FINANCIAL
TIMES

Keep your eyes on the prize: total return is what matters

25th July 2015

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Understanding of this subject might not be assisted by the plethora of research available online that basically asserts "dividend paying stocks outperform non-dividend payers". Just try typing those words into a search engine and see how many links you get.

This statement is a classic example of statistical analysis that finds a correlation without proving cause and effect.

I am told you can find a correlation between the sightings of storks and the number of births, but it does not mean one leads to the other. Similarly the observation that dividend payers tend to outperform non-dividend paying equities does not explain the factors which cause this. Understanding those factors is vital to avoid fundamental errors.

There are two types of company into which non-dividend payers might be divided:

1) those that cannot pay a dividend as they do not have the profits and/or cash flows from which to do so — these are start-ups and companies in some distress; and

2) companies that have the capability to pay a dividend, but choose not to and reinvest the whole of their earnings and cash flow to expand the business.

There is clearly a massive gulf in quality between these two groups, yet research often simply lumps them both together as "non-dividend payers". They include companies such as Warren Buffett's Berkshire Hathaway.

I wonder what the result would be if you compared the performance of dividend payers with those non-dividend payers that are capable of paying a dividend, but choose not to?

After all, where management is behaving in a logical manner and retaining all the earnings because they are capable of earning a superior investment return, like Mr Buffett did, they will outperform a company in the same situation that pays a dividend. Nor is Berkshire an isolated example.

There is also an intermediate class of companies that pay a dividend, but retain most of their earnings for reinvestment. In most cases this means they are unlikely to qualify as high yielders and find their way into income funds.

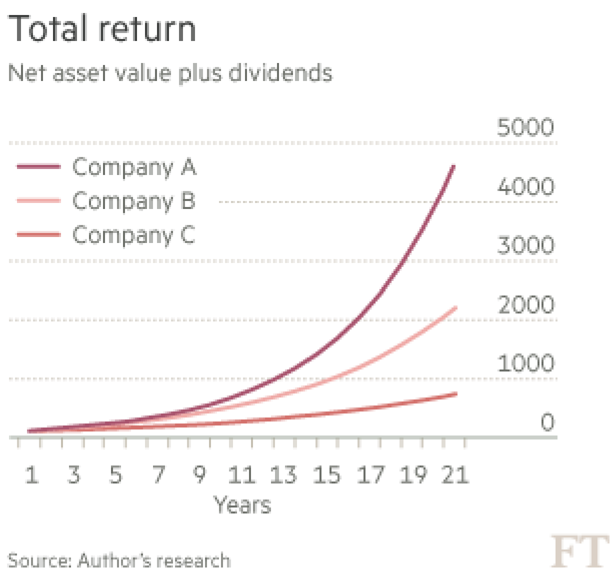
But if this distribution policy is driven by reinvestment opportunities to earn high returns within their business, they are likely to be good performers as investments.
The chart below illustrates this. It shows the return to investors from investment in three companies based on the following:

Company A makes a 20 per cent return on capital. It pays no dividend and reinvests 100 per cent of its profits.

Company B also makes a 20 per cent return on capital. It reinvests 70 per cent of its profits — the other 30 per cent is distributed as a dividend to investors who spend it, or at least do not reinvest it.

Company C reinvests 100 per cent of its profits, but makes only a 10 per cent return on capital.

The vertical axis shows the resulting Net Asset Value (“NAV”) of the companies plus the amount of the dividends, if any, received by the investors.



The chart illustrates the point that it is the rate of return you make on the reinvested earnings or dividend that makes the most difference, as A and B outperform C. It also makes the case that you do not perform as well if you either spend the dividend or do not reinvest it.

You might argue that NAV is not the best indicator of the performance for investors — what about the share price? I agree, but I would suggest that A and B will obtain a higher "share price to NAV" ratio than C, as the market will value their higher returns, and that A would be more highly rated than B because it invested more of its earnings at the high rate of return.

So £1 reinvested by A or B is likely to be far more valuable in stock market terms than £1 reinvested by C.

You might also argue that the relative valuation at which you — or your fund manager — could buy each of these shares would affect the outcome. This is true, but if you are a long-term investor it has less of an effect than the rate of return the companies can generate. This was covered in a previous column, "Bond proxies: Can you afford not to own them".

Turning to individual investors' behaviour, it seems the desperate search for yield and the popularity of income funds is in part driven by a view, which many investors seem to hold, that they can only safely spend the income from their portfolio. This view seems particularly prevalent among retirees, for whom this is the sole source of income.

This thinking is what attracts investors to income funds and high-yield equities. While it might seem commendably prudent, it is erroneous and can lead to the assumption of risks associated with high yield investment.

What investors should be doing is seeking to maximise their total return. Maximising total return over the long term relies upon investing in companies that can generate a high return on capital and retain some or all of their earnings to reinvest at that high rate of return. Such companies are unlikely to feature heavily in true income funds. If the resulting yield is too low to fund investors' spending requirements, the solution is simply to redeem some of the capital sum.

I realise that what I have just said may sound like sacrilege to many investors. But what they fail to realise is that providing you leave at least enough of your gains invested to allow capital to keep pace with inflation, you are not be behaving imprudently, assuming savings were adequate to begin with.

The suggestion also has the merit of tax efficiency. It is hard to avoid income tax outside an Isa or Sipp and few people regularly exceed the capital gains tax threshold, which is any event charged at significantly lower rate than top rate income tax.

This is the second of a two-part series on income investing. Terry Smith is chief executive of Fundsmith LLP