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RBC WEALTH MANAGEMENT

Global Insight

Focus Article

Dividend strategy: Slow & steady wins the race

With time on your side, putting the power of compounding to work can have a potent effect on portfolio performance.

Mark Allen

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All values in U.S. dollars and priced as of June 30, 2017, market close, unless otherwise noted.

RBC Wealth Management

Focus article

Dividend strategy: Slow & steady wins the race

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- Dividend-paying stocks can buffer equity portfolios against market volatility
- Dividend payers have a proven track record of delivering superior returns with lower volatility
- Sustained dividend growth is a simple but effective indicator of investment quality

“The effects of compounding even moderate returns over many years are compelling, if not downright mind boggling.”

– Seth Klarman

With equity markets near all-time highs, valuations elevated, and much political uncertainty, investors are wondering what strategy to employ. There is a time-tested, “slow and steady” approach that offers superior returns and less volatility.

Companies with a demonstrated ability to increase their dividends over time tend to be high-quality businesses that create shareholder value. As the earnings of these businesses rise and shareholders reinvest the dividends, the wealth-building effect of compounding can be compelling.

For investors to take full advantage of the benefits of compounding, the message is fairly simple: (1) the earlier you start, the more compounding can do for you, and (2) try to avoid risks that may disrupt the process.

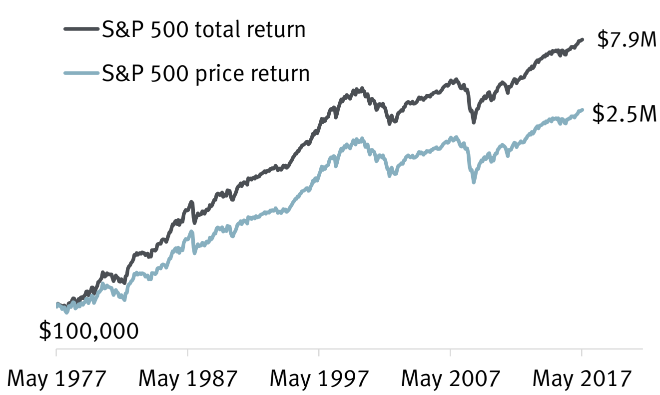
A short lesson in compounding

In any given year, an investor expecting perhaps a 6%–9% return on an equity portfolio with a dividend yield of 2%–3% is anticipating roughly one-third of the return to come from dividends and two-thirds from price appreciation.

Over the longer term and with the reinvestment of dividends, this expectation is turned on its head. The value of $100,000 invested in the S&P 500 40 years

Value of $100,000 invested in the S&P 500

Log scale



The power of compounding shines when comparing the difference in price appreciation versus total return with dividends reinvested over a long period of time.

Source - RBC Wealth Management, Bloomberg; data range: 5/31/77–6/27/17 ago would have advanced to about $8M today on a tax-free basis assuming all dividends were reinvested. Price appreciation alone would have taken the portfolio to just $2.5M. The effect of dividend reinvestment and compounding accounted for roughly two-thirds of the ending value and price appreciation roughly one-third.

With an early start and decades to grow, the effect of compounding on the absolute sum is surprisingly powerful. Similar results were delivered over the same period by Canada's S&P/TSX Composite.

Avoiding potholes

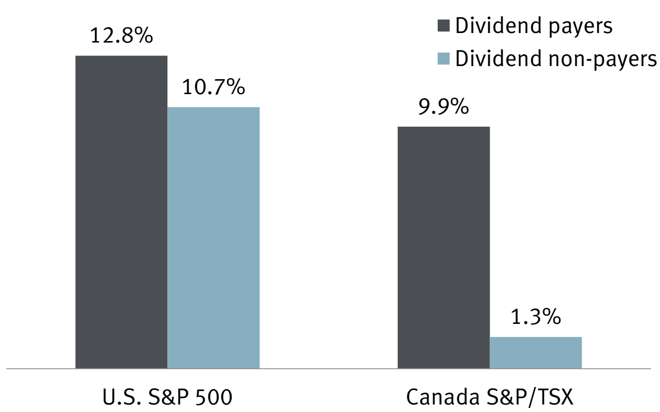
Avoiding disruption to this process is also important. Confusingly, percentage losses and percentage gains are not made equal. A portfolio that declines by one-third must go up by 50% just to break even. A portfolio designed for stability that declines by perhaps 20% during the same market correction has much less ground to make up (a 25% rise) before resuming gains above the baseline, pre-correction level. Just as compounding can provide a growth wonder over time, several periods in a row of negative performance can have a cumulative, destructive effect.

