DOW
PUBLISHING COMPANY
Sound advice for generations

dows.com
358 US Route One, Falmouth, Maine 04105
207.878.3000 ■ 800.578.9981 ■ info@dows.com

INVESTING FOR "TOTAL RETURN"

Security analysts utilize a concept they call the "total return" of an investment. The total return of a common stock is simply the sum of (or difference between) the stock's dividend return and the average annual appreciation (or depreciation) in the price of the stock over some period of time. If a stock's dividend return is 10%, but it depreciates in value an average of 5% per year, its actual return or "total return" is only 5% per year; and, on the other hand, if a stock's dividend return is 5%, but its price appreciates an average of 10% per year, its average total return is 15% per year. Clearly, it would seem better, in the long-run, to try to maximize the "total return" on one's investments, rather than to try to maximize dividend return alone.

Many investors prefer securities with high dividends in the belief that these high dividends imply more efficiently employed funds. There are, however, three basic reasons why such may not be the case:

GROWTH COMPANIES VERSUS MATURE COMPANIES

The first reason concerns the type of company represented by a stock with a high dividend yield. Almost without exception, such companies tend to be in mature, troubled, or declining industries. The reason their current yields are so high is usually a combination of two factors: (1) The dividend payout is high in relation to the company's earnings; this is so because the company does not have sufficiently attractive investment opportunities of its own in which legitimately to reinvest its shareholders' earnings, and so it pays out most of its earnings to its shareholders. (2) The price of the stock is low relative to the dividend because of the investment community's perception that the prospects for the company are poor and/or the element of risk is inordinately high.

In contrast, a stock with a lower current dividend yield usually has this lower yield for the two opposite reasons: (1) The investment opportunities for the company seem so promising that the board of directors determines it in the best interest of the shareholders to plow back the greater part of earnings into the expansion of the company's business; hence, the dividend payout is small as a percentage of total earnings. (2) The price of the stock is relatively higher, reflecting the investment community's assessment that the prospects for the company are indeed promising and/or the element of risk is small.

It is this writer's experience that, ironically, those investors who invest in lower-dividend-paying securities, over a period of time, are actually apt to receive more in total dividends than those investors who invest in high-dividend-paying issues. That is because the rate of dividend paid by a company typically increases at a rate commensurate with increases in earnings. Though the lower-dividend stock investor may receive a smaller dividend than the high-dividend stock investor initially, the former's dividend is apt to increase over time to exceed the latter's dividend quite substantially. It is not uncommon for the lower-dividend stock investor to observe that, though his current yield on present value is low, his current yield on original cost is very high. This is far less apt to be a claim by the high-dividend stock investor.

DOW
PUBLISHING COMPANY
Sound advice for generations

dows.com
358 US Route One, Falmouth, Maine 04105
207.878.3000 ■ 800.578.9981 ■ info@dows.com

THE DOUBLE TAXATION OF DIVIDENDS

The second basic reason that lower-dividend-paying stocks may prove more efficient investments than high-dividend-paying stocks concerns the handicap that is frequently referred to as the "double taxation of dividends."

In the case of any dividend paid by a company, though the company has already paid a tax on the earnings out of which it paid the dividend, the investor, in a taxable account, must also pay a personal income tax on the dividend he receives. To the extent that a company retains its earnings, though the company must still pay the corporate tax, the investor is spared the additional personal income tax on those earnings which the company itself plows back into its own operations on the investor's behalf.

TAX PREFERENCES FOR LONG-TERM CAPITAL GAINS

The third reason lower dividend, higher-appreciation stocks may be more efficient investment vehicles than higher-dividend, lower-appreciation stocks concerns the way dividends and capital gains are currently taxed in a taxable account. At the federal level, dividends are presently taxed as ordinary income with rates that go as high as 39.6%. In contrast, capital gains on stocks held more than one year (long-term) are taxed at a maximum rate of 20%. Furthermore, while dividends are taxed in the year earned, capital gains are not taxed until a security is sold which may effectively defer taxation many years beyond the year in which such gain is actually earned. Moreover, if a security is left in one's estate or given to a charity, the gain on it escapes taxation altogether. In short, from a personal income tax perspective, capital gains income may be much more tax-efficient than dividend income.

CONCLUSION

It should finally be noted that, for those investors who use the cash flow from their investments as a source of livelihood, capital gains income can constitute every bit as legitimate a source of cash flow as dividend income. If one deliberately purchases a lower-dividend stock instead of a high-dividend one in the hope of realizing a capital gain, he should have no compunctions about spending a part of whatever capital gain he realizes for the same purposes that he would otherwise have spent the incremental dividends.

Moreover, historically, those investors willing to forego some current dividend income for greater capital gains potential have, indeed, generally enjoyed capital gains considerably in excess of the dividend income they sacrificed to pursue the gains. In short, the after-tax rates of "total return" on their portfolios have usually exceeded, by wide margins, the after-tax rates of "total return" of the portfolios of those who sought to maximize dividend yield alone.

Clifford G. Dow, Sr., CFA, CHFC, CFP®
Chief Investment Officer

Securities offered through Delta Equity Services Corporation. Advisory services offered through Delta Global Asset Management, an SEC Registered Investment Advisor. 579 Main Street, Bolton, MA 01740 978.779.5361 FINRA SIPC MSRB