What Difference Do Dividends Make?
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Financial Analysts Journal, November/December 2016

In their classic text *Security Analysis*, Graham and Dodd (1934) argued that investors prefer a sure dividend to allowing the company to reinvest it. Dividends can provide a reliable return, buffer capital losses, reduce portfolio volatility, and lower the risk of overpaying for a stock. Dividends can also reduce the possibility of misuse of funds by managers. Dividend yield is widely used as an investment metric by mutual funds, exchange-traded funds (ETFs) and investment advisers. Some mutual funds go so far as to inflate their dividend yield by trading in and out of stocks around ex-dividend dates. This so-called Dogs of the Dow strategy, a popular investment strategy that relies on dividend yield, has attracted considerable attention.

Dividend yields have significant predictive power for future stock market returns. A high dividend yield implies greater risk and greater expected return. Dividend yield is also commonly associated with style investing. Growth stocks have low dividend yields. Value stocks have high dividend yields. Value stocks outperform growth stocks in the long run. This relationship is referred to as the *value effect.* The return difference between value and growth stocks is called the *value premium*.

Small-cap and midcap investors gain a clear advantage by adding a dividend tilt.
For these investors, the addition of a dividend exposure results in a significant increase in returns, less risk, and greater liquidity. In contrast, for large-cap investors, adding a dividend exposure produces only a small gain in returns but does lower risk substantially.

Small-cap companies are typically viewed as young companies with numerous promising projects that require the reinvestment of cash flow. Thus, it is surprising that dividends improve small-cap performance so dramatically. The return benefit of dividends is largest for the small-cap and mid-cap portfolios. For mutual funds, the Dogs of the Dow strategy would be more effective for lower market cap stocks, since adding a dividend exposure produces a larger increase in returns for the small- and mid-cap portfolios.

Adding a dividend exposure reduces risk considerably across all the style portfolios. In all cases, the high-dividend group has the lowest volatility. Risk benefit is largest for the large-cap portfolios. This is counter to the view that a dividend payment signals financial stability and is thus more informative for smaller, less visible companies. In contrast, the smallest risk improvement occurs for the small-cap portfolios.

In general, focusing on dividend-paying stocks significantly reduces risk, independent of investment style. This finding is true for value and growth portfolios as well as small-, mid-, and large cap portfolios. In addition to reducing risk, growth investors could receive higher returns by focusing on dividend-paying stocks. It is particularly noteworthy that dividend-paying growth stocks have higher returns than non-dividend stocks. It is often presumed that growth companies have good investment opportunities and dividend payments would detract from investor return. Low dividend pay outs do not imply higher future earnings growth. For value investors, an investment in dividend-paying stocks reduces risk without sacrificing return. Small- and mid-cap dividend payers have significantly less risk and higher returns than small- and mid-cap non-dividend-paying stocks.

The performance of non-dividend-paying small and mid-cap growth portfolios has been abysmal. These portfolios report by far the lowest returns, and their risk exceeds that of all dividend paying portfolios. The Sharpe ratios demonstrate a generally consistent risk-adjusted return benefit for high-dividend mid-cap growth stocks. With the exception of the late 1990s, which witnessed a tech bubble, the high-dividend portfolio has performed better over time.