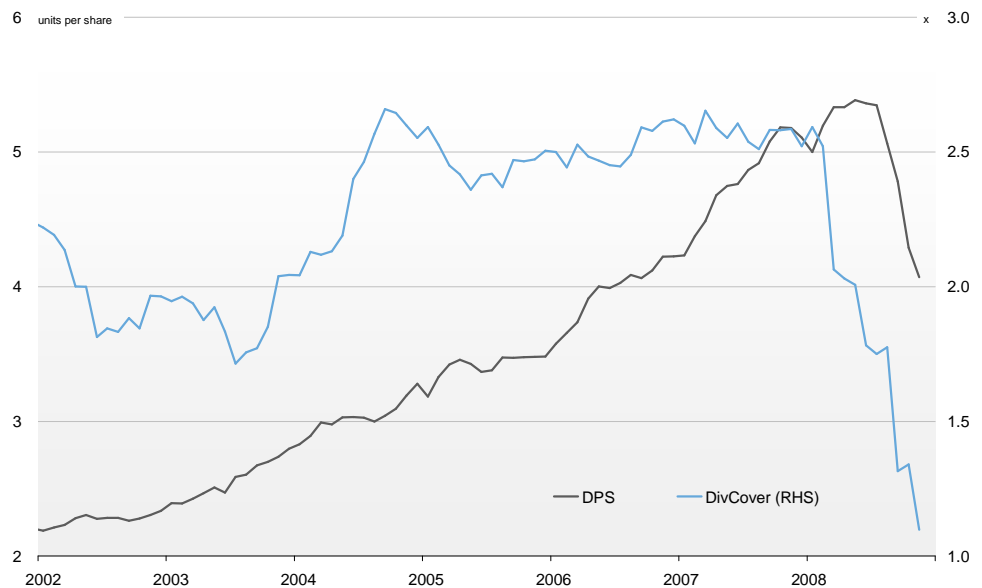
SOURCE: Russell Calculations, FactSet as of 30-Nov-08

We do not fully understand why this is so, but it might be the idea that paying dividends imposes a fiscal discipline on a firm’s managers. Once you declare and start paying a dividend, you are loathed to cut it later, and only do so under the most extreme circumstances. Below we look at this concept in some detail as it relates to banks during the current credit-crunch environment. This hypothesis suggests that the portion of earnings that is not paid out, but retained for investment purposes is directed primarily towards legitimate and remunerative projects, capable of generating enough future earnings so that the dividend remains safe.

What about the current market?

Are dividends really safe now? It is no secret that a large portion of dividend payers tend to be banks and other financial companies, and as the credit crunch has taken deeper and deeper hold on the markets, firms in this industry have seen massive earnings collapses, and have had to suspend dividend payments. As a condition of receiving state aid, many banks across the globe have had to slash their dividends. Figure 4 shows that for the MSCI World Financials Index, a simple measure of dividend cover (earnings per share divided by dividends per share, indicating the ability of firms to generate earnings to pay their dividends) has collapsed recently. Also, as this measure has weakened, dividends themselves have fallen, and are quite likely to fall further.

Figure 4. Dividend Cover and Dividend per Share, MSCI World Financials.



NOTES: MSCI World Financials.

SOURCE: Russell Calculations, FactSet as of 30-Nov-08

Nevertheless, there are still plenty of firms in other sectors that at the moment have healthy fundamentals in terms of their ability to pay income to their owners. We looked at every non-financial firm in the MSCI US, MSCI Europe and MSCI World indexes and found that 39%, 63%, and 51%, respectively, had a “cash dividend cover” (i.e. cash earnings per share divided by dividends per share) greater than the average for their entire market. Thus, there are plenty of candidate firms which can healthily pay their dividends. Furthermore, just under a third of the companies that we looked at in each market yield more than the market average, so again, **plenty of income opportunity** to be had.

Granted, we do not want to give the impression that in light of the current pressure markets are under, dividends are unquestionably safe; in a period of unprecedented economic and market pressures, corporate earnings and cash flows across most sectors will certainly take a hit well into 2009 (at least). This means that dividend cover will have to be continually re-examined. It is best left to professional investors to examine – at the individual company level – the sustainability of dividends and select those companies whose dividends look safe and sufficiently high to add value to an income portfolio.

Nevertheless, the larger point that we make in this note is still relevant under any market regime; ultimately one owns a company because he or she wants a claim on that company's earnings, namely the dividend. Evidence over a long period of time suggests that this is the **primary source of value** an investor is exposed to when owning equities. Obviously, being geared to growth and the return on invested capital of a firm is an important consideration, and a well diversified portfolio should have elements of both growth and income. However, right now may be a very good time to remember the all too often overlooked dividend.

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