3 Reasons Why Dividends Matter

Description

The debate continues to rage as to whether or not dividends should really matter for investors. Some pundits view dividends in a negative light, seeing them as a leakage of capital that could be better used by being retained and invested in the business. This, they claim, represents a far more efficient use of a company's excess earnings and will deliver a superior return for investors.

While there may certainly be some truth to these sentiments, dividends in practice are far more important than many pundits believe.

Now what?

Firstly, dividends signal a company's financial strength and stability.

Those companies that pay regular, steadily growing dividends typically have reliable cash flows, mature businesses, and a strong competitive advantage. These characteristics give companies the ability to keep profits high, fend off rivals, and ensure they are resilient to economic downturns.

default watermark

Some of the best dividend-paying stocks are those that operate in industries where demand for their products and services remains relatively inelastic regardless of the state of the economy.

An example of this is **Canadian National Railway Company** (TSX:CNR)(NYSE:CNI). It operates one of North America's few transcontinental railways, giving it unique access to a wide range of internal markets and a large portion of the population. The rail industry has steep barriers to entry, endowing Canadian National with a wide economic moat that protects its earnings.

These factors when coupled with rail being the only cost-effective means of bulk freight transportation mean that Canadian National's earnings growth is virtually guaranteed. For these reasons, it has been able to hike its dividend for an impressive 17 years straight.

Secondly, dividends are an important tool for promoting discipline and good corporate governance.

Studies demonstrate there is a distinct connection between good corporate governance and regular dividend payments. There is evidence that those companies which pay regular dividends use capital more efficiently and management is more focused on sustainable growth that will help to ensure the stability of the dividend.

Finally, dividends over the long term have been an important contributor to the total return generated by equities.

According to research from ratings agency Standard and Poor's, dividends make up over a third of the total returns of the **S&P TSX Composite Index**. This is such a huge chunk of returns that it is just far too big for investors to ignore.

Meanwhile, research from U.S. fund managers shows that over a 60-year period, dividends and reinvested dividends accounted for roughly 90% of the total returns of the **S&P 500 Index**.

These factors highlight that dividends are a key driver of long-term wealth creation.

Let's not forget that by reinvesting dividends, investors can enhance their returns by accessing the power of compounding. This becomes apparent when considering the performance of **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS).

Had an investor invested $10,000 in Bank of Nova Scotia 10 years ago and not reinvested the dividends, that investment would now be worth $18,690, which is a total return of 87%.

However, had they reinvested the dividends through the bank's dividend-reinvestment program, that investment would now be worth $21,064. This represents a total return of 111%, or 24% higher than the return generated when taking the dividends as cash, highlighting how dividend reinvesting can enhance returns over the long term.

So what?

By ignoring dividends, investors are limiting their ability to create wealth and achieve investing success. For these reasons and many more, I — like my fellow Fools — am a tremendous fan of dividend investing. Regular dividend payments and a company's means of increasing them are key indicators as to its financial health.

default watermark

More importantly, dividends not only enhance the opportunity for investors to successfully create wealth, but they also form a handy means of generating a reliable tax-effective income stream.

CATEGORY

1. Dividend Stocks
2. Investing

POST TAG

1. Editor's Choice

TICKERS GLOBAL

1. NYSE:BNS (The Bank of Nova Scotia)
2. NYSE:CNI (Canadian National Railway Company)
3. TSX:BNS (Bank Of Nova Scotia)
4. TSX:CNR (Canadian National Railway Company)

PARTNER-FEEDS

1. Msn
2. Yahoo CA

Category

1. Dividend Stocks
2. Investing

Tags

1. Editor's Choice

Date
2025/08/23
Date Created
2017/02/02
Author
mattdsmith

default watermark

default watermark