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Market Analysis

Why Dividends Have Outlived Their UseBy **[Mebane Faber](#)****RealMoney Contributor**

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URL: <http://www.thestreet.com/p/pf/rmoney/marketanalysis/10452294.html>*When the facts change, I change my mind -- what do you do, sir?*

-- J.M. Keynes

Dividends certainly tell a good story. Companies that have the ability to pay dividends are usually profitable and can consistently return cash to shareholders. WisdomTree has essentially built its entire business on the premise that high-dividend-paying stocks are superior investments. In the 19th century, virtually all of an equity investor's returns came in the form of dividends, not capital gains. The dividend camp has become entrenched, and for good reason: Dividends have worked for a long time.

But are dividends predictive of future stock returns *now* (what we should really care about), or have they become outdated? Are they simply a piece of a bigger story and a useless factor on their own? My view is that because of structural changes in the marketplace, dividends are no longer helpful on their own.

Michael O'Higgins placed his stamp on the investment world with the 1991 publication of his book *Beating the Dow*. He details a strategy he calls the High-Yield 10, in which he buys the 10 highest-yielding **Dow Jones Industrial Average** stocks -- out of a potential 30 -- and rebalances yearly. *Barron's* labeled that strategy the "Dogs of the Dow."

While O'Higgins may not have been the first to come up with the strategy -- John Slatter mentions it in his 1991 book *Safe Investing: How to Make Money Without Losing Your Shirt* -- O'Higgins generally gets most of the recognition for popularizing it. (Indeed, an article by H.G. Schneider published in the June 1951 *Journal of Finance* documents a strategy of investing in low-P/E Dow stocks.) O'Higgins also details a subset of the Dogs -- the five lowest-priced of the 10 highest-yielding -- that he calls the Flying Five.

How have these strategies performed? According to performance figures on O'Higgins' Web site, from 1973 to 2007 the annual returns have been:

- DJIA: 11.37%
- Dogs: 14.57%
- Flying Five 17.00%

Very strong outperformance! James O'Shaughnessy documents the performance of the Dogs back to 1929 and finds similar outperformance of a few percentage points. In the summer of 1997, the *Financial Analysts Journal* published a paper titled "Does the Dow-10 Investment Strategy Beat the Dow Statistically and Economically?" The authors, McQueen et al., examine the results from 1946 to 1995 and find that the Dogs outperform by roughly 3%, with slightly higher volatility. However, the authors suggest that most of the outperformance would have gone to transaction costs and the IRS, and the strategy went decades underperforming as well. Their conclusion was that an investor would have been better off in the Dow 30.

One of the problems with quantitative analysis is mining the past data to optimize the results. A way to avoid this no-no is to use in- and out-of-sample data. A good way to determine whether O'Higgins' strategies have merit is to test their performance after the publication date (1991).

Below is a table showing returns from 1973 to 1991 and post-publication returns from 1992 to 2007. As you can see, the returns after publication have been in line (slightly lower) with the Dow. (The Sharpe ratio measures the reward to risk in an investment strategy -- the higher the number, the better its risk-adjusted performance has been.)

Dow vs. Dogs and Flying Five

A comparison of returns

1973-1991	DJIA	DOGS	Flying Five
Returns	11.10%	17.62%	20.30%
Volatility	18.17%	17.37%	22.46%
Sharpe (8.6%)	0.14	0.52	0.52
Worst Year	-23.14%	-7.60%	-15.20%
1992-2007	DJIA	DOGS	Flying Five
Returns	11.20%	10.53%	11.73%
Volatility	14.47%	14.51%	15.12%
Sharpe (4.2%)	0.48	0.44	0.50
Worst Year	-23.14%	-8.68%	-15.20%

[Click here for larger image.](#)

During the in-sample period, the Dogs beat the DJIA in 74% of the years vs. only 38% of the years since 1992. The Flying Five outperformed the DJIA in 79% of the years in sample vs. only 50% out of sample. Is O'Higgins guilty of optimization? Or is this simply the result of too much money chasing after the strategy? After all, there is a "Dogs of the Dow" closed-end fund (the **Defined Strategy Fund** (DSF) , currently trading at a 10% discount) as well as a number of mutual funds that follow the Dogs strategy. At one time, Merrill Lynch had a unit trust named the Select-10 with over \$10 billion in assets under management. It is difficult to come to a conclusion; the evidence so far is mixed.

