Dividends: Beautiful, and Sometimes Dangerous

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In Homer's *Odyssey*, Circe was the loveliest of all the immortals. But she had a dark side, turning Odysseus' men into swine after they gorged themselves on her hospitality of food and wine.

Like Circe, dividends are beautiful, at least in the eyes of investors. Considered a sign of corporate health, dividends typically reflect the ability of a company to make money with some consistency. Dividends also indicate that management is attentive to shareholders and confident in the prospects for the business. But investors need to understand how the dividend is being paid for and where it fits within the capital allocation policy. Otherwise, the blind pursuit of dividends for their own sake has proven to be financially hazardous.

Review: the appeal of dividend payers

Dividends are back in fashion, with the virtues of dividend payers increasingly highlighted by the financial press. To review what may be familiar ground, over long periods, companies that pay dividends have outperformed those that do not. And, they did so with considerably less volatility. Over the past 40 years (1/31/1972 to 10/31/2011) companies that initiated or grew dividends had annualized returns of 9.4%, according to Ned Davis Research.[1] Returns for companies with stable dividends were 7.1%. This compares to returns of 1.5% for non-dividend-paying stocks and -0.9% for companies that cut their dividends.

The difference in results is even more impressive given that the period covered includes the 1980s and 1990s, when investors focused less on dividends and more on growth. During that period, as interest rates steadily declined, earnings growth and the expansion of earnings multiples provided the bulk of equity market returns.

While the potent results for dividend payers over this period may seem counterintuitive, Robert Arnott and Clifford Asness demonstrated that companies with stated dividend policies are associated with faster earnings growth than firms without stated dividend policies.[2] While many believe an emphasis on the reinvestment of earnings should fuel faster earnings growth, Arnott and Asness speculate that managers signal their earnings expectations through dividends.

Blindly chasing dividends is a poor strategy

Along with increased fanfare for dividends have come marketers sensing an opportunity. Investment strategies that emphasize dividend payers have proliferated. But the pursuit of dividends without understanding the context in which they were generated can lead to poor performance. For example, a high dividend yield is often a sign of distress: with a falling stock price as a denominator, yields rise. For the 40-year period we cited previously, Ned Davis Research found that while dividend payers provided an average annual return of 8.6%, the top 5% of dividend paying stocks (by dividend yield) returned only 5.6%.[1]

Hence, investors need to know where dividends come from. Are they getting a return *on* their capital, or a return *of* their capital? The only way to be sure is to learn how much free cash a company generates. The next, and more difficult, step is to gain confidence that cash can be produced with transparency and consistency. Another readily seen example of a pitfall for dividend strategies is the emphasis on financials prior to the crisis in 2008. Investors searching for dividend yields in a low-yield environment were attracted to the sector. At the end of 2007 the U.S. financial sector had a dividend yield of 3.4% compared to a dividend yield of 2.0% for the entire S&P 500 Index. Similarly, global financials had a dividend yield of 3.6% compared to a dividend yield of 2.4% for the entire

1 Ned Davis Research
2 Robert Arnott and Clifford Asness, "Surprise! Higher Dividends = Higher Earnings Growth," Financial Analysts Journal, January/February 2003.

MSCI World Index.[3] These yields were a Circean poison, intoxicating equity investors and causing them to overlook the lack of transparency in how cash was generated.

Investors also need to consider if a dividend is the best use of cash. Effective CEOs and CFOs weigh the benefits of returning cash to shareholders against internal reinvestments and potential acquisitions as part of a capital allocation strategy. If projected returns for reinvestment or acquisitions exceed the firm's cost of capital, then they should make those investments. If they do not, then excess free cash flow should be returned to shareholders. When returning cash is appropriate, dividends, share buybacks and debt repayments all add value, but more or less so at different points in the economic cycle.

Wolfe Trahan & Co. recently studied the effectiveness of various uses of cash during early and late phases of economic expansion and contraction.[4] They found that firms raising dividends the most were rewarded only in the late-contraction part of the cycle, when economic conditions were at their harshest. Investors tended to overlook dividends under other business conditions, with pronounced underperformance in the late-expansion phase.

