The Dividend Trap: How Seeking Stability Might Limit Your Returns

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Keith: Welcome to the Empowered Investor. My name is Keith Matthews and I'm joined by my cohost, Lawrence Greenberg. Lawrence, how are you today?

Lawrence: I'm doing great. Very happy to be back on the show.

Keith: For our listeners, Lawrence is an associate portfolio manager at our firm, Tulett Matthews and Associates, and a client-facing advisor. And Lawrence, if I'm not mistaken, this is number eight or nine for a podcast for you right now. You're becoming a seasoned vet. So today's topic is a great one. We're choosing to do dividend investing as the theme. We're going to review what is dividend investing. We will discuss whether it's all that it's cracked up to be. There's a lot of press, a lot of people talk about why you should be really focusing on dividends, etc. We're going to review some limitations of the strategy, discuss some of the advantages. And then at the end, we're going to wrap up and have a series of takeaways around dividend investing. So let's jump right into it, start with a few definitions, try to understand why we're having this show. So, what is dividend investing followed by why are we having this discussion?

Lawrence: Yeah. So very simply, dividend investing is prioritizing stocks that have high dividends, maybe only investing in stocks that pay dividends and omitting ones that don’t. So there tends to be more of a mentality that you want to buy stocks to produce income, and it's not as well balanced as it could be. So we're talking about this because this is definitely a trend with investors in Canada. This has been around for decades now. There's a bit of a cult following with investors who are very passionate about this topic, about investing in dividends and how it may not be a coherent investment philosophy. There are some flaws that we want to outline today.

Keith: Okay. So again, this is about mostly individuals that follow the, “I'm just going to invest in dividend stocks and I'm going to ignore the rest.” So let's dive in. One of the bases that we're going to review and look at is this idea of dividend irrelevance. And that's at the core of understanding, do I want to receive a dividend, or should I be with a company that doesn't pay a dividend and tries to have capital appreciation? And I guess the last thing about dividend investing that we want to bring up is in the last year or two, interest rates have come up quite a bit. So, we've seen the negative pressure on bond prices. Dividends have had that same pressure. So, for many years, dividend investing was always perceived as a no-brainer. But if you look at dividend results in the last 12 months, they are significantly negative, not only in Canada but also in the United States. So now all of a sudden people are asking more questions like, does this make sense? And we're not here to necessarily discredit dividend investing totally because we have dividends in our portfolios. Absolutely. They're an important part, but we want to just have a conversation about dividend investing. And how to think about them. And how to think about it. So, let's jump into the foundational theory around this concept called Dividend Irrelevance. What is it and why is it important?

Lawrence: Yeah, so it's really interesting. So, this was brought on in an academic paper in 1961 by economists who afterwards won the Nobel Prize for all their research they did. But it was the foundation of this concept that investors should be agnostic or indifferent towards stocks that get dividends versus those who don't. And you're not better or worse off as a result. So you're better off owning the entire market and being neutral. It was reinforced a couple of times in subsequent papers. And that's what we've seen in the marketplace as well, is that investors should be indifferent towards it.

Keith: It seems like motherhood statements being indifferent. Give us concrete examples now. Talk to us about how money would flow from a company as a dividend versus it doesn't flow and it's kept in the company.

Lawrence: Yeah. So, to outline what we're seeing here, I've outlined a pretty simplistic example here. You have a firm, it's ABC Inc. There's one shareholder and the firm has 1 million in profit this year. The firm has two options on how to use those million dollars. Option one is you pay the million dollars to your one shareholder.

You as the shareholder are now a million dollars richer as a result. Minus taxes. So that's option one. You. Paid out in a dividend and as an investor, you're a million dollars richer. Great. Option two is you reinvest that 1 million in profits to grow, to expand, to hire people and so on.

But you as a shareholder are exposed to this firm that still has that 1 million. So your net worth has stayed the same. You're just moving cash from one pocket to the other.

Keith: So from an accounting perspective, you're indifferent, whether you receive the dividend or whether the dividend stays in the business, but from an accounting perspective, from a valuation perspective, from a "how wealthy am I?" perspective, one gives you the dividend. The other one has the dividends still in the company.

