The Stan Clark Financial Team's

PERSPECTIVES

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Investing

What's more important: dividends or earnings?

By Michael Chu - Investment Advisor

Everyone likes dividends – mostly because you are getting paid. But it's also useful to find cheap companies to invest in.

Unquestionably, dividends are a great indicator of value. They have some other good qualities, too. It's difficult to manipulate the variable since you are either paid or you are not. And dividends also provide some downside protection by appealing to income-oriented investors.

But are dividends more important than company earnings? After all, dividends come from earnings. Dividends are the portion of earnings that management decides to pay out to shareholders. The rest of the earnings are re-invested into the company. More earnings usually mean more dividends. Conversely, lower earnings usually mean lower dividends. So, while everyone likes dividends, earnings are more important since they dictate the dividend.

Companies that pay a lot in dividends tend to be larger and more established, with stable earnings. These companies typically don't need all their earnings re-invested into the company because usually the growth prospects are not that high. They can afford to pay out more of their earnings in dividends. Examples of these types of companies would be banks, telecom and utilities. On the other hand, high-growth companies usually need all their income re-invested back into the business. That way they can grow their business and generate more income. For example, an emerging high-tech company would typically not pay a dividend.

So, what type of company makes a better investment: established dividend payer or high growth? Well, the answer is both. Each type of company has its distinct characteristics and advantages; each has a place in your portfolio.

We all like receiving income, but shouldn't place too much emphasis on it. Instead, we should focus on total return. As shown below, total return is the total of dividends and price appreciation. A low or no dividend stock can have a higher total return than a high dividend paying stock. Of course, the reverse can just as easily be true. The point is that a stock shouldn't be shunned or favoured based solely on dividends. It can have many other attractive features to compensate for the low dividend.

	Dividends		2%
+	Price appreciation	+	10%
=	Total return	=	12% ←

You might need income from stocks and really favour dividends. But why not just sell a portion of your stocks? It's the same thing, really. Let's say there are two identical companies, except that company A pays no dividend and company B pays all its earnings in dividends. As you'll see below, both stocks are $10 and have earnings of $1. Company A keeps the $1 earnings to re-invest in the company, so it should be worth $11. Company B paid out the $1 as dividends. But what happens after the payment? All else being the same, company B is worth $10 still, because of the payout. If owners of company A want some income, they can sell a portion, say $1 worth. In the end, both shareholders are in the same boat: Each has $10 worth of stock and $1 of cash. In a sense, you can create your own dividend policy by selling shares or re-investing dividends into more shares.

	Company A		Company B
1) Starting Price	$10		$10
2) Earnings	$1		$1
3) Dividends	$0		$1
4) Ending Price	$11		$10
5)	Sell $1 of stock		
6) Total	$10 stock plus $1 cash	=	$10 stock plus $1 cash

Earnings are less stable than dividends. But earnings are the real driver behind stock prices. So, we're not saying don't look at dividends; just don't overly focus on them. The best investment approach is to select the companies with the best overall characteristics. This will give you the most total return. Then you can decide how much or how little income you want to pay yourself and how much you want to keep invested. ■

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

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