Stocks Article

Dividends: Myths and Realities

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A recent spate of big-name companies that have cut their dividends—from Citigroup to Sprint—is a stark reminder of an unappreciated reality: Dividends are by no means a sure thing. What's more, contrary to conventional wisdom, our research finds that dividend-yielding stocks as a group have underperformed the market during recent years. And since they tend to cluster in certain sectors and style groups, getting overly enamored of them can introduce unexpected concentrations and unnecessary risk to your portfolio.

But just because a company has cut its dividend doesn't mean its stock will underperform. In fact, our research finds that such stocks often outperform! Indeed, the rules of the game have changed so much in recent years tl some of the most common strategies for picking dividend-paying stocks no longer appear to work very well. Understanding what's real—and what's not—is key.

Basic dividend realities

The first reason to pay attention to dividends rests on the simple understanding that a stock's total return is bas upon price changes and dividends received. For a one-year period,

Total Return % = Stock Price Change % + Dividend Yield %.[1]

All things being equal (which they seldom are), higher dividends mean higher returns. Indeed, about one-third average U.S. stock total returns historically have come from dividends.

Second, dividend yield is known at the time of purchase, while future price changes are highly uncertain. Of course, future dividends aren't guaranteed, but most firms aim for a stable dividend payout and typically cut dividends only when under severe financial stress.

Third, dividends tend to grow over time, offering potential income growth and inflation protection that bonds cannot provide. Finally, dividend-yielding stocks tend to be less volatile than the average stock and have offer nice cushion during bear markets.

Myth No. 1: dividend-yielders outperform

Back in the 1980s and 1990s, many academic studies found that dividend-paying stocks historically provided t best of all worlds—above-average total returns with below-average risk. The result: a flood of ETFs designed t capture the potential performance advantages of higher-yielding stocks. But in reality, Schwab research has fo that dividend-paying stocks have generally underperformed non-dividend-payers over the past 18 years (see