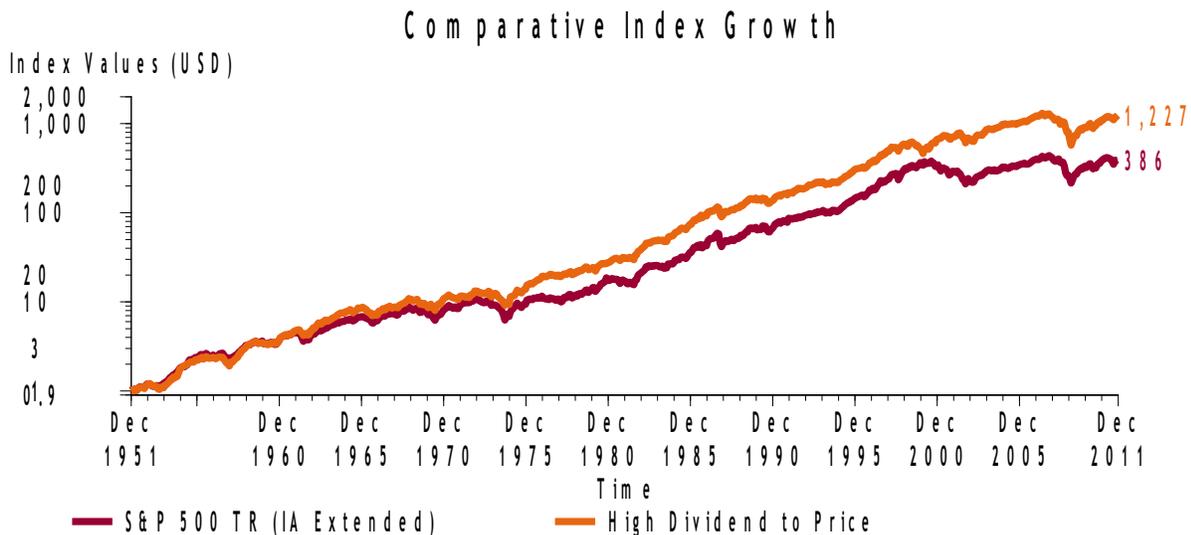




High Dividend Yield Strategy under the Microscope

Today's ultra-low interest rates have propelled investors into a frantic quest for higher income. In response, high dividend yield stocks have become the favourite recommendation of a host of advisors. Yet, an undue focus on income alone obscures the irreducible fact that long-term investment success is based on the *total return* of a portfolio including both income *and* capital growth. This raises two questions. First, given its income focus, how has the total return of a high dividend yield strategy fared relative to the market overall? Second, how does its total return performance compare to the returns of other possible stock selection strategies?

A high dividend yield strategy is a systematic methodology to buy and hold stocks where the dividend is high in relation to the stock's price. In effect, it is a strategy that selects value stocks since it is actually the low price of the stock relative to the dividend that primarily creates the high yield. As evidenced in the following graph, from 1952 through 2011, \$1.00 invested in high dividend yield stocksⁱ (in orange) grew to \$1,227, more than three times the \$386 in the S&P 500 (in red).



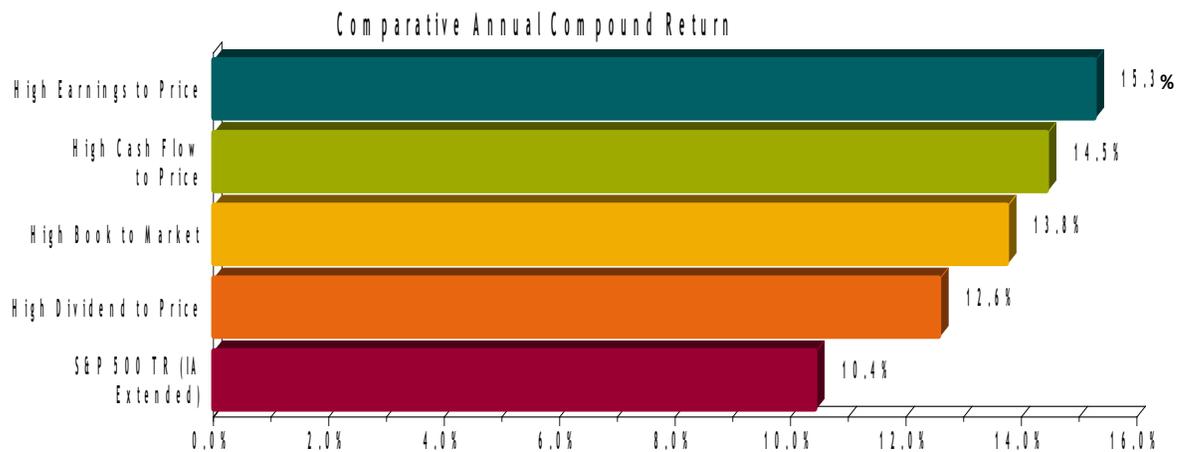
Over this period, high dividend yield stocks returned 12.6% annually, far outpacing the 10.4% of the S&P 500. The US market is not alone in evidencing a return premium from high dividend yield stocks. A global reviewⁱⁱ of dividend yielding stocks in 21



