

# **DRW Investment Research**

## **Dividends: The Major Source of Real Equity Returns**



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## 1. All that trading, speculation and short-term positions...

- The sensible stock market investor buys shares in a business to stake a claim in the future profits of the business and to share in the cash payouts (dividends) to shareholders. This investor believes that businesses will be able to grow their dividends better than the inflation rate and market prices will more or less follow the dividend stream over time.

[Chart 1 & Chart 2]

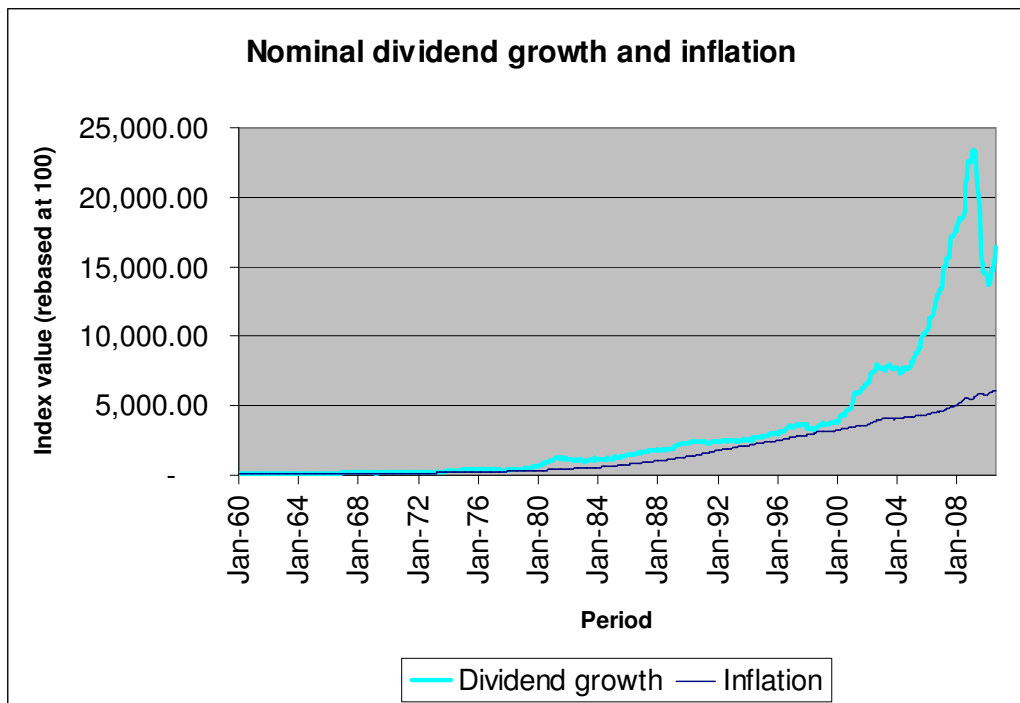


Chart1: Growth in dividends (FTSE JSE All Share Index) and inflation rate (CPI)

Source: DRW Investment Research

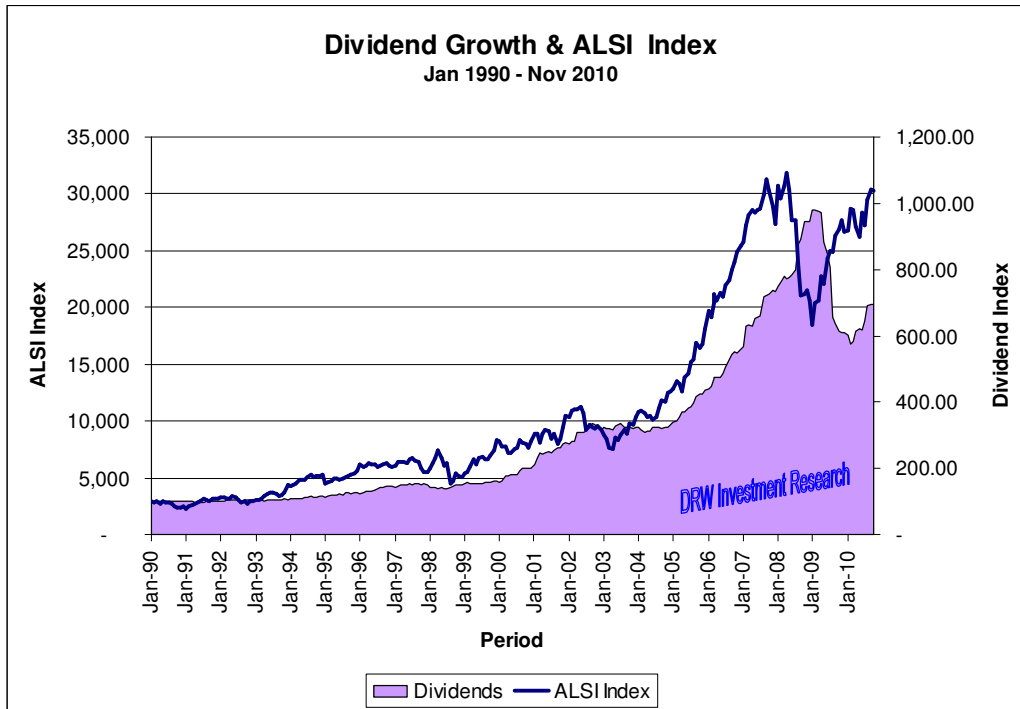


Chart 2: Growth in dividends and stock market prices

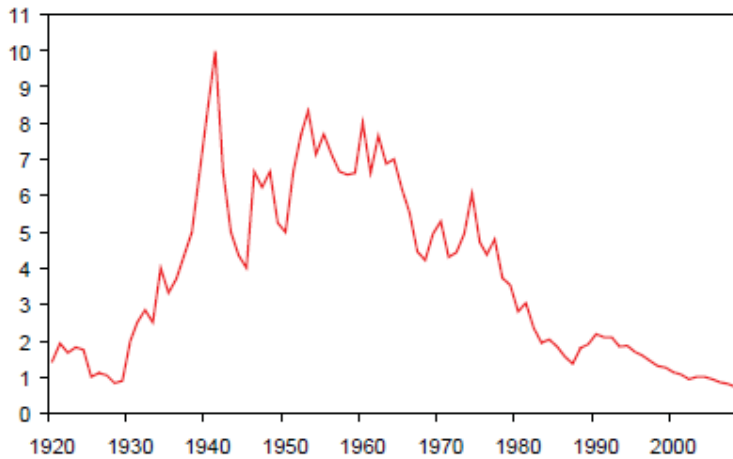
Source: DRW Investment Research

- However, most investors (or, perhaps more correctly, speculators) buy stocks with predominantly one objective in mind, namely to make profits from price actions on the stock market. This idea stems from the erroneous belief that the stock market is one big casino where one should be actively trading one's positions. Moreover, active trading is the talk-of-the-town; trading platforms are relatively easy accessible with modern day technological advances and stock markets are very liquid to make frequent trading possible.<sup>1</sup>

<sup>1</sup> Ironically, in many instances the same investors will hold the view that property investments should be a long-term commitment. However, if similar liquidity levels existed in the property market, it is doubtful whether these investors would profess the "long-term" view on property investing!