Lawrence: Yeah. And what we've seen in the marketplace is this holds true. When I say that you pay out the dividend, what happens in the public market is when a stock issues their dividend as of the ex-dividend date, so the date in which new investors will not be able to participate in this dividend. So on the day it's announced, for simplicity's sake, the share price drops by the amount of the dividend. So that's the market's way of equaling everything out. So a dividend can't be conceived as free money, like it's a bonus. The stock price adjusts to factor in that cash leaving the business, going to investors.

Keith: Okay, so put real numbers around it. Stock trades at 40, they announce a 1 dividend. And on the announcement date, the stock now trades at 39. So, you go 39 plus your 1 dividend, you're back to the same 40.

Lawrence: Hence, you're indifferent.

Keith: Okay, so then this concept was really explored and developed...

Lawrence: In the early 60s. Yeah, and it's been reinforced ever since, and that's what the data shows is that stocks adjust for the dividends.

Keith: Okay, so let's switch gears. There's one more fundamental point we need to understand, and then we're going to go into the factors to consider around dividend investing. So, let's talk about stock returns, and total returns, and what are...

Lawrence: They made up of. So the concept of a total return is that for an investor, that's the top-line number you should look out for. If you own a stock that pays a dividend, you have a certain breakdown of a dividend return versus a capital appreciation return. So let's say you own Apple shares. It goes up 10 percent in a year. That's capital appreciation, but it also paid a 2 percent dividend. Your total return is 12%. And the theory reinforces that you should be indifferent on how much of that total 12 percent is capital appreciation versus dividends.

Keith: As long as there's no tax implications, we'll talk about that after because there are tax implications.

Lawrence: Very important.

Keith: So the total return, we at our firm for years and ever since we've been started, actually, we focus mostly on total return. So we build retirement projections on total return. Which includes appreciation and dividend. And to be clear again, what's our dividend yield on our portfolios right now, Lawrence?

Lawrence: Yeah. So naturally by being a stock investor and exposing your portfolio to the overall stock market, you will be exposed to dividend stocks and non-dividend paying stocks. Our equity portfolio is yielding around 3%. It produces that type of income from dividends.

Keith: Dividends. And so that's Canadian, U.S., and international. So again, not to say that we don't necessarily want to be investing in dividends. It's part of a diversified global portfolio. The commentary around here is geared around not wanting to overemphasize dividends or only invest in dividends. So we very much believe in making sure we capture the capital appreciation side of a stock. A lot of our clients are in the higher income tax bracket. And so they pay out. And for any investor who's in a higher income tax bracket, if you're paying out high taxes on dividends, that is less tax efficient than paying out taxes on capital gains. So before we go to the next topic, let's review tax structures on interest, dividend, and capital gain. Interest is straightforward it's on a bond or a GIC also on foreign dividends.

Lawrence: Yeah. So let's break down how investors are taxed because this is very important and will lead the next discussion. So going from most optimal to least optimal. So capital gains are taxed the most favorably. It's the lowest tax rate followed by Canadian dividends. There's a bit of a tax break for investing in firms in Canada, followed by foreign dividends and interest. So capital gains are taxed at 50 percent of your marginal tax rates. Canadian dividends are somewhere in the middle at the highest bracket, around 39%. And for foreign dividends are treated the exact same way as interest income, which is actually at the highest bracket, 53%. So the least favorable, the most tax.

Keith: Yeah. So when you talked about capital gains, 50 percent of your capital gain goes to your income. And then, if you're at the highest tax bracket, half of that, so 25%. Okay. This sets the foundation for the next series of comments here. What we're going to talk about are factors to consider and perhaps disadvantages around dividend-only investing. And these are concepts you need to think about if you're going to go down that path. So the first thing is that dividends increase your tax burden.

Lawrence: Yeah, it's very important. So, for those who have stocks and investments in a taxable account, so outside of an RRSP or TFSA, you have taxes to worry about, and dividends create a tax burden that may not be optimal. It's taxed higher than capital gains and if you don't need the income, you don't need the cash flow, sorry, you're producing income by virtue of receiving these dividends that you may not need, and then paying more taxes for it.

