

## Global shares that pay dividends – not such a novel idea after all

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This paper examines historical total returns of global equities and the importance of dividends to the total return. The paper will also examine the historical importance of including dividend-paying and dividend-growing companies in global portfolios and the impact on overall returns and the potential to lower risk/return outcomes relative to the broader global market. Discussion will be presented in the context of addressing client ideas of risk and not benchmark related concepts of risk management and portfolio construction.

### Definitions:

**Capital Asset Pricing Model (CAPM):** is used in finance to determine a theoretically appropriate required rate of return (and thus the price if expected cash flows can be estimated) of an asset.

**Dividend payout ratio:** is defined by dividend payment per share divided by earnings per share.

**Dividend yield:** is the dividend per share divided by the share price, and is considered to be the more predictable (although not guaranteed) component of a stock's annual return.

### Introduction

Throughout the history of the Australian share market, companies and investors have rarely forgotten the importance of dividends. There are numerous reasons why dividends are so important in Australia - this paper has listed several of the major reasons why this is the case, and explains why the importance of dividends relative to total returns has somewhat been diminished over the past decade in a number of international equity markets. The paper then examines the historical and current importance of dividends on a global basis in various share markets and show examples as to how Australian investors today can find high quality, high dividend paying companies outside of the Australian share market.

### Why Dividends are so important:

The most obvious reason why dividends are of such importance to Australian shareholders is the huge tax benefit that dividends can generate for investors, provided the dividends are attached with franking credits. While rules regarding taxes paid on dividends are different throughout the world, most OECD nations do treat taxes on dividends differently - generally at lower rates than the nominal income tax rate.<sup>1</sup>

The one major exception to this was the United States, which until May 2003 treated dividends as income and therefore were taxed at the same rate as income.

While preferential tax treatment has been an important reason why dividends are so ingrained in the history of Australian corporations, there are however other reasons why both investors and companies place such high importance on dividends. They mostly refer to various aspects of the same theory called the Signal Theory, in that dividends can send a “signal” to shareholders about the viability of the company.<sup>2</sup> Dividends are a very transparent way of showing the financial viability of a company. While earnings can be smoothed over time and can have many “below the line” or “one-off” charges that can either depress or accentuate earnings from one year to the next, the dividend payment is a concrete cash payment to company’s shareholders that cannot be inflated or lowered without major repercussions. While dividends are not guaranteed to shareholders, a decrease in dividend payments often indicates mismanagement of the company’s cashflows and could potentially be an early indication of a company under duress. Therefore the dividend is an important signal of the health of the company.

Growth in dividends is also considered to be a sign of the underlying growth opportunities of a company. Management and boards of companies will increase the dividend payout only when they believe that there will be future earnings growth. Global Value Investors (GVI) believes excellent management is demonstrated by management that can increase earnings *and* dividend payments over time *as well as* fund capital expenditures through internal sources of cash in a manner that does not hurt the company’s future prosperity through under-investment. It does not make sense for management to pay out all of its earnings as dividends if it hurts the long-term viability of the company. This would therefore mean that growth in dividends should be done in a responsible and prudent measure.

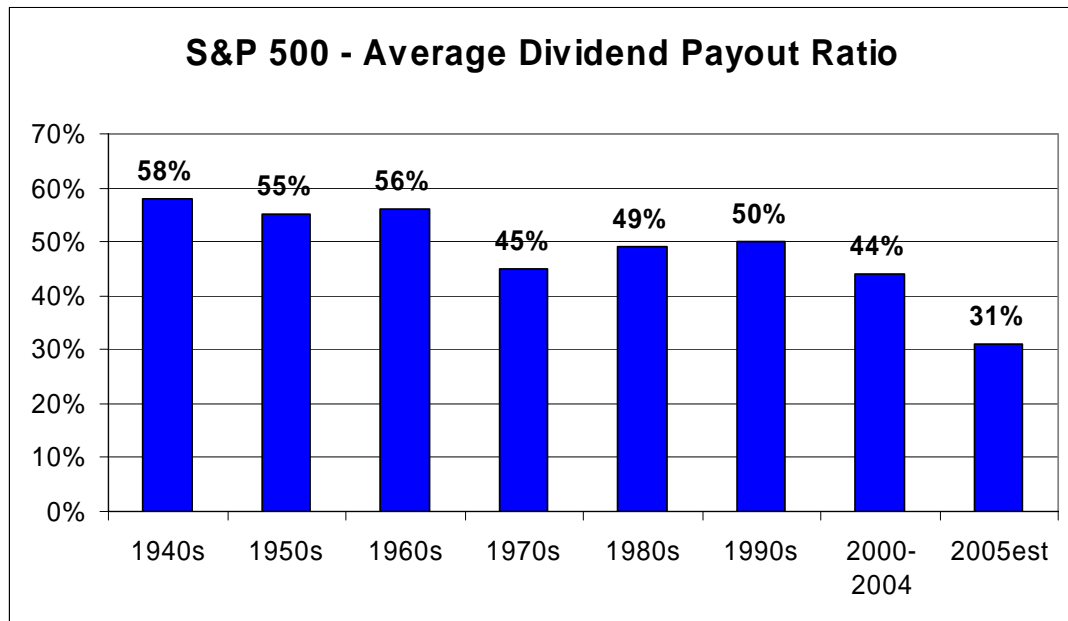
### **Australian Investors Dilemma when Investing Internationally over the Past Decade**

