Morgan Stanley

Why Dividends Matter

Christopher F. Poch, Private Wealth Advisor

"... (The true investor) will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies."

- Benjamin Graham
World Commodities and World Currencies, 1944, p. 42

In over 33 years in the wealth management industry, I have seen what works for the long-term, tax paying investor.

The importance of dividends and the contribution to overall total return, for new and experienced investors alike, should not be overlooked. Portfolios focusing on growing dividends can deliver strong long-term returns regardless of the market cycle. Dividend paying companies, in general, tend to be higher quality with stronger balance sheets than non-dividend paying companies[i].

Not only do dividend stocks as a group have less volatility year- to- year, they outperform non-dividend paying stocks over time as well[ii]. During bull markets, investors often forget that total return comes from two sources: Dividends and price appreciation. We believe that today quality companies trade at more reasonable valuations than the market as a whole.

Dividends Account for 40%+ of Total Return

In fact, over the last 90+ years, dividends have accounted for more than 40% of the total return equation.

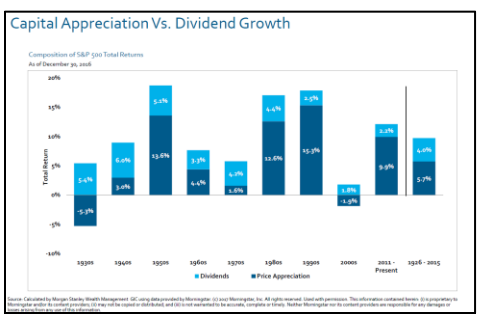

Exhibit 1[iii]

Investors who focus solely on price appreciation are implicitly pegging their total return only to the price change of the stocks they own. However, as history reveals, this can lead to disappointing results for investors over long time frames. With equity prices hovering near all-time highs, investors could be disappointed with price returns over the next ten years. I believe a better approach for large cap allocations may be to own companies that focus on growing their cash flows, increasing dividends and repurchasing shares.

Dividends Paying Stocks vs. Non-paying

A recent study by Factset shows that dividend paying stocks outperform their non-paying counterparts by a dramatic amount. From 1991 through 2015, non-dividend paying stocks earned just +4.18% return per year while dividend paying stocks significantly outperformed with a +9.7% average annual return.

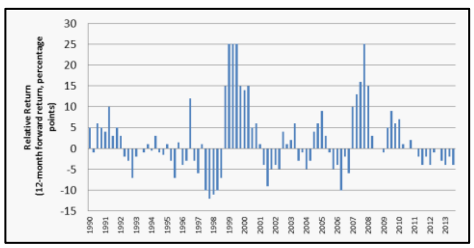

Exhibit 2[iv]

Increasing Dividend Paying Stocks Outperformed

Those that paid a dividend and raised it year after year outperformed the benchmark in 17 of the 23 years.

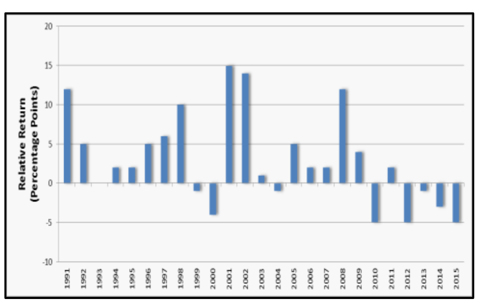

Exhibit 3[v]

Rising Dividends, Moderate Payout

The *sweet spot* for dividend investing, in my opinion, seems to be at the intersection of companies increasing their dividend with the dividend representing a conservative but meaningful payout and yield.

When selecting dividend-paying stocks, I believe it is important to focus on these critical data points:

- Current yield vs. historic average yield
- Dividend payout ratio (dividends per share versus earnings per share)
- Annual earnings growth compared to annual dividend growth
- Quality of dividend sources

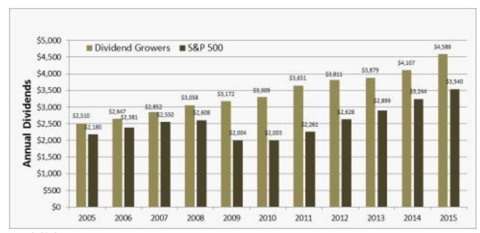

Exhibit 4[vi]

Dividends Can Be a Defensive Tool

With tens of billions of dollars trading hands every day on the New York Stock Exchange alone, it's easy to lose sight that when purchasing a stock investors are effectively purchasing ownership interest in a business. Assume for a moment that you don't get a quote every day for your shares in that business and that you can't sell your ownership interest for several decades. Your focus would likely shift from price to value.

