



## Do Dividends Really Matter?

### Description

The topic of dividends has become hugely popular in recent years. Low interest rates across the globe have led to a more challenging environment for income seeking investors. Therefore, shares paying generous dividends have in turn become more popular. But is this popularity misplaced? Are dividends nothing more than a psychological boost to a company's investors?

### The theory

In theory, dividends do not matter. This may sound counterintuitive, but the fact is whether cash is paid out as a dividend or retained within a business, the end result is the same. This assumes, of course, that a company's valuation increases when cash is held rather than paid out as a dividend. It also assumes that the increase in its valuation is the same as the income return would have been if the cash had been paid out to shareholders.

In such a scenario, investors seeking an income from their shares could simply sell a portion of their holding. This would provide them with cash and the value of their investment would be the same as if they had received a dividend. That's because the company's share price will have risen to reflect the retention of cash, thereby providing a small profit for the investor which equals the dividend yield.

Furthermore, it could be argued that retaining cash rather than paying dividends is a more efficient means of distributing capital. Most businesses can find a profitable means of deploying cash and in many cases this will be a superior allocation of capital than that achieved by the investor. Therefore, failing to pay dividends could lead to higher profits for an investor in the long run.

### The practice

In practice, though, things do not quite work out as above. For starters, markets are relatively inefficient, so the retention of capital is unlikely to lead to a rise in a company's share price which equals what would be the dividend yield. As such, selling shares to replicate a dividend payment if cash is retained by the company would be unlikely to leave an investor with the same investment position as if a dividend had been paid.

In addition, it could be argued that the payment of a dividend is much more than simply providing investors with an income. It signifies financial strength in the eyes of many investors, as well as management confidence in the future of the business. This can lead to higher valuations for dividend paying stocks, as well as increased popularity due to the demand from income hungry investors.

## The takeaway

Dividend stocks have been popular in recent years due in part to low interest rates across the developed world. However, as Central Banks become increasingly hawkish, their popularity could begin to wane. Despite this, dividend paying stocks will always be relatively valuable, since they provide an insight into management's view of the company's future. They also display a company's financial strength and therefore remain an area which long term investors should focus upon.

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