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Dividend Dreams

For the better part of this year, equity market leadership has been provided by two groups commonly considered mundane, low-growth, uninspiring businesses -- telecoms and utilities. The reason for this reputation is simple: telecoms and utilities really are mundane, low-growth, uninspiring businesses. They also offer investors high dividend yields, which brings us back to their surprising leadership status.

With the benefit of hindsight, the strong performance of these stocks can be explained by an insatiable search for yield. As interest rates around the globe collapsed to historic lows, investors turned to stocks such as AT&T, Verizon Communications, Duke Energy and Edison International as bond proxies. Why accept a two-percent yield in a long-term Treasury, when yields two and three times as high are available in the ownership of low-risk businesses?

Fair enough so far.

Wall Street loves jumping on the bandwagon, and this has been no exception. The response among pundits has been predictable, if a bit dangerous. Suddenly everyone has the secret sauce of successful investing; what for years we all have been missing; what is blatantly obvious; that dividend yields are the critical component to equity investing.

And this is where a sensible rally causes sensibilities to go haywire.

We dust off a 'white paper' from a reputable Wall Street firm to begin exposing the folly. Here's what it says: "Dividend income historically accounts for a meaningful portion of the long-term performance of equities -- since 1970, dividends have represented over 70 percent of the S&P 500's total return."

70 percent. If only it was so easy. This may be the biggest dividend whopper of all time, and features a severe, if unintended, misinterpretation of historic data.

Here's where it goes wrong, and with it the whole theory of dividend investing.
In a four-decade period, the S&P 500 index, on a price-only basis, returns 2100 percent.

Over the same time span, the S&P 500, with dividends re-invested, produces a total return of 6800 percent. From here, the math is as simple as it is mistaken; divide 2100 by 6800 and the result is 31 percent. This is the growth in capital attributed to price gains. The remaining 69 percent must come from dividends.

And it's a wonder any growth stock ever saw the light of day.

Now let's flip it around. In the same 40 years, the average dividend yield was three percent, which compounds to a cumulative return of 226 percent. Since we know the total return equals 6800 percent, this implies that dividends account for only three percent of total returns, nothing more than a rounding error. If we try to square the prior calculation with the latter, the numbers simply do not add up.

What is missing from the white paper's analysis, and from the examples above, is the magic of compounding. When we add dividends into price returns, and compound the larger total return number for decades, we achieve much higher returns than if we only compounded dividends or price returns, then added the two. With this simple correction, the '70 percent' claim is disproven, and the entire premise put in doubt.

Consider this example. Jack, a young investor, borrows 200 dollars, interest-free, to be paid back in a lump sum in 10 years. Jack places half the money in a dividend-paying stock with a three percent annual yield for the entire period, but no price appreciation. He invests the other half in a stock with zero yield, but with price appreciation of eight percent per annum.