It is therefore understood that Australian investors, be it value or growth investors, appreciate the concept of the dividend. Also it is understood that the Australian investing public generally understands that modern portfolio theory has shown in empirical studies that portfolios including a portion of international shares have increased the overall return of portfolios while lowered the volatility versus domestic only share portfolios.<sup>3</sup>

Over the past decade or so the global share markets and in particular the US share markets have seen a decline in overall payout ratios and dividend yields. Since 1994, dividend growth rates on average started to decline relative to earnings growth rates, or stated differently, dividend payout ratios started to decline precipitously.

Pasternak (2006) noted that the S&P 500 Index not only witnessed a reduction in its dividend yield, but also a reduction in its average dividend payout ratio as well. Historically the S&P 500 Index in the US had a much higher dividend payout ratio, and this is in direct contrast to the past twenty years where the S&P 500 index has seen its average dividend payout ratio fall from 50% in 1990 to 31% in 2005. In fact, the average dividend yield of the S&P 500 Index fell to 1.1% in March 2000, the lowest point in its history.<sup>4</sup>

## The S&P 500 Index Average Dividend Payout Ratio (1940 to 2006)



### Reasons for the Decline in the Importance of the Dividend

There have been many explanations given to this decline in dividend payout ratios and dividend yield rates in the US. This paper offers some possible explanations why this phenomenon occurred, the first being primarily U.S. centric, but some other possible reasons that might better explain why this was a global phenomena are included.

As stated previously, until May 2003 dividends were taxed as income in the US, and therefore whatever an individual's income tax rate was the rate of tax investors paid on their dividend payments. This could be as high as 38.5%, which was the highest individual income tax bracket. On the contrary capital gains tax was 20% until May 2003, and therefore investors of US shares have in general preferred capital gains rather than dividends. Of course investors in US shares would only have to pay capital gains after a sale and a capital gain had been made, which is different to taxes paid on dividends, which occurred every time a dividend payment was issued. This discrepancy started to weigh on the mind's of management of US domiciled companies in the mid 1990s, who were acting partly on the advice of shareholders who didn't want as high dividend payouts as in the past due to the higher tax payments. Particularly when equity markets around the world and the US equity markets in particular moved into the "Dot.com Bubble" of the late 1990s.

The drop in dividend payout ratios was compounded by the enormous capital returns that the US equity markets witnessed from the early 1990's up until March 2000.

As managers witnessed extraordinary gains in the market values of the companies that they worked for during the late 1990s, they were often at times trying to understand and predict how to continue the success of their company's share values. Cynically speaking, managers of many US companies had share options as part of their remuneration packages throughout this decade. Share options are usually linked to a specified share price which awards increases in the share prices rather than total shareholder

returns, a calculation which includes dividends. Therefore managers were encouraged to increase their company's share price and not place as much emphasis on the company's dividend policy. The dividend policy was often times considered as an afterthought.

Another theory, developed by Kahneman and Tversky (1979), called Prospect Theory, explains that investors respond differentially to certain gains versus probabilistic gains and losses and care more about losses than they do gains. And this theory can be applied to companies and shareholders around the world as well. Prospect Theory suggests therefore that investors may prefer cash from dividend-paying stocks more when they predict future uncertainty or economic downturns, and less when the market is doing well. While this theory is a little self-perpetuating, it does explain the lack of importance shareholders placed on dividends from the companies they invested in when they believed there was more earnings growth to come in the mid to late 1990s.