- Active and frequent trading has become the dominant characteristic of stock markets around the globe. For example, in both the U.S.A. and South Africa the average holding period of stocks among investors has declined rapidly in recent decades and is currently below twelve months while trading volumes skyrocketed. Indeed, good times for brokerages, clearing houses and exchanges!

[Chart 3 & Chart 4]



Source: NYSE, GMO

Chart 3: Average holding period of stocks among U.S. investors

Source: James Montier, GMO Asset Management, 2010

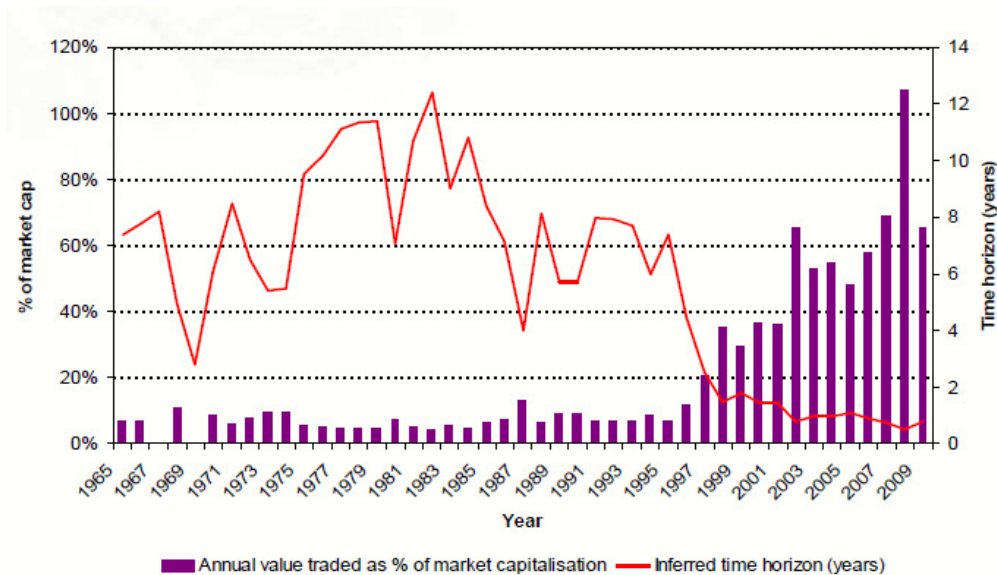


Chart 4: Average holding period of stocks in South Africa and trading volumes

Source: Prudential Portfolio Managers, 2010

## 2. The Decomposition of Real Equity Returns

- Nominal equity return = Dividend yield + nominal dividend growth + rating change
- Nominal equity return = Dividend yield + inflation + real dividend growth + rating change (valuation)

*FTSE JSE All Share Index: (Jan 1960 – Dec 2009)*

*Average dividend yield = 5%*

*Inflation rate = 8.5%*

*Real dividend growth = 1.8%*

*Rating change = 1.6%*

$$\begin{aligned}\text{Nominal equity return} &= 5\% + 8.5\% + 1.8\% + 1.6\% \\ &= 16.9\% \text{ per annum}\end{aligned}$$

- Real equity return = Dividend yield + real dividend growth + rating change (valuation)

*FTSE JSE All Share Index: (Jan 1960 – Dec 2009)*

*Average dividend yield = 5%*

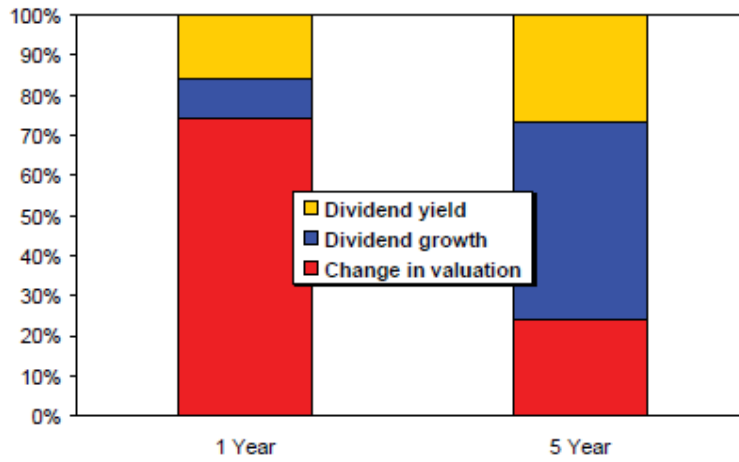
*Real dividend growth = 1.8%*

*Rating change = 1.6%*

$$\begin{aligned}\text{Real equity return} &= 5\% + 1.8\% + 1.6\% \\ &= 8.5\% \text{ per annum}\end{aligned}$$

- Over short-term periods (for example, one-year periods) the change in market rating is a major determinant of overall real equity returns.

