

".....dividend-paying stocks outperform the average stock, and stocks with rising dividends have, in most periods, ranked among the highest performers."

As investors view a horizon which may include multi-year increases in interest rates combined with significantly reduced expectations regarding growth stock performance (and those two items are not unrelated), there has been a notable return among market strategists and in the media toward time-tested classic approaches of investing. Among the foremost elements of classic investing is the demand for dividends.

Through the years there have been numerous academic studies which have consistently shown that dividend-paying stocks outperform the average stock, and stocks with rising dividends have, in most periods, ranked among the highest performers. Since the long-term superior performance of stocks over bonds is almost an investment given, we wonder why dividend-oriented investing ever fell out of favor at all?

Rather than answer that question, which would involve a deep journey into human character and motivation, we thought we would share some studies and insights into the comparison of dividend stocks with bonds, and with stocks in general, that have recently crossed our desk.

Sungard strategist Gail Dudak noted in 2002, after and during some of the (many!) accounting scandals, "Only companies with real cash flow and real earnings will consistently pay dividends to investors! Dividends are a financial commitment from a company. They cannot be paid with smoke and mirrors." She goes on to tabulate over 200 years of returns from stocks, concluding that "In 13 of the 20 decades, reinvested dividend returns represented an average of 57% of the total return seen over the course of each decade... An important side benefit of high-yield stocks is the protection the dividend provides in a weak stock-market environment. This will also be rediscovered by the new generation of investors..."

While Dudak is correct about the proportion of returns attributable to dividends and the re-investment of dividends for each decade, she really doesn't go far enough in evaluating the impact of dividends on total returns over the rather longer periods that comprise most individual investors life expectancy, nor the infinite life expectancy of an institution such as an endowment, foundation, or defined benefit pension fund.

The longer the time period, the greater the impact of reinvested dividends on total return. (This is largely due to the fact that dividends are always buying more shares, creating a compounding dynamic. Each share purchased at the beginning of a decade, for example, might become two to four shares by the end of the decade, depending on the level of income and the course of prices. The greater number shares produces, obviously, a greater effect from changes in equity prices, since it is a multiplier).

In a recent article in *PlanSponsor*, William Raver, investment director for Verizon

Income Percentage of Total Return*

Length of Rolling Period	US Equity	US Real Estate	US Fixed Income	UK Equity	UK Fixed
5 years	43.0%	77.0%	97.0%	48.0%	91.0%
10 years	50.0%	81.0%	99.0%	55.0%	94.0%
20 years	63.0%	86.0%	103.0%	68.0%	98.0%
78 years	96.2%	99.5%	99.8%	97.7%	99.7%

*Note: Rolling returns are annualized returns for a series of overlapping, smaller time periods within a single, larger time period. For example, the 20-year time period from 12/31/82 through 12/31/02 consists of 16 five-year segments. The first segment is the five-year period 12/31/82-12/31/87, the next segment is the five-year period 12/31/83-12/31/88, and so on.

Source: Brandes Institute, as of January 31, 2004

Communications, wrote on “Recognizing the Value Of Current Income.” Working with the Brandes Institute, he revisited the work of Professor Elroy Dimson of the London Business School—who has further studied and amplified the conclusions of Roger Ibbotson of Yale, that “the current income stream from both equity and fixed income securities, when reinvested, forms the predominant share of long-term reported returns.” Raver points out that, on average, after *ten* years the percentage of income attributable to income and its re-investment is greater than 50%; the value of the income at that point exceeds the value of changes in the asset price of equities. After 78 years—the period covered by Ibbotson—the proportion rises to 96.2% of total return attributable to the dividend portion! Try asking even sophisticated investment professionals what the very long-term contribution of income to equity total return is—you’ll not likely hear the right answer. As one might expect, the contribution of income to fixed-income total return is about 100% over the long term.

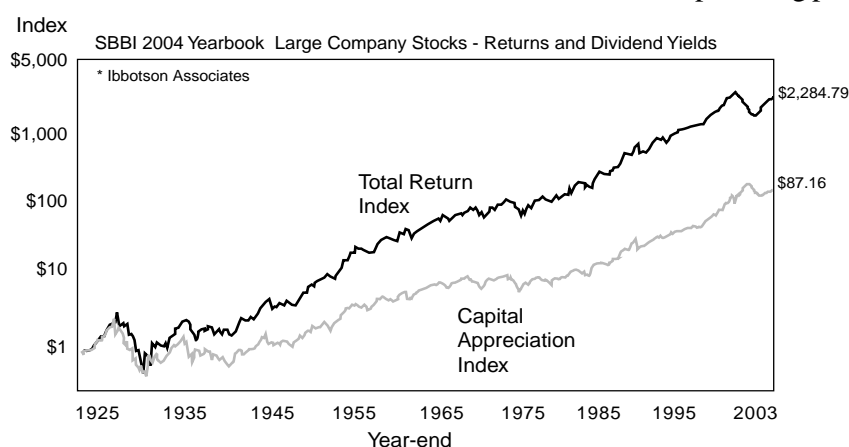
Raver talks about the difficulty managers have in delivering value-added performance: “One obvious example is a portfolio whose current yield regularly carries a lower current yield than the market benchmark against which

performance is being measured. This effectively raises the “alpha hurdle” for the product—often by as much as 50-100 basis points in an environment where three- and five-year expected excess return is only 150-200 basis points. Why active managers want to handicap themselves like this has always puzzled me, especially in the context of the long-term importance of current income to total return...”

In our view, the same thinking may be applied to investors of all kinds. Fancy asset allocations and pie charts decorate presentations filled with total return expectations. Investors get some growth, some value, some large, some small, and it all makes them feel like they own a fully furnished house. But what about the fact that history, over decades and centuries, shows us that the compounded *income* from investing—not style, not sector, not asset classes, but *income*—is the true driver of long-term total returns?

Investing for income from equities is great if you have a spending need and want to avoid invading principal, particularly when markets are down, and especially if you would like your income to increase over the years. But those whose investment goal is total return for the long term should emphasize income, too, since they receive an even bigger benefit from the re-investment and compounding process. □

“Dividends are a financial commitment from a company. They cannot be paid with smoke and mirrors.”



Lowell G. Miller, founder, president, and chief investment officer for Miller/Howard Investments, began his studies of the securities markets while still an undergraduate, and has continuously pursued the notion of disciplined investment strategies for over twenty-five years. He is the author of three acclaimed books on investing including the recently published *The Single Best Investment* (Adams Media, 1999). He has also written on financial subjects for *The New York Times Magazine* as well as editing the periodical *Investment Values*. Mr. Miller has been a featured guest on Louis Rukeyser’s *Wall Street Week* and is often quoted in financial sources such as *The Wall Street Journal*, *Dow Jones Newswires*, and *Barron’s*.