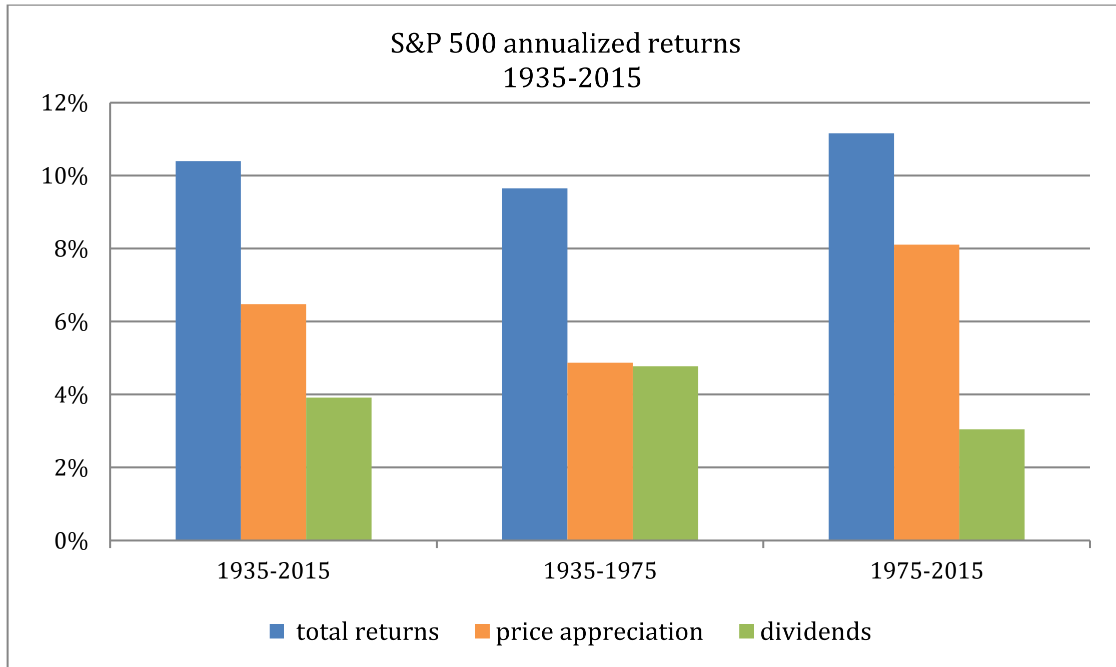
A second investor, Jill, borrows just 100 dollars, placing it in a stock producing a three percent yield and eight percent growth per annum.

After 10 years, both investors repay the loan. Jack keeps the three percent compounded gain on a 100-dollar investment, plus the eight percent compounded gain on the other 100 dollars. Jill keeps the eleven percent compounded gain on half the investment. Who has more money?

Jill. Even though she started with half the capital, Jill's compounded returns of eleven percent generate a gain of 184 dollars. Jack, working with twice as much capital, ends up with just 150 dollars, the shame of being out-smarted by Jill, and a lesson in the power of compounding.

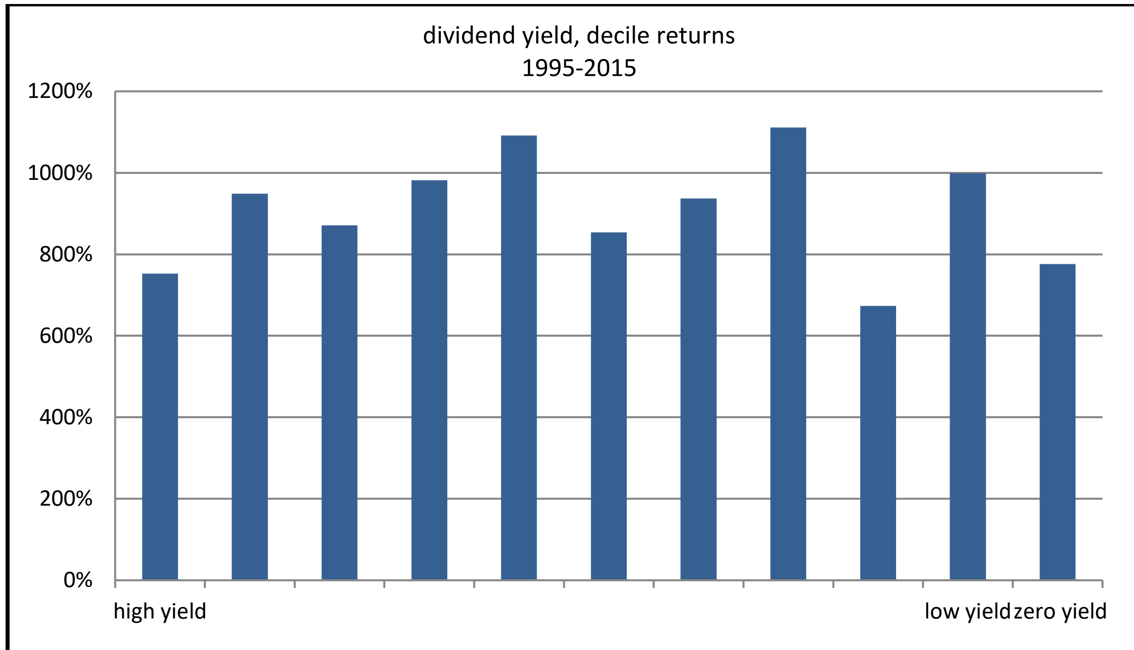
And, excluding tax considerations, it does not matter if Jill's eleven percent annual return was generated through price gains, dividends, or a combination of the two.