There are many more reasons why dividend yields and dividend payout ratios fell in the mid 1990s to 2000, too many to cover in this paper. Of course we have seen a large reversal in attitudes towards dividends in the US since then. There has not only been major changes to US tax laws but also a reemphasis of the importance of dividends, especially when investors cannot be guaranteed the lofty capital gains they had previously been achieving in the US. There has also been a renewed research emphasis on the power of dividends to be able to predict the future earnings growth of companies, not only in the US but globally.

### **Dividends are again increasingly becoming more important around the globe**

The George Bush administration changed the tax laws in May 2003 which lowered the tax rates for both dividend tax and capital gains tax down to 15%. While the response from companies domiciled in the US has been varied, there has been an increased interest regarding dividends in the US and around the globe. But this has not been the only time in the history of the US share market that dividends were an important part to investors' total return.

Low dividend payout ratios and low dividend yields haven't always been the norm in US equity markets. Before the 1930s dividends and the share's dividend yield was an important indicator of the financial strength of the company. This is before companies had to publish audited annual reports. As investors didn't have as much faith in company reports as they do now, a high dividend yield indicated that the company was financially sound and could afford to payout a higher proportion of its earnings as dividends.

Empirical studies have shown that over long periods of time that dividends have comprised a significant portion of the total return of investing in the US share market. Plexus Asset Management has produced a very indicative chart, shown below, which illustrates that dividends have represented 4.8% p.a. of the total 9.2% total return p.a. of the S&P 500 since inception, which was 1871-2006.

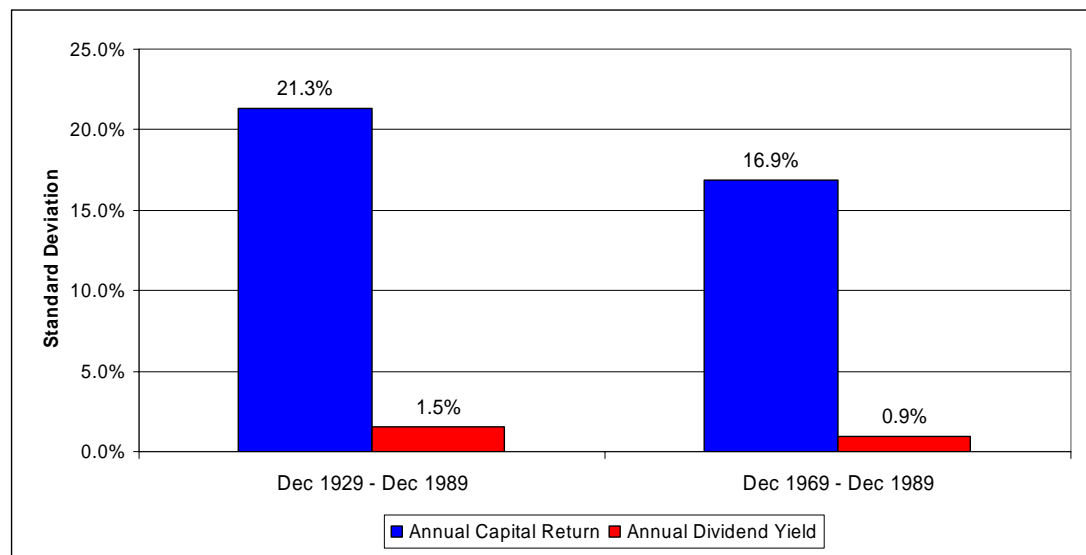
Allison and Saryan (2007) looked at the S&P 500 Index from 1926-2006 and found that dividends made up 4.3% p.a. of the total 10.4% p.a. for the 80 years, or 41% of the total return.

This is not however only a US phenomenon. ABN-Amro's Global Investment Returns Yearbook finds UK shares have returned 9.6% p.a. from 1900-2006. Of this, 4.9% or over 50% have come from dividends, and 4.7% from capital gains.

