ADVISOR PERSPECTIVES

Earnings Growth Drives Total Return and Dividend Income

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Introduction

This article was inspired by an interesting debate between two commenters on my most recent article "Why a 15 P/E Ratio Represents Fair Value for Most (Not All) Companies: FedEx – Part 2." In a nutshell, the argument revolved around whether dividends were a driver or a contributor to total return. Interestingly, one of the commenters even suggested that their argument was simply a matter of semantics. Personally, I tend to agree with that sentiment because my experience suggests that arguments regarding financial principles and/or terms are often nothing more than misunderstood communications. In other words, both parties are attempting to state the same case, but utilize imprecise language which leads to perceived conflict or debate.

In this example, the phrases driver of returns versus contributor to total return may be a case in point. Are these people meaning to say the same thing in different ways, or is there really an argument that needs to be made and solved? Furthermore, these arguments are also often the result of one party utilizing deductive reasoning whereas the other party is applying inductive reasoning. The website LiveScience has a clear and concise explanation of the differences between inductive, deductive and abductive reasoning for those interested in knowing more.

Nevertheless, whether it comes down to semantics, different forms of argument or reasoning, or simply a failure to communicate, I believe the real issue is for investors to clearly understand how and why investments in common stocks can reward them. Investors armed with this knowledge and understanding can make better, safer and ultimately more profitable long-term investment decisions. I've written on the subject in the past, what follows are excerpts from previous articles I have authored:

Excerpts From Previous Articles I've Written

In March 2016 I wrote the article "Dividends Don't Drive Total Return They Contribute To It: Part 1", what follows are excerpts from that article:

"Introduction

I believe there is a critical piece of investment wisdom that all investors in common stocks should possess. Every common stock investor should have a clear understanding of where and how long-term common stock returns are generated or come from. When an investor does not possess this knowledge, they can be easily led towards drawing erroneous conclusions about their portfolios and/or the individual stocks that they own. Knowledge is power, and the knowledge of where and how long-term stock returns are generated is incredibly enlightening.

Importantly, every common stock investor should also understand that there are significant differences regarding how or where short-term stock returns come from or are generated. In the short run, common stock prices can go anywhere, often do, and often defy logic in the process. Therefore, when dealing with the short run, it's critical to recognize anomalous price behavior when it is manifest. This empowers the prudent and intelligent common stock investor in making sound long-term investment decisions. However, don't confuse sound decisions with short-term market timing decisions. The first is prudence in action, and the latter is merely guessing.

The Primary Sources or Drivers of Long-Term Returns When Investing in Common Stocks

There are two primary sources or drivers of long-term returns when investing in common stocks. The first, and fundamentally the most important, is the rate of change of earnings growth (and/or cash flow growth) that the business behind the stock generates. Simply stated, the faster a business grows its earnings and cash flows, the greater the long-term returns it will generate for its stakeholders over the long run. Stated differently, all things being equal, a faster growing business will generate greater long-term returns than a slower growing business. Long-term investment returns are functionally related to how fast a company grows its business.

The second primary source is the valuation (not the price) you pay to buy a company's earnings growth (and/or cash flow growth). Too high of a valuation will cause you to earn less than the company's growth warrants, and a low valuation will cause you to earn more than the company's growth warrants. And just like the porridge in the fairytale Goldilocks and the Three Bears, when you get valuation just right, your long-term returns will be highly correlated to the company's earnings growth (and/or cash flow growth) rate achievements.

However, in addition to these primary sources or drivers of return, there are also contributors, or contributing factors. The most common or obvious contributor to long-term returns are dividends, if a company pays one. The reason I suggest that dividends are a contributor rather than a source of long-term returns, is simply because dividends are paid out of earnings (or cash flows) which as stated above is the primary source. Moreover, the total amount of dividends (if any), as well as the long-term growth of dividends are also directly related to the growth of earnings (or cash flows).

The consistency of the company's earnings growth (and/or cash flow growth) is another important contributor to long-term returns. The long-term returns produced by a cyclical company can vary greatly from one cycle to the next. In other words, if you are measuring long-term returns at the bottom of the cycle, they can be significantly less than they would be if you measure them at the top of the cycle. However, once again, the primary source remains the earnings (or cash flow) growth. At the bottom of the cycle earnings growth (and/or cash flow growth) will likely average low, while at the top of the cycle earnings growth (and/or cash flow growth) will average higher."

In March 2016 I wrote the article "Dividends True Contribution to Total Return May Surprise You". An additional debate that occurred in the comment stream of my last article were discussions regarding the difference between value versus growth stocks. Consequently, I thought I would also address that discussion with this article. Here are a few excerpts from that March 2016 article:

"Summary

Which perform better, dividend paying stocks or non-dividend paying stocks?

