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Beware the Dividend Trap

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Despite the market gyrations of the last few months, and the headlines that go with them, stock valuations are not meaningfully lower as compared to the end of 2017 and have still not provided the kind of new opportunities we like to see. Our cash position remains high and we remain patient.

I often get questions as to whether we have a "dividend strategy". Dividend investing is much in vogue these days. To be clear, most of the stocks we hold in the Lionridge Total Equity Portfolio do pay a dividend. That said, we don't make the payment of dividends a requirement in our stock selection process.

To be sure, there are advantages to dividends. The tax-advantaged treatment of dividends is the main one. However, if a given company chooses to use its excess cash for profitable re-investment (as opposed to paying dividends), the shareholders are better off from both a wealth-building and a tax-deferral perspective. Also, if the shares of a company are trading at a reasonable valuation, it is more advantageous to the shareholders if the company uses excess cash to buy back its own shares.

I'm therefore of the view that an over-reliance on dividends can interfere with the long-term building of wealth. It's possible that a strategy of investing in stocks with sustainable dividends can result in decent investment returns compared to the overall stock market, but I believe that the approach we follow is more effective at growing wealth - particularly on a risk-adjusted basis (do you recall my metaphor comparing jelly beans to broccoli?).

> "For the equity portion of your portfolios, it is much more rational and disciplined for us to focus on long-term capital appreciation as opposed to the immediate generation of income."

Unfortunately, dividends do meet a psychological need on the part of many people for the instant gratification that they can provide. The investment industry often responds by providing investors with strategies and funds that focus on dividends (i.e., giving people what they want, as opposed to what they really need). Over the long term this can result in suboptimal results, for reasons cited above. I also worry that the low interest rate environment of recent years has caused many people (particularly retirees) to expose themselves to inappropriate risk by chasing dividends as a replacement for interest payments, thereby shifting their portfolios too aggressively towards equities.

A simple dividend strategy can also run the risk of overlooking issues that could be inherent in stocks with high dividend yields. Often times these dividends might not be sustainable, setting up investors for future losses. A good example in recent memory was Kodak. Despite an obviously declining business, Kodak was able to maintain its dividend for a period of time while its stock price was declining. This attracted a number of investors who were intrigued by the prospect of the resulting high dividend yield for a period of time, but they eventually suffered losses.

For the equity portion of your portfolios, it is much more rational and disciplined for us to focus on long-term capital appreciation as opposed to the immediate generation of income. Although bond yields remain low, we can provide clients with cash flow from our bond portfolio as our positions tend to be very liquid. Relying too heavily on dividends from equity investments to meet current cash flow needs, however, may lead to the risk of permanent losses of capital. This is what we strive to avoid. ■

At Your Service,

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