**[Chart 5 & Chart 6]**



Source: GMO

Chart 5: The decomposition of real equity returns (S&P500) over different time horizons

Source: James Montier, *GMO Asset Management*, 2010

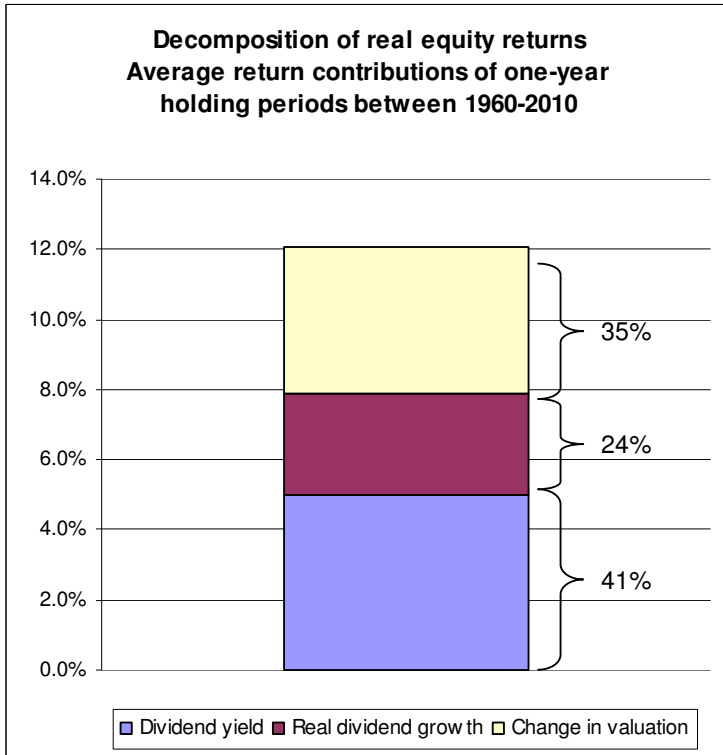


Chart 6: The decomposition of real equity returns (FTSE JSE ALSI) over one-year periods since 1960

Source: DRW Investment Research

- Over long-term holding periods (for example, ten-year periods) the change in market rating on average has had little effect on the overall equity return. The actual dividends and to a lesser degree the growth in dividends were responsible for most of the total real equity return (on average 85% of the total, combined).

[Chart 7 & Chart 8]

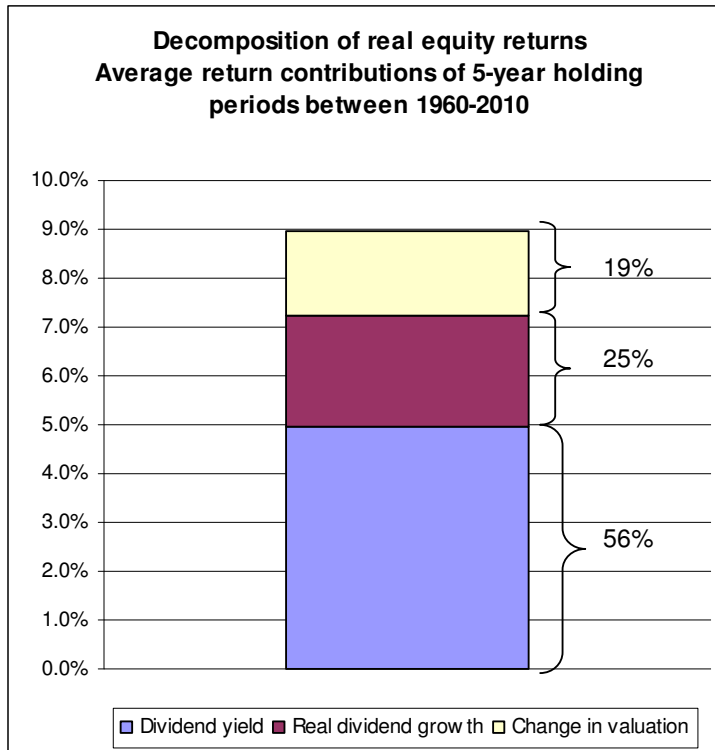


Chart 7: The decomposition of real equity returns (FTSE JSE ALSI) over five-year periods since 1960

Source: DRW Investment Research



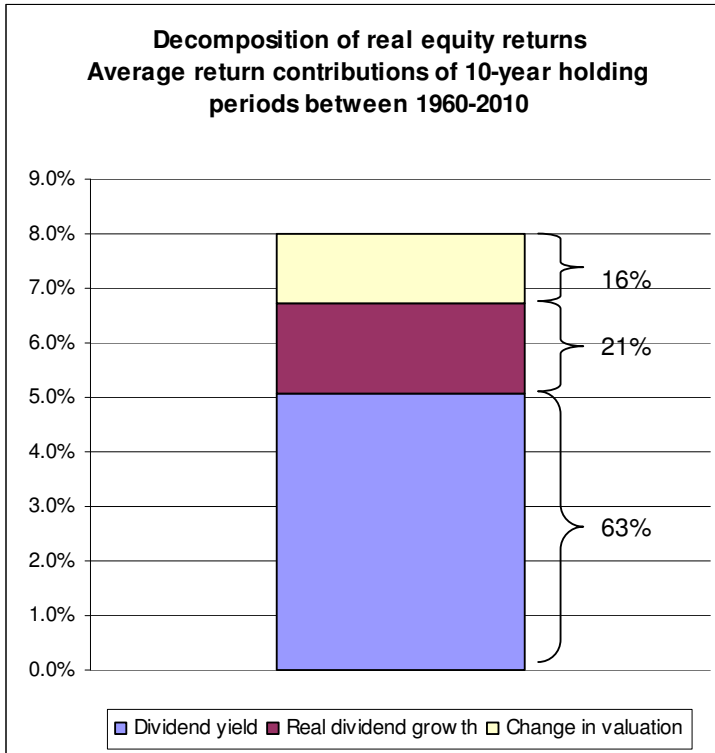


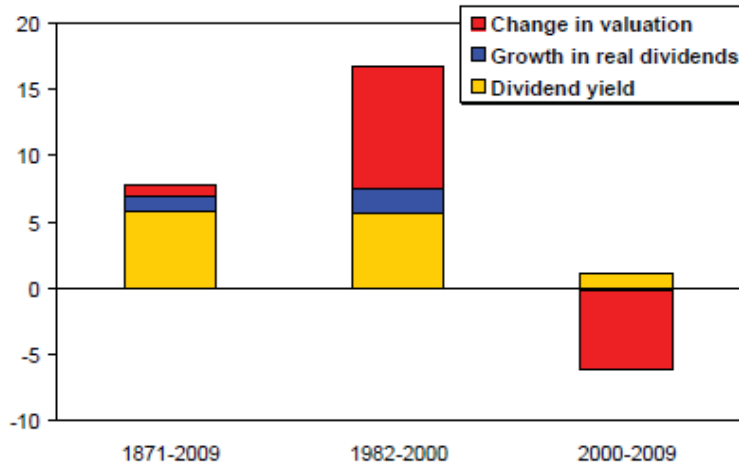
Chart 8: The decomposition of real equity returns (FTSE JSE ALSI) over ten-year periods since 1960

Source: DRW Investment Research

### 3. Different Time Frames

- When the total real return from the stock market is measured over different starting periods, very different return decomposition profiles are possible. However, dividends remain the major source of total real return over the very long term and it is true for all major markets around the world.

