COLUMBIA THREADNEEDLE INVESTMENTS

Cautionary words for investors chasing dividend yield

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Dividend yield doesn't tell you about the health of a company — a lesson learned from GE. That, and other cautionary advice from a veteran income investor.

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Don't focus too much on dividend yield

One thing everyone should know about dividend yield is this: it doesn't tell you much. It doesn't give you clues about the valuation of a corporation, changes in corporate fundamentals, sustainability of the dividend or future returns. It's just a simple ratio: the current dividend, divided by the price.

Here's an example: General Electric had a 2.9% dividend yield at the end of 2016. One year later, it had a 3% dividend yield, which is not that much of a difference in yield. But the yield alone conveyed nothing about the deterioration in fundamentals of the corporation, the fact that dividends had been cut, nor that investors lost 45% of their principal in the stock over that year.

Don't sacrifice total return for yield

When I talk to investors, I find it fascinating that they're willing to focus only on dividend yield, instead of looking at the total return picture. Suppose you could get an extra $500 per year in dividend income, but it would cost you $10,000 of total return. Most people would not consider that a good trade or a good strategy.

A better strategy is to invest in stocks that can not only maintain their dividend, but also continue to grow while doing so. When I began my career (a long time ago), the Dow Jones Industrial Average Index was at 825. It's now close to 26,000, which is more than 30 times what it was when I started. Investors who are chasing yield often lose sight of the importance of this total return opportunity.

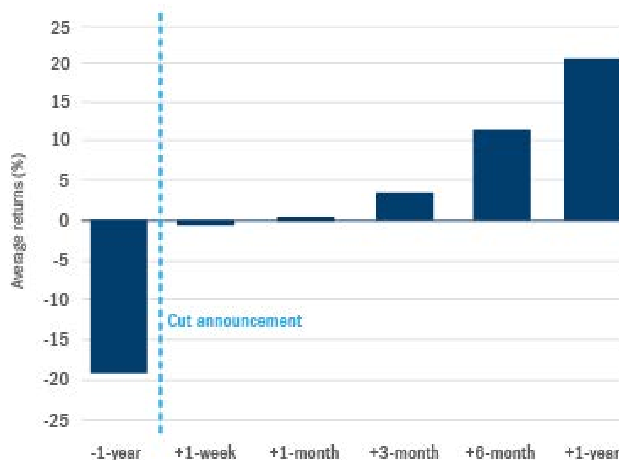
Understand the danger of a dividend cut

So we know that many investors prefer what they believe to be the certainty of a dividend to the potential ups and downs of a stock price — even though dividends

aren't guaranteed. But why is avoiding a dividend cut critical? Research shows that the damage is done in the year *before* the cut. Both income and total return are affected. Analysis of stock performance over a 20-year period shows stocks that cut their dividend went down by about 20% on average the year *before* they cut the dividend. The market figured out that the company wouldn't be able to pay their dividend because cash flow from operations was suffering. Performance was flat after the cut — the damage had already been done.

The impact of a dividend cut

Both income and total return are affected



Source: Wolfe Research Accounting & Tax Policy Research as of 10/31/18. The universe includes Russell 3000 companies, excluding <$250 million market capital companies since 1995. Measurement date from 5 days after the cut announcement. Past performance does not guarantee future results.

Focusing on the fundamentals of a company to avoid the cut is critical. If you wait for the announcement, it's too late. You've already lost total return.

I was recently in a meeting, and I was asked if I would consider higher yielding stocks. I turned to the analyst and asked, "Do you really want me trading dollars for dimes?" Because that's what people do when they make this mistake. Generating reliable income and investing in stocks that can continue to grow are more important to me than the dividend yield ratio.

Bottom line

Dividend yield doesn't tell you much, and it certainly doesn't provide any clues into a company's fundamentals. Yet, many investors continue to focus only on dividend yield and lose sight on the bigger picture: the total return opportunity. Stop overreaching and look for more consistent returns over time.

The Dow Jones Industrial Average Index is the most widely used indicator of the overall condition of the stock market and is a price-weighted average of 30 actively traded blue chip stocks as selected by the editors of the Wall Street Journal.

The Russell 3000 Index is an unmanaged index that tracks the performance of the 3,000 largest U.S. companies, based on market capitalization. It is not possible to invest directly in an index.

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