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Six common misconceptions about dividends

Reasons why experts recommend dividends and why such advice is often unsound

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During periods of low yields and market volatility, more than a few experts recommend dividend stocks and funds. This may sound like good advice, but unfortunately, it is often based on misconceptions and anecdotal evidence.

It is time to take a closer look at the six most common reasons why advisors and other experts recommend dividends and why, based on these reasons, such recommendations are often unsound advice.

Misconception No. 1: Dividends are a good income-producing alternative when money market yields are low.

Taking cash and buying dividend stocks isn't consistent with being a conservative investor, regardless of what money markets are yielding. Additionally, there is no evidence that money market yields signal the right time to invest in dividend-focused mutual funds. In fact, money market yields were anemic throughout 2009, a year that is also one of the worst periods for dividend-focused funds in history.

Many advisors also call dividends a good complement to other investments during times of high volatility and low bank yields. In an October 22, 2009 article, financial guru Suze Orman recommended the following dividend funds: iShares Dow Jones Select Dividend Index (DVY-N 43.91 -0.59 -1.33%), WisdomTree Total Dividend (DTD-N 41.32 -0.36 -0.86%) and Vanguard High Dividend Yield Index (VYM-N 38.00 -0.37 -0.96%).

Reality Check:

The 12-month performance after Orman's recommendation was DVY (up 7.86 per cent), DTD (up 21.91 per cent), VYM (up 17.72 per cent). These returns seem pretty good - until you realize you could have just held on to the S&P 500, which was up 26.36 per cent over the same period.

Misconception No.2: Dividend companies are more stable and better managed.

It is generally believed that companies that raise their dividends over a long period have solid market positions and strong cash flow. As a result, the stocks' total return is likely to outpace other stocks.

It's also common to hear the argument that dividends tend to hold companies to a certain standard of financial discipline and that, as a result, these companies budget more carefully and avoid wasteful projects out of fear that shareholders will punish the stock if it fails to return profits to its investors.

Reality Check:

It's easy to pick a "solid" stock in retrospect but it is impossible to pick a company today that will meet this statement moving forward. Sure, if you had purchased Coke in 1962...but what about today? In 2007 we would have said that General Electric (GE-N 15.13 -0.22 -1.43%) and AIG (AIG-N 29.98 -0.62 -2.03%) were stable and well-managed dividend companies. Would we say the same in 2009? What about in the future?

The notion that dividend-paying companies are held to higher standards does not bear out. Look no further than the financial industry. In September 2008, AIG had a $4.40 (U.S.) dividend - almost a 4 per cent dividend yield. By 2009, it was clear that AIG and others such as Freddie Mac, Fannie Mae, Bank of America, Bear Stearns and Citigroup were far from being financially disciplined companies, despite that fact that they were all long-time dividend-paying companies. As it turns out, dividends aren't much of an indicator of the financial discipline or the quality of a company's management.

Misconception No.3: You can count on dividends from solid companies.

Many people believe that it's rare for a solid company to suddenly reduce or rescind its dividend payment.

Reality Check:

"Solid" companies like Bank of America (BAC-N 15.06 -0.01 -0.07%), General Motors, Pfizer (PFE-N 18.19 -0.31 -1.68%) and GE, have either suspended or cut their dividends. Unfortunately, it is a lot easier to identify companies that had a solid record than to identify companies that will have a solid record going forward. It is impossible to predict which "solid" companies today are going to be on shaky ground tomorrow. There is no certainty or stability in future dividends.

The idea that dividends allow you to get paid to wait doesn't make sense. It is the total return of your portfolio that matters, not the current yield. Throughout 2008 and 2009, companies were cutting or suspending their dividend payments at record levels, proving that there is no guarantee for those who buy in to these companies. Just ask anyone holding Freddie Mac since June 12, 2008, which was when Freddie Mac last distributed a dividend and traded at $23.01 a share. At that time, Freddie Mac had a dividend yield of 4.34 per cent. By October of 2009, the stock was down over 90 per cent and hope for future dividends had all but evaporated.

Misconception No.4: Dividend stocks provide upside potential and downside protection.

A 2009 SPDR University brochure states that "Dividends provide a stable source of income that can help partially offset market price depreciation that occurs in turbulent markets."

Reality Check:

Dividends provide very little - if any - downside protection during market corrections. The S&P 500 was down 41.82 per cent during the September 2008 to March 2009 crash. During the same time, the SPDR S&P 500 Dividend ETF was down 35.87 per cent, which doesn't seem like much downside protection. Additionally, some well-known, dividend-focused funds provided no downside protection and performed worse than the S&P 500 over this period. For example, the Fidelity Dividend Growth Fund was down 46.94

per cent and the iShares Dow Jones Select Dividend Index was down 43.07 per cent.

Since 1926, dividends have provided about one-third of the total return for the S&P 500, while capital appreciation has provided the other two-thirds. Focusing on dividends, which provided less returns than capital appreciation, makes little sense, especially since the dividend focus is just as risky.

Misconception No.5: Preferential tax treatment makes dividend stocks more attractive.

This misconception seems to imply that dividend stocks are more attractive investments since they are taxed at a preferential rate. Obviously, the lower rate is better than the normal income rates but what does it really mean? Does it mean you should avoid dividends in tax-deferred accounts since they are less attractive?

Reality Check:

Of course it doesn't. Then why should the tax treatment warrant dividend investments more attractive than capital gains? It doesn't, which is shown by the lack of any noticeable bounce in 2003 when the preferential tax law was implemented. We need to remember that the tail should not be wagging the dog. After-tax returns are important, but taxes should not drive your investment decisions.

Misconception No.6: Dividend-focused investing is ideal for retirees and conservative investors.

An October 5, 2009, article in the Wall Street Journal stated that "Most types of fixed-rate bonds don't provide any protection against inflation and can lose value when investors are worried inflation will flare. Rising dividends, along with any appreciation in the share price of the company paying them, offer a measure of insurance against inflation."

Reality Check:

This statement is incredibly misleading. First, if you want a bond that protects against inflation, you can buy an I-bond instead of taking equity risk. Secondly, all equity investments provide a measure of protection against inflation, not just dividend stocks.

No one ever said you could only have one investment. If you are a conservative investor, you can simply create a portfolio of bond funds and a little bit in a stock fund. The idea is to create an investment portfolio, not an investment collection. Each investment in the portfolio should work with the others to achieve a goal. This works much like the ingredients in a recipe, which come together to create a great dish.

Why are dividends a better way to generate income than capital gains? Capital gains are not a sure thing, but neither are dividends. And there is simply no way to know which stocks will continue to be "solid" in the future.

Conclusion

Dividends are absolutely an important part of the investment equation. Yet there is no empirical evidence that focusing on dividends is a wise decision. Actually, Miller and Modigliani received the Nobel Memorial Prize in large part for their paper, "Dividend Policy, Growth, and Valuation of Shares," in which they found that dividends are irrelevant to a company's value ("irrelevant" is their word, not mine).

On one side the media is dishing out long-lived misconceptions about dividends. On the other side, the Nobel winners are saying dividends are "irrelevant" to stock values. I'm not sure about you, but I know which one of these two groups I'm going with.