Creating wealth through dividends

All too often, dividend investing is associated with older investors who seek more conservative equity exposure and are in need of the cash flow generated from dividends to help fund retirement. While this is true, we believe dividend investing is appropriate for all investors and that investing for total return is a great way for younger investors to create wealth over time, since time is on their side.

Over the long term, dividends have played a significant role in the returns investors have received. Over the past 50 years, 72% of the total return of the S&P 500 Index can be attributed to reinvested dividends and the power of compounding.

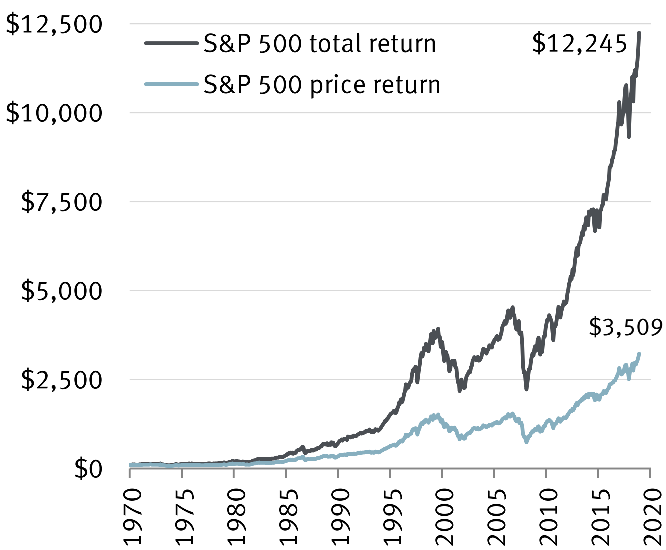
Dividend-paying stocks are not guaranteed to outperform non-dividend-paying stocks, sometimes they do not. However, as the chart on the left shows, dividend-paying stocks have been a solid way to create wealth over time.

Dividend contribution by decade

If we look at the S&P 500 Index performance on a decade-by-decade basis going back to the 1940s, we see how dividends' contribution varied greatly.

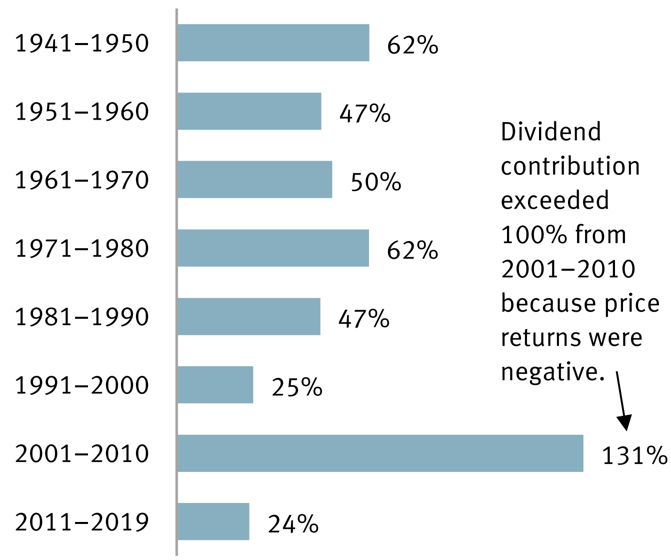
Dividends played a significant role in total returns during the 1940s, 1960s, and 1970s, decades in which total returns for the S&P 500 were below 10%. Dividends played a less significant role during the 1950s, 1980s, and 1990s when

S&P 500 total return vs. U.S. Treasury total return overlayed on U.S. inflation, 1970–2019



Source - RBC Wealth Management, Bloomberg; monthly data through 12/31/19

Dividend contribution to S&P 500 Index total return



Source - Source: RBC Wealth Management, RBC Capital Markets, FactSet average annual total returns for those decades were well into double digits.

During the 1990s, the great tech decade, many companies de-emphasized dividends as management teams determined they were better able to deploy capital by reinvesting it in their businesses instead of returning it to shareholders. Significant year-over-year capital appreciation during that decade caused many investors to shift away from dividends, in favor of growth.

Investor sentiment changed in the first decade of the 2000s, a period that saw the dot.com bubble, the financial crisis, and the start of a secular bear market for equities. The S&P 500 actually finished the decade lower based on price only than where it started. If you were a buy-and-hold investor that decade and not actively trading, your positive returns in the index came from dividends.

Highest yield doesn't necessarily provide the best returns

Often times, investors seeking dividend-paying investments make the mistake of buying purely based on yield, thinking higher is better. Wellington Management did a study that showed some potential flaws in that train of thought. The Wellington study found that stocks paying the highest level of dividend payouts and highest yields have performed well over time, but not as well as those that pay high, but not the very highest, levels of dividend payouts and yields.

The Wellington study started by dividing dividend-paying stocks in the S&P 500 into quintiles by their level of dividend payouts/yields. The first quintile, the top 20%, consisted of the highest dividend payers, while the fifth quintile, the bottom 20%, consisted of the lowest payers and no payers. Its study tracked the performance by quintile for each decade from 1930 through 2019. The results are reflected in the table below.