Although selecting the top dividend-yielding stocks in the DJIA has produced outperformance, the returns have declined, and dividends have lost most of their predictive value. Is there a simpler reason for the change?

Let's look at a strategy based on a more holistic measure of returning cash to shareholders, a strategy that has continued to outperform the DJIA.

A newer paper in the *Journal of Finance* takes a new twist on the Dogs of the Dow strategy. The paper, by Boudoukh, Michaely, Richardson and Roberts, is titled "On the Importance of Payout Yield."

Dividends are only one way of returning capital to shareholders. Share repurchases are another such method (see **Microsoft** (MSFT)), and since buybacks are not taxed like dividends, it can be argued that they provide a more efficient way of returning profits. Buybacks represent about half of all shareholder payouts, and they have increased steadily since the early 1980s. There is a structural reason for this, and is due primarily to the **SEC** instituting rule 10b-18 in 1982, providing a safe harbor for firms conducting repurchases from stock manipulation charges.

The authors examined the payout yield and net payout yield, whose formulas are:

Payout Yield = \$ spent on dividends + \$ spent on share repurchases

Net Payout Yield = \$ spent on dividends + \$ spent on share repurchases - \$ raised through new share issues

The authors find that "the widely documented decline in the predictive power of dividends for excess stock returns is due largely to the omission of alternative channels by which firms distribute and receive cash from shareholders." Additionally, while dividend yield has lost its predictive ability over time, the payout yield has remained a robust indicator for excess stock return. The Net Payout Yield strategy has historical returns roughly 5% to 6% greater than that of the DJIA.

2008 is shaping up to be potentially the worst on record since 1972 for the Dogs and Flying Five strategies. Previous worst years are -8.7% and -15.2% respectively. Currently, through Dec. 8, 2008, the year-to-date returns are as follows:

- DJIA: -32.65%
- Dogs: -34.97%
- Flying Five: -44.80%
- Net Payout Yield: -32.41%

So, currently none of the screens are offering any value over the index, but the net payout yield is the best performer of the three.

When looking at net-payout-yield stocks, the top 10 right now are:

- **Alcoa** (AA)
- **General Motors** (GM)
- **Home Depot** (HD)
- **Boeing** (BA)
- **Caterpillar** (CAT)
- **Intel** (INTC)
- **Merck** (MRK)
- **McDonald's** (MCD)
- **Exxon Mobil** (XOM)
- **General Electric** (GE)

A new paper in the *Journal of Finance* is even more encompassing -- "Asset Growth and the Cross-Section of Stock Returns," by Schill, Gulen and Cooper.

The paper basically says that any decrease in total assets is good -- things like dividends, buybacks, spinoffs and paying down debt. Ominous signs for future stock performance include acquisitions, share issuances, borrowing and sitting on lots of cash.

Given this information, why do analysts and portfolio managers continue to focus solely on dividends? The main reason is that investors do not see the markets as constantly changing and evolving.

In a paper called the "Global Financial Guide to Total Returns," Dr. Bryan Taylor of Global Financial Data runs down the last 200 years of market history. He points out that in the 1800s, people were more likely to invest in stocks than in bonds, and almost all returns came from dividends, not capital gains. And since the government did not issue Treasury bonds, investors had no "risk-free" alternative.

After listing further characteristics of the 19th-century market, and showing how each of those factors was turned on its head in the 20th century, Dr. Taylor writes:

This makes us wonder how reliable the assumptions that investor make today will be for the next 100 years. Will everything that we assume to be true about investing today prove to be false by the end of the 21st Century, and why was it that the rules for investors changed so radically over the course of the 20th Century?

Well said, Dr. Taylor!

At the time of publication, Faber had no positions in stocks mentioned.

Mebane Faber is managing director and portfolio manager at Cambria Investment Management, where he manages portfolios based on quantitative strategies. He is also the co-founder of AlphaClone, an Internet-based equities research service that lets an investor track and back-test the stock ideas of top hedge funds.

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