

## Alley Company Commentary Three Cheers for Dividends

*“Do you know the only thing that gives me pleasure? It’s to see my dividends coming in.”*  
-John D. Rockefeller

Dividends aren’t necessarily for everyone. Iconic American companies such as Berkshire Hathaway and Amazon.com don’t pay them. Investors in such things as art, commodities, venture capital, and hedge funds don’t focus on them.

But dividends do indeed provide shareholders with a *tangible return* on their invested capital and eliminate the need to rely entirely on less-certain capital appreciation.

In this commentary, we make “three cheers for dividends” by highlighting the following positive attributes:

- 1. Dividends can instill discipline within the management team of a company**
- 2. Dividends can offer a smoother (less volatile) ride for investors**
- 3. Dividends can be an attractive source of investment income**

### DISCIPLINE

The regular payment of cash dividends can instill a culture of shareholder friendliness and disciplined financial management within the leadership team of a company. Once started, dividends are not technically an *obligation* for a company, but they are mostly viewed as sacrosanct by shareholders and management alike and neither party wants to see them reduced. As a result, capital allocation decisions that could jeopardize the long-term sustainability of the dividend are held to a high standard.

In addition to paying dividends, other capital allocation choices include:

- Invest in capital expenditure (capex) projects
- Engage in merger/acquisition activity
- Share repurchase

While high-quality companies with solid balance sheets can potentially fund *all* of these activities, a strong dividend policy instills discipline into the process.

## A SMOOTHER RIDE

The total return equation for investors is made up of dividends plus capital appreciation. For companies that don't pay dividends, more must be produced in capital appreciation to meet a given level of expected total return. Conversely, attractive dividend payers (for example, with a hypothetical dividend yield of 3 percent) are less reliant on capital appreciation over time.

	Dividend Yield	Capital Appreciation	Expected Total Return
<i>Dividend Payer</i>	3%	5%	8%
<i>Non-Dividend Payer</i>	0%	8%	8%

During inevitable market corrections, the concept of “*yield support*” has the potential to kick in and offer investors downside protection. This is particularly the case with high-quality companies where the dividends are deemed to be durable. In these cases, while stock prices are moving lower, dividend yields are rising, *getting ever more attractive* to prospective investors. The net result is typically that high-quality dividend payers provide downside protection and dampen portfolio risk (less volatility).

## ATTRACTIVE SOURCE OF INCOME

Dividends have long been an attractive source of investment income due to their ability to *grow* and *fight inflation*. To illustrate, consider the past thirty years for Genuine Parts Company (GPC). GPC's dividend was 34.8 cents per share in 1985 and since then the Company has increased its dividend *every year* to where its 2015 level stood at \$2.46 per share. While the current dividend yield on GPC shares is 2.5 percent, for the investor that purchased in 1985, their current yield on *original* cost basis (i.e., “yield on cost”) is now 26.1 percent and cumulative dividend growth has totaled 607 percent. It is clear that the power of dividend growth can outstrip traditional fixed-income investments with the benefit of time.

In addition, with the currently depressed interest rate environment around the world, dividends can provide an immediate level of investment income that is attractive on a relative basis as well.

Company	Corporate Bond		Country	10 - Year Government
	Yield to Maturity	Dividend Yield		Bond Yield
<i>Verizon</i>	2.3%	<b>4.1%</b>	<i>United States</i>	1.51%
<i>Exxon Mobil</i>	2.1%	<b>3.2%</b>	<i>Germany</i>	-0.09%
<i>Microsoft</i>	2.2%	<b>2.7%</b>	<i>Japan</i>	-0.29%
<i>Merck</i>	2.4%	<b>3.1%</b>	<i>U.K.</i>	0.82%

Source: Thomson Reuters and Schwab Institutional. Data as of 7/12/16. Corporate bond yields are reflective of the closest bond to a 10-year maturity. Verizon, Exxon Mobil, Microsoft, and Merck are examples of blue-chip companies where dividend yields are attractive relative to their own corporate bond yields as well as global sovereign bond yields.

## ***Conclusion***

John D. Rockefeller hit the nail on the head: watching consistent and growing dividends from high-quality companies come into a portfolio is a beautiful thing. While not everyone is interested in dividends, the three attributes referenced herein make them appropriate for most investors. In fact, from a risk-adjusted perspective, investors would be well served with high-quality dividend payers as the centerpiece of their portfolio around which other asset classes can be added.

## **Alley Company, LLC**

Alley Company, LLC is a private wealth management firm based in Lake Forest, Illinois. The firm was founded in 1998 by Steven J. Alley to operate a disciplined investment philosophy for clients in a separate account format. Our team takes a dispassionate approach to providing investment advice, focusing first and foremost on clients' investment objectives, including their risk tolerance and asset allocation preferences.

The **Alley Company Dividend Portfolio** is a flagship strategy for the firm and it seeks to achieve a balance between attractive absolute dividend yield and strong dividend growth underpinned by quality company fundamentals. Our results are achieved by maintaining portfolio holdings in companies with strong financial condition, strong relative earnings power, astute management, and a culture of returning capital to shareholders through dividends.

For more information, please visit our website at [www.alleycompanyllc.com](http://www.alleycompanyllc.com) or contact us at 847-482-0938.

*The Alley Company Commentary discusses general developments, financial events in the news and investment principles. It is provided for information purposes only. It does not provide investment advice and is not an offer to sell a security or a solicitation of an offer, or a recommendation, to buy a security. The statements and opinions contained herein are solely those of Alley Company LLC and are based upon sources and data believed to be accurate and reliable. Additional information regarding Alley Company, LLC can be found by accessing the SEC's website at [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov).*

July 2016