Why Dividends Matter

Income and Growth of Income

CRAWFORD
INVESTMENT COUNSEL
-EST. 1980-

SEPTEMBER 2013

At Crawford Investment Counsel, Inc. all of our equity strategies are dividend oriented. We believe that dividends are an essential element for serious, long-term common stock investors. In this paper we outline what we find so attractive about the income component of returns that dividends bring to a portfolio of stocks.

John Burr Williams, writing in "The Theory of Investment Value" in 1938 stated:

> *A cow for her milk, a hen for her eggs,*
> *And a stock, by heck, for her dividends.*
> *An orchard for fruit, bees for their honey,*
> *And stocks, besides, for their dividends.*

Williams, a pioneer in developing rigorous methods of determining the intrinsic value of stocks, was also practical in his approach. No great poet, his little verse on dividends at least points to the basic importance of dividends.

We share Williams' delight for the unsung benefits of dividends and believe all investors would be wise to consider them as well. As an equity investor, one desires some type of return, and the safest and most assured way of obtaining this is through the dividend. When all the attractive attributes of dividends are considered, among the most favorable is the fact that the income component of total investment return is always positive.

Silent Factor in Equity Returns

Over time, the impact of dividends on total investment returns is significant. According to Ibbotson SBBI 2012 Classic Yearbook, large company stocks produced a compound annual return of 9.8% for the period 1926 through 2011, of which some 43% came from dividends and dividend reinvestment. This figure comes as a shock to many investors, as the common assumption is that dividends are only a minor contributor to the total return of stocks. We like to refer to dividends as the "silent factor" in a portfolio. Dividends are not normally headline-making events, but over time they quietly build up and create a larger impact on returns.

We find especially compelling an attractive dividend yield that is also growing over time.

Buying stocks that pay dividends is a reasonable way of achieving the goal of having some current return on your investment. Investors may buy stocks for any number of reasons. Most often, there is the expectation that they will appreciate in value and provide a profit. One way to think about dividend-paying stocks is to contrast them with stocks that pay no dividend. If the stock pays no dividend, then the hope that it will rise in price is nothing more than hope.

If the price of the stock goes up it will be the result of other investors changing their mind about its value and bidding it up. But there is no guarantee that this change of opinion will occur, and if it does not, the investor would be left with no return. Obviously, in terms of safety of return, or assuredness of some return, the dividend-paying stock has the advantage over the non-dividend-paying stock.

Dividend Growers

Beyond the security of returns that dividends provide, we also look to the future and determine what type of total return might be earned from a stock over the longer term. Indeed, our approach is not only to invest in companies that pay a dividend, but to ferret out those companies that increase their dividends on a regular basis. This begins to get at the heart of our approach to investing.

- There are a select few companies that have unusually stable businesses, so stable that in fact they have been able to increase their dividends with great consistency over long periods of time. There are some 200 companies that qualify by having met the standard of having increased the dividend in each of the last ten years.
- There are another 150 or so companies that have paid the same or higher dividend for at least 10 years.

This total of approximately 400 companies represents our universe of potential candidates for purchase. Importantly, this group of companies meets a rigid test of consistency when one considers there are some 9,000 publicly traded companies. It is their consistency that draws us to these type of companies. These dividend-paying companies tend to sell products that are in continuous demand, and therefore are able to keep their sales, earnings, and dividends in a relatively stable pattern, even in difficult economic settings. Even so, more is required than a stable of in-demand products: consistent businesses also require strong balance sheets, capable management, and in many cases, substantial market share positions. These are all attributes that enable businesses to perform with consistency and, for our purposes, continue to pay and raise their dividends on a regular basis. We find especially compelling an attractive dividend yield that is also growing over time.

