live mint

Print Close

Sun, Jul 12 2015. 11 56 PM IST

To earn may be human, but to get dividends is divine

Dividends are real cash in the investor's hands

Vikas Gupta

Jayachandran/Mint

Unlike investors in the developed market, especially those in the US and the UK, dividend paying stocks are not appreciated by retail investors in India. They prefer bank fixed deposits, bonds, debt mutual funds, or even non-convertible debentures for their interest payouts. Investors even like long-held real estate for its rental yields. However, buying stocks for their dividend yields is an alien concept. When it comes to listed equities, Indian investors want quick gains, ideally, 20-50% in a matter of weeks or months.

This is not that surprising. In a high-inflation country like India, fixed income paper pays an interest of 7-9% every year. In comparison, the typical dividend yield of 1-4% looks meagre. The bank deposit principal is nearly guaranteed, while the price of a share could fluctuate significantly with a risk of losing capital.

However, if one were to dig a little deeper, it can be seen that dividend-paying stocks can be a great asset class to invest in, even for investors who prefer a regular payout.

Let's consider two people: A and B. Both are about 50 years old and would require income 10 years from now when they retire. Let's say they have `10 lakh to invest.

A invests his capital in fixed deposits of his favourite public sector bank earning an interest of 8% per annum. And since he is in the top tax bracket, he has to pay 30% tax on the interest. That means he will get 5.6% a year, net of taxes.

On the other hand, B invests her capital in a portfolio of 20-30 high quality, dividend paying stocks. She ensures that the dividend yield is at least 2% and that these are low-debt companies with large established businesses. (Possibly, she built it up over a period of time when she invested in good companies at her required dividend yield. For now, we will assume that she invested all of the `10 lakh on the same day when she was 50 years old). These companies have an average 25% return on equity, payout 40% of earnings as dividends and reinvest the remaining. Assuming she bought them at precisely 2% dividend yield, she starts out at a low 2% income.

Ten years later, A has `17 lakh as his principal, assuming he reinvested all his interest income as well at the same rate of 5.6% a year after tax. Furthermore, he receives an income of `1.38 lakh tax-free since he is in the lowest tax bracket.

B, on the other hand, has received `4 lakh as dividend income, tax-free, which was not reinvested. Her principal has grown to `40 lakh and she gets an income of `80,000 from dividends. She can move `10 lakh to a fixed deposit and start earning an income of `80,000 and more, thus providing her an income of `1.6 lakh and `30 lakh in dividend paying stocks. The `80,000 from dividend income will keep growing and the `30 lakh will keep growing over the long term.

This shows that the right basket of dividend paying stocks can be a great source of income if initiated early enough, and over the long haul, is much superior to fixed deposits.

There are other reasons for preferring dividend paying stocks. Over the long run, inflation is uncertain and most countries, including developed economies, have bouts of high inflation. In emerging economies such as India, this risk is even higher. During high inflationary conditions, in India, typically, the seemingly high interest coupons are not enough to compensate for inflation. And it is definitely not enough after tax is deducted, especially for those who are in the highest tax bracket. In comparison, stocks are able to fight inflation better.

Well-established companies are able to survive and pay dividends even in challenging economic conditions—such as deflation and slowing growth or even recessions—although, the dividends might be somewhat lesser.

Most importantly, dividends are real cash in the investor's hands. While earnings could be manipulated and are hence less trustworthy, dividends indicate good corporate governance, at least to the extent of the dividend payments. Consistent dividend payment indicates that the company is at least earning that much.

A less appreciated idea is that dividends being paid consistently is equivalent to an interest payment, and that shares of that company are

similar to a debt paper. But yes, it is true that a company is not legally bound to pay a dividend and that it is more of a company policy.

However, before picking dividend paying stocks, one has to keep a few things in mind. Look for companies of substantial size. For example, in India, one can look at companies with revenues of `1,000 crore or more. The companies shouldn't have high debt; one can look at debt-to-asset ratio of less than 30%. Dividend per share to book value should be 10% or lower. Also, ideally, stick to dividend yields of 2% or more. Create a portfolio of 20 or more dividend paying stocks from different sectors.

Yes, Warren Buffett's Berkshire Hathaway Inc. does not pay dividends, and that might convince many value investors that they, too, should not look at dividend paying stocks. Also, since India is a "growth" market, many value investors believe that one should look at growing companies that can reinvest all their earnings for growth and hence, dividend paying companies don't make sense.

I address both the issues here. Buffett invests in the US, where dividends are taxed at high rates. In India, dividends are tax-free in the hands of the investor. Here many companies show growth for long periods of time and then collapse. With dividends, there exists at least some discipline and corporate governance since the company has to pay regularly and not just manage accounting entries.

Vikas Gupta, executive vice-president—traded markets and investment research, ArthVeda Fund Management Pvt. Ltd