INSIGHT

THE GREATEST WEALTH IS **YOUR PEACE OF MIND...**

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Don't chase dividends

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Readers of the Sunday papers’ financial pages will be familiar with the dividend chasing stories that pundits and some fund managers peddle. These generally focus on high dividend paying stocks or ‘income’ funds that focus on these stocks. The thought that one can take an income from a portfolio without the need to sell shares can feel – at least superficially - appealing to some (this is sometimes known as taking ‘natural yield’ from a portfolio). But dig a little deeper and it quickly becomes evident that a portfolio constructed from a bottom up dividend-driven approach may be suboptimal and contain risks that may not be fully appreciated.

The first point to note is that you cannot have your cake and eat it! If a company pays out a high dividend, that money cannot be reinvested by the firm to deliver higher future earnings which drive share prices (being the present value of future cashflows of a company). You forgo tomorrow’s price growth for today’s dividends. In theory, the dividend policy of a firm should make little difference to its total return (dividends plus share price appreciation)[1].

The second point to note is that different sectors of the economy tend to have different average dividend payout strategies as the chart below illustrates. For example, tech companies tend to reinvest most of their cash flows into product development and attaining greater market share, whilst energy companies – operating in a more mature industry - may not be able to find projects in excess of their cost of capital and may return money to shareholders via dividends. Chasing dividends tends to end up in large sector ‘bets’ away from the market.

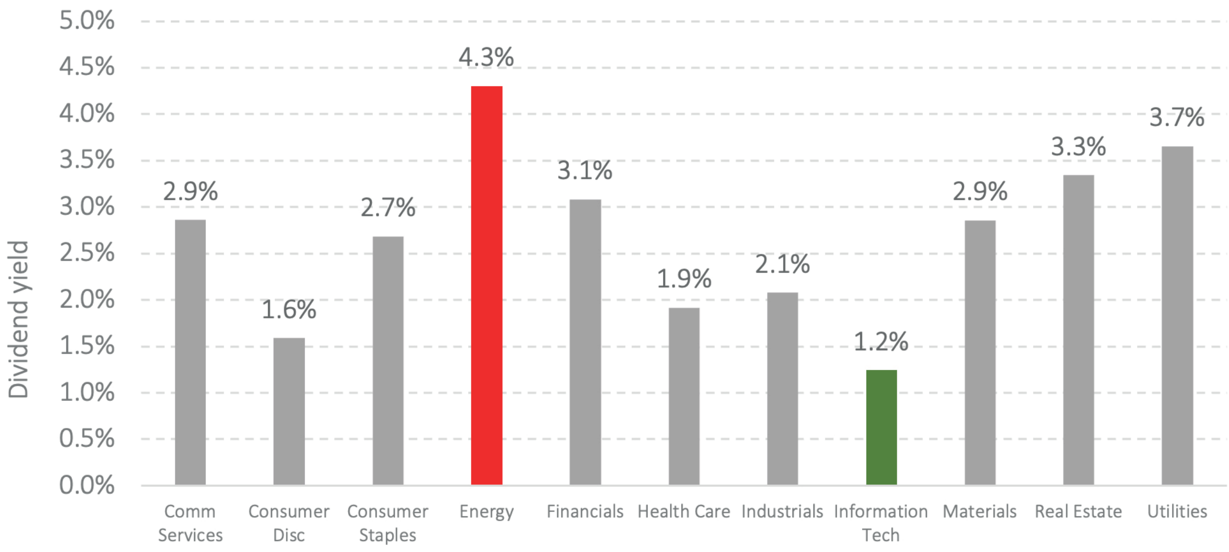

Figure 1: Average dividend yield 11/2014 to 07/2023 of global sectors

Data: MSCI world sectors from Morningstar Direct ® All rights reserved (refer to endnote).

The third point to note is that because each stock market reflects the companies listed on it, large sector differences exist between markets. For example, the UK has materially less exposure to technology stocks compared to the US but higher weightings to energy stocks. As a consequence, the UK market has a higher dividend yield than the US market. A dividend-driven approach will likely overweight the UK (and other higher yielding markets) relative to other lower-yielding markets. Take a look at the average dividend yield on the top 10 markets by size.

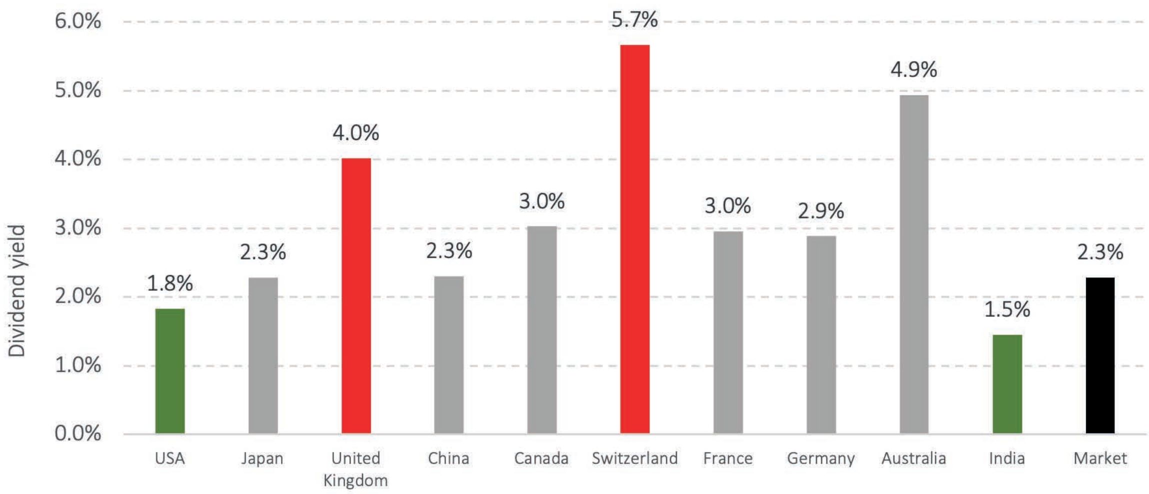

Figure 2: Average dividend yield 11/2014 to 07/2023 of 10 largest global markets

Data: MSCI country indices; 'Market' represented by MSCI ACWI. Source: Morningstar Direct ® All rights reserved (refer to endnote).

The final points worth noting are: within each market, dividend payments are often concentrated in just a few stocks resulting in stock concentration risks; and higher dividends tend to describe value stocks (less healthy companies with higher expected returns) potentially inadvertently skewing a portfolio towards this risk factor.

If you have bonds in your portfolio, chasing higher yields from lower quality bonds (i.e. lower quality borrowers) simply adds equity-like risk to your portfolio. The higher the yield, the riskier the borrower. But that story is for another day!

An eminently sensible alternative approach to taking income from a portfolio is to think on a 'total return' basis where an investor is agnostic to taking dividends or selling shares to deliver the capital required. This is the way that pension plans and endowments tend to draw income. It allows an investor to maintain the structural integrity of their portfolio and to avoid company, sector and market bets in the pursuit of higher dividend yields on portfolios.

Don't chase the dividend chimera.

End notes.

1.
Miller, M.H. and Modigliani, F. (1961) Dividend Policy, Growth, and the Valuation of Shares. The Journal of Business, 34, 411-433. http://dx.doi.org/10.1086/294442

Other notes and risk warnings

Use of Morningstar Direct© data

Risk warnings

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