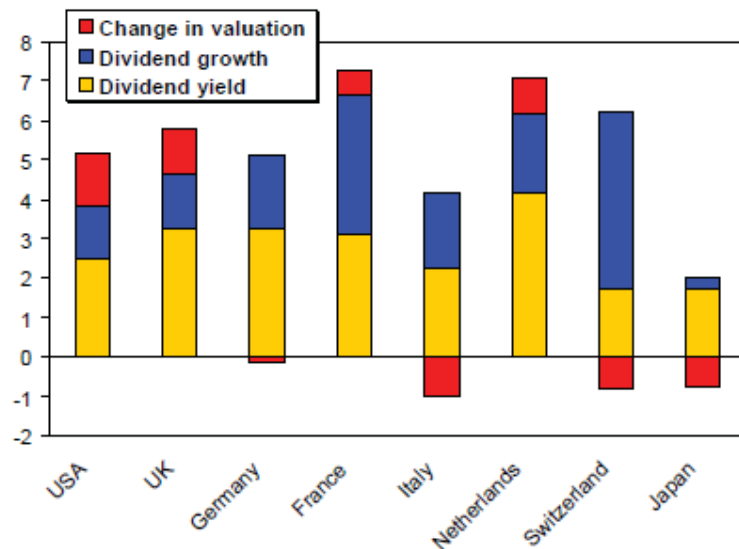
[Chart 9 & Chart 10]



Source: GMO

Chart 9: The return profile of the S&P500 over different periods

Source: James Montier, *GMO Asset Management, 2010*



Source: GMO

Chart 10: The importance of dividends across different markets (since 1970)

Source: James Montier, *GMO Asset Management, 2010*

- Similarly, we found that in South Africa dividends is the major contributor of real equity returns over long-term holding periods.

[Chart 11 & Chart 12]

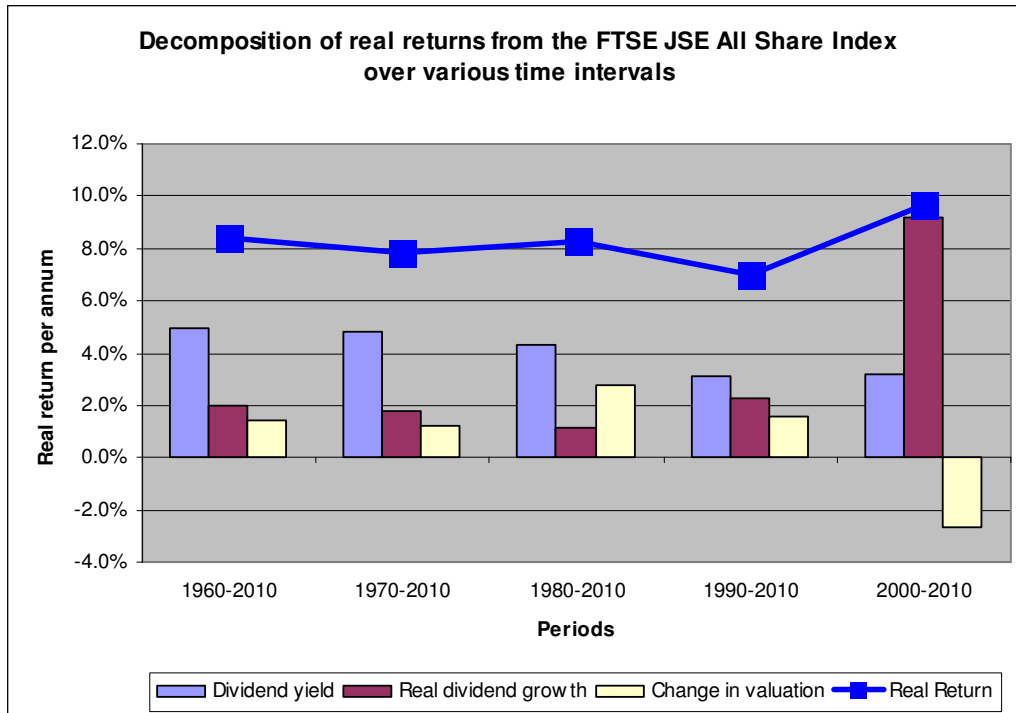


Chart 11: The contributions of equity return components over different time periods (FTSE JSE ALSI)

Source: DRW Investment Research

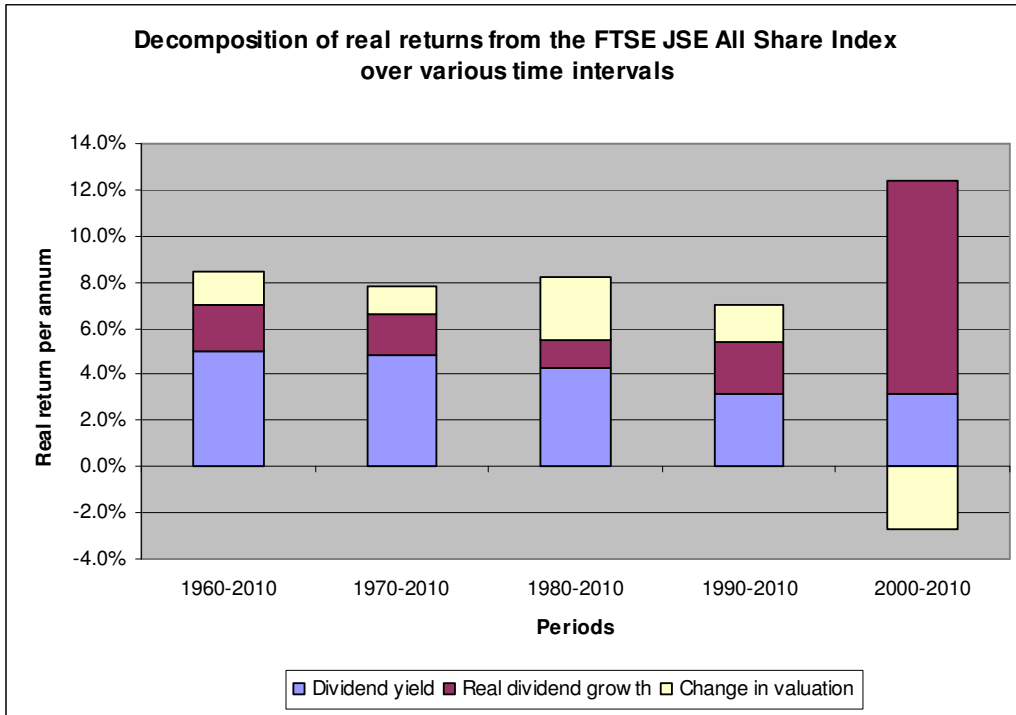


Chart 12: The importance of dividends over different time periods (FTSE JSE All Share)