As shown below, equity returns over the past 40 years have been driven by stock price appreciation, with only 27 percent coming from dividends. This contrasts with the prior four decades, where dividends accounted for nearly half of equity returns. Moreover, the recent 40-years provided a lower average dividend yield than the earlier period, yet generated a higher total return.



This becomes more than an academic exercise when considering portfolio construction and stock selection. If dividend yields are a critical component of investment success, then portfolios should be loaded with income-generating equities. Stock pickers would be richly rewarded for focusing on yield above all else. Yet none of this holds up to scrutiny.

As shown below, for the last 20 years a stock selection strategy focused on high dividend yields underperformed a strategy based on low or no yield. High yielding stocks may appear cheap, but often represent value traps. The most important component of a dividend-paying stock is not its stated yield, but its growth.



A focus on high-yielding stocks is a belief in a free lunch. It is a misguided hope of receiving high levels of current income, while also generating growth of capital.

There may be a time and place for high-yielding stocks, for mundane and uninspiring telecoms and utilities, with the recent past being a case in point. But there is no free lunch.

Maximizing Job Losses Via Minimum Wage Hikes

Reprinted from The Wall Street Journal September 2, 2016
Economist Mark J. Perry writing on the blog of the American Enterprise Institute, Aug. 23:

Cities and states around the country that are considering a hike in their minimum wages to $15 an hour might want to take a look at how that's working out in the nation's capital. . . .

New BLS data for restaurant employment in July . . . tell the story pretty clearly. Since the DC minimum wage increased in July 2015 to $10.50 an hour, restaurant employment in the city has increased less than 1% (and by 500 jobs), while restaurant jobs in the surrounding suburbs increased 4.2% (and by 7,300 jobs). An even more dramatic effect has taken place since the start of this year -- DC restaurant jobs fell by 1,400 jobs (and by 2.7%) in the first six months of 2016 between January and July -- that's the largest loss of District food jobs during a 6-month period in 15 years.

Reprinted from The Wall Street Journal June 5, 2016
From "Minimum Wage vs. the Carwasheros: New York's new $15 wage floor pits man against machine" by writer Jim Epstein for the July issue of Reason magazine:

When the minimum wage goes to $15 an hour, automating will be a no-brainer. "Since I have 15 guys on the property, I wouldn't be able to charge less than $30," [New York City car-wash owner Martin Taub] says. "Who's going to pay $30 for a car wash?"

Amir Malki, a leading car wash equipment installer in the region, says over a dozen car wash operators in New York City have inquired about putting in the necessary machinery to cut their labor costs.

One owner, who talked to Reason under the condition of anonymity because he's worried about the political repercussions of speaking out about the minimum wage, says he's considering purchasing $300,000 in equipment, which would allow him to eliminate 15 of the 22 men who currently staff his full-service hand wash.

When the minimum wage goes from $9 to $15, he estimates that his expenses per wash will rise about $7 to $22, meaning he'll have to charge at least $25 to make a profit. "Now put yourself in the shoes of the customer," he says. "The first thing they'll do is wash their cars at home. Or they'll drop from washing their cars three times a month to once a month." If he automates, he figures he could lower his price to about $8. "That's the only way I can think of to survive."

