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How Much Effect do Corporate Dividend Policies have on a Stock Portfolio's Total Return?

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Executive Summary

Since the great economic downturn of 2008-2009, there has been a gradual increase in economic activity and a stabilization of the financial infrastructure. During this period where economic activity has grown, slowly but steadily, companies have continued to stockpile cash even as they reinvest in themselves and distribute dividends and repurchase shares.

According to Moody's Investor Services, U.S. nonfinancial corporations held approximately $1.8 trillion in cash at the end of 2016. This cash balance was net of 2016 Capital Spending ($600 billion), Share Buybacks ($500 billion), and Dividend Payments ($400 billion).

Dividends have played a major role in the total return calculation for stocks. According to JP Morgan Asset Management and FactSet, dividends have accounted for approximately 40%, or the annualized total return for the S&P 500 from 1926-2016. These same companies had a Payout Ratio (Dividends/Net Earnings of 40.2% as of the end of Q3, 2016. As of the same period, 44 companies (in the S&P 500) had a Payout Ratio exceeding their net earnings, the second highest count in the past ten years (after Q1-2016). (Source: FactSet).

An investment strategy that includes companies paying dividends has added alpha over the duration of this Study. Whether part of the alpha can be attributed to a long period of declining interest rates as investors seek yield alternatives can be debated as part of that reasoning.

Key Study findings include:

- Companies paying dividends outperform their universe peers.
- Companies with increasing dividends outperform those companies with stable dividends.
- Dividend paying Mid Cap stocks have had better performance over other cap size universes.
- Dividend paying Value shares outperformed Growth shares.

Background

As companies improve their balance sheets, DeMarche continues to update its annual study of how these organizations deploy their cash and calculate the subsequent total investment return resulting from those decisions. We initiated the Study in 2005 and have updated it annually since its inception date. It presents a 27-year history (1990-

2016) - a period that includes the three most recent bull markets and downturns associated with the Tech Bubble, the 9/11 World Trade Center disaster, and The Great Recession of 2008-2009.

During this period, we have analyzed over 3,000 stocks each year for subsequent one-, three-, and five-year average annualized returns. We have looked at five Uses of Cash Strategies: (1) Dividend Policy; (2) Share Buybacks; (3) Merger & Acquisition Activity; (4) Capital Expenditures; and (5) Research & Development.

The purpose of this White Paper is to specifically look at Dividends (only) from the perspective of the Investor. Does corporate dividend policy add alpha to an investor's return when comparing to a universe of stocks similar to that of the company (in cap size and investment style) distributing the cash?

In this paper, we are showing three-year annualized returns by the following characteristics for companies that increase their dividends or maintain their dividends:

- Four Market Cap Sizes (Large, Mid, Small, and Micro)
- Two Investment Styles (Growth or Value)
- Ten S&P Economic Sectors

Study Details

Figure 1 shows the definitions of two specific dividend strategies employed by companies. Figures 2 and 3 show the market cap size category ranges and the metrics DeMarche uses to classify companies as either Growth or Value, respectively.

Since the Study period is 27 years, companies can/will rotate in cap size and investment style over that period. On January 1 of each year, every company in our universe is categorized by market cap size, economic sector, and investment style. We then capture the dividend information from Standard & Poor's Compustat database.

Figure 1: Corporate Dividend Alternatives

Dividend Strategies

1. **Dividend Changes:** ***Increasing dividends***
2. **Stable Dividends:** ***No changes in last twelve months***

Figure 2: Uses of Cash Cap Size Ranges

Cap Size Ranges:

Large Cap: ≥ $20 Billion

$2 Billion ≤ Mid-Cap < $ 20 Billion

$600 Million ≤ Small Cap < $ 2 Billion

Micro-Cap: < $600 Million

Figure 3: DeMarche Value and Growth Style Factors

VALUE TO GROWTH SPECTRUM

Value Stocks	Factor	Growth Stocks
High	Book-to-Price	Low
High	Sales-to-Price	Low
High	Dividend Yield	Low
High	Cash Flow Yield	Low
Low	Dividend Growth	High
Low	Asset Growth	High
Low	Earnings Growth	High
Low	Relative Price Strength	High

Figure 4 illustrates the number of observations by market cap size since the Study inception—just over 80,000 observations.

Figure 4: Study Observations by Cap Size

Large Cap	**4,200**
Mid Cap	**19,200**
Small Cap	**20,500**
Micro Cap	**44,800**
TOTAL	**88,700**

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CONCLUSIONS

All Stocks (Total Study Universe)

For the total Study period, Table 1 illustrates the three-year annualized returns for the Total Universe of Stocks and subgroup categories of Cap Size and Investment Style (Growth or Value).

Table 1

Total Returns by Cap Size & Style 3-Year Annualized Returns (1990-2016)	
Total Universe of Stocks	7.35%
Large Cap Stocks	7.86%
Mid Cap Stocks	8.83%
Small Cap Stocks	8.30%
Micro Cap Stocks	5.98%
Value	8.12%
Growth	6.52%

Conclusions When Comparing Growth Stocks vs. Value Stocks (see Table 2 below)

For companies that increased their dividends, both Value and Growth stocks outperformed their respective universes. Where companies maintained stable dividends, however, only Growth-oriented companies outperformed their universe.