And the value of that business, whether publicly traded or privately held, is the present value of all future cash flows. After all, what is the point in owning a business – or any investment – if you're never going to receive any cash from it? When a company generates positive free cash flow, it has several options; the company can hold cash in reserve, fund organic growth, make acquisitions, pay down debt, or return it to shareholders through dividends or stock buybacks.

Many growth investors might view dividend payments negatively in lieu of earnings retention. But in a more risk-averse investing climate, dividend payments offer an advantageous method of returning value to shareholders. Shareholders, just like any owner, should be concerned about maximizing long-term value, not short-term earnings per share.

Dividends are Regaining Popularity

Below, the graph on the left shows that the S&P 500 forward earnings are estimated to be 5.9% while the 10 year Treasury bond is approximately 2.4%. The chart on the right shows the dividend payout ratio has been below 40% while the dividend growth rate has been 6.5%.

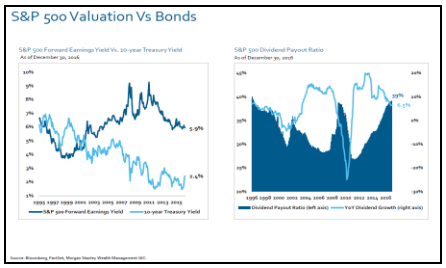

Exhibit 5[vii]

One should expect the price of dividend stocks to be more volatile than bonds. However, for investors who can withstand the volatility, the combination of moderate dividend payout and growing dividends can be an attractive choice.

Still, Dividend Investing is Not Simple

As dividends have once again become more popular, some companies are initiating dividends in hopes of attracting investors. Some companies are doing so by borrowing to pay the dividend while others are growing their dividend faster than earnings are growing – which is unsustainable over the long-term. Companies that do that for too long may be forced to cut the dividend and usually concurrently experience a significant drop in price.

Dividend investing is not as simple as selecting the highest yielding stock with the fastest short-term dividend growth. We posit that fundamental analysis is required and therefore active management is best for dividend strategies.

The Bottom Line

Dividend investing is not new but it has recently come back into vogue. Historically, dividend-paying stocks have outpaced the performance of non-dividend paying stocks – and have done so with lower volatility.[viii]

We believe dividend investing, under the framework of stocks with conservative but meaningful payout ratios and yields – with strong track records and future prospects of rising payouts – offers potential value in an environment where many assets are at or above fair value. Low interest rates, strong corporate balance sheets, and investor demand should help this trend continue.

Christopher F. Poch, Private Wealth Advisor is the author of numerous articles and publications on investing. He has managed international private banking units, advised billionaires and heads of state, has been the chief executive of a trust company, and founded the industry leading UHNW platform.

Mr. Poch advises private clients and family offices.

christopher.f.poch@morganstanleypwm.com
1850 K St. NW, Suite 900
Washington, DC 20006
w. 202-862-2861
m. 202-557-8801

---

[i] Jeremy Siegel, "The Future For Investors", page 126, Random House 2005

[ii] IBID

[iii] Source: Calculated by Morgan Stanley Wealth Management GIC using data provided by Morningstar. (c) 2017 Morningstar, Inc. All rights reserved. Used with permission. This information contained herein: (i) is proprietary to Morningstar and/or its content providers;(ii) may not be copied or distributed; and (iii) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information.

[iv] Source: FactSet, Fidelity Investments, as of Dec. 31, 2015. https://www.forbes.com/sites/fidelity/2016/03/24/how-to-pick-dividend-stocks/#617e16808c2d. This is a hypothetical portfolio of low debt, high dividend yield stocks which outperformed by an average of about two percentage points annually, and bested the benchmark about half the time.

[v] ibid. This is a hypothetical portfolio made up of companies within the S&P500 that increased their dividends and their performance compared to the S&P500.

[vi] Standard & Poor's. Dividend growers represented by the S&P 900 10-Year Dividend Growth Index. Over this time period the companies in this index outperformed the S&P500 index.

[vii] Bloomberg, FactSet, Morgan Stanley Wealth Management GIC. Past performance is no guarantee of future performance. Estimates of future performance are based on assumptions that may not be realized. This material is not a solicitation of any offer to buy or sell and security or other financial instrument or to participate in any trading strategy. Please refer to important information, disclosures and qualifications at the end of this material. This slide sourced from Market Performance section.

[viii] Westcore Global Dividend Growth

Clarifi, Compustat

Exhibit 3 (as of 12/31/2015): Treynor Ratio

	Return	Beta
Non-Dividend Payers	6.89%	1.16
Russell 1000® Index	10.44%	0.64
Dividend Payers	10.62%	0.82
Divided Growers	11.20%	0.79
Consistent CF Generators	11.54%	0.64
90-Day T-Bill	3.26%	
