Why Dividends Matter to Investors

5 Reasons Why Dividends Matter to Investors

By
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THE FINANCIAL DOCTOR is an active trader, commodity futures broker, and stock market analyst 17+ years of experience, in addition to 10+ years of experience as a finance writer and book editor.

Five of the primary reasons why dividends matter for investors include the fact they substantially increase stock investing profits, provide an extra metric for fundamental analysis, reduce overall portfolio risk, offer tax advantages, and help to preserve the purchasing power of capital.

KEY TAKEAWAYS

Companies that issue dividends can provide inherent fidelity to the financial state of the company; unhealthy companies are generally not in a position to provide dividends to their shareholders.

- Qualified dividends paid are taxed at rates lower than the ordinary income tax rate—0% to 20%.[1]
- Even during periods of recession, dividend stocks have historically shown growth.
- 75% of the returns from the S&P 500 from 1980 to 2019 came from dividends.

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1. Growth and Expansion of Profits

One of the primary benefits of investing in dividend-paying companies is dividends tend to steadily grow over time. Well-established companies that pay dividends typically increase their dividend payouts from year to year. There are a number of "dividend aristocrats," or companies that have continuously increased their dividend payouts for more than 25 years consecutively. Over the last 10 years (as of Jan. 28, 2022), the compounded annual growth rate (CAGR) of the total return for S&P Global Dividend Aristocrats was 2.72%.[2]

One of the basics of stock market investing is market risk, or the inherent risk associated with any equity investment. Stocks may go up or down, and there is no guarantee they increase in value. while investing in dividend-paying companies is not guaranteed to be profitable, dividend stocks offer at least a partial return on investment that is virtually guaranteed. It is very rare for dividend-paying companies to ever stop paying dividends, in fact, most of these companies increase the amount of their dividends over time.

Many investors fail to appreciate the huge impact dividends have on stock market profits. From 1980 to 2019, 75% of the returns of the S&P 500 came from dividends. This means the inclusion of dividend payments made up the majority of what stock investors have realized in returns on investment as compared to what their returns would have been without dividend payments.[3]

Additionally, in this low-interest-rate environment, the dividend yield offered by dividend-paying companies is substantially higher than rates available to investors in most fixed-income investments such as government bonds.[4]

Dividend-paying stocks can also improve the overall stock price, once a company declares a dividend that stock becomes more attractive to investors. This increased interest in the company creates demand increasing the value of the stock.

2. Dividends Are Helpful in Equity Evaluation

Just as the impact of dividends on total return on investment, or ROI, is often overlooked by investors, so too is the fact that dividends provide a helpful point of analysis in equity evaluation and stock selection. Evaluation of stocks using dividends is often a more reliable equity evaluation measure than many other more commonly used metrics such as price-to-earnings, or P/E ratio.

Most financial metrics used by analysts and investors in stock analysis are dependent on figures obtained from companies' financial statements. The potential problem with evaluating stocks solely based on a company's financial statements is companies can, and unfortunately sometimes do, manipulate their financial statements through misleading accounting practices to improve their appearance to investors. Dividends, however, offer a solid indication of whether a company is performing well. In short, a company has to have real cash flow to make a dividend payment.

Examining a company's current and historical dividend payout gives investors a firm reference point in basic fundamental analysis of the strength of a company. Dividends provide continuous, year-to-year indications of a company's growth and profitability, outside of whatever up-and-down movements may occur in the company's stock price over the course of a year. A company consistently increasing its dividend payments over time is a clear indication of a company that is steadily generating profits and is less likely to have its basic financial health threatened by the temporary market or economic downturns.

An additional benefit of using dividends in evaluating a company is that since dividends only change once a year, they provide a much more stable point of analysis than metrics that are subject to the day-to-day fluctuations in stock price.

3. Reducing Risk and Volatility

Dividends are a major factor in reducing overall portfolio risk and volatility. In terms of reducing risk, dividend payments mitigate losses that occur from a decline in stock price. But the risk reduction benefit of dividends goes beyond that basic fact. Studies have historically shown that dividend-paying stocks outperform non-dividend-paying stocks during bear market periods. While an overall downmarket generally drag down stocks across the board, dividend-paying stocks usually suffer significantly less decline in value than non-dividend-paying stocks.

However, that trend did change of late. There have been three bear markets over the last 20 years, with dividend stocks outperforming during the first two, but during the most recent—amid the coronavirus pandemic—dividend-paying stocks underperformed.[5]

Meanwhile, dividend-paying stocks did outperform during the other two bear markets—the tech bubble burst in the early 2000s and during the financial crisis. As well, dividend stocks have proved to be less volatile. Per a Merrill Lynch study, stocks with a history of steadily increasing dividends outperformed non-dividend-paying stocks from 1990 to 2018 with less volatility.[6]

4. Dividends Offer Tax Advantages

The way dividends are treated in regard to taxes makes dividends a very tax-efficient means of obtaining income. Qualified dividends are taxed at substantially lower rates than ordinary income. Per the IRS, for individuals whose ordinary income tax rate is in the highest brackets (35% or 37%), qualified dividends are taxed at only a 20% rate. And for individuals whose ordinary income tax rate is below 12% to 35%, qualified dividends are taxed at 15%, and for those in the 10% or 12% tax brackets, they pay no tax on qualified dividends.

5. Dividends Preserve Purchasing Power of Capital

Dividends also help out in another area that investors sometimes fail to consider: the effect of inflation on investment returns. For an investor to realize any genuine net gain from an investment, the investment must first provide enough of a return to overcome the loss of purchasing power that results from inflation.

If an investor owns a stock that increases in price 3% over the course of a year, but inflation is at 4%, then in terms of the purchasing power of their capital, the investor has actually suffered a 1% loss. However, if that same stock that increased 3% in price also offers a 3% dividend yield, the investment has successfully returned a profit that outpaces inflation and represents an actual gain in purchasing power for the investor. The good news for investors in dividend-paying companies is that many dividend yields outpace inflation.