Dimensional

Yield vs. Total Return

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Many investors, including retirees, rely on their investment portfolio to fund their cash needs. This need can be approached in one of two ways.

The first approach looks primarily to interest and/or dividends from securities and avoids touching principal. In low-yield environments, investors using this approach may search for securities with higher yields to meet their cash flow needs. If yields are high enough, investors may be able to live off the income from their portfolios' dividends and interest without having to touch principal. This approach may appeal to those who believe that selling principal reduces the longevity of their portfolio and prefer the discipline of living off portfolio income rather than determining a sustainable amount to withdraw from their portfolio.

An alternative approach, focused on total return, involves selling assets in the portfolio to synthetically create cash flow. This method reflects the idea that, from an investment standpoint, it makes little difference whether returns are delivered as dividends or capital gains. It allows greater control over the amount of cash flow generated because it does not depend on how total returns are split between yield and capital appreciation.

Before pursuing a yield bias, investors should understand the potential effect on portfolio diversification and expected returns.

Traditionally, income-oriented investors have chosen the first approach, resulting in a bias for securities that pay interest and dividends. Even if generating cash is their top priority, investors should carefully consider the investment tradeoffs in pursuing an income-based strategy, as their income bias may affect diversification and expected returns.

In this brief, we explore the yield vs. total return approaches to generating income in a portfolio and address misconceptions about the benefits of emphasizing dividend and interest income at the expense of other portfolio issues.

Exhibit 1: Ex-Dividend Price Change Illustration

Before Dividend Payment

Scenario 1: Dividends

Asset	Quantity	Price	Portfolio Value
Stock XYZ	100	$20	$2,000
Total			$2,000

Scenario 2: No Dividends

Asset	Quantity	Price	Portfolio Value
Stock XYZ	100	$20	$2,000
Total			$2,000

After Dividend Payment

Scenario 1: Dividends

Asset	Quantity	Price	Portfolio Value
Stock XYZ	100	$19	$1,900
Cash			$100
Total			$2,000

Scenario 2: No Dividends

Asset	Quantity	Price	Portfolio Value
Stock XYZ	100	$20	$2,000
Cash			0
Total			$2,000

For illustrative purposes only. Assumes no nondividend-related price movements.

DIVIDEND APPEAL

The traditional appeal of dividends stems from a long-held belief that stocks paying high dividends are less risky because they offer a regular stream of payments to investors. But dividend payments are not created out of thin air. They flow from a company's earnings or assets, which are reflected in the current stock price. As illustrated in **Exhibit 1**, when a company pays a dividend, its stock price is reduced by an amount approximately equal to the dividend (Scenario 1). When accounting for this cash dividend, the portfolio value may be unchanged.[1]

Part of the conventional wisdom about dividends is that a high dividend yield may help a retiree avoid encroaching on capital to generate cash flow. Yet, as illustrated in **Exhibit 1**, a dividend distribution does encroach on capital unless it is reinvested rather than spent. Although no stock may have been liquidated, the economic impact is essentially the same.

Another common misconception is that dividends offer downside protection by mitigating the impact of a falling stock price on the portfolio. For example, owning a stock that yields a 5% dividend might provide an equivalent amount of price support if the stock declines. However, since a dividend paid reduces the stock price by the same amount, the price would have dropped less for a stock that pays no dividend. In both the Dividends and No Dividends scenarios, the total portfolio has dropped by more or less the same amount.

Exhibit 2 illustrates that a dividend-paying stock may not offer special downside protection. In both scenarios, the initial portfolio loses 25% of its value before the dividend payment. After the payment, the Scenario 1 portfolio (dividend payer) has a lower share price but also has cash from the dividend; the Scenario 2 portfolio has a higher share price but no cash dividend. Overall, the portfolios have the same value, just different asset compositions.

OTHER TRADEOFFS

Holding a portfolio that emphasizes dividend-paying stocks may also force significant tradeoffs related to diversification and expected returns (Black, 2013).[2] The research concluded that:

- A global portfolio of dividend-paying stocks would have similar average returns to a portfolio of nondividend-paying stocks. However, a dividend-focused portfolio would exclude 35%–40% of stocks globally, resulting in lower diversification. Also, the number of US and international firms that pay dividends is shrinking—from 71% of the market in 1991 to 61% in 2012.
- The proportion of dividend-paying firms varies considerably across countries. For example, 92% of Japanese stocks paid dividends in 2012, compared to only 38% of Australian stocks. Dividend payout levels also have high cross-country variation. For example, an average 31% of corporate earnings were distributed in Switzerland vs. 73% in New Zealand.
- Holding only dividend-paying stocks may impact investors' ability to pursue higher expected returns. The research shows that global portfolios holding only dividend-paying stocks exclude about 47% of the available small cap stock

1. Certain studies show the price drop on the ex-dividend date is, on average, lower than but close to the amount of the dividend when controlling for market movement.
2. Black, Stanley. March 2013. "Global Dividend-Paying Stocks: A Recent History." Dimensional Fund Advisors white paper.