The importance of dividends in the long-term for shareholders comes from the importance of compounding. While receiving regular payments can seem inconsequential to investors in the short-term and to some even as a nuisance who would rather see capital gains than dividends, they become increasingly important the longer the investment time horizon becomes. The compounding effect becomes more pronounced when dividends are reinvested back into companies; commonly known as dividend reinvestment plans (DRPs). The effect produces two positive results for investors. Firstly it lowers the volatility of the investment as shares are bought automatically when the dividends are paid out, and therefore averages out the cost of the investment. Secondly, DRPs will over time increase the amount of shares owned and therefore increase the future earnings opportunity the longer the investment time horizon is.

Another somewhat related topic is how dividends reduce the overall volatility of the total return. Keppler (1991) notes that the standard deviation of the annual capital return during the period between 1929 and 1989 was 21.3%, while the standard deviation of the annual dividend yield during the same period was only 1.5%. Therefore having a portfolio with a higher dividend yield over the long run will naturally lower the overall volatility of the total portfolio return.

**Annual Volatility of Capital Returns and Dividends of the MSCI World index (Dec 1929 to Dec 1989)**



**Another benefit of Dividends - Higher Dividends = Higher Expected Returns**

There have been many recent studies however that refute the notion that companies which have high dividend payout ratios will have lower earnings growth in the future.

This is counter intuitive to many market observers and investors who believe that companies with higher dividend payout ratios will generate lower future earnings growth. The rationale behind this is that management of companies with ample growth opportunities will retain more of their cash, and therefore have a lower dividend payout and reinvest more back into the company. Therefore higher dividend payout ratios signal that there may not be as many future earnings growth opportunities for companies.

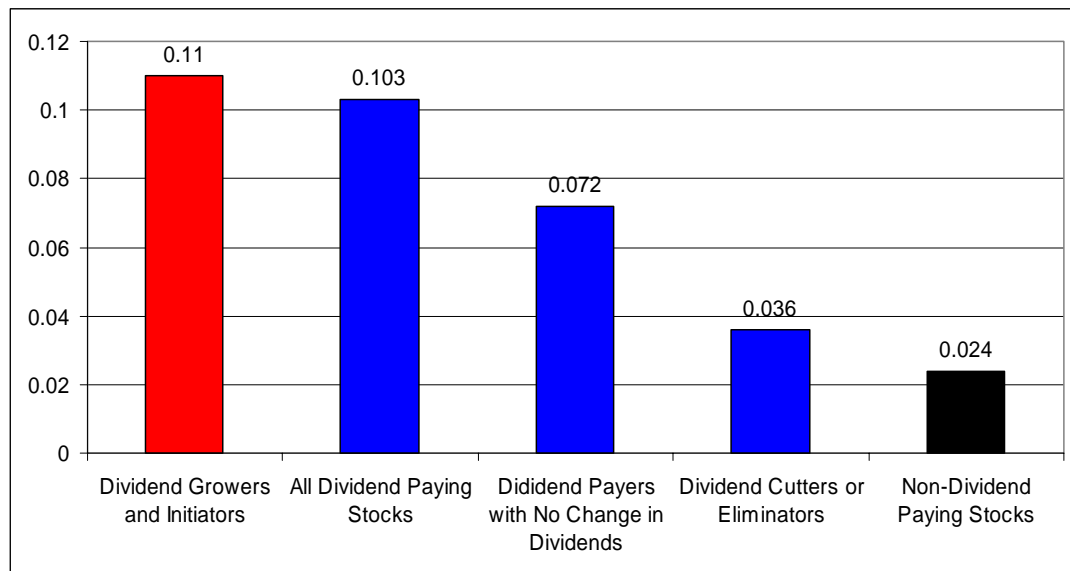
Arnott and Asness (2003) investigated the relationship of high dividend payout ratios of the S&P 500 index and the future earnings growth. Arnott and Asness found that future earnings growth of the S&P 500 index

is associated with high dividend payouts rather than lower dividend payouts. This is counter intuitive to studies conducted by Modigliani and Miller (1961) that proved dividends didn't matter to shareholders when tax rates for capital gains and dividends are synonymous. Also it had been common thought that companies that have lower dividend payout ratios and reinvested more money back into the company would have higher earnings growth rates.

Arnott and Asness gave one reason for this phenomenon as it could be attributed to investments funded by internal cash generation as they do not come under as much capital market scrutiny as when companies raise cash via outside means, being either debt or capital.

There has been another study performed by Ned Davis research which shows that by far the best performing stocks in the S&P 500 index are the stocks that have been dividend growers and initiators, followed by all dividend paying companies. So while it is important for its total return for companies to pay dividends in this study, it is even better if these dividend paying companies grow their dividends over time.

