

# High Dividend Investing – The Importance of Dividends for Shareholder Return



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During recent years, investors were confronted with an ever increasing number of active and passive investment strategies competing for their money. As a result of the financial crisis and the following search for yield, Dividend investing is one strategy which benefited from a particular increase in investor attention due to its quality bias and ability to generate more predictable income in a low-growth, low-yield environment.

While the strategy receives increased coverage in the media as of late, its origins trace back to the concept of value investing, introduced by Benjamin Graham and David Dodd in 1934. The main idea of value investing relates to the application of fundamental analysis to identify stocks that trade below their intrinsic valuation. Since its inception, value investing was the subject of a vast amount of academic research, which allows for the conclusion that the strategy leads to significant long-term outperformance.

In this context, dividend investing can best be described as a specific application of the concept of value investing with a specific focus on dividends. This

approach has a variety of advantages due to the unique nature of dividends.

Firstly, while fixed-income investors have a contractual right to receive interest on their borrowings, investors in equities lack this form of secured return. One way by which companies can return money to investors and effectively provide a compensation for risk-taking is the payment of dividends. Differently to changes in stock price, dividend payments are a repeating and positive source of return to investors. When looking at the historical contribution to total shareholder return (fig. 1), one can see that dividends and dividend growth represent most of the return earned by investors over the period.

Secondly, dividends act as an effective tool to overcome agency problems acting against the interest of current shareholders. As subjected in a variety of management literature and commercial media, incentive structures within companies have an important influence on performance. The existence of a strong dividend policy is effectively limiting the cash flow at the discretion of management and thereby enforces discipline to put remaining funds to their most productive use. Furthermore, the likelihood that management, unrestrained in its activities, turns to empire building or wasteful M&A activities is limited.

Thirdly, the focus on dividends has a mitigating effect on overall portfolio volatility, which improves the strategy's risk/return profile. This reduction is related to a reduced sensitivity of high yielding stocks to changes in market interest rates. Considering that the duration of cash flows to investors is the lower the higher the yield, an effective value protection is put into place reducing investor risk. In addition, the risk profile is asymmetric, providing downside protection without putting much limitation on upside participation.

This risk-reducing impact of dividends has further benefits to investors. While common perception dictates that higher dividend payouts by com-

panies are inevitably linked to lower future growth rates, empirical evidence suggests the contrary. There are however different possible explanations – other than management discipline – for the finding that high-dividends companies are experiencing above-average growth rates. One explanation links dividend payments to management's expectations of the future, implying low payout ratios are an implicit acknowledgement that future growth opportunities are limited. Another one assumes predictive power of dividends as a result of dividend stickiness and earnings volatility. Independently of the reasoning however, the positive impact of dividends on future growth is reliably documented and provides additional benefits to high-dividend strategies.

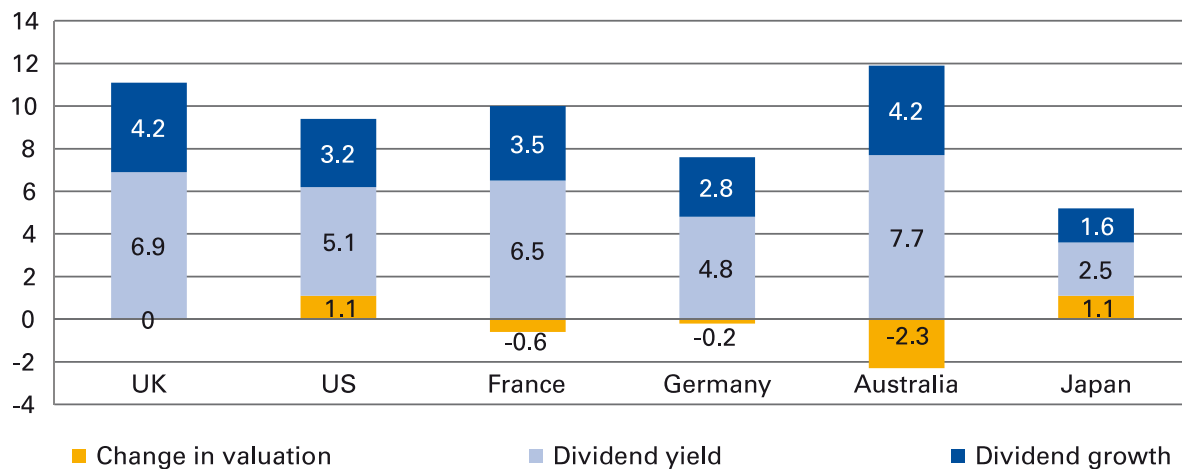
In general, high-dividend strategies aim to generate outperformance for investors while reducing overall portfolio risk. These attractive characteristics make the strategy an interesting alternative to classical investment products and explain the strong interest during recent years.