The second-quintile stocks outperformed the S&P 500 seven out of the nine time periods (77.8%), while the first- and third-quintile stocks tied for second, outperforming the index six out of nine time periods (66.7%). Fourth- and fifth-quintile stocks lagged, outperforming four times each (44.4%).

Dividend payout ratios matter

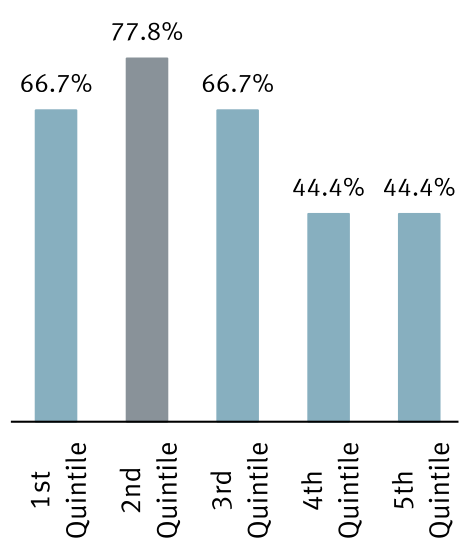
One reason second-quintile dividend stocks outperformed the first is dividend payout ratios. One of the best ways to measure whether a company will be able to pay a consistent dividend is through the payout ratio. A high payout ratio means a company is using a significant percentage of its earnings to pay a dividend, leaving it with

Dividend-paying stocks beat the market nearly every decade

CAGR (%) for U.S. portfolios by dividend yield quintile by decade, 1930–2019

	S&P 500	1st Quintile	2nd Quintile	3rd Quintile	4th Quintile	5th Quintile
Jan. 1930–1939	-0.20%	-1.22%	0.40%	-2.21%	-0.65%	2.00%
Jan. 1940–1949	9.51%	13.92%	13.06%	10.26%	8.63%	6.83%
Jan. 1950–1959	18.33%	18.52%	20.31%	18.47%	16.57%	19.81%
Jan. 1960–1969	8.26%	8.82%	8.90%	6.45%	7.96%	9.32%
Jan. 1970–1979	6.05%	9.67%	10.23%	7.00%	7.57%	3.94%
Jan. 1980–1989	16.80%	20.23%	19.62%	17.19%	16.20%	14.66%
Jan. 1990–1999	17.96%	12.35%	15.57%	15.07%	18.07%	18.92%
Jan. 2000–2009	-0.44%	4.91%	4.57%	4.48%	1.91%	-1.77%
Jan. 2010–2019	13.56%	12.71%	13.39%	14.32%	13.58%	10.88%

Percent of the time the quintile beats the S&P 500



Source - Professor Kenneth French, Dartmouth College, http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/ ; data compiled by Wellington Management. U.S. stocks are represented by the S&P 500 Index, which is a composite of the 500 largest companies in the U.S. The Index is unmanaged and not available for direct investment. Data through 12/31/19 less money to invest in future growth of the business. In addition, excessive dividend payout ratios are not always sustainable and can potentially put dividends at risk, should company fundamentals deteriorate. Going back to 1979, the first-quintile dividend payout ratio has averaged just north of 70%, while the second-quintile payout ratio has averaged just over 40%.

A payout ratio of 70% or greater could be difficult to sustain if a company experiences an earnings decline, which might, in turn, force a company to cut its dividend. Investors often view a dividend cut as a sign of weakness, often resulting in a significant share price drop.

Dividend policies and stock performance

A study done by Ned Davis Research (NDR) shows that dividend policy has a significant impact on share price performance. The study first divided the companies in the S&P 500 into two groups based on whether or not they paid a dividend during the prior 12 months. These groups were labeled "Dividend Payers" and "Dividend Non-Payers."