Keith: That's a great point. I'm going to use a real extreme example. Let's say two stocks yield an 8 percent total return. One 8 percent comes 100 percent in a dividend. And the other 8 percent comes 100 percent in a capital gain. The dividend investor will be paying tax every single year. If he or she's at the highest tax bracket, 39%. The capital appreciation holder will pay the tax when they sell the security, five years, 10 years, 20, or 30 years, and they only pay 25 percent of the total tax, assuming capital gain taxes don't go up. So that's a pretty major difference in tax rates. All things considered, if we're dealing with the same expected return of a company.

Lawrence: Yeah, so two things to be mindful of, right? So is the difference in rates is that it's less tax favorable. It's a higher tax rate for dividends. And it's the whole idea of trying to defer taxes as much as possible where dividends, you can't do that. It's being triggered quarterly regardless. So very important from a tax perspective to be mindful of.

Keith: Yeah. And furthermore, even this whole concept of deferring your capital gain, I know that's not part of what this message is about, but there's a massive power being able to defer your capital gain because your deferred capital gain compounds over time. So it's actually worth more if you can actually defer it. So we have lots of our clients that have securities that were purchased 20 years ago, 30 years ago. So there's a long deferral we've been going through. Okay, so that's the first factor to consider, which is perhaps the dividend strategy, perhaps not always, because for lower-income Canadians, there are some advantages to having the dividends, but for moderate to higher-income earners, there's perhaps a disadvantage on the tax front. Let's move to the second front, and that has to do with decreased diversification when you pursue dividend strategies.

Lawrence: Yeah. So, when you strictly invest in stocks that pay dividends or mostly, you ignore the rest of the marketplace. So, in the US, for example, only 38 percent of US stocks pay dividends. So, 62 percent of stocks, you're completely ignoring, not a good way to diversify similar in Canada. I don't have the numbers, but understanding of the breakdown here in Canada, stocks that pay dividends tend to be in the energy, financials, and utilities and underweight things like technology and other sectors. So, you're not diversified on a couple of dimensions.

Keith: Yeah. Marcelo and I spoke about that in the international diversification podcast, and we'd be like, why would you, when most kids have a lot of their money in Canadian stocks, perhaps more than they should, why would you ignore the rest of the world? It's the same concept. Why would you ignore all these great companies? Warren Buffett's company, Berkshire Hathaway, does not pay a dividend. So why would you ignore Canadian stocks? So the big question is, what is the best way to maximize your return? And it's this idea that you can make more certain opportunities just because you want to really focus in on one type of return. What about the next concept? We're going down a list of about six or seven, dividends are not free money. What do you mean by that?

Lawrence: So we've alluded to this already, is that some investors have this bias or this perception that a dividend is a bonus, right? So you invest in the stock and you get this extra return by dividend that goes into your account. And as you alluded to earlier, that's not how it works, right? Your total return factors this in stock prices do adjust for dividends and they decrease by that amount. So you're net neutral from a valuation perspective for stock that paid in versus don't.

Keith: You know what? That's a great point because I do actually think that investors feel that all stocks give about the same appreciation. That just hit me here. Let's call it 7%. And the dividend, I get on top of that. So I think there's a perception that some people feel that there's that extra bonus. And what you're talking about dividend relevance about five minutes earlier is there's no such thing. It's all part of the total return. It's not free money and you call that a free dividend fallacy.

Lawrence: Yeah, exactly. You're giving up future capital appreciation for receiving those dividends. There's no free lunch in finance, right? That's an important distinction to make.

Keith: I thought diversification was a free lunch.

Lawrence: Actually, it is, yeah.

Keith: Anyway, so listen, let's move along here. Point number four, dividends limit total returns. And what we mean by that is if you do not reinvest timely, you've got cash on the side, which is not getting the expected return of either the security or the general market. So therefore, you're not going to get the same rate of return as somebody who's constantly reinvesting.