Source: DRW Investment Research

- Yet, each return component has had a different effect on total return in each of the past five decades; especially the rating change and real dividend growth were not consistent and over some decades contributed negatively towards total real equity return.

For example, over the past decade real dividend growth contributed strongly towards total real equity return, while the rating change had an adverse effect on returns. In the previous decade (1990-2000) the respective roles were reversed.

[Chart 13 & Chart 14]

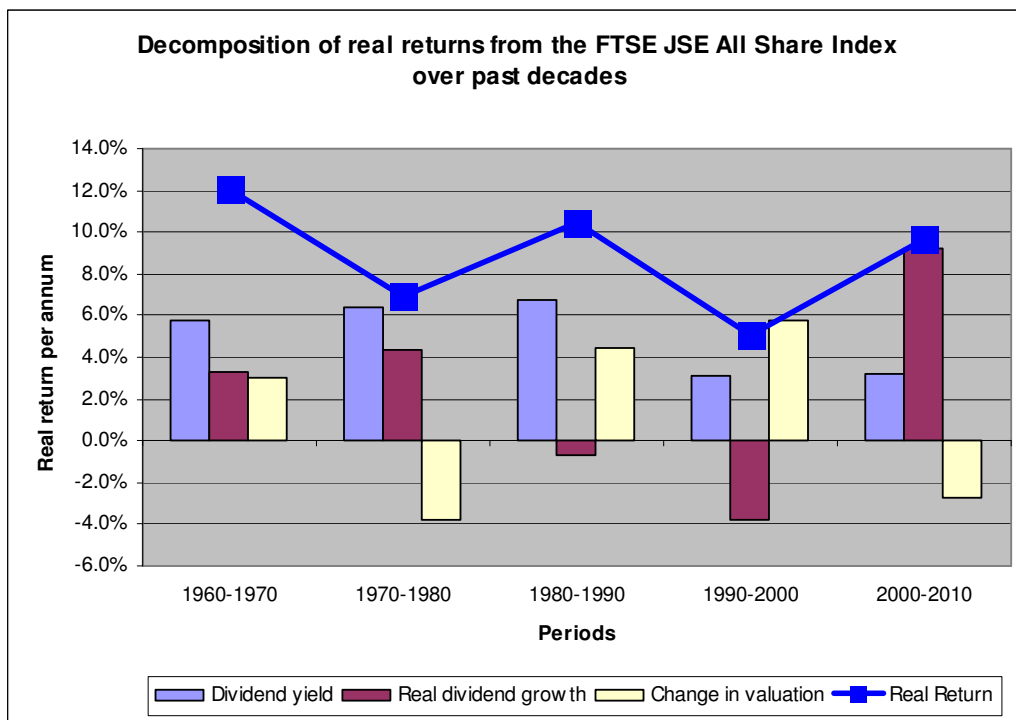


Chart 13: The contributions of equity return components over different decades (FTSE JSE ALSI)

Source: DRW Investment Research

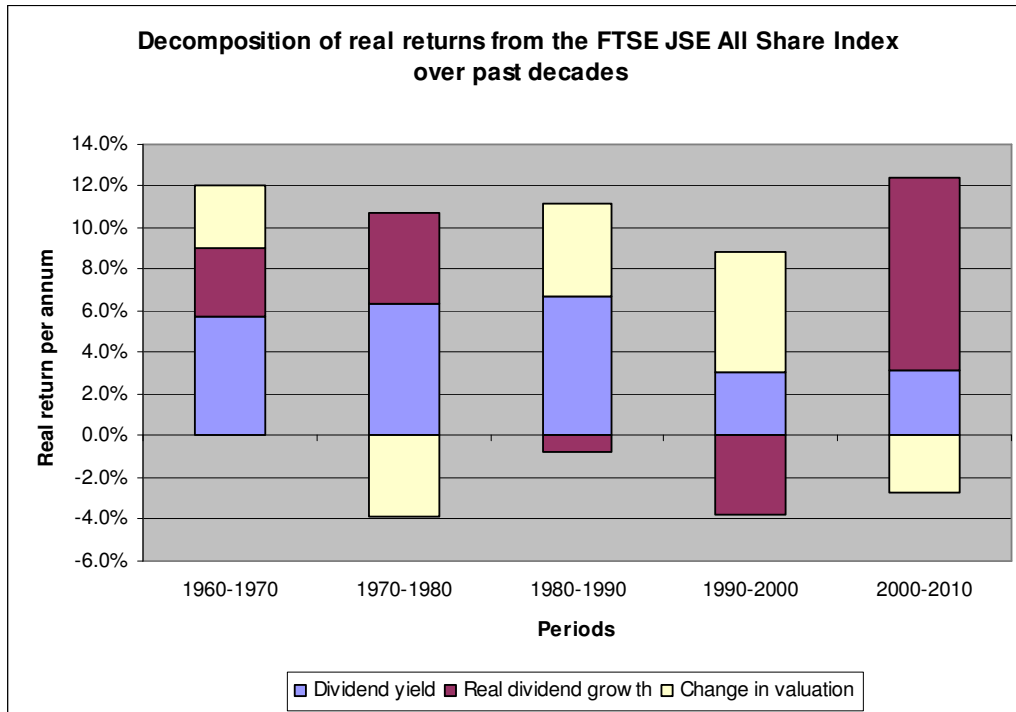


Chart 14: The relative contributions of equity return components over past decades (FTSE JSE ALSI)

Source: DRW Investment Research

#### 4. A closer look at dividends over the years...

- Dividends are paid from companies' earnings. Not surprisingly, over the years the growth in dividends closely tracked the growth in companies' earnings with a correlation factor of 87% between the two variables. The long-term average real earnings growth and real dividend growth are 3.7% per annum and 2.9% per annum respectively, but these numbers are highly cyclical and inconsistent over time.

