Are Dividends Irrelevant?

Description

Dividends are widely considered to be a long-term investor's best friend. Providing a steady supply of income irrespective of market moves, they can provide some stability in turbulent times. For some investors, dividends are ends in themselves: dividend growth investing is a philosophy that strives to maximize dividends by buying stocks that raise their payouts over time.

Not all investors are huge fans of dividends, however. Many growth investors will voluntarily sacrifice dividend income for the sake of high returns. In fact, there's an entire school of thought that says dividends don't matter at all. Though far from universally agreed on, this philosophy has gained some traction over the years.

It's important for any investor to know whether they'll aim for pure capital gains or a mix of income and gains. With that in mind, let's take a close up look at dividend irrelevance theory, and what it means for your portfolio.

Dividend irrelevance theory

Dividend irrelevance theory states that dividends have little effect on a stock's price. In more "hard" forms, it even argues that dividends can hold back total returns. Any money paid out in dividends is not being reinvested in growth, so there's definitely something to this. Big dividend yielders like **Royal Bank of Canada** (TSX:RY)(NYSE:RY) usually don't offer the frothy gains that are possible with non-dividend paying tech stocks.

You can also make the case that dividends damage a company's balance sheet. **Fortis Inc** (TSX:FTS)(NYSE:FTS) is well known for its consistent dividend payments. What's less well known is that the company has a lot of debt, which it incurred paying for acquisitions and capital expenditures. HadFortis not paid a dividend, it's possible that it could have bootstrapped its growth from its earningsstream, resulting in a less leveraged balance sheet. Hypotheticals like this are hard to answer with anydegree of certainty, but when a company doesn't pay a dividend, it has more cash on hand to pay for acquisitions interest-free.

The case against

That said, there's a strong case to be made against dividend irrelevance theory.

While that theory isn't wrong, it ignores a central fact of investing in everyday life: volatility. Markets can be extremely volatile, and sometimes, market downswings can last for a long time. For investors who depend on their stocks to pay for daily expenses (e.g., retirees), there's a need to protect against this volatility. Dividends provide some such protection. Although dividends can be cut, they'll likely still be paid through a market crash if the company has a dependable income stream. This means that they can be a much more reliable source of income than selling stocks on fixed intervals.

Foolish takeaway

What is a stock but a piece of a business? We normally expect businesses to generate income for their owners, and stocks are no different from any other ownership stake in an enterprise. Of course, businesses that are investing heavily in growth have an incentive not to pay dividends. That said, for established blue chips, a dividend is probably a good thing overall–especially for investors who live off their portfolio income.

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