The Stan Clark Financial Team's

# PERSPECTIVES

*An excerpt from "Perspectives" - Volume 11 - Issue 6*

Investing

## Behind the Numbers: Dividend yield (part three)

*By Michael Chu, Investment Advisor*

**Like the price-to-earnings (P/E) ratio we've discussed earlier, the *dividend yield* is another traditional measure of value. The dividend yield is a stock's annual dividend, divided by the stock price. For example, if a stock has an annual dividend of $1 and the stock price is $20, then the dividend yield is 5%.**

All else being equal, a higher dividend yield means a cheaper valuation and a lower yield means a more expensive valuation. Let's say you are comparing two stocks. Stock A is priced at $20 and pays $1 in dividends; stock B is priced at $40 and pays $3 in dividends. Which one is cheaper? The dividend yield for stock A is 1/20 = 5% and stock B is 3/40 = 7.5%. So based on dividend yield, we see that stock B is the better deal as it pays more income per dollar.

The dividend yield has a special advantage over other value measures, because it is highly objective. Dividends are either paid or not – no matter what the accounting standards are. That means the dividend yield cannot be swayed or manipulated.

High-dividend-yielding stocks are usually out of favour. That's why they are cheap, selling at a lower price relative to their dividends. This good value is attractive for investors, which eventually brings the stocks back into favour, resulting in a higher price.

Numerous academic studies discuss the results of using dividend yield to choose stocks. For example, in an 83-year study[1] from 1926 to 2009, stocks were divided into 10 groups, based on dividend yield. The research showed that high-dividend stocks had returns of 11.8%, while low-dividend stocks had returns of 9.7%. The market average during this time was 10.5%. Those results, from choosing stocks based only on dividend yield, show that high-dividend-yielding stocks outperformed low-dividend-yielding stocks. Furthermore, high-dividend-yielding stocks also outperformed the market.

So far in this series, we've covered two value measures: price-to-earnings and dividend yield. The results from long-term studies show the advantage of buying low P/E stocks or high-dividend-yielding stocks. But the results get even better when we combine the two measures and look for stocks that have both good P/E *and* good dividend yields. Actually, we take it even further. By adding a few more variables, we get the best long-term results: above-average returns with lower-than-average risk. We have less risk because having more variables gives us more consistent results.

Basically, that's how we create our stock strategies. We use variables that show positive value and also make sense. Then we test the combinations of the variables in long-term studies. For instance, our Canadian High Yield strategy looks at dividend yields. But it also includes some momentum factors to help ensure that a stock is trending reasonably well so that it's not falling more out of favour.

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In summary, value strategies work, rewarding patient investors who stick with them. But it's the sticking-with-it part that sometimes can be hard. Despite the good long-term track record, in the short term, strategies can underperform for many consecutive years. People also tend to like glamour stocks and their sizzling growth stories rather than boring dividend yields. Glamour stocks are typically more expensive, making them harder to justify. That being said, there's a place for certain types of higher-growth stocks. We'll talk about that next time. ■

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