Table 2

Annualized Three-Year Returns
For Dividend Increases & Stable Dividends (Growth vs. Value) vs. Their Style Returns

(1990-2016)	**Dividend Increases**	**Stable Dividends**	**Universe Returns**
All Stocks Universe	8.90%	7.63%	7.35%
Value Stocks	9.18%	6.95%	8.12%
Growth Stocks	8.52%	8.39%	6.52%

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Conclusions When Comparing by Cap Size (see Table 3 below)

For companies that increased their dividends, all cap sizes outperformed their respective universes. Mid Cap Stocks outperformed the other three cap size universes. Where dividends remained stable, however, only Micro Cap stocks outperformed their universe.

The one outlier noted in Table 3 is a negative performance number for Large Cap stocks with stable dividends. We believe this number relates to a very small sample size.

Table 3

Annualized Three-Year Returns
For Dividend Increases & Stable Dividends (By Cap Size) vs. Their Universe Returns

(1990-2016)	Dividend Increases	Stable Dividends	Universe Returns
All Stocks Universe	8.90%	7.63%	7.35%
Large Cap Stocks	8.60%	-6.36%	7.86%
Mid Cap Stocks	9.75%	8.13%	8.83%
Small Cap Stocks	9.68%	5.91%	8.30%
Micro Cap Stocks	7.87%	6.32%	5.98%

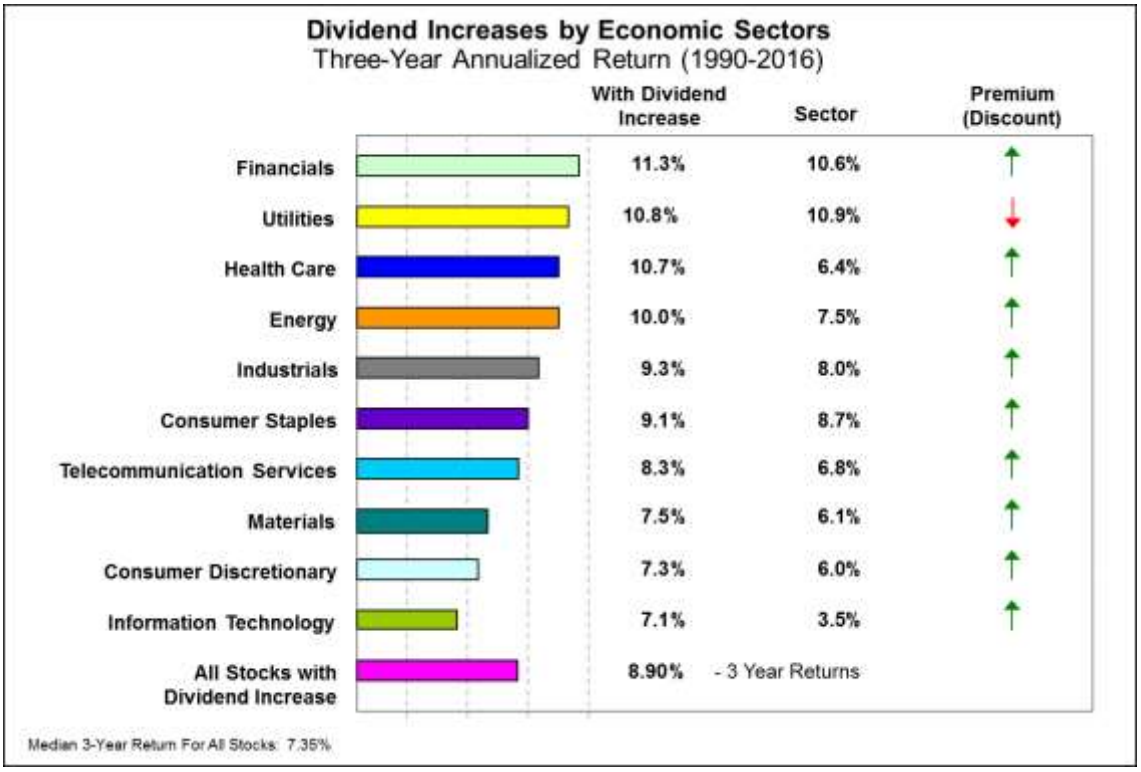
Conclusions when Comparing By Economic Sector (see Figure 5)

As mentioned in the Background Section of this paper, we have analyzed results by economic sector. Figure 5 illustrates the incremental premium that Dividend Increases had on each respective Economic Sector Universe. A green up arrow in Figure 5 indicates a premium comparing to the overall sector return. A red down arrow indicates a discount to the sector return. Only companies that increased dividends in the Utility sector did not match the overall sector return, but the difference is not considered material.

When analyzing sectors by Dividend Increases, Financials, Utilities, and the Health Care sectors were ranked one, two, and three, respectively.

Please see Figure 5 on the next page.

Figure 5



Final Thoughts and Considerations

This paper provides only a portion of the Dividend Study conclusions. DeMarche has data including return numbers over one- and five-year periods. We have data when combining cap size with investment style (Growth vs Value) and returns by Industry subcategory. We can provide that information upon request.