Musings on Dividends

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By: Direk Khanijou

A company can do 5 things with its capital:

1. Reinvest in the business
2. Acquire other businesses
3. Pay down debt
4. Repurchase shares
5. Pay dividends

Let's explore option 5.

The conventional view is that dividend paying stocks are regarded as 'safer' and that companies that does not raise (or pay) the dividend is doing nothing for its shareholders. Increases in dividends are almost always referred to as 'favorable' while the reduction of dividends is nearly always called 'unfavorable'.

In general, the markets tend to reward companies with a high dividend yield. There is a strong positive correlation between dividend payout ratios and PE ratios. The reason behind this is that it attracts a group of people who seek 'current income' and this helps support the stock price.

Beware of the imposters

I believe that stocks should **not** be bought on the basis of their dividend yield. Here are 2 reasons why:

1. Many companies have high dividend yields because the share prices have fallen – not because the dividends have been increased. Often, these are poor quality or struggling businesses. To prevent a further drop in the stock price, managements maintain the payout which weakens the company even more.

2. Many companies have unstable earnings yet they pay large dividends. They do so to attract a loyal investor base that likes dividends. During difficult times, I have seen many companies borrow money to maintain its dividend payout because they do not generate enough free cash flow. They eventually end up in some kind of trouble.

Looking deeper

Investors must look below the surface and understand what is actually happening in the business. As a result, there is no correct dividend policy.

Companies that pay out a high percentage of earnings in dividends may turn out to be poor investments if their growth prospects are unfavorable. Conversely, companies that are able to reinvest their earnings at very high rates tend to pay out little or none of their earnings in dividends. It would have been a mistake for Berkshire to pay dividends.

Investors should also understand that all earnings are not created equal. In many asset intensive businesses (characterized by high asset/profit ratios), inflation causes some/all of the reported earnings to become 'fake'. This portion of earnings cannot be distributed as dividends. This is because these earnings must be reinvested in order for the business to remain competitive. It's a bit like running up a down escalator. There are no economic earnings for the owners.

It may be worthwhile to look for profitable businesses with a solid track record of consistent dividend payout. This suggests that the business is in good financial health, has some kind of competitive advantage and generates a lot of free cash flow. What is even better is if management owns a large percentage of the company, receives a low base salary and is living off the dividends. In this arrangement, they have an incentive to see the business succeed.

According to Buffett, the test whether a company should pay dividends is *'for every dollar you retain, can you create more than one dollar in market value?'*

Dogs of the Dow

Since the earliest days of the equity markets, people have always been searching for the 'silver bullet' that will allow them to make money without commensurate risk. A popular strategy is called 'Dogs of the Dow'. The strategy entailed buying each year the ten stocks in the DJIA that had the highest dividend yields. However, like all such strategies it became too popular and the free lunch disappeared.

General Motors

This is how I would look at GM from the vantage point of dividends. Today, GM is a $54 billion ($36/share) company trading at 6x earnings (second lowest multiple in the S&P 500), it pays a 4% dividend yield and has a very strong balance sheet. In 2016, GM made $9.4 billion and it returned $4.8 billion to shareholders through share buybacks ($2.5 billion) and dividends ($2.3 billion). In other words, earnings could fall three quarters and they would still earn enough to pay the dividend. Not many companies can pay a 4% yield and it's only a quarter of the earnings. So every year, you own 5% more of GM and get a 4% dividend yield – that is sort of a 9% return for waiting. This analysis is only the first step and there is much more to GM than a high yield.