One way to cushion the blow of market corrections is to invest in dividend-paying stocks.

One way to cushion the blow of market corrections is to invest in dividend-paying stocks. Returns generated by dividends are more reliable than are short-term stock price gyrations because dividends are generally paid through market ups and downs.

Dividend payers give the investor a leg up

Average annual return, dividend payers versus non-payers

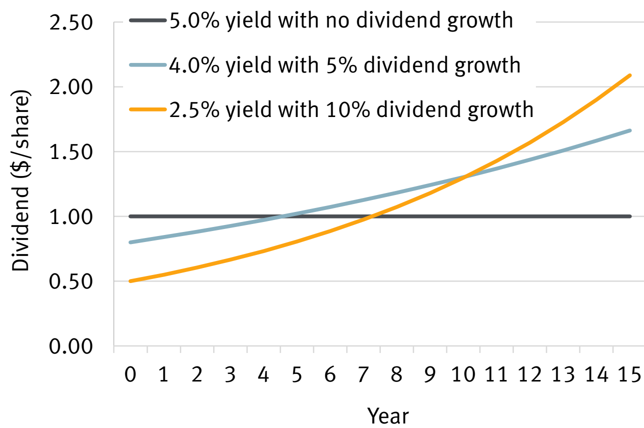


Source - RBC Capital Markets, Ned Davis Research

Dividend-paying stocks have delivered superior returns.

However, dividend-oriented strategies that are solely focused on seeking high dividend yields result in two common biases: a higher concentration in value stocks and a portfolio more focused on interest-rate-sensitive industries such as Telecom, Real Estate, Pipelines, and Utilities. Strategies focused on those themes can lag when markets shift from "value" to "growth," or when interest rates rise. Designing a strategy based on dividend growth broadens the pool of investable stocks and degree of sector diversification beyond what a narrow focus on dividend yields above a specific threshold can deliver.

Illustrative dividend growth scenarios



Seemingly attractive, high dividends can be surpassed by an initially smaller dividend that grows over time.

Note: Initial yield based on a $20 initial stock price in all three cases
Source - RBC Wealth Management

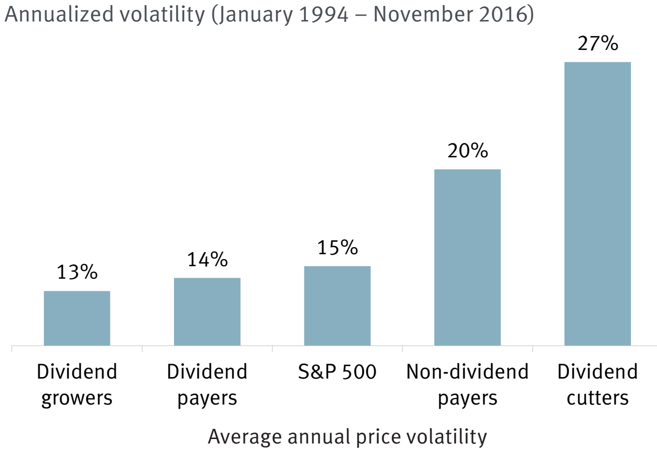
Dividend growers

The benefit of focusing on dividend growers versus dividend payers is really just an extension of the compounding theme. The income from a stock growing its dividend modestly will, in time, eclipse the income from an initially higher yield stock that does not deliver dividend growth. The compounding effect of steady growth can be illustrated with a simple mathematical representation.

Companies that raised, or at a minimum protected, their dividend through various economic cycles have demonstrated positive trends in their underlying businesses. Sustained dividend growth is a simple but effective indicator of investment quality that has produced better rates of return over time.

Easier to own

Annualized volatility (January 1994 – November 2016)



Payers experience much less price volatility.

Source - RBC Capital Markets Quantitative Research, RBC Wealth Management

Building a cash flow machine

Building portfolios including only "dividend payers" can help to buffer against market downdrafts allowing an investor to better harness the longer-term benefits of *boring* but *effective* compounding. Taking it one step further, selecting stocks that generate an increasing cash flow stream to the investor—"dividend growers"—over the long run has historically delivered even more superior rates of return.

Research resources

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