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Private Asset Management Ltd

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DIVIDENDS – WHAT ARE THEY GOOD FOR? – Part 1

The performance of share portfolios managed by humans is often constrained by one or more of the behavioural factors which have been well-documented in the literature. These include overconfidence (I know more than the market does), self-attribution (blaming other factors for your mistakes) and loss aversion (holding on to shares that have gone down because it is painful to admit you were wrong and incur a loss). The same biases are often also held by retail financial advisors and stock brokers but even if they aren't they pose a problem: Do you tell the client what he/she wants to hear and thereby take advantage of their weakness or do you confront them with their non-rational behaviour and risk losing their business? Fund managers face the same issue but, as they are primarily in the business of maximising their funds under management, it is no surprise that they invariably originate products to cater for investor demand even if that demand is based on faulty logic. The impact of behavioural factors on performance is pervasive: One could argue that the success of the IPO market is in part based on overconfidence, ego (I'm important and that's why I'm getting this offer) and the availability heuristic – the tendency to use only readily available information to make decisions (newspaper headlines about the latest successful IPO and the IPO marketing document) and ignore what's hard to find and more relevant (all the research about the poor historic performance of the average IPO.)

Today we will take another look at the behavioural factor of "dividend focussed investing" – the belief held by many investors that the dividend yield of a stock or fund is the most important criteria in determining its attractiveness and the related behavioural constructs behind this investment framework. In my work, I see "buy the dividend" behaviour all the time and must admit that I too have occasionally succumbed to the siren call of high yield. However, like the 1960's anti-war song, most academics, when determining the outlook for the returns of a share, believe the answer to the question in the heading is "Absolutely Nothing".

First though let's get back to basics: Investors buy shares in the hope of achieving a return. The total return of shares consists of dividends and capital appreciation. Since 1926, dividends have contributed about one-third of the total return on equities from the S&P 500, whereas capital appreciation contributed roughly two-thirds. The make up of return on equities can be expressed in the standard Gordon growth model which is taught in most first-year finance courses:

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Return = dividend yield + the rate at which dividends grow

Dividend growth can be considered as a close proxy for growth in profits and, simplifying, growth in the share price i.e. capital growth. So all the formula is saying is that the return of a share in percent per annum is equal to the dividend yield at the time you buy the share plus capital growth. Most retail investors haven't done finance 101 but they know enough to believe that high dividend yields are good and low dividend yields aren't so good. Reinforcing the focus on dividends is the fact that working out the dividend yield is easy but estimating growth isn't. Therefore non-institutional investors frequently focus on the dividend and that's the phenomenon we will look at today.

Buying stocks or funds with high dividends is often referred to as income focused investing but why is it so popular amongst retail investors? Probably the most significant factor is that many investors see a high yield as indicating that a stock is cheap and low yields as implying that the company or fund is expensive. This naive approach ignores two important points – the dividend yield is a function of the payout ratio – how much of profits a company pays out in dividends. This can vary widely amongst stocks and sectors – some companies distribute all their profits as dividends and others very little or even none. Secondly many companies (and their shareholders) prefer to distribute cash by way of buy-backs rather than just dividends for tax reasons.

The next important factor explaining the popularity of buying high yield is that it appears to confer psychological benefits to investors in that this investment approach ostensibly provides a tangible return in an uncertain world. The strategy thus supplies a simple model for "understanding and playing the stock market". Behavioural finance has long postulated that individuals prefer to apply simple rules of thumb to complex systems rather than spend the time and effort to comprehend them more fully. It is easier to just "buy the yield" rather than read and understand a discounted cash flow model of Amazon which doesn't pay a dividend. An excerpt from a stockbrokers manual touches on this idea. "By purchasing shares that pay good dividends most investors persuade themselves of their prudence, based on the expected income. They feel the capital gain potential is an additional added benefit. Should the stock fall in value from their purchase level they console themselves that the dividend provides a return on their cost".

Besides the fact that just looking for the highest dividend in the newspaper is much easier than constructing a full-blown net present value model there are a number of other behavioural factors that explain its popularity. Many retired people like the idea of just living off the income produced by their portfolio, rather than spending their capital. This strategy reinforces their perception that they are acting prudently. A paper in the Journal of Finance back in October 2019 entitled "The Dividend Disconnect" explains this mindset quite nicely: harvesting dividends rather than spending capital is consistent with other experiences in life – "harvesting the fruit from the tree is viewed as fundamentally different than harvesting the tree itself". The apparent wisdom of this strategy is compounded by the fact that investors who focus on dividends invariably also subscribe to the "free dividend fallacy" – the belief that dividends are "free" in the sense that paying dividends would not lead to a reduction in prices. As per the analogy - harvesting the apples doesn't diminish the productivity of the apple tree.

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In another paper, "Explaining Investors Preference For Cash Dividends", by Shefrin and Statman, the authors provide a simple explanation for income investing. They suggest that, as many individuals are worried that their funds might run out in retirement or they wish to safeguard their wealth against the risk of overspending, they employ a rule to the effect that "thou must only spend dividend and interest income". This rule prohibits spending your capital. A related factor is that individuals who have employed a disciplined savings regime over the 40 or so years of their working life find it very difficult to suddenly switch to a strategy of dis-saving. A Grattan Institute study of the Australian retirement sector, a few years back, found that many Australian retirees shift to the next life with more savings than they began their retirement with.

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.

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