This Decision Could Have a Major Impact on Your Investment Performance

Description

The last decade has seen the world economy experience a period of deflation. If central banks across the globe had not pursued ultra-loose monetary policies, changes in the price level would have been likely to move into negative territory. As such, many investors have experienced positive real income returns from their shareholdings.

Looking ahead, global inflation is widely expected to move higher over the medium term. Although interest rate rises could keep it pegged back, the reality is that dividends may become much more important to investors in future. As such, the proportion of profit paid out as a dividend by companies may come under the spotlight and could act as a catalyst on share prices.

Payout ratios

Clearly, it is not possible for a company to pay out over 100% of net profit as a dividend in perpetuity. Some capital is required for reinvestment in future growth opportunities. How much depends largely on the maturity of the company and its operating environment.

For example, a business that is mature and which operates in a well-established industry may not require a significant amount of capital to be reinvested each year. This may allow it the freedom to increase its dividend payout ratio to a level which is close to 100% of profit. Likewise, a younger company which has high-growth opportunities may need to retain a large proportion of capital each year.

Balancing act

The ability of a company’s management to get the balance right between reinvestment and rewarding shareholders through a higher dividend may become more challenging in future. If inflation moves higher, investors may reward companies which are able to increase their payout ratios to relatively high levels. That’s because they may value dividends to a much higher extent than they have in the past, since obtaining a real return may become more difficult.

Company management may therefore have a decision to make. They could reinvest for the long-term health and growth potential of the business, but risk causing investor sentiment to decline in the short run. Or, they could increase the payout ratio and potentially see the share price rise, but with the opportunity cost of foregone avenues of growth. As such, obtaining a balance between investment and payout may become much more important, and also more difficult at the same time.

Looking ahead

The global economy could be entering a new phase where inflation takes on a more significant role. Investing in companies which have wiggle room when it comes to payout ratios may be a shrewd move, since a rise in payout ratio may act as a positive catalyst on investor sentiment and, ultimately, a company's share price.

Therefore, buying mature companies operating in mature industries that currently pay out a low proportion of profit as a dividend may be a shrewd move. They could realistically become the stocks which are seen as the most attractive in a new world of inflation, rather than deflation.

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