The End of Dividend-Investing Strategies?

Description

Despite the stellar longer-term performance of dividend-based investment strategies, these strategies have underperformed the broader equity market indices over the past 18-24 months in both Canada and the U.S.

The table below indicates the excellent longer-term but lagging short-term performance of the **S&P Canadian Dividend Aristocrats Index** (^GSPTXDV) compared to that of the broader Canadian market on a total return basis (capital appreciation plus dividend income).

Index	Returns (year to date)	Returns (1 yr.)	Annual Returns (10 yrs.)
S&P/TSX Dividend Aristocrats Total Return	10.3%	18.2%	12.1%
S&P/TSX 60 Total Return	14.2%	22.8%	9.0%

Source: S&P Dow Jones Indices.

Higher long-term interest rates are causing the damage

Despite considerable fluctuations, longer-term interest rates have steadily been moving higher since mid-2012, when Canadian 10-year yields were as low as 1.60% compared to the current level of around 2.17%. The upward movement in bond yields also roughly coincided with the start of the underperformance of the broad-based Dividend Aristocrats Index as investors started to factor in the possibility of interest rates normalising, making dividend-based investing relatively less attractive.

Is this the end of dividend-based investing strategies?

As demonstrated in the table above, dividend-based strategies have experienced a very strong relative performance in Canada and the U.S. for at least the past 10 years. The question now is whether the recent underperformance of dividend strategies will continue as interest rates normalise.

The answer is “perhaps,” but, fortunately, dividend-seeking investors do not need to agonise too much over that question. The longer-term attraction of dividend-based investment strategies is pervasive. Consider the following:

- Over the past 100 years, $1 invested in the U.S equity market and held for the entire period became $152. Including dividend payments reinvested back in the market, the outcome was $9,435.
- Evidence from the U.S market indicates that dividends contributed around 50% of the total market return over the past 100 years.
- Volatility (risk) associated with dividend-paying stocks is less than the wider market.
- Dividend payments are more stable than company profits as boards are normally reluctant to reduce or pass dividend payments once established.

Apart from the longer-term advantages, dividend-based investment strategies remain an attractive option in an investment environment where Canadian bank deposits provide yields of less than 2% and 10-year government bonds only slightly more.

High-quality corporations with a starting dividend yield of 2.5% or higher that pay a consistent and growing dividend should provide a much better return when compared to current cash or bond pricing.

High-quality dividend champions still available at relatively attractive prices

Telus (TSX: T)(NYSE: TU) has a great track record of growing dividend payments (+12% per year over the past five years), a solid balance sheet, and excellent free cash flow generation leading to a comfortable dividend cover. The dividend yield on the stock is currently 3.8%, which is in line with the average and still considerably higher than the yield on the 10-year Canadian government bond of 2.25%. Also, take into account that the dividend should continue to grow while the income from a government bond will not.

The second example is **Toronto-Dominion Bank** (TSX: TD)(NYSE: TD), which also has an excellent dividend-paying track record (+10% per year over the past five years), is well capitalised, and has good levels of profitability. The stock is trading at a dividend yield of 3.24% with the potential for ongoing growth in the dividend payment. It looks like a better deal than a government bond.

No end in sight

Dividend-based investment strategies can produce great investment results for the patient investor. Despite the possibility of a temporary respite in relative performance, I do not believe this century-old phenomenon will produce inferior results over the longer haul.

CATEGORY

1. Bank Stocks
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2. NYSE:TU (TELUS)
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