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Investors in US stocks set to demand more dividends



CRAIG HAFNER

COULD the next opportunity in the US stock market lie in dividend stocks? Daniel Peris believes so, and after reading his insightful book, *The Ownership Dividend: The Coming Paradigm Shift in the US Stock Market*, readers may find it hard to disagree.

Peris is a senior portfolio manager at Federated Hermes; he joined the firm in 2002. His focus has been on dividend-paying stocks, and he is considered one of the leading authorities on the subject.

Previously, Peris authored several books on investing, including two about dividends: *The Strategic Dividend Investor* (McGraw Hill, 2011) and *The Dividend Imperative* (McGraw Hill, 2013). Both books remain valuable for any investment professional because they challenge one's assumptions about how well companies use their cash.

In *The Ownership Dividend*, Peris writes that there will soon be a realignment in the stock market that can create "profitable opportunities for those who are prepared". Investor preference is likely to shift away from a price-based relation-

ship with their investments, towards a cash-based one.

After four decades of an "anything goes" environment where investors were dependent on the ever-changing price of a stock, Peris believes the tide has begun to turn. Investors will demand that more companies share their profits via dividends. Predicting a realignment in the stock market is bold and could easily be dismissed. But Peris makes a great case for why dividends should be given a lot more attention than they currently receive.

He carefully explains how the past four decades of declining interest rates have led investors to focus on the price growth of shares, rather than the income they provide. He challenges the generally accepted notion that large, successful companies do not need to share their earnings with shareholders by paying dividends.

Misunderstood theory

Peris takes readers through history of dividends in the stock market. Dividends encouraged investment, but they have been diminished by the misapplication of the work of Franco Modigliani and Merton Miller, whose dividend irrelevance theory has been misused as an argument for companies not to pay a dividend at all.

The theory states that the dividend policy of a company has no effect on its stock price or capital structure. The value of a company

is determined by its earnings and investment decisions, not the dividend it pays. Thus, investors are indifferent as to whether they receive a dividend or a capital gain.

As Peris points out, however, this theory is often misunderstood. Created in 1961, the theory assumes that most companies would be free-cash-flow negative, because they operated in capital-intensive industries and would need external capital to fund their growth plans and to pay dividends.

While that may have been the case in the 1960s, Peris estimates that this situation applies to only 10 per cent of the stocks in today's S&P 500 Index. The current S&P 500 is made up primarily of service companies that are free-cash-flow positive, and have sufficient cash flow to fund their growth and also pay a dividend.

Peris provides countless reasons for the role that dividends play as an investment tool, but his review of stock buyback programmes should be read by every investor. He is ahead of his time and unafraid to point out that perhaps the emperor has no clothes.

While many on Wall Street applaud stock buyback programmes as a tool to boost earnings per share, Peris exposes the reality that too often a significant portion of what is "bought back" is used for employee stock option plans. Investors would be well served to understand how stock buyback programmes are often diluted by stock



compensation plans.

In fiscal year 2023, Microsoft repurchased US\$17.6 billion of its common stock and issued US\$9.6 billion in stock-based compensation. Microsoft is hardly an outlier; the past 40 years have seen dramatic growth not only in stock buyback programmes but also in employee stock option plans.

Over the course of 10 chapters, Peris makes a compelling case for the importance of dividends. His book is written for practitioners, not academics, which makes the book approachable and absent of any pretence.

As Peris sees it, the fall in popularity of dividend investing can be attributed to three factors: the decline in interest rates over the past four decades; the change in the securities tax code in 1982 that enabled share buybacks; and the rise of Silicon Valley.

These three factors caused the stock market to shift from a cash-based return system (where dividends mattered) to one that is driven by near-term price movements. However, these factors have potentially run their course. According to Peris, "the 40-year decline in interest rates has come to an end." Over time, he maintains,

the market will revert to where investors will expect a cash return on their investments.

Interest rates and cost of capital

Peris' review of the relationship between interest rates and the cost of capital is especially timely. As interest rates fell from their highs in the early 1980s, companies had little difficulty raising capital. The recent rise in interest rates could make it more difficult. It was not long ago that investors were faced with money market funds and savings accounts with negative real rates of return, leaving them few options in which to invest for current income.

Now that rates have risen, investors have more options and companies will no longer be able to borrow funds as cheaply as before, investors are given more leverage to demand that companies share their earnings via a dividend.

Peris wrote this book for investors, and so after making his case for dividends, he also provides useful guidance on what sort of companies investors may want to consider to get ahead of the upcoming paradigm shift. While much of this information will be familiar to investment professionals, his fresh

The Ownership Dividend contends that dividends should be part of any investor's strategy.

PHOTO: PIXABAY

take on the subject is insightful.

The counterargument to Peris' view is that Wall Street expects the interest rate increases by the Fed to be followed by a series of cuts. If interest rates were to decline to near pre-Covid levels, a shift away from the preference for price growth may not occur.

However, Wall Street's assumption that interest rates will fall soon may be flawed. With low unemployment and strong housing and consumer spending, the Fed has no incentive to lower interest rates to stimulate the economy. Higher rates give the Fed greater flexibility in the future to address unforeseen economic events.

All of this leads back to the point that Peris makes: Wall Street sometimes gets it wrong. The situation over the past 40 years was the result of specific factors that may have run their course. If that is the case, then the market should revert to investors favouring dividends over share growth alone.

For those who are prepared, there will be opportunities. In *The Ownership Dividend*, Peris provides a roadmap of how to take advantage of the coming paradigm shift and, without question, the best argument for why dividends should be part of any investor's strategy.

The writer is president of an investment advisory firm specialising in selecting companies with a history of dividend growth and the potential to provide long-term growth