Lawrence: Yeah, that's a big one. That's something investors who fall victim to this may not appreciate. Is that, if you receive dividends and you don't reinvest it right away, or you're not in a DRIP program, Dividend Reinvestment Investment Plan. If you do not reinvest your dividends and it goes to cash, a period of time may take place, maybe weeks or it's months or maybe even years where you're not reinvesting, you're not exposed to the market and that creates underperformance. There's a drag on your portfolio, which is not optimal.

Keith: To be clear here, what you're talking about is underperformance. Why? Because you've got cash in your account that theoretically should have stayed in that account for equity exposure to get equity expected returns. And the fact that you've got cash sitting around in your account means it's underinvested and you're missing out on the opportunity for the return**.**

Lawrence: Exactly, and I'll go a step further. If you're an investor and you're doing it yourself and you have dividend stocks and there's cash piling up, are you making the right investment choices with those funds? Are you chasing things? Are you falling into the flavor of the day? And there's room for human error is what I'm saying. The more you automate things, like you reinvest your dividends or stay invested, the better your outcome will be.

Keith: For example, how we manage our client assets is dividends are paid every quarter by all the strategies and either one of two things will happen. They will be automatically reinvested in the same strategy, which is simultaneous, pays out the dividend and it gets reinvested the same day. Or our trader, Julie DeRosier, is going into every single client account within two weeks, we're doing a full reinvestment back in. Into whatever asset class has sunk down a little bit, but it's the same. Reinvestment is occurring as opposed to when we see client portfolios or potential client portfolios coming in, sometimes there's significant cash positions. We're not talking one or 2%. Could be 10, 15, 20 percent cash easily uninvested, even more. Uninvested and you ask them, why is it? I lose track of the fact that I've got to go in and reinvest.

Lawrence: Yeah. Or they're waiting for the right time or all these other kind of fallacies.

Keith: So what you've got an example, it's a pretty extreme example is the S& 500 with reinvested dividends versus S&P 500 with uninvested dividends. And the returns quite significant.

Lawrence: Oh it's staggering. So it's a simplistic example because. No one would not reinvest for that period of time, but this takes the S&P 500 from 1985 to 2018, and the first example is you reinvest your dividend throughout. Your total return is over 3000%, so you reinvested every time it was issued, and you stayed invested the whole way through. In the second example, you never reinvested your dividends. You were left with a little under

1500%. So half the return just from dividend reinvesting. And no one would do that. It's 40 years of not investing. But the idea here is to show the difference it can make.

Keith: You're 100 percent correct here. And if you look at the compounding rate of return, the one that invested dividends yielded 10.68 over that same time period versus the uninvested dividends of 8.4%. So about 2.2%, which kind of makes sense. That's the ongoing dividend. But the mere fact of not reinvesting that dividend is absolutely massive. That’s obviously an extreme example, but the point is still, it's something that investors need to be aware of. How about the next one, and that one's entitled, forced withdrawals. In other words, dividends are forcing the return onto you whether you want it or not. You're getting it.

Lawrence: Yeah, so this is a big one, especially for those that are not currently drawing down from their portfolio. They're not in the drawdown phase. If you're constantly triggering income, i.e. dividends that you don't necessarily need, you're creating a taxable event, A. And you're bringing your income higher within a non-taxable account. So for example, there are benefits and pensions like OAS, for example, that are income tested. And by bumping up your taxable income, it's a not optimal tax situation where you could do other things to minimize taxes, like deferring capital gains.

Keith: Okay, part of this idea as well is you want to, as an investor or an advisor, control when you get your distributions up to a point. You don't want to be encouraging your distributions to be significantly larger than they need to be. Another way to control that is when you sell, when the advisor or the investor sells a security to raise cash. So you can either get it by a dividend, or if you don't have a dividend, you can get it by selling shares. Selling shares creates the cash flow that you need as well.

Lawrence: Yeah. So you can create your own dividend when you need it, and it's more tax efficient.

Keith: Yeah. When you need it on your terms.

