Dividends bonanza has wider message for investors

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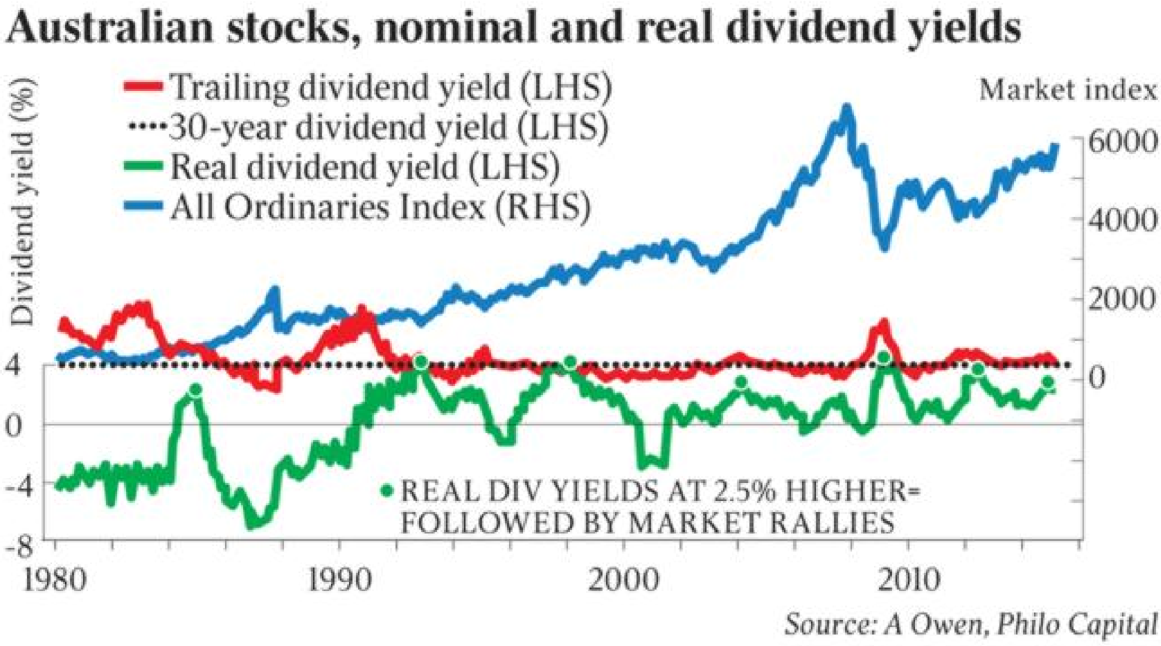

Dividend yields. *Source:* TheAustralian

I'VE never known investors to be as keen on dividends as they are now. And despite subdued growth in the world economy, the mid-year collapse in oil producers' revenue and, in Australia, downgrades in forecasts for company profits, demands for higher dividends are generally being met.

Welcome to the dividend bonanza.

The 1200 top global companies increased dividends by 10.5 per cent to $US1.17 trillion ($1.5 trillion) in 2014, research at Henderson Global shows.

In Australia, average dividend a share has climbed 5 per cent, although earnings per share have risen by only 2 per cent.

The reasons for this are wide-ranging.

● With interest rates exceptionally low, investors are on the hunt for yield — and shareholders are letting company boards know they want bigger distributions.

● Many companies are not committing to major items of capital spending. As a result, retaining profits to finance future growth isn't a priority.

● In the US, leading technology companies such as Apple and Microsoft have moved on to the stage in their life cycles where they're paying big dividends. Apple's last-year dividend is the equivalent, at the present exchange rate, of $14 billion. In total, our listed companies paid $72bn in dividends.

● Resource behemoths BHP Billiton and Rio Tinto have stepped up dividend payments — announced in US dollars — even though their revenue is crimped by falling commodity prices. These leading companies are showing investors they won't have surplus cash burnt up by expensive and wasteful acquisitions, such as Magma Copper (BHP) and Alcan (Rio) in past years.

● Thanks to our system of franking dividends, most Australian-based investors — particularly those on low or zero tax rates — always appreciate dividends. Consequently, companies listed on the ASX pay out, on average, two-thirds of their after-tax earnings as dividends — more than double the dividend payout ratio of US businesses, where, in aggregate, share buybacks dominate.

Of course, the pendulum of investor sentiment hasn't moved as far as John D. Rockefeller, perhaps the richest investor ever, would have liked. "The only thing that gives me pleasure," he observed, "is to see my dividends coming in".

At the other extreme is Warren Buffett, who has famously built Berkshire Hathaway by not paying dividends, using profits to buy new businesses or expand existing ones.

To show he's unrepentant, Buffett recently teased Berkshire Hathaway shareholders by telling them they can expect dividends (or share buybacks) — but only if they're prepared to hold Berkshire Hathaway shares for a decade or more.

To be fair, I should point out that a lot of experienced investors, investment advisers and academics downplay the role of dividends, arguing a dollar of company profit creates similar value for investors regardless of how it's later split between dividends, retained earnings and share buybacks.

All the same, investors on the hunt for yield should check the sustainability — or better, the growth prospects — of the dividend streams from the shares or share funds they hold. They need to avoid the dividend yield trap: a high dividend yield may arise because a share price has collapsed in anticipation of an imminent cut in the dividend.

And investors should allow that dividend flows are less stable year-by-year than is often thought.

Let me mention another, compelling, reason for investors to keep a close watch on aggregate dividends.

The chart, from the latest issue of Philo Capital's Market Monitor, shows "the level of real (or inflation-adjusted) dividend yields across the market has provided a pointer to broad stock market rallies ahead

"A similar measure also works for the US market … When the (Australian) real dividend yield reaches 2.5 per cent, the market rallies for the next several quarters … At the end of February the real dividend yield is still 2.5 per cent (4.2 per cent nominal yield less 1.7 per cent inflation), providing another level of support for (their) bullish stance."

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