The Stan Clark Financial Team's

PERSPECTIVES

An excerpt from "Perspectives" - Volume 6 – Issue 10

Asset Allocation

Changing thoughts on dividend payouts

By Michael Chu, Investment Advisor

Dividends are a big part of the total return for stocks. Today, with interest rates so low, many investors are focusing more on dividends. In this issue, let's look at how dividends are related to company earnings – and how this relationship has changed over time.

Companies are in business to earn profits. When a company earns profit, it must decide how much of this profit to pay out to shareholders in the form of dividends. This also determines how much profit it will keep to re-invest for growth. The percentage of a company's earnings that it pays in dividends is called the payout ratio.

As you can see in the chart, the payout ratio has varied quite a bit over the past 130 years. For the 70 years before 1950, the payout ratio averaged 68% of earnings. In other words, for every dollar of profit, companies paid out 68 cents in dividends and retained 32 cents to help them grow. During the 1930s, the payout ratio rose to over 80%.

But the thinking on dividends started to change in the '40s and '50s as a trend towards lower dividend payout ratios started to form. The post-World War II economy had improved for nearly a decade and the Baby Boom was in full swing. Consumers and businesses were full of confidence, resulting in higher expectations for growth. Also, the tax environment of the time created a strong preference for capital gains over dividends.

The thought process was like this. Suppose a company has growth opportunities and needs capital to fund that growth. Rather than borrowing the money or issuing more shares, why not just retain more of its earnings instead of paying them out as dividends? This would help the company's value grow more quickly. From a tax standpoint, if a company pays out a dividend, all of its shareholders will need to pay tax on it – even those who don't need the income. If any shareholders need more income, they could just sell some of their shares, thereby unlocking some of the increased value in the form of capital gains.

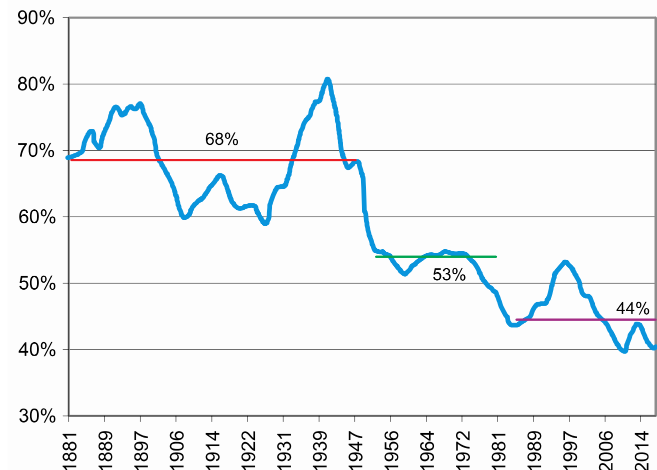
Warren Buffett has taken this approach. His company generates a lot of cash, but has never paid a dividend.

Since the 1950s, as you see in the chart, the dividend payout ratio has steadily declined. It averaged 53% in the 30 years following. And then, in the 30 years after that, the payout ratio declined to 44%. In the last 10 years, the payout ratio has declined even more, to just 39%. Earnings reached record highs in 2014, but many companies opted to build cash reserves rather than increase dividends. In 2014, the dividend payout ratio was only 36%.

Corporate cash reserves are now at very high levels, but there is little value in increasing them further. If the next five to 10 years present lower growth opportunities to companies because of a slower economy, they will have little need to retain more earnings to fund growth. Based on history, there is a lot of room to increase the payout ratio, and there is certainly a demand from shareholders too. Some companies that didn't pay dividends before have started to. Perhaps this trend will spread to other companies, as well.

Looking ahead, some of the best returns to shareholders might come from companies that currently have little or no dividends. These companies may choose to start or increase their dividends. In a slow-growth, low-interest-rate environment, this might be the best path for companies to increase both their share price and the total return for their shareholders.

Michael Chu is an Investment Advisor for the Stan Clark Financial Team at CIBC Wood Gundy. Michael is a specialist in investment research and information technology.



Source: Robert J. Schiller

The Stan Clark Financial Team
Where planning, investing and behavioral finance meet

Phone: (604) 641-4361 Toll free: 1 (800) 661-9442 Fax: (604) 608-5211 Email: StanClarkFinancialTeam@cibc.ca www.stanclark.ca

Stan Clark is an Investment Advisor with CIBC Wood Gundy in Vancouver, BC. The views of Stan Clark do not necessarily reflect those of CIBC World Markets Inc. This information, including any opinion, is based on various sources believed to be reliable, but its accuracy cannot be guaranteed and is subject to change. Clients are advised to seek advice regarding their particular circumstances from their personal tax and legal advisors.
If you are currently a CIBC Wood Gundy client, please contact your Investment Advisor. CIBC Wood Gundy is a division of CIBC World Markets Inc., a subsidiary of CIBC and a Member of the Canadian Investor Protection Fund and Investment Industry Regulatory Organization of Canada.