#### Historical total returns of stocks in S&P 500 (January 1972 to January 2006)



Source: Ned Davis Research-returns based on monthly equal-weighted geometric average of total returns of S&P 500 Index reconstituted monthly.

There have been numerous studies that have examined this relationship in other global share markets. Visscher and Filbeck (2003) analyzed the performance of investing in the top 10 highest yielding stocks on the Toronto Stock Exchange against the performance of investing in the TSE 35 over a ten year period (1987-1997). The results showed that investing in the top 10 dividend paying companies produced higher compound returns for the decade. The study also showed that the top 10 dividend paying companies also provided a higher risk-adjusted return than the TSE 35 using both the Sharpe ratio (measuring excess return to total risk) and Treynor index (measuring excess return to market risk).

Cai (1997) performed a study that examined the performance of value stocks versus growth stocks on the Tokyo Stock exchange. The results were, in general, value stocks outperform growth stocks by between 6 and 12 percent per annum for the five years after portfolio formation.

Michael Keppler (1991) studied the performance of 18 country indexes from 1969 through 1989. The indexes were grouped into quartiles based on dividend yield and adjusted quarterly. In both local currencies and dollars, the most profitable strategy would have been to own the highest yielding quartile of indexes. Keppler also discovered that global equity investors can achieve excess risk-adjusted returns over long holding periods by selecting markets with higher than average dividend yields. Keppler also states that this analysis is contrary to the assumption of modern portfolio theory (CAPM), which states the higher expected return will equate to a higher expected volatility.

<b>Selected Country Indexes and the MSCI World Index</b>		
<b>December 31, 1969 - December 31, 1989</b>		
	<b>Capital Gain in % of Total Return</b>	<b>Dividend Yield in % of Total Return</b>
MSCI Market Cap. - Weighted	73.8	26.2
MSCI Equally Weighted	72.8	27.2
Australia	68.4	31.6
France	68.8	31.2
Germany	59.5	40.5
Hong Kong	85.7	14.3
Japan	89	11
Netherlands	57.3	42.7
Singapore/ Malaysia	87.2	12.8
Spain	51.4	48.6
Switzerland	68.1	31.9
United Kingdom	71.5	28.5
United States	64	36

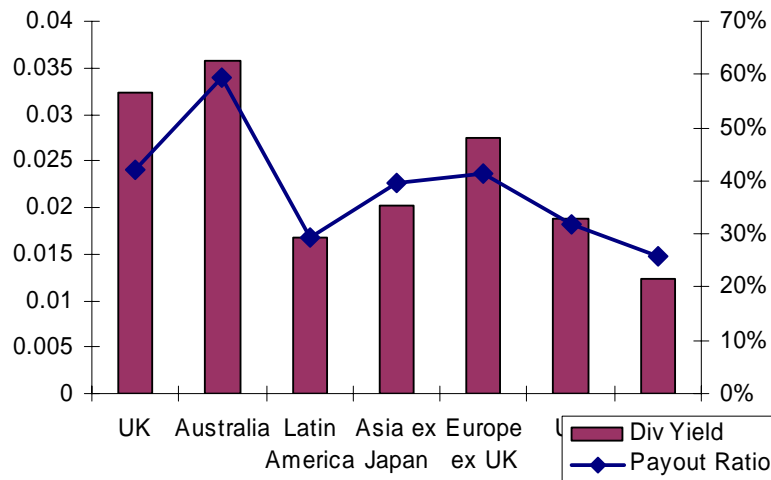
Source: Mike Keppler (1991)

All of these studies have shown that higher dividend yielding companies will appreciate investor's total return in the long term over lower dividend paying companies, another huge benefit of dividends for investors.

## Conclusion

In conclusion, investing internationally does not necessarily mean a lower dividend portfolio. Dividends have been an integral part of all share markets around the globe over time. While the past decade has seen a reduction in the importance in dividends, in equity markets, the long term data supports the importance of dividends in every share market around the world.

While there are many international funds available to Australian investors, there are not many that deviate away from the MSCI World Index, a benchmark that generally represents the opportunity set when investing internationally. There are difficulties however investing internationally with a dividend focus while using the MSCI World Index as a benchmark.