Exhibit 2: Portfolio Value Decline Illustration

Initial Portfolio

Scenario 1: Dividends

Asset	Quantity	Price	Portfolio Value
Stock XYZ	100	$20	$2,000
Total			$2,000

Scenario 2: No Dividends

Asset	Quantity	Price	Portfolio Value
Stock XYZ	100	$20	$2,000
Total			$2,000

Portfolio Value Drops 25% Before Dividend Payment

Scenario 1: Dividends

Asset	Quantity	Price	Portfolio Value
Stock XYZ	100	$15	$1,500
Total			$1,500

Scenario 2: No Dividends

Asset	Quantity	Price	Portfolio Value
Stock XYZ	100	$15	$1,500
Total			$1,500

After Dividend Payment

Scenario 1: Dividends

Asset	Quantity	Price	Portfolio Value
Stock XYZ	100	$14	$1,400
Cash			$100
Total			$1,500

Scenario 2: No Dividends

Asset	Quantity	Price	Portfolio Value
Stock XYZ	100	$15	$1,500
Cash			0
Total			$1,500

For illustrative purposes only. Assumes no nondividend-related price movements.

universe, which historically has offered higher expected returns than large cap stocks.

- Dividends are not certain or guaranteed. Although dividends may be less volatile than the capital gains component of stock returns, the aggregate stream of dividend payments is subject to the same broad, macroeconomic risks that affect capital gains. As demonstrated in the 2008–2009 financial crisis, companies may cut dividends when facing declining profits and worsening economic conditions.

TOTAL RETURN: GENERATING SYNTHETIC DIVIDENDS

The alternative to meeting a cash flow need through dividend payments is to create synthetic dividends by selling securities in the portfolio. This method has many benefits. It allows investors to focus on total return rather than on the income component of return and gives them greater control over the level and timing of cash flows.

Investors in taxable accounts should consider any tax implications that may arise from differences in capital gains and dividend tax rates.[3] For example, if capital gains are taxed at lower rates than dividends, a stock sale may be more tax efficient. Furthermore, the lower tax rate is only applied to the portion of the cash flow that represents the stock's capital gain, whereas the higher tax rate for dividends is applied to the full amount of the dividend. Tax treatment of dividends from domestic companies vs. foreign companies may also play a role in the outcome.

Exhibit 3 illustrates the impact of earning dividends vs. generating cash flow synthetically from a portfolio. In Scenario 1, the stock's price per share is reduced by the dividend, whereas in Scenario 2 the share price stays the same but the number of shares is reduced. After the respective dividends are received, the portfolio balance sheets for Scenarios 1 and 2 have the same value and asset composition. Thus, an investor's approach to generating cash flow may not affect total portfolio value on a pretax basis.

While generating cash flow from security sales is currently more tax efficient than receiving dividends, the potential tax savings must be weighed against corresponding transaction costs incurred in a sale. Receiving interest and dividend payments should incur no costs, while a security sale may incur transaction costs. All else being equal, the priority should be to sell securities that trade without a direct transaction cost.[4]

3. As of this writing, tax rates for long-term capital gains and qualified dividends are the same in the US (15% or 20%, based on a taxpayer's income bracket). But tax rate differences have occurred in the past and may occur again in the future.

4. Transaction costs, including possible redemption fees, may be incurred within a fund if cash must be raised to meet redemptions.

Exhibit 3: Synthetic Dividend Illustration

Before Dividend Payment

Scenario 1: Dividends

Asset	Quantity	Price	Portfolio Value
Stock XYZ	100	$20	$2,000
Total			$2,000

Scenario 2: No Dividends

Asset	Quantity	Price	Portfolio Value
Stock XYZ	100	$20	$2,000
Total			$2,000

After Dividend Payment

Scenario 1: Dividends

Asset	Quantity	Price	Portfolio Value
Stock XYZ	100	$19	$1,900
Cash			$100
Total			$2,000

Scenario 2: No Dividends (Sell Assets)

Asset	Quantity	Price	Portfolio Value
Stock XYZ	95	$20	$1,900
Cash			$100
Total			$2,000

For illustrative purposes only. Does not include transaction costs from asset sale. Assumes no nondividend-related price movements.

A final consideration in structuring portfolio income is the implication for rebalancing. Generating cash flow from securities sales may enable more efficient tax management and create an opportunity to strategically rebalance by selling assets that are overweighted relative to the target allocation.

FIXED INCOME AS A CASH SOURCE

The yield vs. total return decision should be considered in fixed income as well, since some investors may regard bonds as the primary income-generating asset group in their portfolio. However, given the current environment with historically low yields, investors searching for yield would need to invest in longer maturity or lower credit quality fixed income instruments. Before adding riskier fixed income to a portfolio, investors should ask themselves whether they are prepared to tolerate the additional risk embedded in higher-yield fixed income securities.

CONCLUSION

Focusing on income-oriented investments can result in unintended biases in a portfolio. Biasing a portfolio toward stocks with higher dividend yields or bonds with increased yields will likely change a portfolio's risk and return characteristics. Investors should be aware of the related tradeoffs before pursuing a yield bias.

For a total return investor, once the overall allocation decision has been made on the basis of total portfolio risk and return, the income produced becomes a byproduct. Rather than letting portfolio yields determine spending rates, investors can develop a sustainable withdrawal strategy with their advisors.

In summary:

- Investors should focus on total returns, not income.
- Pursuing interest and dividend income can increase volatility, reduce diversification, and limit opportunities to manage taxes and seek higher expected returns.
- Dividends are not guaranteed.
- Generating cash flow through asset sales (i.e., synthetic dividend) provides more flexibility to manage other important components in a portfolio.

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