Making dividends work for you

Not only is it possible to create a growing dividend portfolio of stocks, it is also possible to grow one's principal significantly

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We had earlier discussed a strategy about how high quality companies with a dividend yield of 2% or more could be used to build wealth and form a growing income stream for retirement years. The hypothetical calculation showed that `10 lakh invested in such a portfolio would end up in a corpus of `40 lakh and an initial income stream from dividends of `20,000 per year, growing to an income stream of `80,000 at the end of 10 years.

The assumption was that this Graham-and-Buffettsville portfolio was invested in 20-30 companies with return on equity (ROE) of 25% and available at a price such that the dividend yield was 2%. These criteria might seem too stringent to some and they might think that this is not practical or realistic. While stringent, as any Graham-and-Buffettsville idea is, this is indeed a practical, and quite a realistic, idea.

We started out with a universe of all the listed companies and selected relatively large-sized businesses, of `500-1,000 crore and above. Then we applied a criteria of return on equity (ROE) being more than 25% and dividend yield being more than 2%. Analysis period was January 2003 to June 2015. The total return of this portfolio was 33.9% compounded annual growth rate (CAGR) over the period. Nifty returned 19.5% CAGR for the same period. The price return—the return excluding dividends—was 29.8%. This means that `10 lakh invested in this strategy would have become `2.6 crore. (In comparison, our conservative calculation showed an expectation of `40 lakh. Even a Nifty investment would have beaten that with `10 lakh having grown to `78 lakh.)

The dividend yield at the time of investing in the portfolio in 2003 was 4.8% and at the end in 2014, it was 3.8%. The rupee payouts would have started out at `48,000 in 2003 (against the conservative expectation of `20,000) and would have been nearly `10 lakh in 2015 (against the conservative expectation of `80,000).

While the dividend results are quite robust, one should keep in mind that it is after all an equity investment and, hence, risky. The portfolio values would have fluctuated. In 2008-09, it would have dropped as the market dropped. However, the drop would have been much less than in Nifty. The index's worst 1-year drop was 55% while the portfolio dropped 34%. So, the strategy also makes the portfolio inherently more stable than the overall equity market. Over a long term of five years or more, this works out to be a very stable strategy.

Now, suppose, you had only applied the criteria at the beginning of 2005 and then forgotten to rebalance, i.e., let the portfolio be a typical (Warren) Buffett "buy-and-hold" (or rather a "buy-and-forget" portfolio). That portfolio would still turn your `10 lakh to `63 lakh with a 19.2% CAGR over the period, beating Nifty's `48 lakh returns at 14.6% CAGR.

In addition, you would have received dividend payouts starting at `38,000 in 2005 to `69,000 in 2015.

Now, let us put the strategy to a more stringent test. Say, you had applied the criteria in January 2008 at the peak of the markets. Would you have been able to select any companies using this criteria? Yes, you would have found 15 companies. Assuming that you forgot to rebalance the portfolio, your `10 lakh would have still turned into `34 lakh over the period of 2008-15 with a CAGR of 17.9%. But the Nifty would have returned `13.3 lakh, which is a CAGR of 4.4%. In addition, the dividend for the 2008 portfolio would have been `26,000, and nearly `45,000 in 2015.

But which are these companies that you would have been able to select with this criteria? Probably, some completely unknown names? No. A majority of the companies were the top names in their sectors and are darlings of the markets today. These were well-established businesses of substantial size and recognition in 2008 as well, and most had been operating in India for decades. There were at least four well known fast-moving consumer goods (FMCG) companies; some were from the information technology sector; a two-wheeler manufacturer; an oil and gas public sector company; one petrochem major; and others from industrial sectors.

While two companies were bad picks and lost significant money, and one gave a middling performance, the remaining 12 have been multibaggers (ranging from two baggers to nine baggers). Many of these were recognizable names and practically all are today considered "high quality" Buffett-like companies. However, the fact that such amazing names were available as value-buys for a dividend generating portfolio speaks on how powerful the criteria is.

In short, not only is it possible to create a high and growing dividend portfolio of stocks that can provide a growing income stream, it is also possible to grow one's principal significantly. What looks like a low-risk conservative retirement strategy is actually a very aggressive-on-returns strategy beating majority of the market participants (probably, all the mutual funds in India), and is able to multiply your capital 3-26 times depending on whether you remembered to rebalance it and how many years you gave it to multiply.

The purpose here is to prove that an alternative income generating strategy is possible as compared to a fixed income investment. That strategy can be risky since the principal and the dividend income can fluctuate, but over the long term, it can pay handsomely, both in terms of increased dividend income and increased capital.

The numbers in the article are for illustrative purposes to show what kind of a portfolio might have been created with this strategy. It cannot be assumed that the same performance will exist in the future. While reasonable efforts have been made to ensure the accuracy of these portfolio results, the reader is cautioned to carry out her own similar studies to verify the results.

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