As can be seen in the chart above, the MSCI World Index's two largest country weights are the US and Japan, with only an average country dividend yield of 1.9% and 1.2%, respectively. These two countries make up over 55% of the MSCI World Index, and so if international funds use the MSCI World Index as an initial indication of what their country weightings should be, they will generally attain a lower dividend yield for their fund.

There are however opportunities available for Australian investors to acquire shares or portfolio of shares in financially strong, high dividend paying companies that will be able to increase their earnings and dividends over time. GVI believes that its fund, the Global Industrial Share Fund (the Fund), offers Australian investors a unique opportunity to invest in an international fund that is comprised of international companies that have attractive and progressive dividend policies. GVI believes that this type of international share fund is unique in the Australian retail landscape with competitors not having a significant focus on valuation and dividends. The Global Industrial Share Fund is an excellent way to acquire international equity exposure with a strong focus on dividends.

By adopting a non-benchmark approach in order to build a portfolio that has a strong preference towards dividend paying companies, the Fund has managed to provide one of the highest risk-adjusted results since inception when compared to its peers. Beyond the headline return, the risks taken to generate these returns (as measured by standard deviation) is one of the lowest available in the Australian market and



when expressed in terms of the risk/reward ratio (see table below), it shows that the Fund has utilized its risk more efficiently than its peers since inception. In addition, the Fund has managed to outperform its benchmark, the MSCI World Index (AUD hedged) since inception with considerably less risk than the market.

(Included raw data for Mercer Survey (Overseas Shares (Modified Universe) Risk vs Return for 2 years to 31 May 2007)

### **Overseas Shares (Modified Universe)** **Risk vs Return for 2 Years to 31 May 2007 (calculated monthly)**

<b>Manager/Fund</b>	<b>Annualised Return (%pa)</b>	<b>Rank</b>	<b>Standard Deviation (%pa)</b>	<b>Rank</b>	<b>Reward to Risk Ratio Value Rank</b>	<b>Excess Return (%pa)</b>
<b>Index managers - Median</b>	16.1		8.5		1.9	0.4
<b>Value Biased - Median</b>	21.1		8.6		2.3	5.4
<b>Growth Biased - Median</b>	16.4		9.2		1.8	0.7
<b>Core Managers - Median</b>	16.8		8.6		1.9	1.2
<b>SRI - Median</b>	16.8		8.3		2.0	1.1
<b>Global Value Investors (GVI)</b>	24.6	(3)	6.3	(104)	3.9 (1)	8.9
<b>Overall Results</b>						
Number of Funds	104		104		104	104
Upper Quartile	20.1		9.1		2.3	4.4
Median	16.8		8.5		1.9	1.1
Lower Quartile	15.4		8.2		1.8	-0.2
MSCI World ex Australia	15.7	(73)	8.5	(52)	1.8	0.0
S&P/Citigroup PMI World ex Aust	16.1	(62)	8.3	(73)	1.9	0.4
S&P/Citigroup BMI World ex Aust	17.1	(45)	8.8	(37)	2.0	1.4



**Further Explanation of the technical terms used in this survey is provided overleaf.**

The index used to calculate excess return and associated statistics was the MSCI World ex Australia.

All rates of return are before tax and before management fees. Rates of risk and return are annualised for periods exceeding one year.

With investment time horizons lengthening as populations, especially in OECD nations, live longer, the importance of having quality above-average dividend-yielding companies (with dividends re-invested) becomes increasingly more relevant. GVI strongly believes that investing in international shares with a focus on companies that are increasing their earnings and dividends over time will in the long run achieve higher returns with lower volatility.

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#### Endnotes

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<sup>1</sup> [http://en.wikipeida.org/wiki/Dividend\\_tax](http://en.wikipeida.org/wiki/Dividend_tax) and [http://en.wikipedia.org/wiki/Double\\_taxation](http://en.wikipedia.org/wiki/Double_taxation)

<sup>2</sup> Signal theory is written and further explained in Fuller and Goldstein (2004) and in Benartzi, Michaely, and Thaler (1997) research papers.

<sup>3</sup> Most Portfolio Management textbooks will provide a chapter on the benefits of International Investing. I used a textbook written by Litterman and Goldman Sachs Asset Management's Quantitative Resources Group (2003). It shows diversification benefits of international investing in four regions, being the U.S., Eurozone, U.K., and Japan.

<sup>4</sup> Historical data can be found at the U.S. Department of Commerce's website, which is <http://www.commerce.gov/>.