Lindsell Train

Do Dividends Really Matter?

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"As we have gone through the very, very good times a few people have said – '5%, that feels a bit stingy'. In the times we're in now, people say 'Wow, that's great, we really appreciate you being very consistent about this' ".

So said Nick Rose, Diageo FD, a day or so after the company's recent final results and remarking on another year of 5% dividend increases. And you would think that he is right - that people would really appreciate Diageo's dividend consistency. I know we do.

After all, dividends are falling across the UK market at a rate not seen, apparently, since before WW1. According to Capita, if it weren't for the currency-translation boost to the recently maintained Dollar dividends from BP and Shell (subsequently well on the way to being reversed), All Share payments would be down 16% in 2009, with the outlook still murky.

What is more, the derivation of UK dividends is also a worry. BP and Shell alone account for 24.4% of all UK dividends, with the next four payers by size – Vodafone, HSBC, Glaxo and BHP – making up a further 24.7%. Yes, in other words, nearly 50.0% of all UK dividends are delivered by just 6 companies. What's worse, investors are clearly sceptical about the growth rate, or even sustainability of the dividends of five of these six behemoths, because only BHP trades on a yield lower than the market average. A lurch down in the Dollar or the oil price and the All-Share's ability to pay the widow's stipend looks dubious indeed. Certainly we do not regard any of these six dividends as absolutely safe and none of them safer than Diageo's and, for a variety of reasons, we do not own any of the shares.

Yet it is not obvious that other investors do value Diageo's dividend consistency and security. Or, if they do, it is hard to account for the fact that Diageo stock is actually down in 2009, while the All Share is now up over 15%. On the day of its results the shares fell by 4%. By contrast, on that same day FTSE 100 constituent copper miner Kazakhmys reported its interims, which were purportedly better than expected, but accompanied by a passing of the interim dividend. Its shares put on 5% that day and now stand 20% higher than before its removal from the dividend lists, having trebled in calendar 2009.

There are three explanations for these (and other similar) divergent price moves between steady payers and dividend cutters. First, Diageo shares performed well in 2008, amidst the wreckage. On this analysis, Diageo shares are now understandably treading water, while beaten-up sectors benefit from a "dash to trash", as investors embrace risk in search of recovery.

Next, more subtly, consider that along with Kazakhmys another 5 out of the 11 FTSE 100 mining stocks have passed or slashed their dividends, including the bluest blue chip, RTZ. Nonetheless and subsequently they have all made robust share price gains. For these names and others current dividends seem not to matter. Can this really be so?

And, to an extent, for marginal new buyers – short term dividends really don't matter. Theory says that an equity is, effectively, an undated bond, which pays a variable coupon. If that coupon is missed for a year or two, well, the income foregone doesn't add up to much against the net present value of the quantum of dividends to be paid between here and eternity. In partial confirmation, here are some findings – actually on what make share prices go up and down - from Rob Arnott, chairman of Research Associates, a research boutique, quoted extensively in the FT on 10th August – "the market price is not forecasting the next quarter's dividends or earnings; it is forecasting decades into the future. Indeed, some 20% of the value of a typical stock is based on future distributions that lie 50 years or more into the future." In other words, long term dividend paying capacity is more important than this year's actual distribution.

Intellectually, one agrees with Arnott. And the share price resilience of the dividend cutters in 2009 seems to vindicate his argument. Viscerally though, we remain suspicious. Whatever theory says and however the offending companies gloss it, cutting or passing a dividend is a serious matter, which tells you a lot about the nature of a given business franchise.

For instance, as one of the smartest investors in our funds pointed out to me – the fact that Marks and Spencer has been reduced to cutting its dividend twice within a decade is telling us that something is fundamentally broken at that business – it is

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certainly afflicted by more than just a couple of economic downturns.

Further, the necessity felt by over half the FTSE 100s mining companies to pass their dividends, less than a year after a multi-year peak in commodity prices, is telling us something important about the cyclicality and cash-hunger of such companies and their inability to sustain regular and growing payouts. As Rene Medori, FD of Anglo American, said back in February, he has "some doubt as to whether a progressive dividend policy is consistent with a cyclical industry such as mining."

The final reason for some investors' insouciance about passed mining dividends is their expectation of rampant and imminent inflation. Indeed, if you fear a monetary inflation - and the gold price is screaming that a lot of people do - then the cash return on a mining share is not only irrelevant, it is almost an insult. Dividends are paid in paper money; in a debauch you want the purest access to the underlying real asset.

In response to this worry we say – "perhaps". Perhaps there will be economic conditions so extreme that the only capital markets assets worth owning will be those with a claim on subterranean metal. We'd prefer to bet, though, that all the inflation protection that investors are going to need over the next decade will be just as well provided by accessing the real dividend growth delivered by the shares of consumer goods companies, which have demonstrated long term product real pricing power, such as, to bring us back to the start point of this note, Diageo.

You can buy Diageo today on a starting dividend yield double the current rate of UK inflation. Meanwhile, that dividend is growing at a rate almost three times that rate of inflation. This proposition gets one close to the heart of what long term equity investment ought to be about – the preservation of the real purchasing power of Sterling capital over decades. If Diageo can maintain its real dividend growth rate from today, we would submit it is not a question of whether Diageo is going to be a successful investment, it is only a question of when.

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