[Chart 15 & Chart 16]

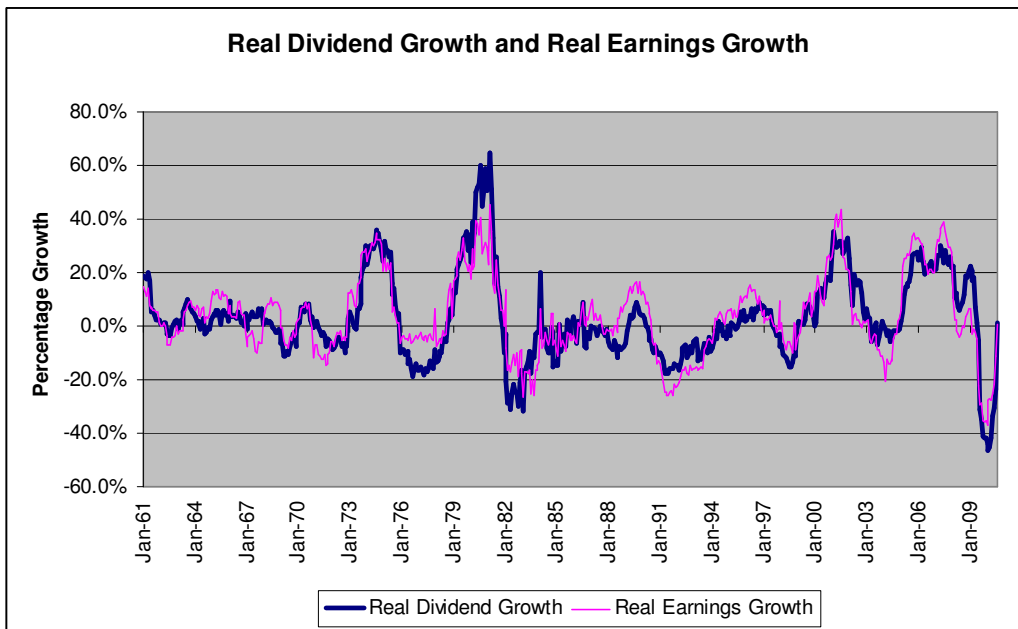


Chart 15: Dividend growth follows earnings growth

Source: DRW Investment Research

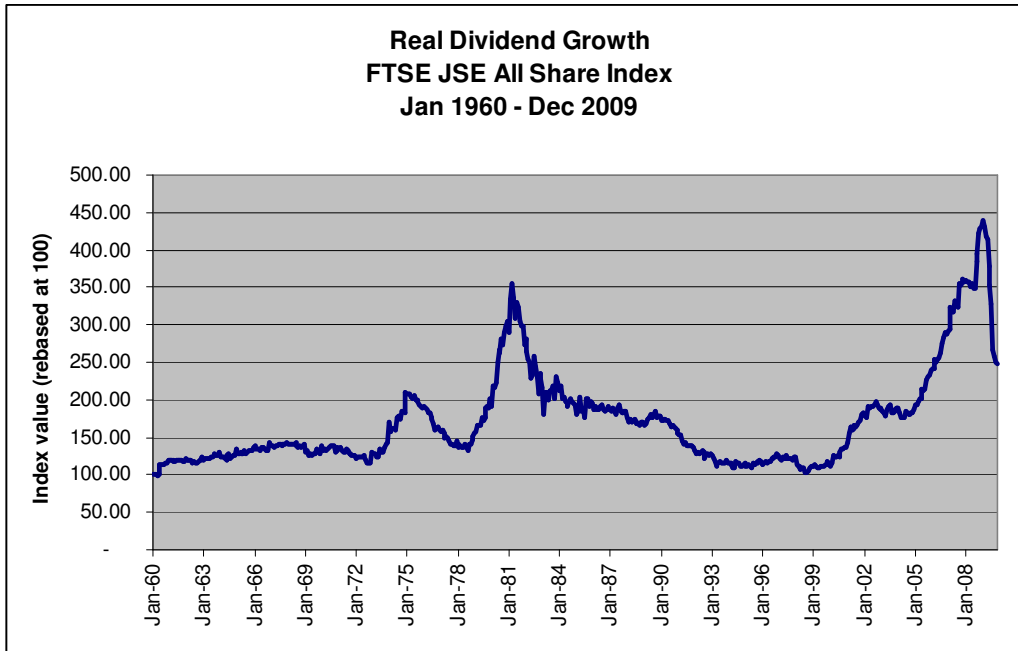


Chart 16: Real dividend growth

Source: DRW Investment Research



- In recent decades the companies listed on the Johannesburg Stock Exchange gradually reduced the dividends paid out to shareholders as a percentage of their earnings (payout ratio). Currently, the payout ratio is about 40%; or, alternatively, the dividend cover is at 2.5 times for the market index.

[Chart 17]