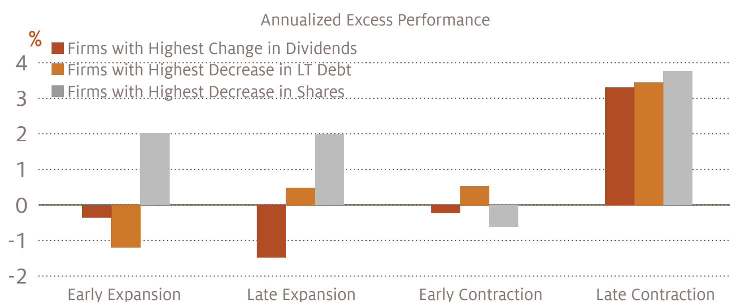

FIGURE 1: DIVIDENDS, SHARE BUYBACKS AND DEBT REPAYMENTS LEAD TO EXCESS RETURNS AT DIFFERENT POINTS IN AN ECONOMIC CYCLE
Source: Wolfe Trahan & Co.

Wolfe Trahan found that companies that repurchased their own shares tended to outperform over the following 12 months with a high degree of consistency while companies issuing shares were punished. Share buybacks were most effective during the late-contraction phase. Buybacks led to underperformance, however, when companies bought near peak prices in the early-contraction phase.

Firms that reduced or maintained their debt level also tended to outperform, while firms that increased leverage too quickly underperformed. Companies that decreased leverage in times of turmoil, i.e., the late-contraction phase, benefited the most. But retiring debt during the early-expansion phase led to underperformance. (Conversely, the early-expansion phase was shown to be the best period for companies to reinvest internally.)

A different picture emerges when dividends, share buybacks and debt repayments — what we call shareholder yield — are viewed collectively. While each has added more or less value during different phases of the cycle, together they have added value consistently across most of the cycle. The only exception was during the early stage of economic expansion. This makes intuitive sense because highly leveraged, low-quality stocks often rebound the most after a market bottom.

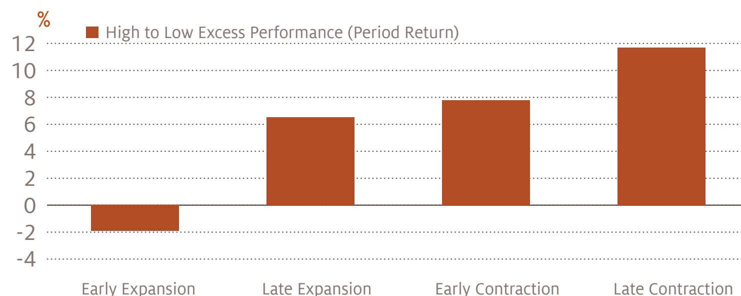

FIGURE 2: "SHAREHOLDER YIELD" LEADS TO MORE CONSISTENT EXCESS RETURNS
Source: Wolfe Trahan & Co.

A holistic look

We think focusing exclusively on dividends misses the point. We advocate a more holistic look at a company's cash flow and its capital allocation policy.

Only fundamental research can shed light on how a company generates cash. Investors need to understand the sources of a company's long-term value creation and how those sources are being nurtured. Identifying companies with straightforward financial statements, a commitment to transparency and an ability to consistently grow free cash flow should be the starting point in building a portfolio that emphasizes yield.

3 Bloomberg
4 Wolfe Trahan & Co., "Where's the Alpha in corporate cash? Profiting from the Abundance of Corporate Cash" August 4, 2011

The next step is figuring out which companies will make wise use of their cash. Cash is king, as the saying goes. It is a bright spot on any balance sheet and a buffer against hard times. But raising cash can be a bearish sign. It might signal that company management anticipates a deteriorating environment and has decided to get defensive. It could also indicate that management sees no opportunities for growth.

Unfortunately, there is no alpha in idle cash, and hoarding it is a poor capital allocation policy. Wolfe Trahan & Co. demonstrated that, while helpful in recessions, a high cash-to-asset ratio is not a performance differentiator over a full cycle. The exception is if a company falls short of cash; under performance was severe for the bottom quintile of companies in terms of cash to assets. Excess returns for the other 80%, however, were fairly homogenous.[4]

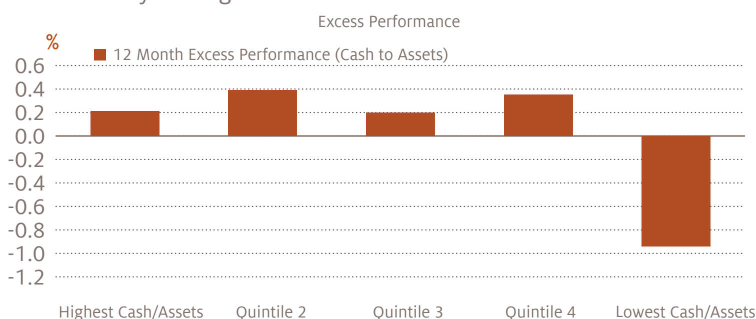

FIGURE 3: WHILE NOT ENOUGH CASH LEADS TO POOR RESULTS, EXCESS CASH DOES NOT LEAD TO OUTPERFORMANCE

Source: Wolfe Trahan & Co.

