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Why I love dividends and you should too

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Key points

> Dividends are great for investors as decent dividends augur well for earnings growth, they provide a degree of security in uncertain and volatile times, they are likely to comprise a relatively high proportion of returns going forward and they provide a relatively stable and attractive source of income.

> If dividends are allowed for the value of an investment in Australian shares has surpassed its 2007 record high.

> It's important that dividend imputation is retained in Australia to ensure dividends are not taxed twice and companies continue to pay out decent dividends.

Introduction

Up until the 1950s most share investors were long term investors who bought stocks for their dividend income. This changed in the 1960s as bond yields rose on the back of inflation and investors started to shift focus to capital growth. However, thanks to the volatility seen over the last decade or so, and an increased focus on investment income as baby boomers retire, interest in dividends has been on the rise. Investor demand for dividends is clearly evident in Australia with even the big resource stocks starting to heed the call. This is a good thing because dividends are good for investors in more ways than just the income they provide.

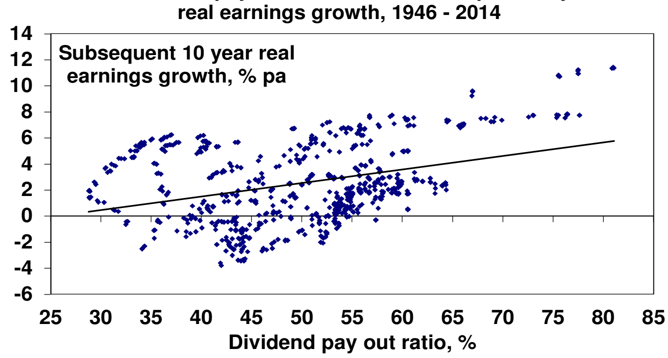
It's well-known Australian companies pay out a high proportion of earnings as dividends. This is currently 75%, and it's averaged around this since the late 1980s. Banks, telcos, consumer stocks and utilities are the big dividend payers. By contrast in the major global markets dividend payout ratios range from 31% in Japan to 49% in the UK.

However, some argue that dividends are irrelevant and simply don't matter – as investors should be indifferent as to whether an investment pays a dividend, or whether the company retains earnings that are reinvested to drive earnings growth. Or worse still, some argue that high dividend pay outs are a sign of poor long term growth prospects or that they are not sustainable. And of course, some just see dividends as boring relative to the excitement that can come from speculating on moves in share values. My assessment is far more favourable.

Dividends are cool

There are lots of reasons to love dividends and here they are. First, dividends do matter in terms of returns from shares. For the US share market it has been found that higher dividend pay outs lead to higher (not lower) earnings growth.[1] This is illustrated in the next chart which shows that for the period since 1946 whenever US companies have paid out a high proportion of earnings as dividends (the horizontal axis) this has tended to be associated with higher growth in corporate profits (after inflation) over the subsequent 10 years (vertical axis).

US - dividend payout ratio versus subsequent 10 year real earnings growth, 1946 - 2014



Source: Global Financial Data, Thomson Reuters, AMP Capital

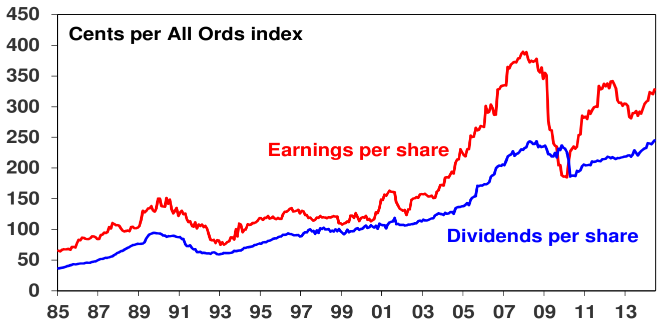
And of course higher growth in company profits contributes to higher returns from shares over the long term. This all suggests dividends do matter & the higher the better (within reason). There are several reasons why this is the case:

- when companies retain a high proportion of earnings there is a tendency for poor investments which subsequently leads to poor earnings growth;
- high dividend pay outs are indicative of corporate confidence about future earnings (otherwise companies would not feel comfortable in paying them);
- high dividend pay outs are a positive sign as they indicate earnings are real, ie backed by cash flow.

The bottom line is that strong dividend pay outs are more likely to be consistent with strong, not weak, earnings growth. The higher dividend yield and pay out ratios for Australian companies, compared to mainstream global share markets, is a positive sign for relative returns from the Australian share market on a medium term basis – particularly at a time when the boost to national income from the terms of trade is going in reverse.

Secondly, concerns about the sustainability of dividends fly in the face of all the evidence that companies like to manage dividend expectations smoothly. They rarely raise the level of dividends if they think it will be unsustainable. As can be seen below, dividends move roughly in line with earnings but are a bit smoother. For an investor this means the flow of dividend income is relatively smooth.

Aust dividends are relatively stable compared to earnings

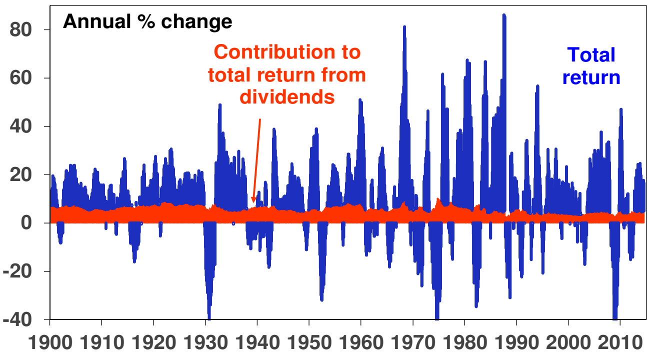


Source: Thomson Reuters, AMP Capital

[1] See R.D.Arnott and C.S.Asness, "Surprise! Higher Dividends = Higher Earnings Growth", Financial Analysts Journal, Jan/Feb 2003. Of course it's become a bit complicated for US shares in recent times as the tax system effectively encourages companies to return capital to investors as buy backs as opposed to dividends, which might be argued to be the same thing.