countries over multiple decades found that high dividend yield stocks outperformed low yield stocks in 20 of the countries with an overall average premium of 4.1% a year.

However, a high dividend yield strategy is just one variant of stock strategies that select value stocks and there is considerable evidence as well as theoretical support that value stocks outperform both growth stocks and the market over longer periods of time. (See our July 2009 Commentary *Beating the Market* at <http://tacitacapital.com/?q=node/29>.) In this context, the “yield” premium ascribed to high dividend strategies is actually a “value” premium.

Other value strategiesⁱⁱⁱ select stocks based on high earnings or high cash flow in relation to price as well as high book value of equity relative to market value. As evidenced in the following chart, over the period 1952 to 2011, high dividend yield stocks, although outpacing the overall market, returned less than value stocks selected on the basis of earnings, cash flow or book value.



One likely explanation for the lower return of the high dividend yield stocks versus stocks selected using other value parameters is that dividend paying stocks tend to be of larger companies. Non-dividend paying companies, by definition, are excluded from selection and these tend to be smaller.^{iv} Hence, a high dividend yield strategy foregoes to a greater degree the return premium available from investing in smaller companies (See our Commentary *Good Things Come in Small Packages* at <http://tacitacapital.com/?q=node/29>.)



Value stocks selected on the basis of high earnings to price or, as more commonly known “low price to earnings”, had the strongest performance. This value strategy can buy non-dividend paying growth companies that are out of favour or whose prospects are underestimated by the market as well as profitable companies that have temporarily suspended or reduced dividends^v. Apple Inc. at one time was a classic example of the former. However, as evidenced in Table I in the Appendix, no single value strategy outperforms consistently over shorter time frames. Hence, strategy diversification could prove beneficial, especially for impatient investors.

A much cited virtue of high dividend strategies is that they are less volatile than the market. As evidenced in Table II, this is true - high dividend stocks are less volatile. However, as illustrated in Table III, value stocks based on either earnings or cash flow had modestly higher risk-adjusted returns than the high dividend yield strategy.

A high dividend strategy does result in less stock turnover than a strategy based on either cash flow or earnings^{vi} and to this extent, it can reduce capital gains taxes. However, a strategy based on high book to market also reduces turnover and potential capital gains taxes. Overall, with a focus on regular and significant taxable income generation, a high dividend strategy is *tax inefficient*, particularly in countries with higher tax rates for dividends.

In summary, a high dividend yield strategy possesses several virtues. It is simple, understandable and appeals to many investors’ innate desire to leave their capital untouched. It also has the potential of outperforming the market with less volatility.

However, on an absolute basis, its returns have lagged other value strategies. Viewed through a risk-adjusted prism, its reduced volatility comes at a cost of lower returns. High income earners and wealthy individuals, in particular, may be disadvantaged by a high dividend yield strategy. By triggering immediate taxes on unneeded income, they are creating an unnecessary tax drag on wealth accumulation.

In general, investors, particularly taxable ones, would be better off creating a stream of cash flow through a systematic withdrawal program from a portfolio that seeks higher returns from other value strategies rather than relying solely on a high dividend yield strategy.