The true contribution of dividends to total return may surprise you.

Do stocks that pay no dividends really underperform?

Introduction

In recent years, dividends' contribution to total return has been one of the most heavily-studied topics in the investment world. Several conclusions about the contribution that dividends make to total return have been claimed. However, these conclusions vary greatly. I have seen studies claiming that 90% of returns are attributed to dividends, several claiming 50% or more, and others arguing for a 30% contribution. Ironically, they all seem to be correct depending on the data sets and/or time frames being measured.

Nevertheless, I am on record of not being a fan of the typical academic study applied to finance. I have several problems with conclusions drawn from studies, but my major issue is with what I consider the over-generalized nature of how they are conducted. Consequently, I believe that although their conclusions may be valid based on the data as presented, I also believe they can be very misleading.

Here are but a few examples of conclusions that I contend can mislead investors. On December 6, 2010, the heads of BlackRock's global equity team suggested that 90% of US equity returns over the last century have been delivered by dividends and dividend growth. A prominent money-management firm reported that according to Standard & Poor's, the portion of total return attributable to dividends has ranged from a high of 53% during the 1940s, to a low of 14% during the 1990s. Standard & Poor's themselves suggest that more than a third of the long-term total return of the S&P 500 can be attributed to dividends. And I have read other studies that conclude that dividend-paying stocks dramatically outperform stocks that pay no dividends.

Now remember, the above are just a few samplings. In truth, there are numerous other studies that have presented varying conclusions about dividends' contribution to total returns. As a result, I commonly come across investors quoting conclusions about dividends from studies or holding what I consider misguided opinions about dividends, dividend-paying stocks and non-dividend-paying stocks. Therefore, my objective with this article is to provide a more rational examination of the contributions, or their lack thereof, that dividends actually generate.

My primary position is that the contributions that dividends make vary greatly from one company to the next. This is aligned with my general position that it is a market of stocks and not a stock market. Therefore, rather than basing decisions on overly-generalized conclusions about the merits of dividend-paying stocks over non-dividend=paying stocks, I prefer a more individualized approach.

In other words, there are certain stocks where dividends matter a great deal, and there are certain stocks where dividends are completely irrelevant. My point being, that trying to associate dividends with returns is, in my opinion and experience, a flawed approach. Instead, I favor analyzing and evaluating the contributions that dividends have made to total return on a specific case-by-case basis.

At this point, I want it to be clear that I am not either for or against dividends in the general sense. If income is your primary investment objective, then obviously dividend-paying stocks make a great deal of sense. Moreover, if highest total return is your objective, then growth stocks might be your best choice. But most importantly, I intend to demonstrate that total return is not a function of whether a company pays a dividend or not. There are many factors that drive total return, and dividends are only one of them."

FAST Graphs Analyze Out Loud Video: The Long-Term Drivers Of Return

It truly is a market of stocks, where every stock in the market is unique. However, there are certain characteristics that allow stocks to be grouped into categories. Nevertheless, even within these groups there are often more differences than there are similarities.

Consequently, I have never embraced the ideas of generalizing about things like X percent of the rate of return from stocks historically come from dividends. The studies that make these statements may be correct in the way their data is formulated and presented. However, it is not logical to suggest that dividend paying stocks generate higher returns than stocks that do not pay a dividend.

In my experience, there are two primary factors that can be considered as determinants or drivers of long-term returns. They are growth and valuation. In my personal experience, these are the only factors that can be universally applied to all stocks whether they pay a dividend or whether they don't. With this video I intend to demonstrate this reality clearly. Moreover, the meat of this article lies in the following video. Therefore, I would respectfully ask that if you don't watch the video, please don't comment.

Summary And Conclusions

The stock market can be approached as a casino of sorts when the focus is totally on price movement. In contrast, the stock market can be approached as the store that allows you to purchase fine businesses that you intend to be a long-term shareholder partner with. My work speaks to the latter.

Therefore, if the long-term ownership of great businesses appeals to you as an investor, then you should focus on from where and how your returns will be generated. To me common sense suggests that long-term results will be functionally related to the success of the business being invested in. At the end of the day, often referred to as the bottom line, total returns come down to how profitable the business you choose is and how fast it grows over time.

If the company pays a dividend your investment will contain both a capital appreciation and an income component. If the company does not pay a dividend, as an investor you will rely solely on capital appreciation for your total return. In either case, valuation at purchase will greatly impact your long-term total returns.