To sum it up, there are only five possible uses of corporate cash: reinvestment, acquisitions, dividends, share repurchases and debt pay downs. Reinvestments and acquisitions should be pursued if the firm expects a return higher than its cost of capital. Otherwise, the best use of cash is to provide shareholder yield. All three forms of shareholder yield — dividends, share buybacks and debt repayments — are effective forms of returning wealth to shareholders. Each adds more or less value at different points in an economic cycle. Adopting a broad view by taking all three into consideration can be more rewarding than only focusing on one. Companies that provide shareholder yield, as a result of growing free cash flow and intelligent capital allocation, should outperform over most of the economic cycle.

Moly for investors

Getting back to our story from the *Odyssey*, moly is a magic herb in Greek mythology that counteracts venoms and poisons. On the advice of Hermes, Odysseus used moly to protect himself from Circe's evil magic. Understanding how a company generates cash and scrutinizing its capital allocation policy is moly for investors.

So, if you don't want to be turned into a pig . . .

Appendix: Examples of companies with strong "shareholder yield" characteristics

Epoch manages a strategy that takes a holistic look at the components of shareholder yield: dividends, share buybacks and debt repayments. The Global Equity Shareholder Yield strategy invests in companies with an ability to generate free cash flow and a policy of returning cash to shareholders.

Epoch's team, led by Eric Sappenfield and Michael Welhoelter, begin with a proprietary screen to find stocks that have paid high dividends and have growing cash flow. Free cash flow analysis is used to review a company's history and develop projections for the next few years. The team then focuses on how management intends to use the excess cash. With this strategy we seek to build a diversified portfolio that captures 4.5% in cash dividends, 1.5%-2% of equity capital in share buybacks and debt reduction and a cash flow growth rate of at least 3%. Position sizes are limited in absolute terms and as a percentage that each stock contributes to the portfolio's income and growth.

We have included several examples of stocks that are currently held in Global Equity Shareholder Yield portfolios. We believe these companies are illustrative of an approach that combines growing cash flow with shareholder-friendly policies on allocating capital, with an emphasis on dividends, share buybacks and debt reduction.

Nestlé

Nestlé is a global food manufacturing giant with over $100 billion in sales. Its many brands include Häagen-Dazs, Lean Cuisine and Nestea. We took note of Nestlé in the spring of 2007 because the company had been buying back stock in significant quantities in addition to its annual cash dividend of over 2%. With recurring total shareholder returns approaching $5 billion and up 20% over the previous three years, we saw this company as a solid source of shareholder yield. In 2011, the company has paid $6.6 billion in cash dividends (equating to a 3.6% yield on September 30) and bought back $4.4 billion of stock through June 30. Nestlé remains a core holding, as we anticipate cash flow to grow in the mid-single digits. This should lead to higher dividends and continuing reduction in shares and net debt.

Vodafone

Vodafone, the U.K.-based wireless carrier, generates $71 billion in global sales annually. The company is the result of numerous acquisitions and investments. Europe accounts for almost 70% of sales but the most significant asset owned is a 45% stake in Verizon Wireless which generates roughly $1 billion of free cash each month for its owners, Verizon and Vodafone. In 2006, new priorities were established; the company moved away from its acquisition strategy and toward one that emphasized shareholder returns, including increases to the dividend and a large share buyback program. Additionally, the company began to shed non-core assets, further increasing the share buyback and debt reduction efforts. The recent announcement of a $10 billion cash dividend by Verizon Wireless, and the pass through of nearly three-quarters of Vodafone's 45% share to Vodafone shareholders in a special dividend in early 2012, confirms management's commitment to shareholders.

Anheuser-Busch InBev

Anheuser-Busch InBev is the leading global brewer with a portfolio of nearly 300 brands. It was created by InBev's $52 billion acquisition of Anheuser-Busch in 2008. In the process, the company issued $44 billion of debt and $9 billion of equity. In 2009, the company began paying down this acquisition-related debt and this continues to be the case today. The company should hit its target leverage ratio of less than 2x net debt / EBITDA by the middle of next year. Once this happens, we expect free cash flow to be allocated to raising the dividend and implementing share repurchases. The company should generate $8-$9 billion of free cash flow annually from 2013 on. We estimate that dividends and buybacks will account for $6-$7 billion of that, leaving the company with flexibility to increase investments, pursue acquisitions or increase its cash distributions to shareholders.

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