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Don’t underestimate the value of dividends

Quality dividends hold firm even in times of market volatility.

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Of late, the headlines on dividends have been primarily focused on the proposed removal of some of the more favourable tax treatments should the Labor Party get elected.

While franking credits certainly enhance the attraction of dividends received from Australian companies, we believe there are other reasons why dividend income will remain an important element to consider when constructing an equity portfolio.

In our opinion, there are three key reasons why dividends have always been and will continue to be an important component for investors to consider:

- They are a reliable source of return from an Australian equity portfolio.
- The level of dividends is not affected by the level of the sharemarket.
- The dividend yield on stocks can act as a safety net in times of volatility.

Over the long term, returns from an equity portfolio come from two sources — the capital appreciation from the shares and the dividends received.

It is interesting to note the returns from the ASX 300 of these two components over the last 20 and 40 years.

	20 YEARS P.A	40 YEARS P.A
TOTAL ASX 300 RETURN	▲8.3%	▲11.1%
SOURCE OF RETURN		
CAPITAL GROWTH	▲3.9%	▲6.6%
DIVIDEND INCOME	▲4.4%	▲4.5%
% OF RETURNS OF ASX 300 FROM DIVIDENDS	53%	40%

Source: Investors Mutual

The importance of the dividend component of an equity portfolio is evident, with almost half of the returns from the Australian market over 20 and 40 years coming from dividends.

While capital returns over any defined period generally depend on the movement in the sharemarket, the level of dividends from an equity portfolio is dependent on the performance of the companies' earnings, not the movement in share prices.

The level of dividends and the dividend payout ratio is set by a company's board and is generally a reflection of the overall profitability of the business and is independent on the level of its share price.

This is an important point to remember as it means that in negative periods in the market, the level of dividends from a diversified portfolio — if made up of quality companies with the right attributes — should not vary greatly from year to year regardless of what is happening on the overall sharemarket.

A breakdown of the level of returns from the ASX 300 shows the dividends paid have been much less volatile than the level of capital returns over the past 20 years.

The key point to remember is that regardless of share price performance, the vast majority of companies in the ASX 300 continue to pay dividends that are not dependent on the mood of the market, which to some extent compensates investors for a share price often beholden to the whims of the market.

The movement in the market — particularly over shorter time periods of six to 12 months — is more often than not dictated by the mood of investors, which in itself is affected by things such as forecasts of economic activity, inflation and interest rates as well as perceptions of geopolitical stability.

Often what are with hindsight quite minor events from an economic standpoint can cause the mood of investors to sour markedly and lead to large declines in the market. For example, Iraq's invasion of Kuwait in 1991 led to all sorts of gloomy predictions about an impending global recession by many analysts and economists.

Times of a perceived crisis can cause investors to panic, and in such times share prices can fall heavily as they reduce their level of sharemarket exposure by selling shares indiscriminately and independent of their quality.

What I have observed over many years of investing is that once the panic subsides and some sort of normality is restored, those companies with sustainable earnings that can support a healthy dividend stream are often the shares that can recover the quickest.

The reason for this is fairly obvious — rational long-term investors are always attracted to companies that pay a healthy dividend from a sustainable earnings stream, as they understand that the level of returns from dividends is not dependent on share price performance.

In other words, once shares in quality companies fall to a level where the dividend yield is attractive, this will spur investors to "lock in" good yields, despite a volatile sharemarket.

Dividends provide investors with a consistent part of their total return and can also act as a "safety net" in downward trending markets.

While we acknowledge that the proposed changes to the tax-effective treatment of dividends in Australia via franking credits is potentially a negative development, dividends will remain an important factor when investing in the sharemarket as they will continue to provide investors with a relatively stable part of returns through the delivery of real cash flow, irrespective of the market cycle.

As a bottom-up value manager, fundamentals are crucial to deciding which companies are included in Investors Mutual's portfolios — mainly the quality and transparency of earnings, cash-flow generation, gearing levels or balance-sheet strength — which ultimately are what is important in the level of dividends paid by companies.

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