Why Dividend Payers Aren't Boring

Recently the Financial Times (FT) noted that the number of U.S. companies raising their dividends had hit the highest level since 1979. Much research has been done on the merits of companies that pay out a large percentage of their profits in dividends (high payout ratio) and those that retain most of their earnings so as to reinvest in their business. Payout ratios have been falling steadily for decades and currently the FT notes that S&P500 companies pay out only 36% of their profits. However, share buybacks have increased over that period so one can't conclude that the total cash returned to shareholders as a percentage of profits has fallen.

Buybacks are a more efficient way of returning cash because they create a return (through a reduced share count and therefore a higher stock price) without forcing each investor to pay tax on the cash distributed (as is the case with a dividend). Theoretically, publicly listed companies need never issue dividends since any shareholder desiring, say, a 2.5% dividend can always sell 2.5% of his holdings.

One might think that companies with low payout ratios are retaining more of their earnings so as to invest in the high return opportunities they see in their business. This ought to lead to faster dividend growth in the future as the projects provide their payoff. I'm currently reading *Successful Investing is a Process* by Jacques Lussier, PhD, CFA. The author kindly sent me a copy as I'll be speaking at a CFA event in Montreal he's organizing later this year. Mr. Lussier notes some interesting research by Arnott and Asness in 2003 that sought to compare low dividend payout ratios with faster subsequent growth.

In fact, they found just the opposite, that low dividends don’t lead to higher dividends later on. In too many cases it seems that managements are overly optimistic about the opportunities to deploy capital either internally or on acquisitions. And in fact this is the real power of stable dividends with a high payout ratio. Rather than suggesting the company has few interesting projects and therefore nothing better to do than return capital to owners, it imposes a level of capital discipline on management that ultimately leads to higher returns. Companies that return more cash to shareholders have less to squander on ill-judged investments, and the shareholders ultimately benefit.

Incidentally, Master Limited Partnerships (MLPs) represent an extreme case of this. Since they routinely distribute around 90% of eligible cashflows they have very little retained earnings and therefore have to raise new debt and equity capital for any project. This imposes a wonderful discipline on MLP managements in that they’re always having to explain to underwriters and investors what exactly they’re planning to do with the proceeds of a debt or equity offering. It’s one of the reasons MLPs have had such consistently strong performance; so many of their management really focus on return on capital.

It’s all part of the Low Beta Anomaly, the concept that low volatility (or low Beta) stocks outperform on a risk-adjusted basis and even on a nominal basis. So far this year the returns to low volatility investing have been good (for example, the S&P500 Low Volatility ETF, SPLV, is +8.6% through June) as many of the high-flying momentum names crashed during the first quarter. Slow and steady dividends with growth may not appear that exciting, but boring is often better where you’re money’s concerned.