The Importance of Dividend Growth

Category: Investing, Retirement, Stock market By Charlie Farrell January 23, 2018

https://northstarinvest.com/2018/01/23/the-importance-of-dividend-growth/

At Northstar, we talk often about the importance of owning companies that pay a dividend. In addition to paying a current dividend, we also want to own companies that have the potential to grow their dividend payments.

Yet, dividend growth is another aspect of portfolio returns that many investors don't understand or focus on. The fundamental theory behind a dividend growth strategy is that a rising dividend income stream will eventually lead to rising stock prices.

The "rising income drives rising prices concept" is clearly evident when investing in real estate.

Let's assume you pay $1 million for a commercial building in town and your neighbor also invests $1 million in another building. The future value of these buildings for the next buyer comes down to how much rental profit you can generate from each building.

Now assume that after 10 years, your building is generating $100,000 in rental profits and your neighbor's is only generating $50,000. Which property do you think would be more valuable to the next buyer? The one that produces more income for that buyer. A buyer wouldn't pay the same amount for the building that produces only $50,000 of rental income as the one that produces $100,000. This is the same concept that applies to stocks. The ones that produce more long-term income for their owners will become more valuable. And the main way stock investors receive their share of income is through dividend payments.

But what makes this hard to see in stocks is the very turbulent price movements that overwhelm income returns in the short term. Once you move beyond shorter-term cycles, the value of the stocks will be linked to the amount of income they produce for their owners.

We know from research on the stock market in general and from research we have conducted on dividend growth stocks that there is a high correlation between the growth of the dividend and the growth of a stock's price.* Our research indicates that over 10 to 12 year cycles, the correlation between dividend growth and the stock price appreciation has been approximately 80% and over 25-year cycles it's close to 90%.

That essentially means as the dividend grows, the price grows at roughly a similar pace over the long term. That's why we focus so much on the dividend growth. If we do that right, we are highly likely to see the stock's price appreciate as well. This is where the control aspect of the portfolio comes into play. Many investors feel as if the stock market is a mysterious beast and that they are simply subject to the whims of market returns. But if you link the value of your stocks to the income produced and focus on building that income, you are also highly likely to see the price appreciate as well.

The main reason to invest in dividend-producing stocks is because the dividend helps raise the odds of a good long-term total return.

It provides a solid foundation for valuing the stock, and the growth of the dividend is the main driver of future returns. Without a dividend and its growth, the future price for a stock becomes more speculative.

While there are no guarantees regarding this correlation between dividend increases and price increases in the future, in many ways, it's a common-sense approach. If you have a stock that produces income, the fact that it pays real cash to investors creates a certain value. As the income grows over time, that rising cash flow has the potential to pull up the price of the stock as investors insist on getting paid more to own a stock that delivers more income.

This all works because companies cannot grow their dividends for extended periods unless their profits are growing. Thus, the dividend is an expression of the company's long- term growth prospects, and that fundamental business growth increases the value of the business.

*Ned Davis Research