NEW ROAD CAPITAL
INVESTMENT MANAGEMENT

OUR TWO CENTS

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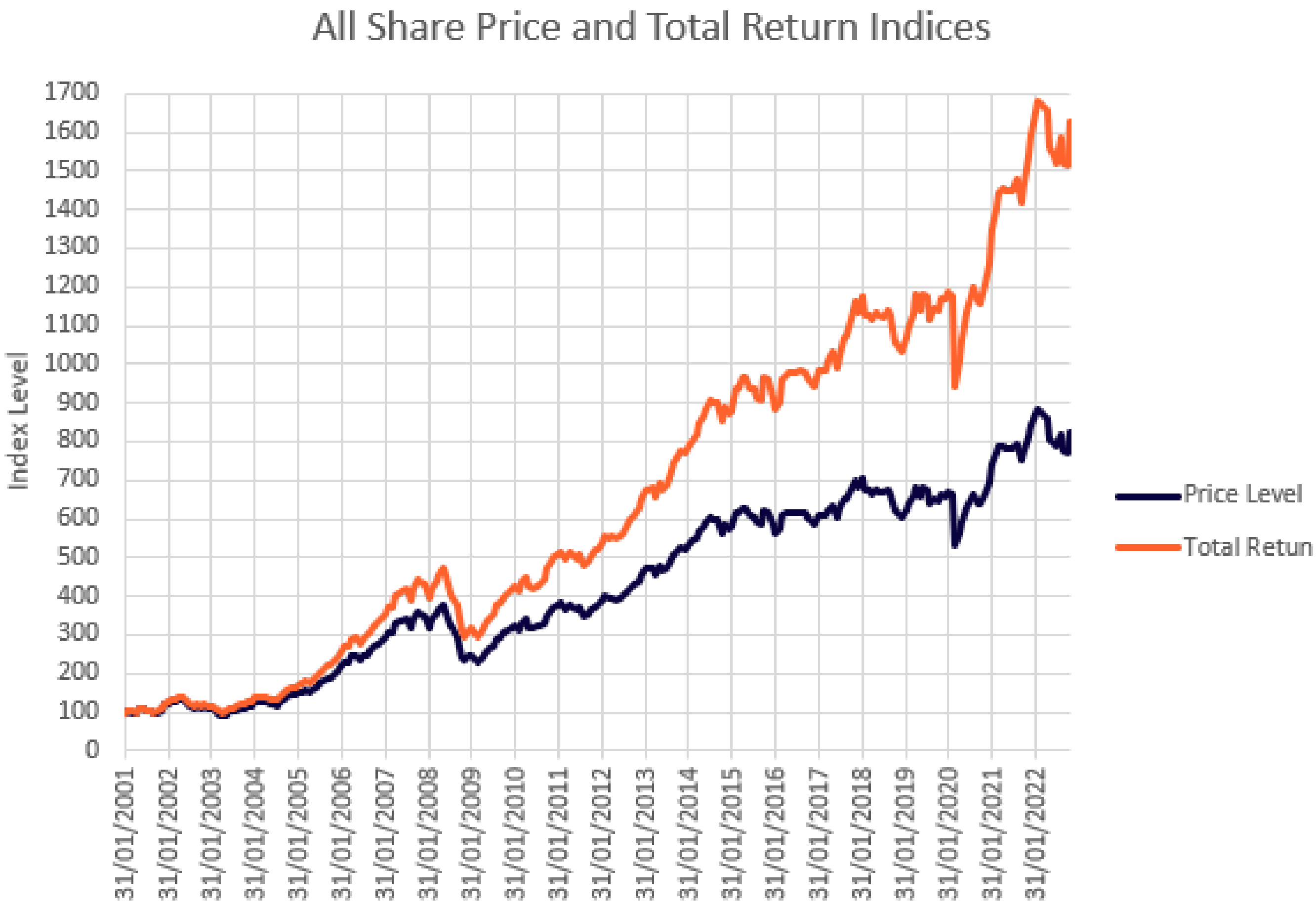
The Value of Dividends

by Michael Caroline

The performance of a portfolio is often assessed in terms of one component of return, the price change of the underlying holdings. It is not uncommon for such focus on price to lead investors to chase capital growth while neglecting the value of dividends, the second component of return.

