Key Questions

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Should You Buy Stocks with High Dividends?

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

We have nothing against dividends, but total shareholder return is our preferred investment approach.

Companies that pay high dividends can be seductive. Some investors may reason, "A seemingly reliable check in the mail no matter how the stock trades? Sign me up!" To these investors, we would offer some words of caution:

- Dividends are not the only way to return cash to shareholders.
- Dividends can be reduced or eliminated without warning.
- Dividends can be a sub-optimal use of cash flow.

Furthermore, investors can "create your own dividend" by choosing when to realize capital gains, likely at a lower tax obligation when compared to receiving dividends, assuming the investor's cost basis is positive and holding period results in a long term capital gains rate. It is worth noting that qualified dividend criteria is met by almost all companies traded in the US. We have nothing against dividends per se, but we firmly believe that dividends should not be the sole reason to own a stock. We prefer to invest based on total shareholder return, determined primarily by share price appreciation plus any dividends.

When a company generates cash flow, it can pursue many avenues to deploy this cash. The company may decide to reinvest in the business, reward employees, acquire new businesses, enter new or adjacent markets, pay down debt, repurchase its stock, or pay a dividend. If a company decides to pay a dividend or buy back its own stock, the management team may be signaling that these actions are the best use of cash flow for the business. For example, the management team may have concluded that it's better to give the money back to shareholders than it would be to expand unwisely.

On the other hand, some may conclude that the company is reaching a more mature stage in which growth slows. But are investors better off if a company repurchases its stock, effectively benefitting existing shareholders in the form of reduced supply, or if the shareholders receive capital directly in the form of dividends?

Using capital to buy back shares is equivalent to paying a dividend to shareholders.

We prefer buybacks to dividends to return capital for three reasons:

1. **The buyback mechanism offers management more flexibility when deploying capital if economic conditions change (e.g., the COVID-induced recession of 2020).**
2. **Buybacks allow investors to decide when and if they want to sell shares to create their own dividend and realize the gains that the cash return has provided them.**
3. **A "create your own dividend" strategy by selling shares results may result in a lower tax obligation.**

We will spare you the mathematical proof but consider a company that has excess cash flow and has determined that cash will be returned to shareholders. If the company decides to issue a dividend or repurchases shares and investors sell some shares to produce the same cash flow as in the dividend scenario, shareholder value will remain the same before taxes. After taxes, 100% of the dividend cash flow will be taxed in most cases at the qualified dividend tax rate, which is the same as term capital gains rate. In the "create your own dividend" scenario, the proceeds from the sold shares less the original cost basis will be taxed at the capital gains rate, which would result in a lower cash tax obligation than in the dividend scenario, assuming assuming a positive cost basis and a long-term holding period. We prefer the flexibility for shareholders observed in the buyback scenario, ***ceterus paribus.***

The dividend rate is the dividend payment divided by the share price. In some cases, companies that have seen rapid declines in share price can sport some nose-bleed level dividend rates purely because the dividend payment is being divided by a much smaller share price. In many cases, if a high dividend payer begins to bleed cash or sees its business fundamentals deteriorate, investors will determine that the company will be required to cut its dividend. Then the payment will no longer be expected, removing a floor from the stock.

Also, when a company underperforms or takes on a large debt load in pursuit of an acquisition, the company may be unable to pay its dividend.

When we hear investors express a desire to own companies that pay high dividend rates, we implore them to consider total shareholder return instead.

We prefer this measure of a company's performance because it controls for various capital allocation decisions. While every tax situation is unique, we encourage investors to explore how the management teams of the stocks they own return capital to shareholders and if that policy is advantageous for their individual tax situation.

We think it is essential for clients to understand that creating your own dividend by selling shares that have appreciated in value may be a superior way to create a reliable cash flow when compared to a high dividend-paying stock – on a pre and post-tax basis. In our view, it is important for shareholders concerned about capital return policy to look at the whole picture because it includes the often-overlooked share repurchase, which is a component of total shareholder return.

For more information, please contact your advisor.

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