

GIVE YOUR FUND PERFORMANCE A BOOST

David Hogarty argues in favour of a high dividend investment strategy...



During the bull run of the 1980s and 1990s the focus of most investors was, naturally, firmly placed on capital returns. With year on year double digit growth, dividend payments were very much seen as secondary benefits. Indeed, many companies, particularly in the technology sector, abandoned dividend payments altogether and stated that their means of rewarding shareholders was through share value appreciation.

This proved popular and profitable for investors and fund managers while the bull run lasted, but an inherent weakness in a strategy which is primarily focused on share price is that it exposes the investor to the full volatility of the market.

There really is no place to hide as many funds found when the bear market took hold at the beginning of this century. At least those investors who had been in at the beginning had the benefits of the very high returns over the years. Looking forward, however, we are unlikely to see such stellar returns any time in the foreseeable future. In fact, the best that can be hoped for would be high single digit growth over the next decade.

This is where a high dividend investment strategy comes in. Such a strategy places far more emphasis on dividend payments than share price growth and thus carries much less risk than the more traditional approach. This may seem like somewhat of a sweeping statement but it is backed up by very sound research.

So what is a high dividend investment strategy? It is one that favours shares in companies that consistently pay above-average dividends, allowing investors to generate a higher proportion of their return from sustainable dividend payments as well as offering the potential for capital gains traditionally associated with stock market investment.

For example, if the market is only going to deliver 8% capital growth per annum and you invest in stocks which are offering 4.5% in dividend payments alone, you already have more than half the return available from the market with less risk.

This reduced level of risk was borne out by research carried out by industry experts in 2004. In their study "Redefining Indexation" Arnott, Hsu and Moore showed that over the 40 year period from 1962 to 2003 high dividend stocks had lower volatility

than other stocks in all circumstances. In addition, the high dividend stocks also offered greater returns than the index in all financial environments except a bull market, and even then the level of underperformance was just 1.5%. (see Chart A over page)

The conclusion is clear: favouring high dividend stocks in a portfolio leads to lower volatility, reduced risk, higher income and increased performance. And performance is very much the key word here.

Despite widely held impressions, dividend income accounts for a much higher proportion of total investment return than most people think. In their study "Triumph of the Optimists, 101 Years of Investment Returns", Dimpson, Marsh and Staunton, of London Business School show that between 1950 and 2000 more than 70% of US returns were made up of dividend yield while the corresponding figure for Europe was more than 60% over the same period.

Of course, this fell to less than 20% globally from 1995 to 2000 due to the bull run. But the long term statistics (and this decade so far) speak for themselves.

The results from high dividend investment funds have been impressive, but it is not

Source: 'Redefining Indexation' by Arnott, Hsu and Moore 2004.

Chart A

	Bull Market		Bear Market		Economic Expansion		Economic Recession		Falling Interest Rates		Rising Interest Rates	
	Index	DY Index	Index	DY Index	Index	DY Index	Index	DY Index	Index	DY Index	Index	DY Index
Volatility	13.9%	12.9%	17.1%	15.1%	14.4%	13.0%	21.1%	18.8%	16.0%	14.6%	14.6%	12.8%
Beta vs Index	-	0.89	-	0.80	-	0.85	-	0.86	-	0.89	-	0.80
Excess Return vs Index	-	-1.5%	-	8.2%	-	0.7%	-	4.3%	-	1.3%	-	1.1%

simply a matter of looking for companies that are currently paying high dividends, nor is it a question of simply focusing on dividend yield.

For example, in the latter case yield can actually be a very misleading yardstick. Yield is a function of dividend divided by share price. This means that yield can actually be improved by a dramatic fall in the share price which in itself is quite probably a very good indicator of problems in the company and a sound reason not to invest in it.

The real yardstick has to be on payout – that is dividend divided by earnings. In other words, the proportion of a company's profits which is returned to shareholders by way of dividend payments.

And there must be a long term commitment to paying out an above average dividend. Companies paying out high dividends only in the recent past may only be doing so because of some short term internal or external pressures and it may not be a long term policy.

Such a long term commitment has proven to be one of the best predictors of out-performing companies. Again, this is contrary to commonly held perceptions but the

relationship is borne out by the statistics. The table below shows that higher yielding stocks have significantly out-performed average market returns over the past ten years. (See Chart B below)

But high dividends reveal much more than this, they also indicate a particular culture within a company. In the first instance they reveal a management's confidence about the future cashflows and earnings required to fund dividend payments. Secondly, high payout ratios require very disciplined financial management and self investment projects.

In other words, the bar is set very much higher for investment projects and financial decisions than it is in companies which don't have a policy of paying high dividends. This is because high dividend payers cannot afford to waste cash on projects that do not deliver a reasonably high return or which have an inordinately high level of risk. These companies also tend to be models of prudence, they rarely if ever feature in the headlines highlighting excessive executive remuneration or other perceived corporate misdeeds. They are firmly focused on rewarding their shareholders through high dividends and this is what drives their performance.

PERFORMANCE DRIVER

Interestingly, being successful in this regard is also a driver of future performance. Shareholders grow accustomed to their higher than average dividends and any attempt by a management to change this will receive a frosty reception from those shareholders. Indeed, in most cases managements know that they will simply not survive if they depart from the high dividend policy.

BUT HOW TO PICK SUCH STOCKS?

They are typically to be found in sectors such as financials, utilities and oil. However, by concentrating on these areas investors can end up with an over-reliance on a few industry sectors and thus end up with quite a high risk investment instead of the conservative approach initially sought.

You overcome this by taking a much broader view, by investing across all regions and all sectors; an average dividend payout for all sectors is calculated and then companies are selected that pay an above average dividend relevant to their peers.

If you accept the collective wisdom of market watchers at the moment and agree that we are in for a long term period of moderate single digit growth then the high payout strategy is one which has proven over time to deliver the best results in such circumstances.

David Hogarty is with KBCAM Investment Managers. The views expressed should not be construed as investment advice.

