C O M P A S S   W A T C H

MARK S. HALVERSON
CHRISTOPHER C. KELLEY, CFA, CAIA
JAY M. JACKLEY, CIMA
LEIGH E. NIEBUHR
CHARLES M. KELLEY, CFA
MARK A. VITELLI, CFA

A quarterly newsletter of Compass Capital Management, Inc.
Volume 28, Number 3: Fall 2016

THE DIVIDEND TRAP

Historically, dividends have played an important role of the total stock market return as measured by the S&P 500 Index. In fact, reinvestment of dividends has accounted for approximately 40% of the stock market return since 1929[1].

The yield on the 10-year U.S. Treasury fell below 4% in July 2008 before the start of the financial crisis (and ultimately fell below 1.40%). Today it sits at 1.83%[2]. Globally, more than $13 trillion of foreign government bonds offer negative yields[3]. Together, these low bond yields have encouraged a stampede into stocks of dividend rich companies—driving up the price and valuations of dividend stocks to lofty levels.

Many companies who pay large dividends have benefited from the low interest rate environment as individual and institutional investors have chosen to reallocate monies to buy *high* dividend-paying stocks over traditional fixed income because the cash flow they receive is greater. We would expect this trend to reverse if bond yields rise, making some dividend paying equities less attractive to investors seeking steady payments. Even with the most iron-clad company, a dividend payment isn't the same as a bond's coupon. Remember, dividends are at management's discretion.

Another reason dividend paying stocks have been so popular is the continued rise in payouts. Since 2011, the share of earnings paid out to shareholders in dividends—known as the dividend payout ratio—has surged. According to FactSet, for the last 12 months, S&P 500 company payouts were nearly 38% of net income, nearing an all-time high. Moreover, 44 of those firms had payouts exceeding their net income. For example, toy company Mattel (MAT)[4] has a payout ratio over 100% and pays a 4.70% dividend yield, while integrated oil company BP p.l.c. (BP)[4] has a payout ratio over 100% and a 7% dividend yield. What the market is completely focused on is the *current* dividend yield as opposed to the *ability* to pay a dividend!

As a result, these expensive and weaker companies continue to binge on debt (and degrade their balance sheet) to augment their low revenue growth in order to maintain their dividends as profits aren't sufficient. However, this strategy can self-destruct in the long-term as more debt is required to maintain a high payout ratio. Capital structure policies require corporations to pay interest on debt before they pay dividends to shareholders.

So, what have we been doing at Compass during this period? The investment team continues to monitor and analyze the long-term health of our companies including revenue, earnings and cash-flow growth in addition to debt levels. Why? The prospects for a growing company provide virtues both in a rising market (higher stock prices) and a declining market (greater downside protection). While dividend-paying companies are and should be part of an investor's stock allocation, substituting them for bonds and cash can create greater portfolio volatility and ultimately smaller total returns than investors bargained for.

At Compass, we invest in high-quality stocks, most of whom pay attractive and **rising dividends** from cash-flows. In fact, the dividend-paying stocks in our portfolio have increased their dividend rates, on average, by over 16% annually since 2011. This has provided a significant measure of inflation protection over this period and has served as a helpful offset to declining bond yields. Of course, rising dividends cannot assure investment success nor would a sensible investor buy or sell stocks simply because a company pays a dividend. However, if **growing income from growing dividends** is a result of rising revenues, profits and free cash-flow; it certainly improves the possibility of long-term success.

[1]Ibbotson/SBBI Classic Yearbook
[2]As of 11/1/16
[3]Wall Street Journal
[4]ValueLine