September 30, 2012

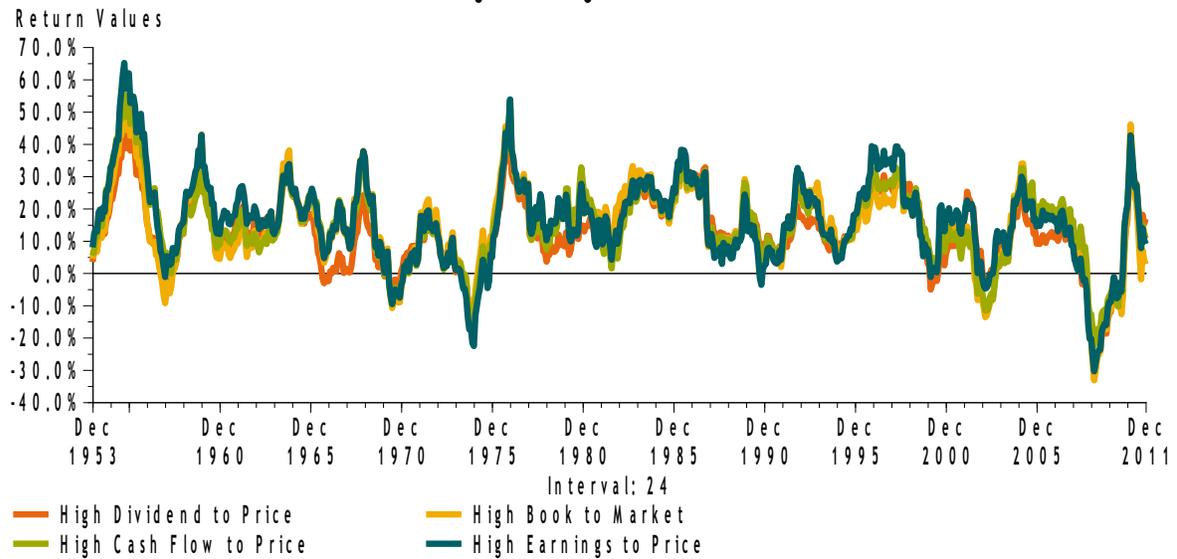
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APPENDIX

TABLE I

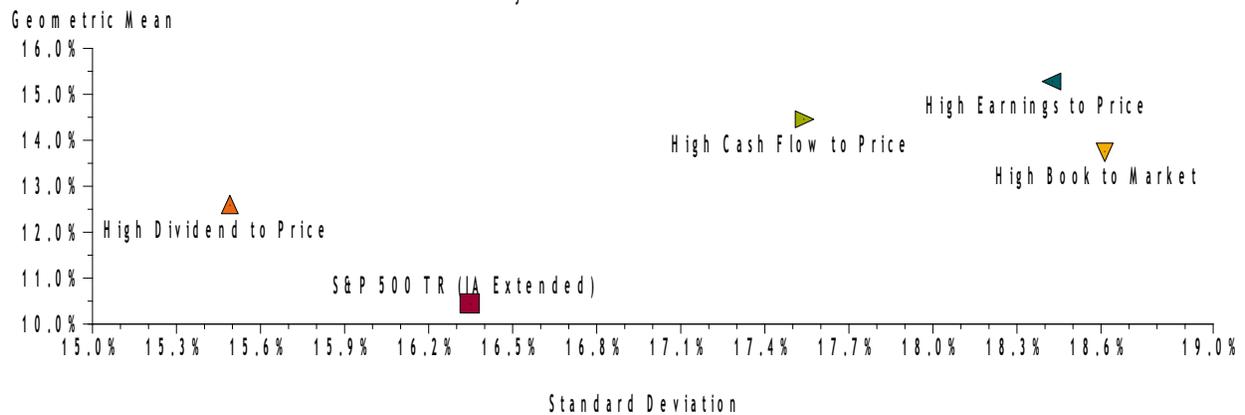
24 Month Rolling Average Annualized Return



