Steadying Portfolio Performance

By Steven Holt Abernathy

The subprime crisis is yet another reminder that the markets are inherently volatile. There are no investment products or strategies that can capture all the upside of rising markets and avoid losses on the downside. Every equity strategy entails risk. The key to consistent long-term investment performance is to secure most of the upside in good markets and avoid significant losses when the markets are down.

The most lucrative and most courted investors, high nets, tend to be more knowledgeable and less apt to accept investment portfolio underperformance. An approach that can help advisors meet the lofty expectations of these profitable clients utilizes dividend stocks from companies with high ROICs.

HISTORIC PRECEDENT

Since 1900, almost two-thirds of total equity returns have been from dividends. Since 1996, companies that paid out at least 25 percent of their net income in dividends delivered total shareholder returns in excess of 400 percent (Bloomberg data) versus approximately 120 percent for the S&P 500. High-dividend paying stocks provided three times the return of the S&P 500 yet were less risky and less volatile.

Until 1956, stock dividends always yielded more than bonds. As a percentage of total equity yields, however, dividends have continued to decline through the decades, falling from over five percent in 1926 to below two percent—an historic low—in the new millennium. From 1999 through 2001, stock dividend levels fell to their lowest point in history, foreshadowing the steep market decline that followed.

Dividend stocks provide an economic underpinning for their price. It doesn't mean they won't fall during market swoons, but they tend to fall less, experience less volatility and recover more quickly than non-dividend stocks. Companies that do not pay dividends or repurchase stock with their earnings force shareholders to speculate that the stock will appreciate. But appreciation is largely contingent on economic and market vagaries that are unpredictable or unreliable, hardly the foundation for a portfolio

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designed to protect investment capital.

The chart below compares the performance of dividend-paying stocks with the S&P 500.

GOOD BUSINESS, POOR MONEY MANAGEMENT

Corporate managers are notoriously poor managers of capital. Many managers view retained earnings as their own money. Sitting on the balance sheet with easy access and no perceived cost, management believes it's "free money." But it's not free. Its cost is at least equal to the amount shareholders could earn in a money market. The money may not have been distributed yet, but it belongs to the shareholders.

Shareholders should demand that management distribute profits annually in the form of dividends or a stock repurchase, typically a more tax efficient method of achieving the same effect. Shareholders can then decide whether to reinvest with the company or find a different home for their money the following year.

Management can rationalize spending on a host of new products, equipment, or other projects, ostensibly to increase sales. While higher sales volume may make management look good—and help ensure career longevity—having free money to spend tends to diminish cost analysis. Will the expenditure generate an acceptable rate of return? Nobody asks the shareholders, who ultimately pay for management follies.

When companies are impelled to pay dividends each year, not only does their stock become attractive, it inadvertently forces corporate management to become more accountable.

Forced to return earnings to shareholders or buy back stock, if management wishes to embark on some new adventure, they are obliged to borrow the funding or issue debt. That means justifying the cost of the debt. If the cost of money is six percent and analysis reveals the project will only return five percent, funding is improbable, which is a good thing. Conversely, if management makes good decisions and the company continues to generate high dividends, investors are more likely to reinvest.

APPRECIATION

One might expect an investment with lower risk and volatility than common stock or bonds to have commensurately lower price appreciation as a trade off. Interestingly, that's not the case with high-dividend paying stocks. One reason is that while every company suffers at least occasional bad news, the stock price of those that pay consistent dividends is cushioned.

If bad news causes a company with a $100 stock and a four percent dividend to drop to $80, the $4 dividend becomes a five percent dividend because of lower stock price. No matter how bad the news, the stock will eventually level off because each dip increases the dividend ratio, making the stock more appealing to investors. When 10 year bonds are paying five percent and the income is taxed at normal rates, a stock with a four- or five percent dividend taxed at 15 percent offers a huge advantage.

Dividend Paying Stocks

	25% Payout Ratio	35% Payout Ratio	45% Payout Ratio	S&P 500
Total Return	412%	431%	542%	120%
Average Return	18.6%	19.0%	21.4%	9.8%
Median Return	19.4%	21.2%	23.8%	13.0%
Highest Return Year	44.9%	39.2%	43.9%	33.5%
Lowest Return Year	-5.7%	-5.6%	-5.9%	-21.6%
% of Years Up	90%	90%	90%	70%
% of Years Down	10%	10%	10%	30%
Price to Book	3.23	2.84	2.16	2.85
Beta	0.91	0.89	0.87	1.05

Source: The Abernathy Group, NYC, 2007

OPTIMISM

Companies do not pay dividends unless they are optimistic about the future. While every firm strives for optimism in their shareholder communications, companies that pay high dividends back up their words. High dividend stocks also facilitate retirement planning simulations. Dividend stocks, with their lower volatility, can help healthcare professionals embrace higher equity-ratio asset allocations, increasing the chances they will not outlive their assets.

DOWNSIDE

Owning stocks purely for their dividends has a potential downside. If taxes or interest rates rise dramatically, the sector is likely to be hurt worse than others.

SO—

Companies paying high dividends tend to be better managed and better able to absorb bad news, which occurs at some time to every company. Stocks with consistently rising dividends tend to appreciate more as dividend increases make them increasingly attractive. They are also less risky than the S&P 500 and less volatile. Historically, dividends represent the only reliable return on equity investments.

Paying dividends (or repurchasing stock) versus retaining earnings makes management teams more accountable and helps avoid empire-building, which is counterproductive for shareholders.

Advisors can serve their clients by promoting a conservative strategy that controls risks. Companies that consistently pay high dividends can benefit that strategy, one that will benefit both clients and advisors. CPAWP

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