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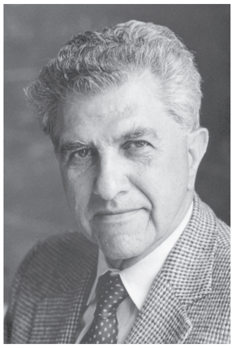
In today's low interest rate environment, investors are increasingly looking for ways to improve the current yield on their portfolios. There are a variety of reasons individuals might want more income. Some believe that stocks with higher yields have higher expected returns. Others, such as retirees and other income-oriented investors, like to have higher dividends coming in to help cover portfolio expenditures and distributions.

The preference individuals have for dividends is nothing new. Investors have long preferred investments with higher yields, especially those that have a long history of paying continuous or growing dividends. And with interest rates at historic lows, there is increased attention in the financial press on the importance of only spending the interest and dividends one receives from a portfolio—implying or directly stating that this is a financially prudent strategy.

Of course, Wall Street is happy to oblige investors by creating mutual funds and ETFs that invest in stocks with high dividend yields. At present, there are 53 high-dividend-yield ETFs with over $100 billion in assets. The sponsors of these funds prepare nice glossy brochures touting the investment merits of high dividend paying stocks.

Unfortunately for investors, there is no evidence that dividend-based strategies are beneficial. In fact, the preference of investors for high-yielding stocks is inconsistent with financial theory and a behavioral anomaly that financial researchers like to debate. The idea that a company's dividend policy is unrelated to its stock return has been an accepted concept of standard finance since Merton Miller and Franco Modigliani established this fact in their famous 1961 paper, "Dividend Policy, Growth, and the Valuation of Shares." Known as the M&M theorem, no one has challenged it in the nearly 60 years since it was written, and it has been taught to virtually every finance MBA student since it was published.


Merton Miller


Franco Modigliani

As Miller & Modigliani explain it, before trading costs and taxes, money is fungible and investors should be indifferent to $1 in the form of a dividend or $1 from selling shares. This is because the dividend is economically neutral—a stock's price will drop by exactly $1 when the dividend is paid. The dividend is therefore nothing more than a forced return of capital to shareholders, although it is taxed at a higher marginal rate than an equivalent sale of shares.

Historical evidence supports the M&M theory. Stocks with similar exposures to common risk factors like size, value, and profitability have the same returns regardless of whether or not they pay a dividend. This is why Dimensional does not consider a stock's dividend yield when constructing portfolios, except in their tax-managed funds where they prefer lower-yielding stocks to reduce taxable distributions.

One possible explanation for the preference for dividends is that they offer a sort of hedge against price declines. The thinking is that the dividend should provide a cushion against falling values, but this logic ignores the fact that when a dividend is paid, a company's value falls by the exact amount of the dividend. In other words, a dividend is not free money—it is a choice a company makes to return capital to its shareholders.

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Samuel Hartzmark, Assistant Professor of finance at the University of Chicago's Booth School of Business, believes that dividends are a type of mental accounting in which investors equate a stock dividend to bond interest. These are not the same because the principal value of a bond at maturity does not fall by the amount of interest payments. According to Hartzmark, investors behave as if dividends and capital gains are disconnected, when in fact dividends result in price decreases and therefore reduced capital gains. Ultimately, it is only the total return on an investment that matters.

What is especially puzzling about the preference for dividends is that taxable investors should favor selling shares for cash flow rather than receiving dividends since this results in less tax. Unlike a dividend, which is fully taxable when paid, when shares are sold, taxes are due only on the portion of the sale representing a gain. And the specific lots that are sold can be identified to minimize the gain.

It is also important to note that expressing a preference for dividends in one's portfolio will result in a less diversified asset mix. Consider that only about 40% of domestic and 60% of international companies pay a dividend. Therefore, any dividend screen one applies will necessarily result in a much less diversified portfolio with far fewer holdings than investing in all companies in the market. Less diversification means greater volatility, which is not advisable without compensation in the form of higher expected returns for increased risk.

Some investors may also be substituting dividend paying stocks for safe bonds in their portfolios, thinking they will achieve higher returns without increased risk. This idea is false. Dividend paying stocks are riskier than bonds because they are subject to price volatility like any stock. As noted earlier, the dividend does not reduce risk in a down market.

This is why we follow a total return approach to managing your portfolio rather than an income-based approach. For clients who need regular income, we sell shares as needed to free up cash. By managing cash flow this way, we keep your portfolio fully diversified and properly allocated to the various factors of higher returns. It also allows us to rebalance your portfolio by selling shares in the funds that are overweight relative to their allocation targets as stated in your investment policy.

As always, thank you for you continued trust and confidence.

Warm regards,

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