

Misconceptions in Finance

Many years have passed since I finished my business degree, but academic misconceptions in finance remain. Dividends are promoted as payments made by companies that are unable to grow. Business textbooks state the only reason people will buy these companies is due to their quarterly cash enticement.

The typical business school argument begins by stating: dividends should only be paid out if a company has excess cash and does not have any quality investment opportunities. A quality opportunity is defined as one that would increase the value of the business. Historically, this has been referred to as a growth stock. We would argue a dividend payment is more complicated when analyzed outside of the textbook. If a management team has \$100 of excess cash and a dividend payment of \$10, the \$90 remaining would go to only fund the best projects. If no dividend was paid out, the remaining \$10 may be spent on mediocre projects.

Dividends are an increasing topic because of the huge increase in dividend yields over the past year. At the end of December 2007, the dividend yield on the S&P / TSX Composite was 2.5%. Currently, it is at 4.1%. Contrast this rate with 10 year Canadian government bonds which are yielding 2.8%. The situation in the United States is the same. Using US data, the last time dividend yields were above 10 year US government bond yields Elvis Presley was at the top of the music charts.

Myles Zyblock, Chief Strategist, at RBC Dominion Securities recently stated in a report that most investors believe “when one stresses dividend income one must surely be bearish on the market”. According to a study done in the United States by Kenneth French of the Tuck School of Business, a strategy of focusing on dividend paying companies leads to better long-term performance. Professor French’s study reviews equity performance beginning in 1927 and reports that a dividend strategy would have out performed the overall market in the United States every 10 year period since then except for one. The anomaly occurred during the run up in the technology bubble of the 1990s.

Mr. Zyblock performed a similar analysis in Canada, Germany, Japan and the UK using data from December 1976 to December 2007. His conclusions were the same. Stocks which have increased their dividends in the past year performed the best. In Canada, companies which kept their dividends constant took the ribbon for second best. The worst performing groups were those companies which cut their dividends or didn’t pay a dividend. In the end, the growth stocks didn’t perform as the textbooks imply.

Dividends inside the Fund

The Small Cap Fund has a dividend yield of 4.5% versus the BMO Small Cap Index at 5.2%. The dividend yield on the index is higher than our Fund as many of the commodity trusts, which we only have a limited exposure to, have dividend yields in excess of 10%. In general, the companies in our Fund have been increasing their dividends. The 5 year dividend growth rate of our holdings is 23.5%. This exceeds the larger cap S&P / TSX Composite index dividend growth rate of 21.0%. Even over the last six months as the market has experienced weak retail sales and lower energy prices, two companies in the fund, Pason and Le Chateau, have increased their dividends. Currently, 78% of the companies in the Fund pay a dividend. We believe these management teams will continue to allocate capital to the best projects and pay out the remainder to us. It looks like a couple of our businesses are signalling with dividend increases that they feel their businesses will continue to generate good cash flow in this economic slowdown.

