



Given the importance of dividends to the total return of a balanced portfolio, we thought it is useful to provide a brief overview of dividends and how dividends may be important signaling devices.

## **Dividend Discussion**

Dividends are payments regularly made by corporations to shareholders from retained earnings. A company's ability to pay steady dividends provides a good sign of its financial fundamentals. Typically, large, mature and profitable companies with solid cash flows pay dividends. However, high growth companies rarely pay dividends because internally generated cash is best reinvested to drive business expansion rather than being distributed. Companies that trade well in excess of book value and enjoying a good return on equity can typically generate more value for shareholders by investing in organic growth and increasing its book value, than providing that cash to shareholders who need to seek out investments with a better return. However, if a company with a history of steady dividend payments suddenly cuts its dividend, then the market will likely interpret this as suggesting the company is not in good financial health.

There are three metrics which are commonly used to show the sustainability of a firm's dividend policy:

*Dividend yield* is calculated as the annual dividends paid per share divided by the current share price. It measures the amount of income received in proportion to the share price.

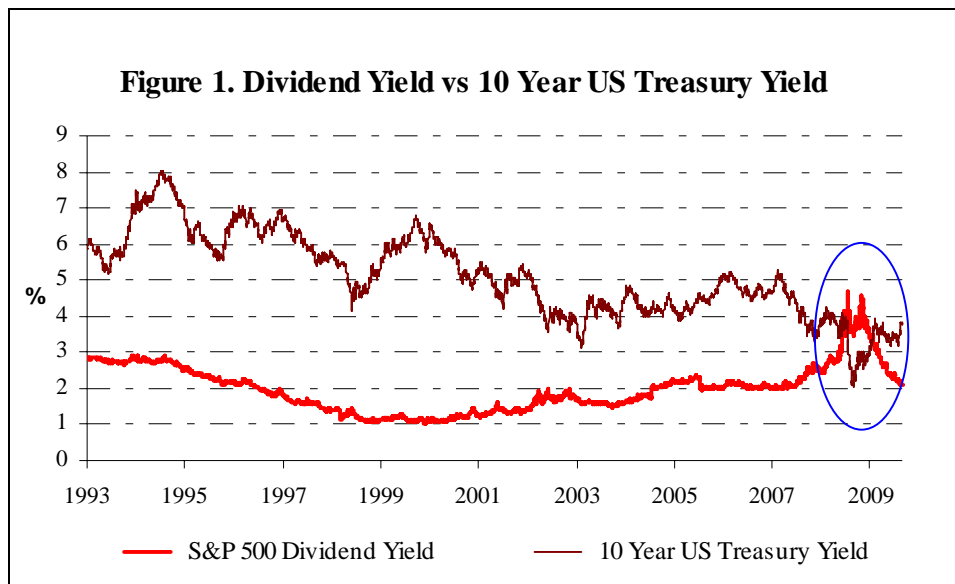
*Dividend coverage ratio* is calculated by dividing a company's earnings by the dividends paid to shareholders. It measures the sufficiency of earnings to cover recent dividend payments. A higher ratio suggests that the Company can maintain dividends even if earnings were to suffer, while if the ratio is under 1, dividends are paid out from retained earnings from prior years, and is likely not sustainable.

*Payout Ratio* is essentially the reciprocal of the above, and reflects that percentage of earnings that are being paid out in dividends to shareholders. Mature companies are often paying out more than 50% of their earnings as dividends, while companies with good internal growth prospects may well pay out a much lower proportion (or none) of its earnings.

Furthermore, dividends can also reflect what a company is worth. The Dividend discount model is one method to estimate the underlying value of a share. A share is thought to be worth the sum of all its prospective dividend payments discounted back to net present value. Dividends are actually the payments made from earnings, i.e. cash flow to investors. Therefore, they reflect a company's equity value.

Investing in stocks with a high dividend yield offers both income and capital gains over the long term. In the current environment of low interest rates, investing in high dividend yielding stocks looks attractive because of the income generation. The outlook for maintaining or growing dividend payments is positive because corporate profits are recovering after the recent recession. Regarding the risk/return profile, high dividend yield stocks often offer more stable returns and bear lower than average market risks from a long term perspective, as high dividend stocks are typically large and mature companies which have solid balance sheets and steady cash flows.

The dividend yields on indices outperformed government bond since recession started in October 2008. Figure 1 tracks the performance of dividend yields on S&P 500 vs. 10 Year U.S. Treasury yield over past 16 years.



During the worse of the financial crisis, share prices fell, pushing the dividend yields for the broad S&P 500 index above 10-year Treasuries. Share prices have since increased rapidly and as a result dividend yields declined. However, there remain plenty of large multinational companies that have dividend yields in excess of both government bonds and their own bond yields. We have a number of these companies in your portfolio.