How Bank of Nova Scotia's 3.6% Yield Grew to 8.5%

Description

We all know the Canadian banks are solid, stable investments, and they pay out excellent dividends. But just how good are their dividends? We'll use **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) as an example here.

Recent performance and actual valuation

If you're relatively new to investing, you might be pouting about missing Bank of Nova Scotia shares at the recent August low of $56. Today it has risen over 7% and is priced at $60. But that's just the recent price action.

In reality, the Canadian bank is still relatively cheap compared with historical valuation levels.

The bank is trading around a multiple of 10.5, while it normally trades at a multiple of 12.3; that implies a fair value estimate of $68.50. So, the shares are still roughly 12% discounted. For a business that has paid dividends for more than 180 years, it's a pretty good deal.

The power of dividend growth: a 3.6% yield in 2004 to 8.5% in 2015

From 2004 to 2014, the bank managed to increase dividends by a compound annual growth rate of 9%. So, if you bought shares in 2004, by 2014 your income from dividends would have more than doubled. Assuming you'd received $100 from Bank of Nova Scotia in 2004, your income would have climbed to $236.7 by 2014.

Actually, at the start of 2004, Bank of Nova Scotia cost $33 per share, and its annual payout was $1.60 per share. So, you would have needed to buy 63 shares, or invest $2,079, to get $100 per year.

If you had held the shares until the end of 2014, you would have received $21.19 per share of dividends over a period of 10 years. You would have gotten back 64% of your initial investment.

Bank of Nova Scotia now pays a 70 cent quarterly dividend. Plus, the shares are worth over $60 today, or close to $3,800. So, your investment would have gone up over 81% if you held on to your shares.

Based on your initial investment of $33 per share, the bank now pays a yield of 8.5%.

What drives dividend growth?

Ultimately, healthy dividends are supported by earnings. From 2004 to 2014, Bank of Nova Scotia's earnings per share increased steadily from $2.82 to $5.72, a compound annual growth rate of 7.3%.

Solid dividend payers also only pay out a portion of their earnings as dividends. In 2004, Bank of Nova Scotia's payout ratio was 39%. It only paid out 39% of its earnings as dividends at the time. In 2014, the bank paid out 45% of earnings. So, it retained 55% of earnings to grow the business.

To summarize

By buying and holding shares of quality dividend payers over the long term, you allow time for compounding to work.

The concept of compounding works on any quality investment that becomes more valuable over time. Today, with roughly a 12% discount in its shares, it's not a bad time to start buying Bank of Nova Scotia shares.

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