Alley Company Commentary
The Power of Dividend Growth

Dividends, and the growth thereof, are an underappreciated aspect of long-term investing. In fact, from 1926-2013, dividends represented over 40% of the total return of the S&P 500[1].

Companies that pay attractive and growing dividends have been superior investments relative to companies that do not pay dividends[2]. One of the reasons for this phenomenon is that companies that have the corporate culture and financial wherewithal to pay consistent dividends tend to have sustainable fundamental business prospects.

A great example of the power of dividend growth can be found in Berkshire Hathaway's investment in Coca-Cola. Between 1988 and 1994, Berkshire accumulated 400 million shares of Coca-Cola for a total cost of $1.3 billion. In Berkshire Hathaway's 2010 annual report, Warren Buffett called out the significance of dividend growth when he wrote:

"Coca-Cola paid us $88 million in 1995, the year after we finished purchasing the stock. Every year since, Coke has increased its dividend. In 2011, we will almost certainly receive $376 million from Coke, up $24 million from last year. Within ten years, I would expect that $376 million to double. By the end of that period, I wouldn't be surprised to see our share of Coke's annual earnings exceed 100% of what we paid for the investment. Time is the friend of the wonderful business."

Based on Coca-Cola's current annual dividend rate of $1.22 per share, Berkshire Hathaway will receive approximately $488 million in dividends in 2014. When measured against the $1.3 billion cost for Coca-Cola shares, this investment's "yield-on-cost" has grown to an astounding 37.5%.

Dividend Yield-on-Cost

The power of dividend growth is illuminated by the analysis of yield-on-cost, which is the annual dividend divided by the original cost basis of the stock. An investor's cost basis is the capital that the investor originally put forth to purchase shares of stock. While the original cost basis remains static, the dividend income from the investment has the potential to grow significantly over time, particularly with blue-chip, dividend-paying companies.

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In the accompanying table, we examine an "income only" comparison of Procter and Gamble (PG) and the ten-year US Treasury bond. Procter and Gamble has had a rich dividend heritage with annual dividend increases for over five decades. The company has increased its dividend by over 10% annually for the past 31 years, as well as at a rate of 10% annually for the past ten years. In our example, we postulate that PG will continue its dividend policy for the next ten years, but at a more conservative rate of 7.5% annually, and compare how the income returns from the two investments diverge as the power of dividend growth manifests itself.

Procter and Gamble vs. Ten-Year US Treasury
"Income Only" Comparison

	Nominal Income Return	After-Tax Income Return	Real After-Tax Income Return (3)
10-Year US Treasury yield 5/31/14	2.50%	1.51% *(1)*	-0.49%
Current PG dividend yield 5/31/14	3.20%	2.56% *(2)*	0.56%
Prospective PG dividend yield-on-cost in year 10 (2024) *(4)*	**6.60%**	**5.28%** *(2)*	**3.28%**

(1) Bond interest income taxed at 39.6%
(2) Dividend income taxed at 20%
(3) Inflation assumption of 2%
(4) Assumes annual dividend growth of 7.5%

This yield-on-cost analysis illustrates two points: 1) on a real after-tax return basis, Procter and Gamble offers superior income potential to the ten-year US Treasury bond in the year 2014, and 2) when factoring in the assumed dividend growth of 7.5% annually in PG shares over the next ten years, the income stream from PG will steadily rise culminating in a yield-on-cost of 6.60%. In contrast, the ten-year US Treasury bond income return will be static at 2.5% throughout the ten-year period. There is also the possibility of capital appreciation for the stock, which seems highly likely for a company that can grow its dividend at this rate.

Historical Perspective on Dividends

Despite the compelling nature of the prior examples, dividends have not always been in vogue. Beginning in the early 1980s, for example, in large part due to the advent of share repurchase as an alternative means of returning capital to shareholders, along with the start of a seventeen year bull market, dividends began to lose favor. Capital appreciation in stocks overshadowed the dividend component of total return during the 1980s and 1990s.

Today, the investment landscape is very different. Interest rates remain at historically low levels making investments in fixed income instruments unappealing. The table below highlights the current yield environment.

Current Yield Environment

Asset Class	Yield	Company	Dividend Yield	Bond Yield
Money Market	0.01%	Procter and Gamble	3.2%	3.1%
1-Yr. CD	0.7%	Merck	3.0%	3.0%
5-Yr. Treasury	1.5%	McDonald's	3.2%	3.2%
10-Yr Treasury	2.5%	ConocoPhillips	3.4%	2.9%
S&P 500 Index	1.8%	Verizon	4.2%	3.5%

Source: Thomson Reuters and Charles Schwab Institutional. Yields displayed are as of 5/31/2014. Each company's bond yield represents the yield-to-maturity of its issued bond that is the closest to having ten years remaining until maturity.

As the table depicts, dividend-paying stocks continue to offer relatively attractive yields compared to traditional sources of generating current income.

A Golden Period for Dividends?

An ancillary benefit of dividend growth is that it can also provide a hedge against the deleterious effects of inflation. Since 1946, S&P 500 dividend growth has been about 6% annually, 50% faster than the rate of inflation[3], meaning that the dividend income component alone has outpaced inflation.

Dividends for the S&P 500 have registered an annual growth rate of 9.8% for the past three years. At year-end 2013, non-financial US corporations had over $1.6 trillion in cash on their balance sheets. High corporate cash balances and investors' increasing preference for income may continue to influence companies to pay out a larger share of profits in dividends. The dividend payout ratio (percentage of earnings paid out as dividends) of the S&P 500 is low by historical standards at about 35% compared to the longer-term average of approximately 50%, further supporting the case for growing dividends.

Dividends have been an afterthought for many investors, though the dividend itself and the growth of those dividends over time matter greatly in the total return equation of income plus capital appreciation. We suspect that dividends and dividend growth will not only stay relevant, but potentially become the centerpiece of investment portfolios in the years ahead. The ongoing shift to dividend investing will be driven by both the desire for income and also the need for that income to *grow* as investors continue to live longer and need their wealth to extend further into the future.

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[1] Data from Standard & Poor's.
[2] Kenneth French, Center for Research in Security Prices (CRSP), and the University Chicago Booth School of Business tracked five portfolios of dividend paying stocks ranking them in quintiles of lowest dividend paying stocks to highest dividend paying stocks and each portfolio of dividend paying stocks outperformed a portfolio of non-dividend paying stocks during the period of 1928-2013.
[3] Data from Robert J. Schiller's long term historical data for the S&P 500 as well as consumer price index data from the Bureau of Labor Statistics. The time period measured was 1946-2013.

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