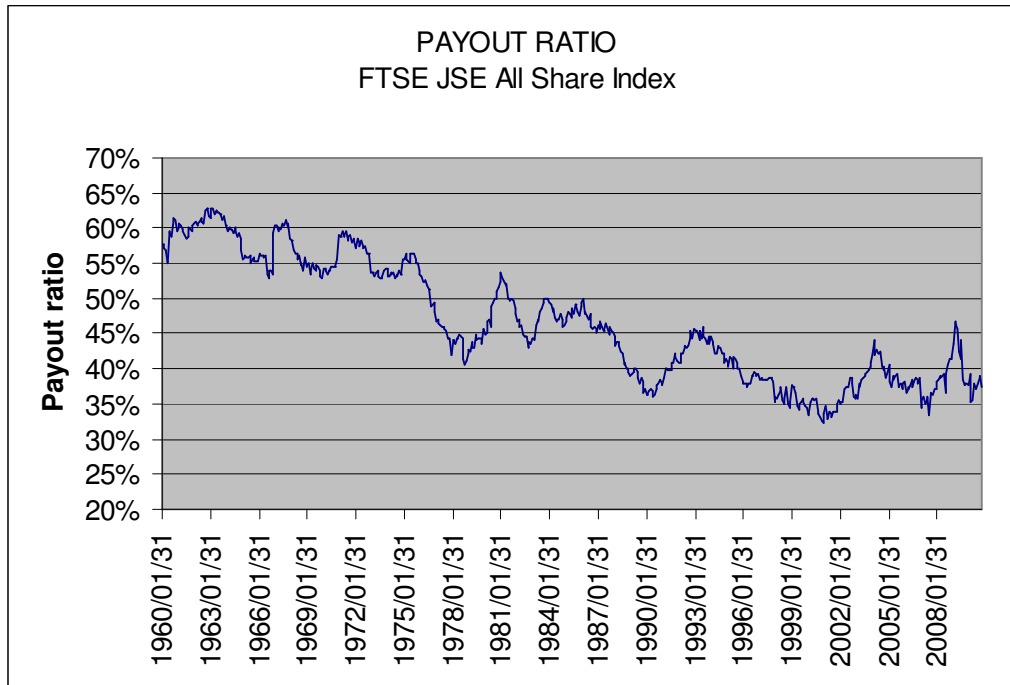


Chart 17: Payout Ratio (dividends as a percentage of earnings)

Source: DRW Investment Research

- Despite the evidence of real growth in dividends over the longer term, there were episodes in the past (1980s and 1990s) where the growth in dividends lagged inflation substantially. The past decade (2000s), however, delivered stellar real growth in dividends.

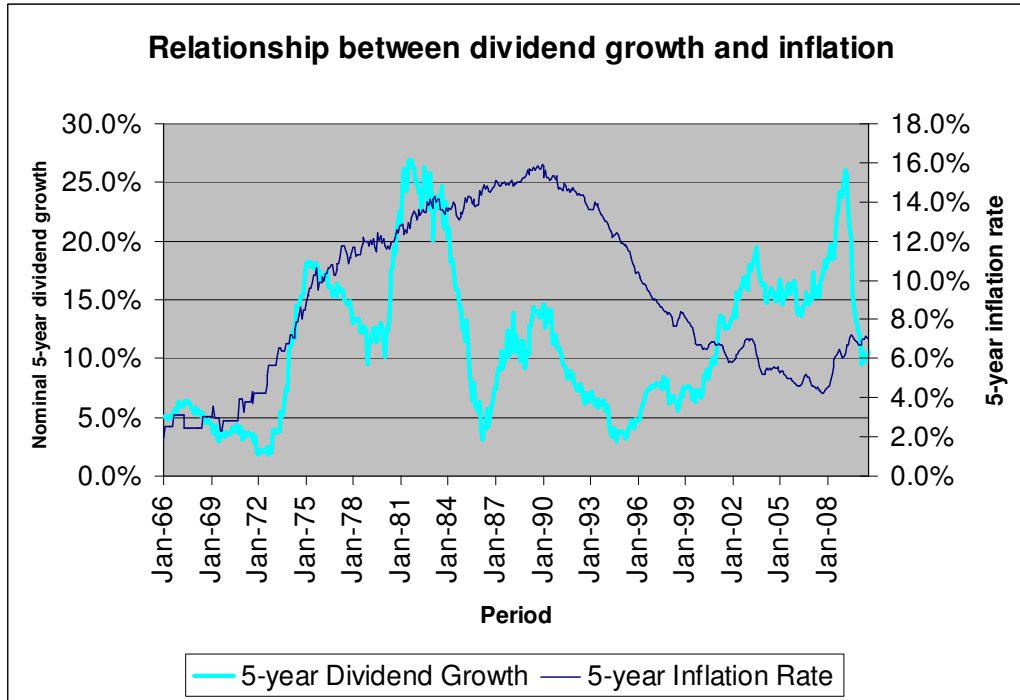


Chart 18: Five-year dividend growth and inflation

Source: DRW Investment Research

- The market rating of stocks, for example, the dividend yield (dividends paid during the past 12 months over the current market price of stocks) may be an important gauge to assess the relative attractiveness of the stock market at a particular point in time. More often than not it follows that low dividend yields predict subsequent low nominal and real equity returns in the next investment period. Alternatively, high dividend yields often indicate subsequent high equity returns.

[Chart 19, Chart 20 & Chart 21]