While these benefits of dividend-centric strategies are extensively documented in the academic literature, the value added of active management remains questioned by some investors. Considering the simplicity of the idea itself, one might ask what additional benefits active portfolio management can add.

To answer this question, it is important to look at the performance of active vs. passive dividend products as well as their respective risk profiles. One of the major drawbacks of passive investments in the high-dividend space is the extremely low diversification that is achieved on a sector level. Due to the nature of certain industries, rule-based dividend strategies tend to show increased concentration in certain high yielding sectors such as financial services.

Furthermore, a differentiated investment process has the potential to add significant benefits to a fund's return profile by adding an additional layer of

**Figure 1: Nominal return components**



Source: SocGen 2012

fundamental analysis on the dividend strategy.

The importance of dividends and their sustainability remain thereby essential cornerstones of the portfolio construction. However, differently to purely passive, rule-based approaches, a focus on companies trading below their estimated intrinsic valuation allows to draw upon the essential elements of value investing.

These benefits become obvious when comparing the performance of the ING IM Euro High Dividend fund to that of the largest ETF – the iShares Euro Dividend (fig. 2). The comparison underlines the benefits resulting of

a more dedicated investment process ensuring performance to be replicable and sustainable. High volatility as found in dividend ETFs can largely be avoided due to a broader allocation among different industry sectors as defined by a stringent risk-management policy capping maximum sector weights.

**Conclusion**

The use of dividends as essential investment criteria adds significant benefits to investors:

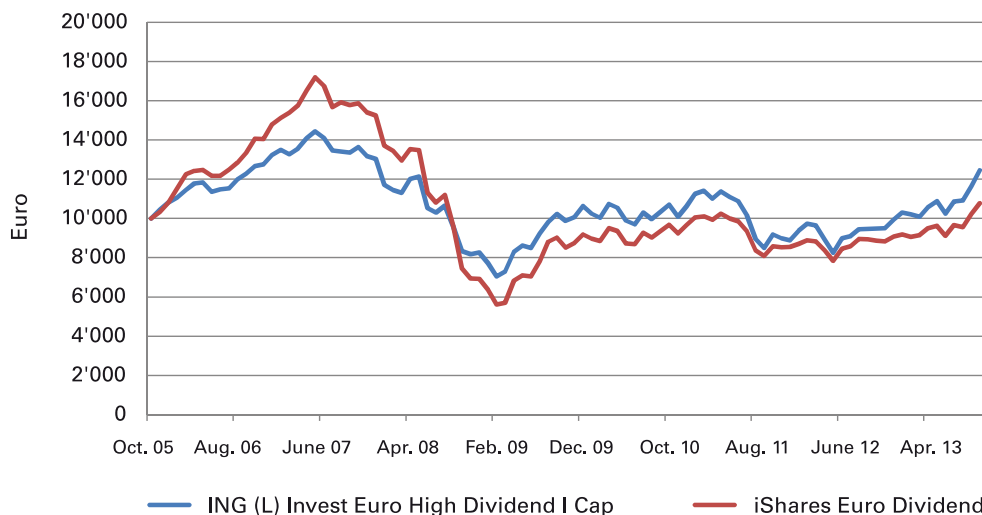
- Dividends are the main provider of equity investors’ return.
- Dividends effectively discipline the use of capital and resources.

- Companies with higher and stable dividend payments experience above-average growth.
- Focus on dividends reduces volatility in an equity investment.

However, the importance of an adaptive and disciplined process is essential to the successful implementation of a high-dividend investment strategy. Only an experienced active manager who combines quantitative filtering with fundamental analysis provides superior risk-adjusted investment results.

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**Figure 2: Active versus passive management**



Source: Morningstar