Why dividends are overrated

Earnings reinvested in a strong business will produce greater income and long-term wealth, argues Roger Montgomery

IN A RECENT WHITE PAPER FOR clients, we argued that while there are benefits in the receipt of fully franked dividends, those benefits may have been overstated, especially when compared with the long-term advantages to company and country from the retention and profitable reinvestment of earnings.

I would like to suggest that the perceived benefits of fully franked dividends and, indeed, the pursuit of yield may be leading investors to invest in the wrong types of businesses and towards equity portfolios that produce undesirable and unintended returns. I will also demonstrate that investing in a similar company that doesn't pay dividends could produce a much more attractive return.

To begin, we need to make some basic assumptions. The first is that you are the owner of a business with $1 million worth of equity on the balance sheet. The business consistently produces a 15% return on that equity and any new equity that it retains. We will also assume that if the shares were to trade on the stock exchange, the market would price the shares at twice the equity value; in other words, its market value is $2 million. For clarity, in the first year this would equate to a price-earnings ratio of an undemanding 13 times current earnings.

As with many Australian listed companies, the board of this business has decided to acquiesce to shareholders' demands and maintain a high 80% payout ratio. Eighty per cent of the company's annual return is received as dividends and 20% is reinvested. Directors often choose this option because they believe it keeps everyone happy – those who want some growth (but don't trust management to deliver it) and those who need income.

In the first year the company earns $150,000 and the dividend is $120,000. The remaining $30,000 is retained and reinvested to grow future profits. Over the years as the profits grow, so would the dividend. Indeed, the dividends and earnings as well as the equity will grow by 3%pa, assuming no additional debt is borrowed nor any new capital raised.

After a decade, the business would have a market value of $2.7 million and your dividend in the coming year would be $166,108. You might be very satisfied with this – growing net worth and income by 3%pa. I would, however, suggest that there is a way to generate more wealth and more income without receiving any dividends. You could be even more satisfied. Under my alternative strategy, I suggest you leave all earnings in the company and instead sell 6% of your shares in the company annually. Since the shares would be sold at 200% of the equity on the balance sheet, this approach would produce the same $120,000 worth of cash initially, and will grow each year.

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What I am suggesting might seem like anathema to any adviser or retiree but before you judge, watch.

Under this strategy, the equity of the company rises to $4 million after a decade ($1 million compounded at 15%pa). As you sell more shares each year, your percentage stake in the business declines. In a decade, it would be 53.86%. But, perhaps surprisingly, the market value of this stake is actually worth more than under the first scenario. The equity has been growing at 15% and trades at two times the equity. It now has a market value of just on $3.8 million. This compares favourably with the $2.7 million market value of 100% of the company in the first scenario.

Perhaps even more surprisingly, the cash receipts from selling shares has been higher every year since the second year began. So you now have more capital worth and more income.

Many advisers and investors would point to the fact that capital gains might be taxed at a higher rate than franked dividends but they forget two things. The first is that many baby boomer investors pay no tax at all. And second, for those investors who do pay tax, the capital gains are paid only on the difference between the purchase and sale price, whereas tax is paid on 100% of the dividends received.

In the real world there are businesses that earn much more than the 15% return on equity I have used here and these businesses also sell for much more than two times the equity in the business. A business such as REA Group trades for 14 times its equity value and Domino's Pizza at nine times equity. It is reasonable to assume that you would be much better off financially if the very best businesses – those that can retain profits and reinvest them at very high rates of return – paid no dividends at all and allowed shareholders to make up their own minds about how much income they needed.

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