Passive Income: Why Dividends ARE Relevant!

Description

Everybody loves receiving dividends. But not everyone is convinced that they matter. There is a popular academic theory known as “dividend irrelevance theory” that says that dividends don’t matter to an investor’s total return. According to this theory, a company that keeps cash as retained earnings will rise as much as what a dividend investor would get between capital gains and reinvested dividends.

In the sense of total return, this theory is correct. Dividend payments take a bite out of a company’s cash and therefore weaken its fundamentals. If stocks are valued based on assets, then a dividend stock should be worth less than a non-dividend stock, all other things the same.

However, all other things are not the same. There are many practical reasons why receiving dividends is desirable. In this article, I will explore those a few of those reasons in detail and make the case that, yes, dividends are relevant.

Reasons why dividends are relevant

Dividends do not directly influence a stock’s total return, but they do influence its short-term behaviour in ways that may be desirable.

- **They help investors avoid stock sales in bear markets.** Dividend irrelevance theory proponents advocate stock sales as an alternative to dividends. But what if you retire into a 1929-style bear market? You’d be selling at unfavourable prices. Your dividends, however, wouldn’t necessarily decline.
- **They maintain voting rights.** With dividends, shareholders can maintain their right to vote on company matters. Without dividends, stock sales are the only source of return, and such sales result in a progressive loss of voting rights. So, dividends are desirable for investors who exercise their right to vote.

Dividends signal positive earnings

Another, less "direct" benefit of dividends is that they signal high earnings quality over a long period of time. One reason why many investors like **Fortis** (TSX:FTS)(NYSE:FTS) stock is because it has raised its dividend every year for 48 years. That suggests that the company has had positive earnings for most of that period. A company that's losing money can pay a dividend (if bond holders don't make a fuss about it), but it won't be able to keep doing so forever. Eventually, a money losing company will run out of cash with which to pay dividends. So, dividend-paying ability can be seen as a sign of financial health.

Dividend Aristocrats outperform

A final virtue of dividend stocks is that the best ones outperform on a risk-adjusted basis.

According to an Investopedia article about Dividend Aristocrats — stocks that have raised their dividends for 25 years or more — they, as a group, performed about average for the market. However, their volatility was lower, so they beat the index on a risk-adjusted basis.

If we look at Fortis again, we see that this is indeed the case with that stock. Fortis is a true Dividend Aristocrat, having raised its dividend every year for more than 25 years. It has also outperformed the TSX utilities sub-index over the last five- and 10-year periods. It appears there is some correlation between dividend consistency and market performance. So, dividends are definitely relevant.

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