PROMOTION

THE POWER OF DIVIDENDS

Where can I double my money this week?’ and ‘Are there any ten baggers around?’ are common questions aimed at anyone working in investment. I hate to be a bore, but I explain such returns mean taking levels of risk similar to those in bookies. So, if not trying to shoot the lights out in a week, how can an investor expect to increase their wealth?

When investing responsibly, I believe you need to take a long-term view and assess what you expect your returns to be. Returns from equities are a combination of dividends and capital growth. It is on dividends that I focus this article.

John D Rockefeller said: ‘Do you know the one thing in life that gives me pleasure? It’s seeing my dividends coming in.’

So what is a dividend? It is simply the sum of money that a company pays to its shareholders out of its profits or reserves. Therefore, with dividend paying stocks you get paid for holding them no matter what the share price is. However, companies choose the appropriate value to distribute to shareholders. This means that as well as rising, dividends can fall.

However, management teams of many dividend paying companies are under pressure to sustain their dividends even in times of falling profits. Take Roche, the world’s largest cancer drug manufacturer. It has increased its dividend every single year for 27 years.

Sometimes though, companies have no choice but to reduce or suspend dividends. When choosing dividend stocks, it is important to choose only those that you believe will sustainably be increase their dividend through free cashflow over the long term.

So how do you assess a company’s ability to increase its dividends over the long term? For this to happen, the company must be able to sustainably increase its profits.

With this in mind, I think it is important to choose only shares in industries with high barriers to entry, operating in markets with favourable demographics and, most importantly, enough of the companies’ profits must be being re-invested for growth.

With a sensible approach, dividends can arguably provide a much more stable income stream than savings accounts, which are reliant on interest rates and can be extremely volatile in the income which they pay. I think we all remember getting 7-8% and now we get 1% if lucky....

However, in order to gain the extra income shares can provide, investors must accept fluctuations in the capital value. We tend to find that clients wanting to take a substantial income and not wanting huge swings in capital value, but accepting some, benefit most from a mixture of equities and other assets, such as bonds, which have low correlation with equities and still provide income.

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