Lawrence: Exactly. Not when the firm dictates that they want to pay it quarterly, for example.

Keith: Okay. Great points. Great points. The next one is a pretty straightforward one, but I want you to elaborate, Lawrence. Dividends are not guaranteed.

Lawrence: Yeah. That's pretty straightforward. There are times, for example, when the economy struggles, firms can cut dividends. So having your spending or your lifestyle based on the policies of these firms can be troubling. A lot of investors will factor in future income and depend on it. And it's not always a guarantee that a firm's dividends are not cut or they're reduced. And when that happens, it tends to be a negative signal and the price of the stock tends to drop significantly as well.

Keith: Okay, well put. So listen, we've just gone through five or six points here we'd like to articulate for people to pay attention to if they want to really be pursuing dividend-only type strategies. There are some advantages though. There are some benefits. What do we see as two main benefits?

Lawrence: So firstly, we do see a psychological benefit. So, to put it into jargony terms, it's mental accounting bias. That's something that we tackled a couple of episodes ago. So, people tend to bucket the dividends or the income from the portfolio differently. So, you feel like predictable cash flow insulates you and that maybe you could stay in your seat for longer. So, you're treating the dividends differently than the rest of your portfolio. And maybe you could stay in your seat longer when things get rocky because you could bank on that dividend return. That has shown to keep people in their seats, which is a good thing.

Keith: Yeah, so you're speaking of if dividend investing makes you stay invested through recessions. Then there's some value to it. That's a win. So, you're staying committed to your investment approach. I'd argue that if you work with a good advisory firm that keeps the process flowing, and if you could come up with a total return strategy, which I think is more effective from a tax perspective, that you're getting to the same endpoint. But the point is still an interesting one in that for those that are pursuing this strategy, if it makes them feel better to buy stocks that way, then that is a win for the strategy.

Lawrence: Exactly, and another one would be that dividend stocks tend to perform better during a low-rate environment. So, when rates are low, there are investors who pile into these companies that boost them up, and that gives you some yield. We happen to be in the opposite environment right now where rates are high, and the dividend stocks and strategies are performing worse. That's something to be aware of as well.

Keith: I think they refer to that as a dividend preference when certain individuals prefer to be in yielding securities and that has a history in Canada because if you go back even to income trusts, there's this period of about 10 years where income trusts were created, and Canadians loved them primarily for yield. They felt they could build a portfolio with diversified income trusts and generate a return. In fact, I once, now that I'm speaking about it, once had a potential client come in as a retiree. They had three income trusts. It was the most undiversified portfolio I have ever seen in my life. And they were 70 and they were totally at peace with three securities. You don't see that as much anymore. But you used to see that 15 to 20 years ago and this was all about their income, trust, and I like the income and I get my, it's like a guarantee. They're using words that we don't like to see used, unfortunately, because it's not finance, it's not how the real-world works, but there's this mental accounting that they get very comfortable with it.

Lawrence: Exactly. Yeah.

Keith: Okay. So listen, two small parts left and then we've got ourselves a nice show on dividend investing. Let's go to the results page. Let's go to the page where essentially what we've done here is looked at Canadian ETFs that are dividend focused. We compared them to a broad market. We compared their returns and we compared their yields from a tax perspective, and then we did the same for the US. Do you want to start with a couple of opening comments in terms of first, how have they done in the last 12 months with the rising interest rate environment?

Lawrence: So we took here a couple of strategies that tend to invest in higher dividend-paying stocks and, or stocks that have growing dividends. So, there's a real thematic strategy here to optimize and boost yield as much as possible through these dividends. And we're looking at the historical data going back for some strategies, almost 20 years, but the one-year performance for these strategies, they're underperforming their broad benchmark by 4 or 5%. In Canada, so four or 5%, which is quite meaningful.

Keith: So hang on. So if the TSX as of October 31st, is it plus one, the dividend securities are at minus five. Exactly.

Lawrence: Exactly.

Keith: Okay. Fair enough. Relative performance. Yep. And the two Canadian ones that we used, one is the longest-standing dividend fund, XDV, Canadian Select Dividend. And the second one is the TSX Aristocrat Strategy. Which is, these are the two most known ETFs for Canadian dividends.

