Dividends vs. Capital Growth

Description

Dividends are often misunderstood. Many investors view them as something which only a mature company that has run out of growth ideas will pay. Such investors may feel that dividends are only of real use for retirees who are living off the income return of their investments. However, this is not the case. Dividends provide an indication of the financial health of a business, its valuation and can act as a catalyst on future share price growth.

In terms of the financial health of a business, dividends show that a company's management team is confident about its future outlook. A company which is raising dividends each year and is increasing the proportion of profit paid out to shareholders is generally one which has a stable long term outlook. In other words, the company does not require 100% of the cash generated by operating activities in order to survive and prosper.

Similarly, a reduction in dividends or even a cancellation can show that a company's financial situation is about to worsen. This could be due to internal or external factors, but in any case it tends to provide evidence that falling profitability and even losses could be just around the corner. Even studying a balance sheet and other financial statements may fail to indicate a company's challenging situation to the same extent as a falling dividend does.

Dividends also provide guidance on the valuation of a company relative to its peers. For example, a company which has a 4% yield while its sector peers have yields of 3% could easily rise by a third so as to bring its yield into line with sector peers. While the dividend yield is not a particularly popular method of ascertaining a company's value, like the P/E ratio it provides a quick and easy guide which can be applied to a range of industries across all geographies of the world.

Increasing dividends can also act as a positive catalyst on a company's share price. A dividend which rises at a faster pace than earnings indicates that the company's financial performance is about to improve by a greater amount than the market currently anticipates. Similarly, a dividend which rises at a faster pace than inflation can cause the company in question to become more appealing to investors concerned about rises in the price level. A fast growing dividend also often indicates strong cash flow, which is a sign of higher quality earnings.

While dividends may be categorised as somewhat dull and only of interest to retirees, the reality is that they provide a quick and simple means of assessing the financial strength, performance and valuation of a company, wherever it operates and whatever industry it is focused on. Few investment metrics tell investors as much as a dividend about these three things, which means that dividends are worthy of consideration for investors seeking growth and income alike.

CATEGORY

1. Investing

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