Investing in Dividend Stocks

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Have you ever met someone who really likes high dividend yielding stocks? What is it about high dividend yields that gets some people so excited? A company adjusting its payout policy, which is just the percentage of earnings that get paid out in the form of a cash dividend, does nothing to create or destroy value. Take a very simple example. Imagine you are the only shareholder in the stock of a company. The company has no debt and it has $100 of assets, all of which are cash. I know this is an unrealistically simple example, but there is insight to be found quite easily from this example's simplicity. This company decides to pay its only shareholder, you, a $1 cash dividend. Now the company only has $99 of assets. This means you went from owning stock in a company that was worth $100 to now owning stock in a company worth $99 plus you have $1 extra of cash. Since the only thing this company ever owned was cash, having $100 worth of this stock is exactly the same as having $99 worth of this stock plus $1 of cash. You are no better or worse off than you were before the dividend. The same is true even if the company's balance sheet is more complicated. The value of the company's stock is reduced by the amount of the dividend.

Of course, there is a simplifying assumption here. The simplifying assumption is that we live in a world with no taxes. Unfortunately, in the real world, we have to pay taxes on dividends, which means we were actually in better shape on an after-tax basis before we received the cash dividend. I know if we sold $1 worth of the stock in the above example, we would pay taxes on that as well, but if we held the stock for at least a year, we could get long-term capital gains as opposed to ordinary income with receipt of the dividend. Even at short-term capital gains, the tax rate is the same, not higher, than the ordinary income treatment of the dividends. Of course, the whole $1 dollar is not taxed with a sale as it would be

with the dividend. Only the gain portion of it is, so receiving a cash dividend is still less tax efficient even if the position is not held for at least a year. The point is that dividends are not tax efficient.

People who like high dividend stocks must believe these stocks can reasonably be expected to outperform the average stock for them to be willing to accept the tax inefficiency that comes with investing in high dividend stocks. At first glance it appears that this belief may in fact have some empirical evidence behind it. From 11/30/1975 to 8/31/2018, the MSCI USA High Dividend Yield Index was up 11.51% per year while the MSCI USA Index was only up 10.49% per year over the same time.

Unfortunately Figure 1 below shows that all of the outperformance of high dividend stocks over all stocks is due to their value tilt. After controlling for the value tilt, there is no difference in performance between the MSCI USA High Dividend Yield Index and the MSCI USA Index. This is obvious from the fact that the intercept is not statistically significantly different from zero with a t-stat of 0.02, which is well short of the roughly 2 that is required for statistical significance. The correlation between the dividend factor and the value factor, on the other hand, is strongly statistically significant with a t-stat of 12.96. The dividend factor is the difference in performance between high dividend stocks in the US compared to all US stocks. The value factor is the difference in performance between the lowest price-to-book ratio stocks in the US and the highest price-to-book ratio stocks in the US. The regression in Figure 1 uses monthly relative continuously compounded returns. More detail is provided in the footnotes of Figure 1.

The strong correlation between the dividend factor and the value factor is intuitive. Imagine you have two stocks, stock A and stock B. A and B both have the same payout ratio (dividend per share divided by earnings per share). A has a lower price-to-earnings ratio than B, so it is more of a value stock than B. A also has a higher dividend yield because the dividend yield is the payout ratio multiplied by the earnings yield and the payout ratio is the same. The earnings yield is just the inverse of the price-to-earnings ratio, so value stocks have high earnings yields. High dividend yielding stocks are either high payout ratio stocks, high earnings yield stocks, or some combination of the two. As discussed already, the payout ratio should not impact relative expected return. Earnings yield or other measures of value actually do impact relative expected return.

More high dividend stocks are value stocks than are growth stocks. This is the case because high dividend yield stocks that have the same payout ratio as low dividend yield stocks, must also have higher earnings yields, meaning they are value stocks. Even value stocks with slightly lower than average payout ratios are still likely to make the cut as being included in the high dividend universe. Growth stocks with very low earnings yields require very high payout ratios to make the high dividend universe, so there are probably some of these, but not many. This is why there is a lot of overlap between the dividend factor and the value factor.

This intuition also makes it clear why allocating to the value factor rather than the dividend factor is likely to lead to more expected return. The only difference between the value factor and the dividend factor is differences in payout ratios between different stocks. Favoring the dividend factor over the value factor is essentially saying you believe the payout ratio matters in evaluating relative expected returns. As discussed earlier, there is no economic theory to support why the payout ratio should impact expected return, and Figure 1 shows that there is also no empirical support for this belief either.

If you want extra return by tilting towards value, directly allocating to the lowest price-to-book ratio stocks (i.e. value stocks) makes more sense than allocating to the highest dividend yielding stocks. The Hi 30 Value Index, which was up 14.39% per year over the 11/30/1975 to 8/31/2018 time period, does exactly that by allocating to the 30% lowest price-to-book ratio stocks. This 14.39% per year return easily exceeds that of the 11.51% per year return of the MSCI USA High Dividend Yield Index.

Those who love dividend stocks often refer fondly to having the knowledge that whatever the price of the stock does, at least they will receive their dividend. Admittedly this is true, but it is also true that the market value of the position will be reduced by exactly the amount of the dividend. Therefore, the dividend does not provide any additional security. It does provide inferior tax efficiency. It does not provide any additional expected return beyond what is gained through the value tilt, which can be more effectively accessed by focusing instead on value stocks. With this knowledge, I pose the question to those who favor dividend stocks, "Do you still like your dividend stocks?"

Figure 1

Predicting the Dividend Factor with the Value Factor

11/30/1975 - 8/31/2018 (monthly data)

R-Square	*0.25*
Intercept	0.00002
	(0.02)
Value	0.35607
	(12.96)

Coefficients shown in this table with t-stats

beneath them in parentheses.

*D = a + b*V*

where D = Dividend Factor and V = Value Factor

Dividend Factor = LN return MSCI USA High Dividend

  Yield Index - LN return MSCI USA Index

Value Factor = LN return Hi 30 Value - LN return Lo 30

Value

MSCI USA High Dividend Yield Index includes stocks in the

MSCI USA Index that have dividend yields at least 30%

higher than the MSCI USA Index. Stocks included in this

index must also pass high quality tests to ensure

sustainability of the dividend yields.

Hi 30 Value stocks are the 30% highest book-to-price

stocks in the US universe, which makes them value stocks.

Lo 30 Value stocks are the 30% lowest book-to-price

stocks in the US universe, which makes them growth

stocks.

Data Sources: Morningstar for MSCI Indices

Fama and French for Hi 30 Value and Lo 30 Value

About the Author

Alex joined White Oaks Investment Management in April 2014 after spending nearly 8 years doing investment research at The Roseline Financial Group in Richmond, Virginia. As an Investment Analyst at White Oaks, he performs investment research, asset allocation of various strategies, assesses client portfolios and assists with overall client communication.

Alex holds a Bachelor of Arts in Economics and a Minor in Mathematics from the College of William and Mary in Williamsburg, Virginia and a Master of Science in Finance from the University of Illinois at Urbana-Champaign, where he specialized in financial engineering. He is also a CFA Charterholder.