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FUNDAMENTALLY

Dividends Still Make a Difference

By PAUL J. LIM

IN stormy times like these, dividend-paying stocks are supposed to excel, because their payouts provide ballast for volatile portfolios.

But dividends have been a hard sell lately, largely because of their association with the market's beleaguered financial sector.

Already this year, 21 blue-chip financial companies have cut their payouts by $16.2 billion, a total reduction of more than 20 percent, according to Standard & Poor's. That's up from just five that cut their dividends last year, and only one in 2006.

Moreover, as a result of the huge sell-off in the financial sector — which accounts for roughly a quarter of the income thrown off by the S.& P. 500 — dividend-paying stocks have lagged of late. From last Oct. 1 to Aug. 15 this year, dividend-paying stocks in the index lost 13.4 percent, on average, versus a 12.6 percent decline for the stocks that didn't pay dividends.

And it doesn't look as if the situation will change anytime soon. Since mid-March, there has been a major divergence in the market, with growth stocks — shares of companies whose earnings are growing faster than the market as a whole — posting positive returns, and dividend-paying value stocks falling.

Still, when it comes to dividends, investors should look at time frames significantly longer than a single year.

Historically, dividend income has represented around 40 percent of the market's total returns. But in the 1980s, that fell to 28 percent, according to S.& P. And in the 1990s, it shrank to just 16 percent.

But guess what? Since the end of the 1990s, dividends have accounted for all of the market's gains. In fact, without dividends, you would have lost money by investing in blue-chip stocks, based on the S.& P. 500.

Indeed, a $1,000 investment in the index on Dec. 31, 1999, would have fallen in value to $871 by the end of June this year, according to an analysis by T. Rowe Price in Baltimore. That's why many investors refer to the current period as the "lost decade," as equity investments have lost ground.

But had you reinvested your dividends from that original $1,000, your portfolio would have grown, though ever so slightly, to around $1,005. It shows that dividends provide "defensive protection in adverse market environments," said Brian C. Rogers, the T. Rowe Price chairman and fund manager.

Step back even further, and you begin to appreciate how a steady, consistent dividend stream can gradually grow into a surprisingly large source of gains, even though the yield of the S.& P. is now a modest 2.2 percent.

"Two percent may not sound like a lot, since stocks can move up or down more than that in a single day without getting written up in the papers," said Howard Silverblatt, senior index analyst at S.& P..

But over time, two percentage points make a huge difference.

Since 1979, dividend-paying stocks have outperformed nondividend payers by 2.16 percentage points a year, based on total return. Had you invested $10,000 in 1979 in the dividend payers — and reinvested the income along the way — you would have wound up with $406,825 by Aug. 15 this year. That same $10,000 in nondividend paying stocks would have grown to just $243,385 — a difference of more than $163,000.

"That's real money," Mr. Silverblatt said.

A separate analysis by T. Rowe Price showed that over the past 27 years — a period marked by generally falling payouts — reinvested dividends accounted for more than 50 percent of the gains in the S.& P. 500, thanks to the long-term effects of compounding gains.

OF course, this doesn't solve one problem. Financial stocks represent a disproportionate share of dividend-paying stocks, and you may not want to make a big bet right now on struggling banks and brokers.

Yet by focusing on companies that don't just pay dividends, but consistently increase them, dividend investors can reduce their exposure to this still-volatile sector.

The Vanguard Dividend Growth fund, for example, which invests in companies with a history of increasing their dividends and enough cash flow and earnings growth to keep doing so — recently held only 10 percent of its assets in financials. By comparison, financial shares make up nearly 15 percent of the market capitalization of the S.& P. 500.

Or you might consider a fund that embraces financials — but only those banks and brokers that haven't cut their payouts. The SPDR S.& P. Dividend exchange-traded fund, for example, tracks the S.& P. High-Yield Dividend Aristocrats index, which is made up of the 50 highest-yielding stocks that have raised their dividend payouts every year for the past quarter-century.

Since the start of July, the fund is up 9 percent, while the S.& P. 500 is up only 1 percent.

Perhaps it's an early sign of better days to come for dividend investors.

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