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In volatile market – dividends continue to grow

by Craig D. Hafer, President

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The most recent market selloff has been a reminder to investors of how volatile stocks can become when there is uncertainty in the world. While stock prices have waxed and waned, there is one thing that has remained unchanged during this period. It is the consistency of the dividends of the companies we invest in and how they continue to grow, even when stock prices are declining.

It has been four years since we wrote our Fall 2011 letter about the importance of dividend-paying stocks in an investor's portfolio. While much has changed during this time, some things have not. The U.S. economy and housing market have recovered nicely, while investors are still wondering when the Federal Reserve will raise interest rates. Against this backdrop, investors are wondering where to invest for the future. Now, as then, we believe that for the long run, stocks with growing dividends remain a good investment.

When we wrote our 2011 letter, the S&P 500 was around 1,100. The index has since gained about 75%, even with the recent selloff. As stocks have performed well, the interest rates on bonds and CD's have caused investors to actually lose money, if inflation is taken into account. When one considers the potential of higher interest rates that the Federal Reserve has been all but promising, and how rising interest rates will cause bond prices to fall, investing in bonds does not appear too attractive at this time.

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There are many reasons for investors to hold stocks of companies with growing dividends; some are obvious, while others are not. A dividend is by definition a portion of a company's earnings that is distributed to stock holders. Therefore, for a company to pay a dividend, it needs to be profitable. For a company to have dividend growth, it should have (or anticipate) earnings growth as well. Increasing a dividend every quarter is a sign of financial strength and that the company has a plan in place for growth. However, it does not preclude the company's earnings being affected by events beyond its control over the short term.

In his classic work, *Stocks for the Long Run*, Jeremy Siegel writes that while stocks outperform bonds and gold over the long run, there are short periods where they do not. It is during these periods that many investors find it difficult to stay invested in stocks. Siegel cautions investors about this short-sightedness by offering a startling conclusion. Not only do bonds underperform stocks in the long run, but the risk of investing in bonds increases over time to a point where "bonds become riskier than a diversified portfolio of common stocks."

The importance of dividend income in an investor's portfolio is noted in the *Ibbotson SBBI 2015 Classic Yearbook*. From 1926 – 2014, stocks of large corporations (large-cap stocks) garnered an average annual total return of 10.1%. Total return includes both price appreciation and income (dividends), and assumes that dividends are reinvested back into the stock. An interesting fact gleaned from this data is that on average, 40% of a large-cap stock's total return is due to dividends, and the rest is from capital appreciation. These statistics show that dividends are indeed an important component in the production of wealth.

As Siegel noted, it is during times that stock prices falter that investors lose interest in stocks. However, if dividends increase but stock prices do not, then the yields increase on these investments. At some point, high yields become very attractive, particularly from solid companies. Ever-aware investors notice exceptionally high-yielding quality stocks and bid the price up in the process of buying them. These stocks grow because they have both good management and good products, which generate cash flows that allow growing dividend payments. Many of these large corporations market all over the globe, somewhat insulating themselves from the economic storms of the individual countries in which they do business.

Included in the Fall mailing to our clients is the "Dividend History of Shares Currently Held" report. Each year we produce this statement to show our clients that dividends on the stocks in their portfolios have steadily increased over the years. This type of report may make even the most ardent skeptic believe in investing in stocks with growing dividends. When we first produced this report in 1996, Procter & Gamble (a stock we held then and still hold in many portfolios) was paying an annual dividend of $.43 per share (adjusted for stock splits). Today, P&G pays $2.61 per share, a 507% increase for that time period, or 27% per year. During this same period, the stock price grew 195%. While the market had numerous declines during this period, those who held this dividend growth stock did quite well over the long run.