Marcelo: So in terms of the US the difference is a lot more striking. A lot of it is because in the US technology has really outperformed and dividend-paying stocks tend not to be technology and your performance. I'm looking right here. You're to date minus eight for DVY. So, the US select dividend versus, the S&P 500 at plus 10%. So, the S&P 500, the broad benchmark, is doing 10%. This strategy is minus eight. The difference is minus 18% of underperformance. That's a lot.

Keith: Let's go back to some of the comments we sometimes hear from investors when somebody says I like getting paid. When the market's going sideways or going down, here, they're down after the dividend payment. Oh, yeah, they are behind the market by 18%. That's not small. That's probably one of the largest gaps I've ever seen. And again, part of it is explained because of the dramatic rise of interest rates last year in the last 12 months. So That's not necessarily a smooth ride. That's for sure.

Lawrence: No, and that one-year performance is now permeating through the long term. So I'm looking at the 10-year numbers now. In Canada, over 10 years, these two strategies that we alluded to are underperforming the benchmark by about a percent and a half to two percent. And on the US side, almost as much as two and a half percent versus the benchmark. So, two and a half percent for a decade of underperformance, that hurts.

Keith: Yeah, and then on the XDV, which is the one we have the longest track record that goes back to 2006 and on the DVY, which is the US Select Dividend, which goes back to 2003, so that's 20 years, both of them now have negative numbers relative to either the TSX or the S&P 500 since inception. Now, part of that got swung unto, by way of what's happened last year, nonetheless, to now say you've got 20 years of track record where you're forget about tax difference before tax. This is before looking at the tax rates of the dividend versus the capital appreciation, just total return. If this was an RRSP. You've got a lag in the dividend strategies.

Lawrence: Definitely.

Keith: What about the different dividend rates? So, let's talk about tax issues just for a split second here. Take XDV versus the TSX.

Lawrence: Yeah. So XDV yields about five and a half percent and the TSX comp as it yields about three and a half percent. So the dividend strategy gives you 2 percent more income through dividends. Very similar for CDZ. They have a yield 1 percent more than the benchmark.

Keith: Let's say we have expected returns of 7 percent on a go-forward basis. One of them pays 5.5%. So 5.5 of the 7 percent technically might come by way of a dividend. That's not tax friendly. These are live pieces of information that we're seeing just in the dividend yields here that we would encourage people to consider when they're using it in their portfolios. Perhaps less of a consideration in an RRSP or a tax-free saving account, but definitely a consideration in a non-registered account.

Lawrence: Correct.

Keith: Anything else on live returns? Now, again, we happen to be discussing this in a period with interest rates have just gone up, but when people say things like it's a no-brainer, it's the only way to invest. I think that this counters a little bit of that, and it is helpful to understand the full picture. Very well put. So Lawrence, that's it. Let's drive for the wrap-up here. So give me your best one or two points about today's show that you want our listeners to consider.

Lawrence: Yeah. So for me, the big one is there's nothing inherently wrong with dividends. It's a normal part of an investment experience, but the best course of action for really all investors is to be well diversified globally, to be exposed to all types of stocks, both dividend and non-dividend-paying stocks. If you're market cap weighted, you're following an index of some kind. That's a great place to start. It's quite simplistic, but really just follow the overall market. It's extremely efficient and don't overcomplicate things.

Keith: Great takeaways. I would echo for sure, follow the globally diversified portfolios. And the only thing I would add in here is keep tax in front here. Understand how you're investing because it does, especially for individuals that have moderate to higher tax rates. We get taxed a lot in this country. So there's no need to pay more tax than you need to when you can control flows a little easier. So I think there's some savvy components that investors should follow and should pursue. And they should be cognizant with regards to dividend strategy.

Lawrence: Absolutely.

Keith: So with that, Lawrence, thank you so much for now your ninth show. It's amazing. It's great to have you on and to all our listeners. Thank you so much for tuning in, and we'll see you next time. Take care.

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