your wealth

# A BIRD IN THE HAND...

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Recently and with little fanfare the Ontario Government agreed to participate with the Federal Government in the reduction of the effective tax rate on dividends paid on shares via an enhanced dividend tax credit. The additional Ontario tax credit will be phased in over a five year period. The result is that for taxable accounts, there will be very little difference between the taxes paid on capital gains versus dividends. It will be interesting to see how investors and companies will respond over time.

The United States some time ago equalized the tax treatment of dividends and capital gains with surprisingly little response from investors. This is interesting because one would expect a preference for having the money up front. Stocks with higher dividends have not shown higher total returns throughout the 90's and so far this decade as a whole. In Canada the phenomenon is repeated but with the commodity bull run playing a large part of the story as investors have been preoccupied with resource stocks.

It was not always this way. Early in the 20th century, both in Canada and the US, dividends made up the bulk of investor returns. For a very long time stock prices were predominantly measured as a function of the dividend or yield they paid. Some of the analytical models used today to value stocks employ dividend growth forecasts. During the post depression era the concept of waiting for a company to initiate payouts was considered very risky indeed. It is only in the last 40 years that dividends have lost their place as the prime driver of returns. Growth investing without regard to dividends, has been the mantra with some sad outcomes for investors. Interestingly in 2003, Robert Arnott, the editor of the Financial Analysts Journal, looked at the last 200 years of equity returns in the US (there is no such study for Canada). He found that dividends made up 5% of the 7.9% total return (or 63%).

One of the largest arguments for companies retaining profits was that taxation was more efficient for capital gains and therefore the shareholder would rather have their returns in the form of share appreciation instead. With the changes in tax legislation this argument does not hold water and investors may want to place an emphasis on those companies that reward them every quarter, and there are very good reasons to do so.

The wonderful aspect about dividends is that they represent a certainty, a return of a portion of the investor's capital for taking part in the business enterprise. A company that does not pay a dividend represents a promise or hope that the entire return will arise at disposition of the investment into the hands of another investor. For this to happen successfully, the other investor will need to form a different opinion of the stock than you have, however using the same information. Some call this the greater fool theory.

These decisions are for the most part built on corporate statements built using GAAP (Generally Accepted Accounting Principles) accounting which is accrual based. Accrual accounting is imperfect but the best we have. The imperfections arise is the flexibility allowed to companies as to how they book assets, liabilities, income and expenses. As a result there is some leeway in interpretation of the numbers and these end up in the earnings reports and balance sheets. Reported earnings are an approximation at best, fiction at worst. Cash in hand suffers no illusions; it simply is what it is.

Dividends give shareholders the freedom to choose. The first is that the holder can reinvest with the company by acquiring additional shares. There are over 50 companies and trusts in Canada that allow investors to participate in dividend reinvestment plans (DRIPs). They allow investors to continue to accumulate shares in the company without having to purchase securities on the exchange and thus saving commission costs. The final two choices are to invest elsewhere or spend it.

The discipline of paying the dividend may help protect the investor from the odd management team's poor plans for investment of shareholder capital. Implicitly, a company that is profitable and does not pay a dividend is assuming the corporate management team can reinvest those funds to earn a higher rate of return than the investor. History is a graveyard of silly acquisitions in pursuit of growth, glory and stock options for managers at the expense of shareholders. We have seen excessive executive compensation, sloppy management and unproductive use of assets in a number of companies that retain profits. Dividends payouts can help keep management disciplined and focused on the shareholder. ☛

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Dividends however are not the only way managers can return capital to investors, share buybacks are another alternative. Managers have the option of notionally returning investor capital by undertaking share buybacks. Share buybacks occur when managers purchase shares of the company in the open markets. They may do this in the view that the shares of the company are undervalued, to support the price of the shares, to improve the earnings per share by reducing the total number of shares outstanding. The drawback is that share buybacks are infrequent and discretionary. While dividends are at the discretion of the company management, usually they are done to avoid suspension or reductions. The market has looked darkly at dividend reductions/suspensions in the past.

Dividend yield is the most popular way of describing the relationship of a dividend and company. There are a number of popular investment strategies that are driven by dividend yields. The "Dogs of the Dow" is one such example. A word of caution however in that a high dividend yield in its own right may not always be a good thing. It may indicate that a company is under stress and has a depressed stock price. In this instance it is best to do a little more investigation.

There are a number of helpful indicators as to the sustainability of a dividend. Past history of the firm in paying out and increasing the dividend should be considered. The business cycle and volatility of the industry (commodity stocks immediately come to mind). It was not that long ago that they were under significant profitability pressure. Perhaps the most helpful is the payout ratio which measures the percentage of earnings a company pays in dividends. A ratio over 100% means that the firm is paying all of its profits in dividends with little or nothing left to maintain facilities and grow the business. The dividend is at risk of reduction or suspension in these situations and the share price will likely be under pressure at this point.

There are a number of companies with a long reliable history of raising the income they pay out. Dividend increases can indicate management's confidence in the firm's ability to continue to produce solid earnings growth. Conversely a dividend decrease may portend stress in an industry or company, best to avoid if possible.

There are 78 stocks listed on the TSX that exceed the average yield of the index (2.6%) and many are quality investments. Sometimes great opportunities arise with careful study. Recently, there was an opportunity to invest in one of the major banks where the dividend yield was 4%, actually higher than the posted rate on the institution's GICs. On an after tax basis, a GIC investor would have to find a rate near 6% to equal the after tax return. This bank has had a long history of increasing its dividend by roughly 6-8% a year. GICs do not do that. Of course, the investor has to accept the price risk of investing in any common stock including banks. There are no guarantees. A student of history however would feel some confidence in the decision over the long run.

Finally, dividends may also provide some comfort during inevitable market declines. Much of the battle for an investor is to keep calm while others panic (not easy to do). Dividends are a positive experience during negative events. Perhaps not unlike collecting rent. They can help keep investors invested. Benjamin Graham's philosophy for investment success was "benign neglect". Another way to look at it is that the market rewards investors with a patience premium rather than a risk premium.

All things being equal it is preferable to have the cash. It leaves the power of choice in the hands of investors. For investors in a taxable account it is now virtually tax neutral between dividends and capital gains. An emphasis on dividend paying stocks going forward may be more sensible. There will always be exceptions of course. On balance however, for common stock.......show me the money.

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