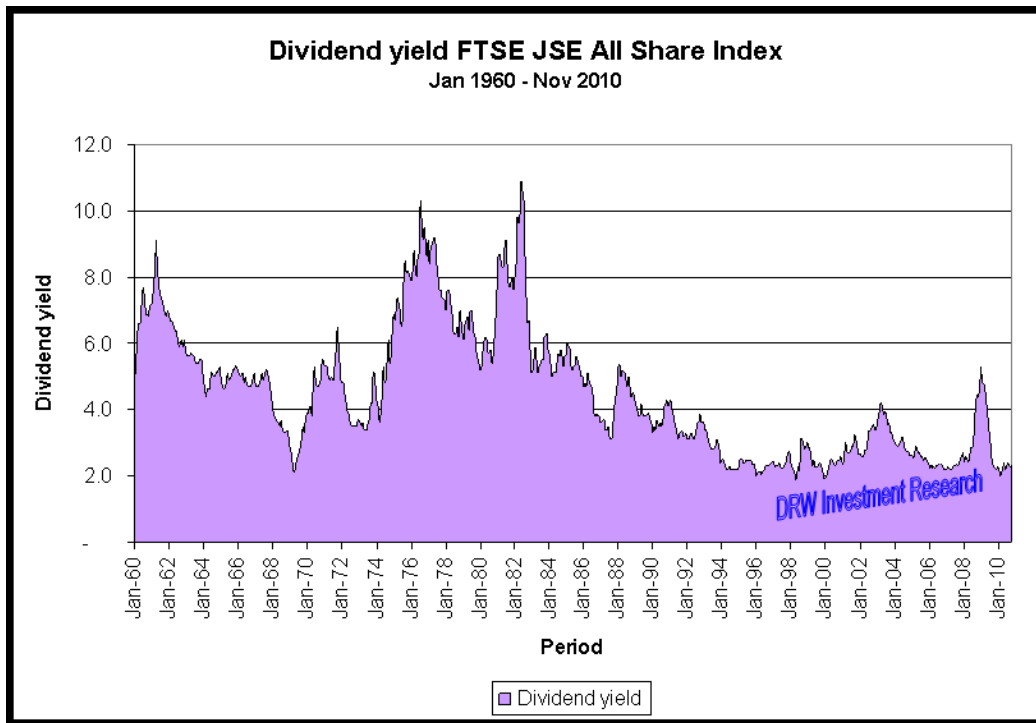


Chart 19: Dividend yield of FTSE JSE All Share Index

Source: DRW Investment Research

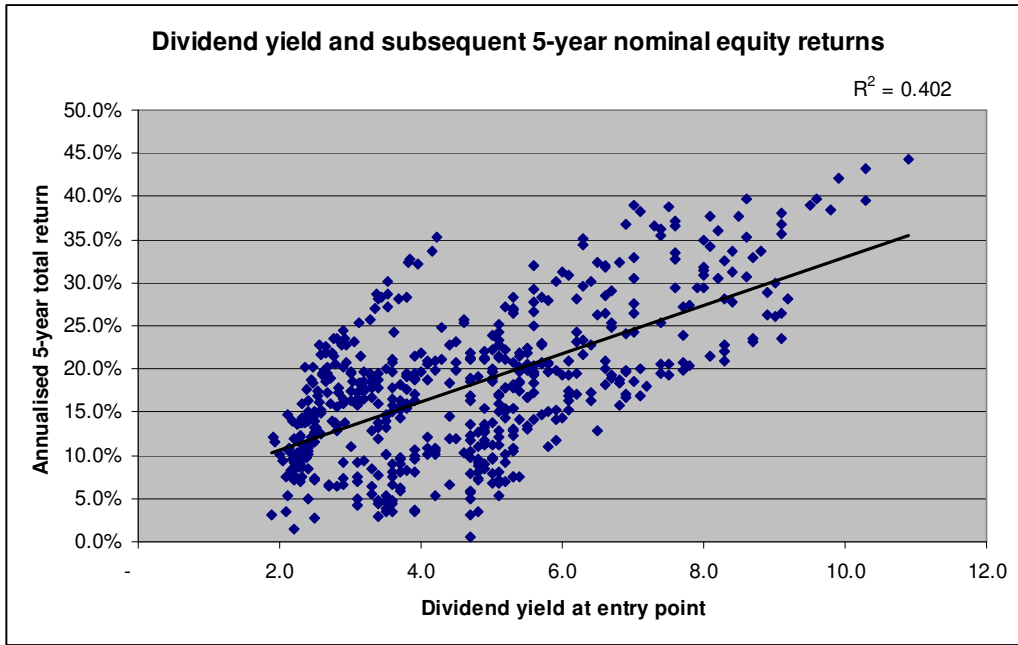


Chart 20: The relation between dividend yield and subsequent nominal equity returns  
 Source: DRW Investment Research

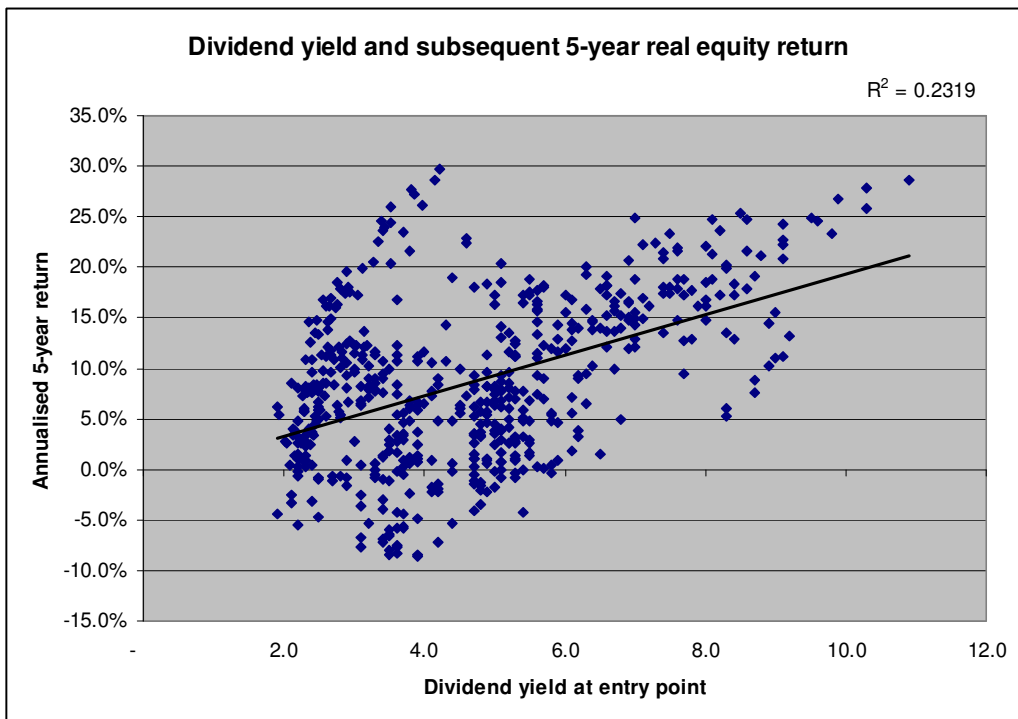


Chart 21: The relation between dividend yield and subsequent real equity returns  
 Source: DRW Investment Research

## 5. Synopsis

- Long-term investors should predominantly invest in equities in search of sustainable dividends and above-inflation dividend growth. Price movements, while exciting or disheartening, should not be the most important consideration for the long-term equity investor.
- The most important and consistent source of real equity returns over the long term is dividend payments to shareholders.
- The real growth in dividends is a function of companies' earnings growth. Thus, the overall growth in the international and domestic economy (economic cycles), price stability and interest rates will all play a key role in determining the actual dividend growth. While the nominal growth in dividends lagged inflation for some periods in time, it outpaced inflation over the longer term.
- The market rating of equities, such as the price/earnings (PE) ratio or dividend yield, at a particular point in time is influenced by the inflation outlook and prevailing interest rates. More importantly, market ratings are mean-reverting over time. Periods of high market ratings tend to be followed by subsequent periods of lower market ratings and *vice versa*. Thus, depending on the starting point of the investment period the change in market ratings will either add or subtract from the overall equity return.
- Notwithstanding, the cumulative effect of dividends and dividend growth will dominate the overall return profile of equities in the long run and should therefore negate the adverse effects of potentially declining stock market ratings.

### Additional Sources:

James Montier, 2010. "A Man from a Different Time" GMO White Paper, August.  
Available at: [www.gmo.com](http://www.gmo.com)

Prudential Portfolio Managers, 2010. Annual Presentation to Financial Advisors.



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