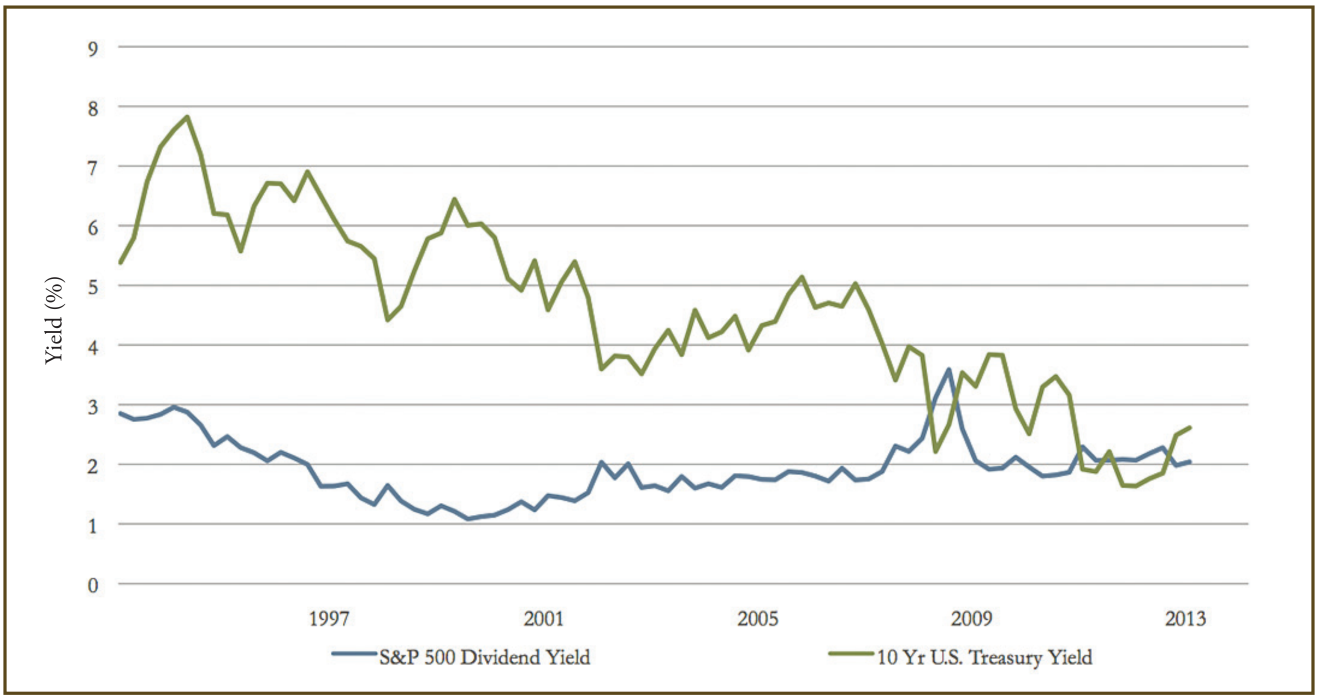
Quality Matters in Prudent Investing

In recent years, dividends have received renewed attention from investors. The chart below illustrates the relationship of stock yields and bond yields. After decades of a wide gap between the two, in the last decade the difference has been reduced almost totally, and at times stocks have actually yielded more than US Government bonds. The attractiveness of stock yields relative to bond yields is enhanced by the fact that as noted above, many stocks raise their dividends consistently, in contrast to the fixed nature of bond interest. Taking into account these factors, many investors are considering dividends as alternatives to bond interest. We are pleased by these developments, but offer a few words of caution. Remember that dividends come from stocks, which are riskier and more volatile than bonds. We believe the best way to mitigate the risk in stocks is to be prudent about limiting stock investments to high quality companies. Finally, don't reach too far for yield, for this is a good way to find disappointment.

Conclusion

It is our belief dividends matter for a number of reasons. We have dealt with one of the most important ones: the ability to provide income. Dividends also matter because they have the potential to make stock prices increase. They matter because they provide downside protection in difficult market environments. They also matter because they are an excellent indicator of quality. These are among the primary reasons we favor dividend payers and growers in our stock selection process.

Bond and Stock Yields Over Time



Time Period: 1/1/93 - 10/1/13

Source: FactSet, Crawford Investment Counsel

Crawford Investment Counsel, Inc.

600 Galleria Parkway, Suite 1650, Atlanta, Georgia 30339

(770) 859-0045

www.CrawfordInvestment.com