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The Poetry of Dividends

A cow for her milk,
A hen for her eggs,
And a stock, by heck,
For her dividends.

An orchard for fruit,
Bees for their honey,
And stocks, besides,
For their dividends.

-John Burr Williams, "The Theory of Investment Value" (1938)

Dividends are not typically the subject of poetry, but given how the current stock market is waxing eloquent about yield, we would not be surprised to see dividends surface in modern prose. After largely being ignored for over 20 years, dividend paying companies have become hot, hot, hot. The more boring and dull the company, the better. In Canada, energy infrastructure companies dominated the list of the top performing stocks in the market last year, and in the U.S., the utilities sector was the top performing sector in 2011 by a long shot.

Sionna has spoken frequently about the importance of dividends. Over the long term, dividends account for a significant proportion of the market's total return and dividend payers outperform non-dividend payers on a total return basis. Academic research shows that dividends contribute between 40% to 60% of the market's total return. This quoted figure varies depending on the time frame examined – in general, the longer the time frame, the more important dividends become, and the less important capital appreciation becomes. The significance of dividends increases materially in sideways or range-bound markets, during which dividends can account for up to 90% of the market's total return.

Given that Sionna continues to believe that we are in the midst of a sideways market, it would be logical to assume that Sionna's portfolios would have above average dividend yields, in order to take advantage of the prior noted benefits. Historically, our portfolios have generally had dividend yields that are at least 10% to 15% above the market average, yet many of our portfolios currently have dividend yields that are merely in line with the market average, which begs the question as to why.

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The explanation is that we are increasingly finding that the valuations of high dividend paying companies are becoming stretched, and many of these stocks are trading at premium levels. Investors are ignoring other traditional valuation metrics entirely in the chase for dividend paying products. In some respects, it seems the market is valuing all yields equally and indiscriminately, regardless of the payout ratios (calculated as dividends divided by earnings) or debt levels that are supporting that income stream.

In a world that wants yield, the message has been made very clear – stocks go up when cash is returned to shareholders. So, if you want your stock price to go up, you must pay and/or raise your dividend. Companies are heeding the call, and we are seeing the evidence across a surprising array of sectors. The traditional players, like utilities and banks, are not the only ones raising dividends – for example, many oilfield service stocks recently initiated and raised dividends (even though the sector is notorious for being incompatible with dividends, given the high volatility of earnings and cash flow).

In a broad sense, Sionna is cheered by the world's newfound love for dividends. We believe that paying a dividend instills a discipline in management teams, which makes them less likely to squander cash on unnecessary projects or overpriced acquisitions, and more likely to focus on controlling costs. However, we think it is critical to analyze the *quality* of the dividend, because not all yields are alike. The easiest way to measure the dividend is by looking at the current yield. This number is easy to pull up on a computer or isolate using a basic stock screen. However, simply looking at the current yield does not provide a true picture of the quality of that income stream. Certain companies with high yields may have unsustainable payout ratios, or may not be well positioned to increase the dividend in the future.

A full analysis of the quality of the dividend requires thinking about the health of the underlying business. It is important to look at whether the business itself is growing over time and whether it can raise prices. The payout ratio should be examined to see whether the company has the capacity to increase the proportion of its earnings that are distributed. The financial health of the company is also relevant because, if the company has elevated debt levels or payments coming due, then it will not have the same degree of flexibility with its cash flow. The capital allocation policy of the management team should also be considered, in order to determine whether management prefers to use excess capital to make acquisitions or repurchase shares, as opposed to growing the dividend.

The following chart provides an example of two large cap stocks in the S&P/TSX Composite. Pembina Pipeline owns oil pipelines and gas processing facilities in Western Canada. With a yield of 5.6%, the stock would show up well on any dividend screen. Yet, looking behind that yield reveals that the stock is trading at a P/E multiple well above the market's P/E ratio of about 14x, and that the company has a high payout ratio and considerable debt. In contrast, a stock like Shoppers Drug Mart has only a modest yield of 2.4%, which is below the market average of 2.7%. Yet, behind that yield is a moderate P/E multiple, a low payout ratio and a strong balance sheet. So, while

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Pembina's high current yield is obviously attractive, Sionna prefers the fundamentals that are behind Shoppers' dividend, even though it may have a lower yield.

	Current Yield	Trailing P/E	Payout Ratio	Debt/Equity
Pembina Pipeline	5.6%	28.3x	157.6%	1.6x
Shoppers Drug Mart	2.4%	14.6x	35.2%	0.3x
S&P/TSX Composite	2.8%	14.8x	42.0%	0.5x

*Source: Company financial statements, Scotia Capital, March 2012

The hunger for income has driven up the price of dividend paying stocks and made it harder to find high yielding names at inexpensive prices. Sionna would certainly prefer if all our portfolios had dividend yields above the market average, but that does not mean that we will pay any price to obtain that yield. In addition to valuation, the sustainability of a company's dividend is important –dividend cuts are often punished with sharp drops in stock price, and the punishment is most severe in an environment where yield is paramount. Sionna has been reducing our exposure to dividend paying stocks as valuations have risen. However, as the sideways market continues, we expect to have opportunities to again increase our exposure at more reasonable valuations.

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