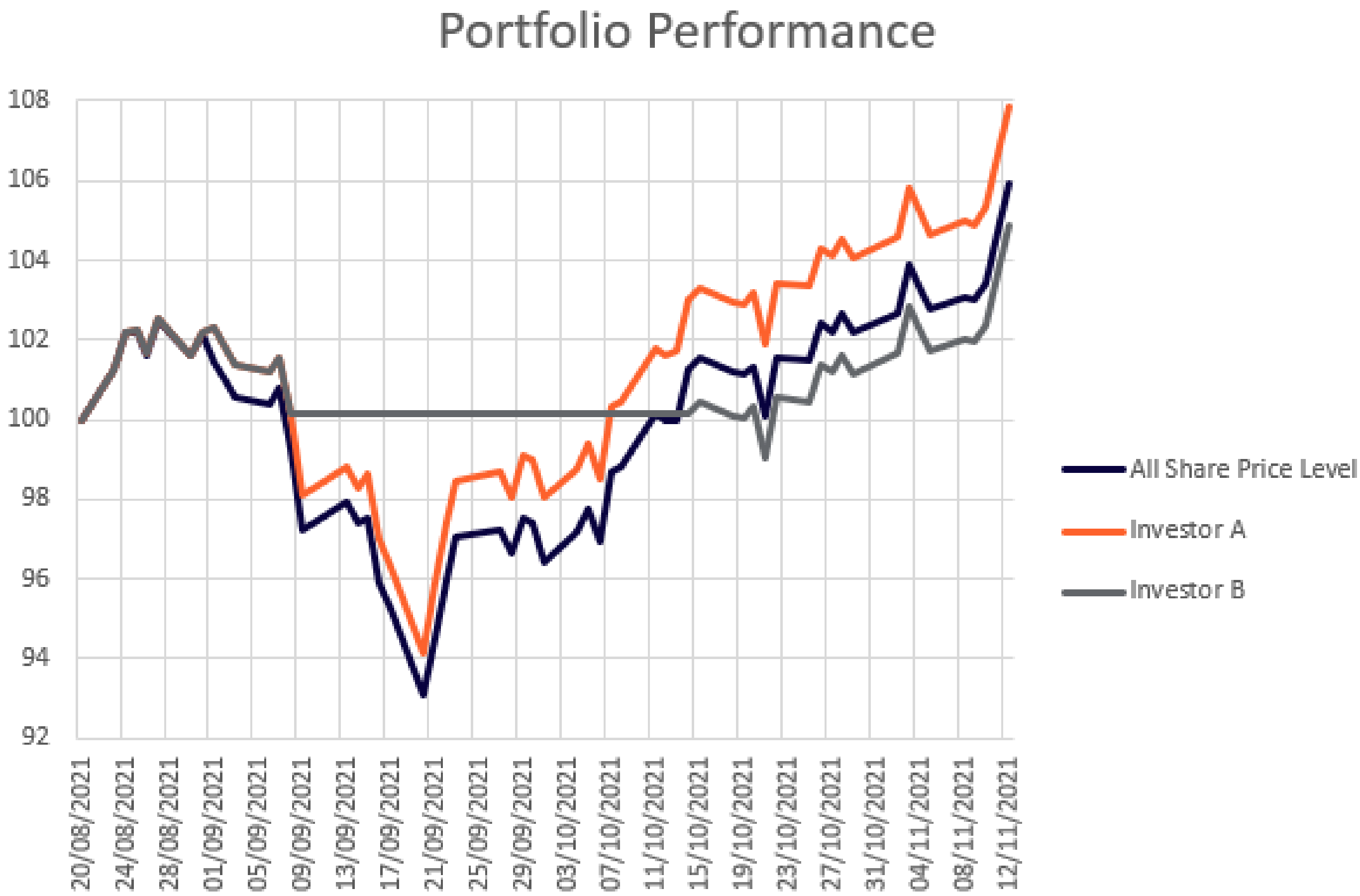
The importance of the dividend component may not be very apparent in the short term, particularly when compared to high growth stocks that have shot up in value over a very short period of time. The value does, however, become clear in the long run and can be seen in the following chart comparing the price level of the All Share index with the total return, a measure that includes dividends and interest payments which are immediately reinvested, for the same index.



Source: IRESS

This shows a clear and large divergence between the two measures. By the end of the 20-year period, the All Share achieved an annualised rate of return of 10.87% based on the price level, however, when dividends were factored in, the total return of the All Share was 14.55%. Although there are periods during which the price falls, dividends help support the total value which, in turn, amplifies the effect of subsequent upswings.

It is important to realise that an investor will only achieve the total return of the index by remaining invested and reinvesting any dividends. This, however, is often not the case. Investors may attempt to time the market and sell out to avoid a drawdown then buy back in at a lower or equal price. This, however, is often unsuccessful leading investors to take a loss by selling at a lower price than when they bought back in, while also missing out on dividends. The following chart illustrates this concept by considering two investors: Investor A and Investor B. Both are invested in the All Share index; however, they react differently to a drawdown. Investor A simply holds, thus achieving the total return. Investor B, however, sells out during the drawdown and waits until the price is at least the same as when they sold out. Their performance over the period is illustrated in the following chart. It can be seen that, despite Investor B's attempt to improve their performance by timing the market, they ended up approximately 3% worse off than Investor A over a relatively short period of time. It can also be seen how a portion of this underperformance is attributable to poor market timing and another portion from missing dividends. This may seem like an acceptable cost to avoiding a drawdown, however, over a long time frame and with regular periods of disinvestment, this difference will compound and further widen the gap.



Source: IRESS

To avoid the costs incurred from attempting to time the market, investors should consider the value of dividends from holding equities over long time periods and avoid the urge to sell out during market downturns. If an investor's portfolio goes through a drawdown, they will still receive something in return for holding onto their investment. This will, in turn, improve the long-run performance of the portfolio, as well as increase the odds of meeting the investor's long-term goals.

Written by: Michael Caroline