Thirdly, decent dividend yields provide security during uncertain times. As can be seen in the next chart dividends provide a stable contribution to the total return from shares over time, compared to the year-to-year volatility in capital gains. Of the 11.8% pa total return from Australian shares since 1900, just over half has been from dividends.

Aust shares - contribution to return from dividends



Source: Global Financial Data, AMP Capital Investors

Fourthly, investor demand for stocks paying decent dividends will be supported over the years ahead as more baby boomers retire and focus on income generation.

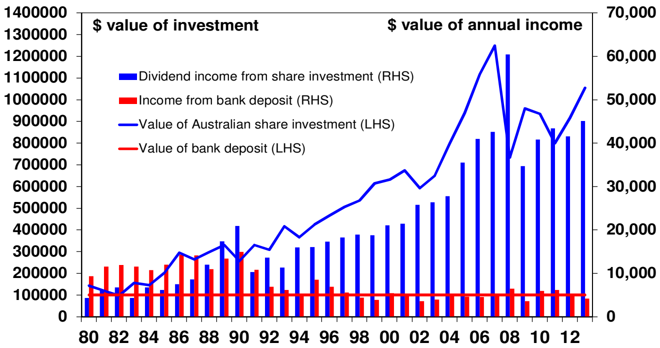
Fifthly, with the scope for capital growth from shares diminished thanks to relatively high price to earnings ratios compared to 30 years ago, dividends will comprise a much higher proportion of total equity returns than was the case in the 1980s and 1990s globally and in Australian shares up until 2007. Around half of the total return from Australian shares over the next 5 to 10 years is likely to come from dividends, once allowance is made for franking credits.

Finally, and for some most importantly, dividends provide good income. Grossed up for franking credits the annual income flow from dividends on Australian shares is currently around 5.7%. That's $5700 a year on a $100,000 investment in shares compared to $3500 a year on the same investment in term deposits (assuming a term deposit rate of 3.5%).

Another angle on dividend income

The next chart illustrates just how powerful investing for dividend income (without even really trying) can be relative to investing for income from bank term deposits. It compares initial $100,000 investments in Australian shares and one year term deposits in December 1979. The term deposit would still be worth $100,000 (red line) and last year would have paid $4,150 in interest (red bars). By contrast the $100,000 invested in shares would have grown to $1,054,000 (blue line) and would have paid $45,000 in dividends before franking credits (blue bars). This would translate to around $59,650 if franking credits are allowed for. The reason for the difference is over time an investment in shares tends to rise in value, whereas an investment in term deposits is fixed.

Comparing a $100,000 1979 investment in term deposits & Aust shares

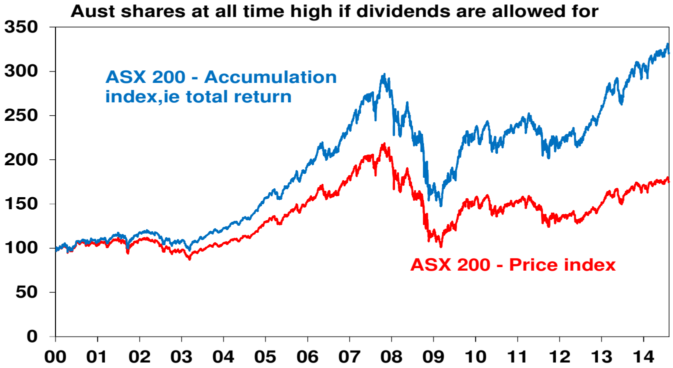


Source: RBA, Bloomberg, AMP Capital

New highs

Finally, while we all bemoan the fact that Australian shares are still trading around 20% below their 2007 all-time high, once reinvested dividends are allowed for (ie looking at the ASX 200 accumulation index) the Australian share market is now above its all-time high. In other words an investor who (god forbid) put all their money into the market at the peak in 2007 would now be in the black if they had reinvested dividends along the way.

Aust shares at all time high if dividends are allowed for



Source: Bloomberg, AMP Capital

Why dividend imputation is important

Which brings us to the topic of dividend imputation. This arrangement was introduced in the 1980s and allows Australians to claim a credit for tax already paid on their dividends in the hands of companies as corporate earnings and effectively boosts the average dividend yield on Australian shares by around 1.5 percentage points. However, in recent times it has been subject to some questioning with the interim report of the Financial System Inquiry questioning whether dividend imputation was creating a bias to invest in domestic equities and adversely affecting the development of the corporate bond market. Meanwhile, some such as Treasury argue that it along with other tax concessions (like negative gearing) primarily benefit the rich.

The trouble is that dividend imputation actually corrects a bias by removing the double taxation of earnings – once in the hands of companies and again in the hands of investors. It also encourages corporates to give decent dividends to shareholders as opposed to irrationally hoarding earnings. Interest on corporate debt never suffered from double taxation as it is paid out of pre-tax corporate earnings. And all such concessions encourage savings in the face of Australia's relatively high marginal tax rates. The removal of dividend imputation would not only reintroduce a bias against equities but substantially cut into the retirement savings and income of Australian investors, discourage savings and lead to lower returns from Australian shares. So hopefully common sense will prevail and dividend imputation will not be tampered with.

Concluding comments

Dividends are often overlooked. But they provide a great contribution to returns, a degree of protection during bear markets and a great income flow. Investors should always allow for them in their investment decisions.

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