"I can't think of any industry where the service that's provided is so expendable," says economist [Donald] Boudreaux. "In economic terms, you'd say that the demand for car washes is highly elastic." In other words, the industry faces strong pressures to keep prices down, because car washes aren't a necessary service, so an increase will lead to a quick fall-off in customer traffic.

That's why most can't afford to pay their workers $15 per hour and stay in business. Car wash operators have no choice but to automate," says Boudreaux.

Unexpected Words of Wisdom

Reprinted from The Wall Street Journal October 5, 2016
Former President Bill Clinton speaking about ObamaCare at a rally Monday in Flint, Mich.:

The people that are getting killed in this deal are small business people and individuals who make just a little too much to get any of these subsidies. Why? Because they're not organized. They don't have any bargaining power with insurance companies. And they're getting whacked.

So you've got this crazy system where all of a sudden 25 million more people have health care, and then the people who are out there busting it, sometimes 60 hours a week, wind up with their premiums doubled and their coverage cut in half. It's the craziest thing in the world.

Brexit, page 2

Brexit means Brexit. So says United Kingdom's Prime Minister Theresa May. Not so fast. The U.K.'s Parliament and judicial system may decide whether it's up to Ms May to choose the timing and terms of departure from the European Union.

From this side of the pond, it seems absurd that one person can trigger exit from Europe, based on the results of a non-binding resolution. And the Prime Minister was neither a supporter of the exit movement, nor the person in power at the time of the vote. Nevertheless, she seems determined to move ahead. Or is it backward?

Meanwhile…

As reported by The Times(London), a cabinet committee draft estimates that the U.K. Treasury could lose up to 66 billion pounds a year in tax revenues under a hard Brexit, and the economy could contract by as much as 9.5 percent. Surely the numbers are mere guesswork, but consider: The tax loss is nearly one-tenth of the government's projected annual tax collection, while a recession that deep would be catastrophic.

Someone needs to call a time out.

Tidbits..

OECD lowers 2016 global growth forecast to 2.9 percent, weakest since great recession; warns that world economy is in a "low-growth trap".
World Trade Organization forecasts global trade growth below world economic growth for the first time in 15 years.

German-based Bayer to acquire US agricultural-products giant Monsanto for 66 billion dollars.
British American Tobacco proposes 47 billion dollar takeover of Reynolds American, to create world's largest publicly-traded tobacco company.
AT&T to acquire Time Warner for 85 billion dollars, pending heavy regulatory scrutiny.
The ghost of AOL-Time Warner.

European companies issue intermediate-term debt at negative interest rates, as 'free money' extends from governments to corporate bond markets.

Median household incomes jump an inflation-adjusted 5.2 percent in 2015, a record advance.
Welcome news, but still below levels of a decade ago.

Cable companies Comcast and Charter Communications developing mobile phone systems combining traditional cellular system and Wi-Fi networks.

Hacking of Yahoo exposes personal information of 500 million account holders.

OPEC reaches tentative agreement for first oil production cut in eight years; details sketchy, markets skeptical.

Banking giant Wells Fargo fires 5300 employees over 'phony account' scheme; Chairman/ CEO retires, forfeits 41 million dollars of compensation.
Former Federal Reserve Chairman Alan Greenspan calls for repeal of Dodd-Frank banking regulation, labels it 'a mess'.

Federal Reserve Chair Janet Yellen suggests US central bank could buy equities in future stimulus efforts, an unlikely breach of US banking protocol.
European Central Bank rumored to consider tapering its Quantitative Easing bond-buying program as a means of reducing monetary stimulus.
Bank of Japan insists negative interest rates are working, while shifting its target to a zero-rate, 10-year government note.
Can anybody here play this game?

Uninsured Americans drop to record low 8.6 percent of population, as Obamacare mandate forces insurance coverage on masses; Administration takes a victory lap.
Obamacare-exchanges health insurance premiums expected to rise 25 percent in 2017.
And if you like your health plan…

Source:
Bloomberg
Guggenheim Investments
The Times(London)
The Wall Street Journal