Source: Tacita Capital based on Ken French's data

TABLE II

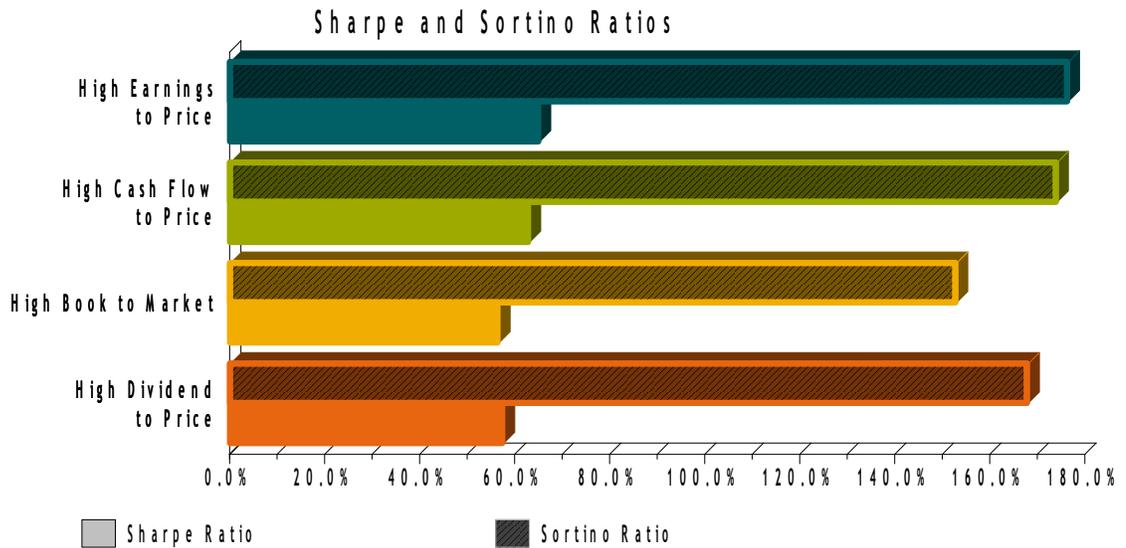
Return vs. Risk
January 1952 - December 2011



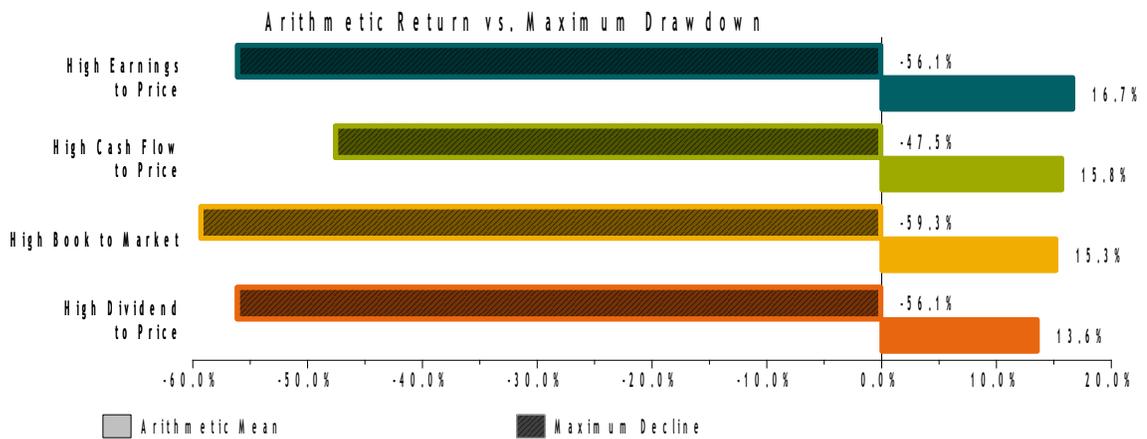
Source: Tacita Capital based on Ken French's data



TABLE III



Source: Tacita Capital based on Ken French's data



Source: Tacita Capital based on Ken French's data



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ⁱ The high dividend yield portfolio was created using data from Professor Ken French’s website at http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html. The high dividend portfolio is based on the top 30% of capitalization weighted dividend paying stocks rebalanced annually.

ⁱⁱ *Credit Suisse Global Investment Returns Yearbook 2011*. February 2011. Credit Suisse Research Institute.

ⁱⁱⁱ All portfolios were created using data from Professor Ken French’s website based on the top 30% of capitalization weighted stocks measured on earnings to price, cash flow to price, and book to market value.

^{iv} Fama, Eugene F. and French, Kenneth R., Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay? (June 2000). AFA 2001 New Orleans; CRSP Working Paper No. 509. Available at SSRN: <http://ssrn.com/abstract=203092>

^v Chan, Louis K., and Josef Lakonishok, 2004, “Value and growth investing: Review and update”. *Financial Analysts Journal*, vol. 60, no. 1, pp. 71-86.

^{vi} Davis, Jim L., and Inmoo Lee, “*Defining Value and Growth: Implications for Returns and Turnover*,” Dimensional Fund Advisors White Paper, 2008.