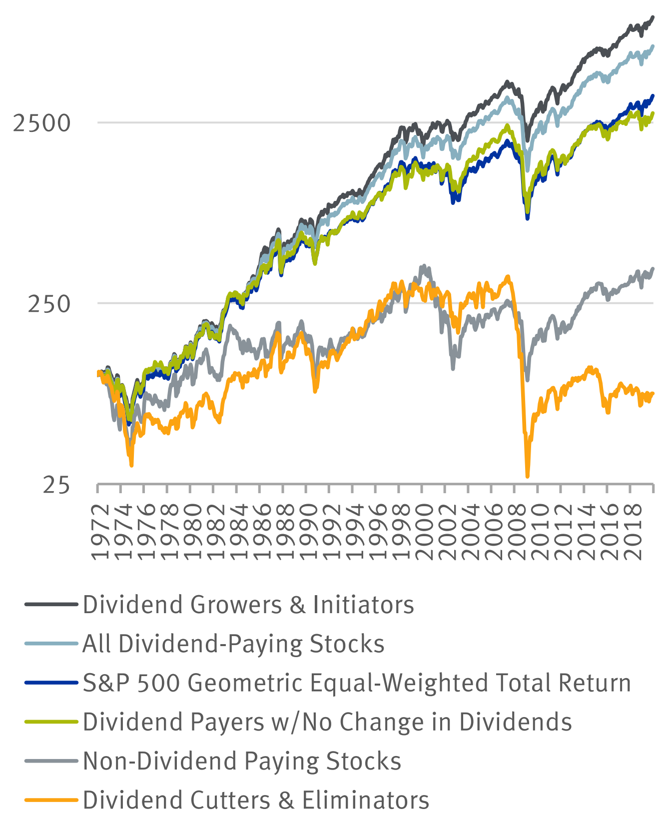
The "Dividend Payers" were then divided into three groups based on their prior 12-month dividend payout policy. Companies that maintained their dividends at the same level were classified as "No Change." Companies that increased their dividends or initiated a new dividend were classified as "Dividend Growers & Initiators." Companies that lowered or eliminated their dividends were classified as "Dividend Cutters & Eliminators." Companies remained in these categories for the next 12 months and then were reviewed and adjusted annually based upon their dividend policy action.

For performance tracking, NDR calculated the geometric total-return average for each of the five categories and rebalanced monthly to smooth out performance and create a level playing field.

The chart clearly shows that "Dividend Growers & Initiators" was the best-performing group, while the "Dividend Cutters & Eliminators" was the worst.

Dividend-paying stocks outperformed Jan. 1972–2019

Returns of S&P 500 stocks by dividend policy



Note: All indexes are allocated to start at 100
Source - RBC Wealth Management, Ned Davis Research, S&P Capital IQ; monthly data through 12/31/19 (log scale) Copyright 2020 Ned Davis Research, Inc. Further distribution prohibited without permission. All rights reserved. See NDR disclaimer at www.ndr.com/copyright.html. For data vendor disclaimers refer to http://www.ndr.com/vendorinfo/.

Low interest rates and demographics—both tailwinds for dividend-paying stocks

With bond yields near historically low levels and expected to remain low, per our research sources, we believe dividend-paying stocks are becoming more appealing to investors seeking income. With the baby boomer generation at or near retirement, demand for income-producing investments is on the rise and many investors are favoring stocks over bonds. Given bond yields are expected to remain low, we think demand for dividend-paying stocks will remain strong as the aging population needs to help fund its retirement.

Growing dividends provide growing cash flows

A growing cash flow stream should be important for retirees and growing dividends provide it. For example, if an investor bought 1,000 shares of ABC Corp. that pays a $1 per share dividend, at the end of one year he or she would have $1,000 of income. If ABC can grow its dividend at a 7.2% annualized rate, after 10 years the original investment will generate $2,000 in dividend income. If the same can be done for another 10 years, the original investment will generate $4,000 in dividend income. In 20 years, the income stream will have quadrupled from the original investment.

Why we believe investing in dividend-paying and dividend-growing companies makes sense

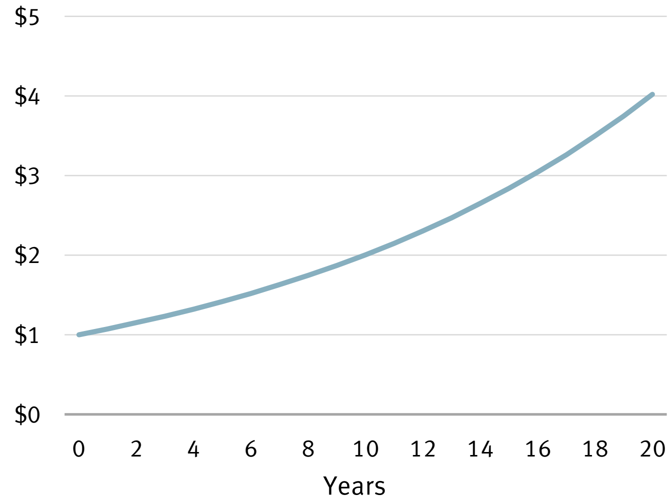
Dividends have historically played a significant role in total return for investors, especially during periods when market returns have been below double digits for extended periods of time.

Companies that have consistently grown their dividends and companies initiating a dividend policy have historically provided greater total return with less volatility versus companies that either maintained or cut their dividends.

The current environment, including baby boomers' need for cash to help fund retirement, historically low interest rates, and high levels of corporate cash on balance sheets, in our opinion, bodes well for demand for dividend-paying and dividend-growing stocks. Plus, for younger investors, owning stocks of dividend-paying, dividend-growing companies and reinvesting the dividends is a great way to create wealth for the long run.

Growing dividends, growing cash flows

Growth of a $1 dividend at a rate of 7.2% annualized over 20 years



Source - RBC Wealth Management

Author

Rick Novak, Portfolio Analyst
richard.novak@rbc.com; RBC Capital Markets, LLC

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