TD Waterhouse

Private Client Services

Do You Need Income or Cash Flow?

I am constantly being asked about dividends and dividend paying stocks so I thought it was time for a discussion. Canadian investors have a longstanding obsession with generating portfolio income, and their bias is exacerbated in the current low interest rate environment. A survey of recent headlines and quotes from the *National Post* illustrates how income from an investment, in the form of interest or dividends, is often viewed as the primary consideration.

Where to find yield in U.S. stocks
July 3, 2010
"High-yielding, dividend-paying stocks offer an opportunity to remain in stocks until short-term market woes are settled. Investors frequently will receive a flow of income that supersedes interest payments received from fixed-income securities of comparable value."

The best dividend payers in Canada
July 3, 2010
"A reader with $100,000 in a taxable account asks if it's possible to create a portfolio of Canadian blue-chip stocks that generate tax-favoured dividend income without taking on too much risk."

Dividends looking more attractive
July 6, 2010
"With bond yields falling on heightened market risk, dividend-yielding stocks are looking increasingly attractive, Desjardins Securities says."

Meeting a specific cash flow need is an important element of portfolio management. The expected return and volatility of the overall portfolio must be factored into determining sustainable withdrawal rates, but income should not be the main concern. In many cases, taxable investors with a cash flow need are better off minimizing portfolio income.

Investors drawing down on their portfolios (e.g., retirees) need cash flow, but it can comprise two components: income (typically interest and dividend payments) and cash from the sale of securities.

There are a number of factors to contemplate when determining how to weigh these components of cash flow in order to meet a specific need. However, investors often gravitate toward the income piece without properly considering all the relevant issues, which can result in a less efficient investment solution. The following discussion touches on some important aspects of the income versus cash flow distinction.

Do Dividends Matter?

It only takes a cursory read of national newspapers to realize that dividends are the sacred cow of the Canadian investment landscape. The emphasis on dividends stems from the notion that a high dividend yielding stock constitutes a less risky investment because of the regular payments. Conventional wisdom is that the regular payment protects you on the downside because, if the stock price declines, you at least receive your dividend cheque. This perceived benefit has led many investors to emphasize dividends, regardless of whether they have a cash flow need. However, those who are drawing down on their portfolio are even more enthralled with high dividend yielding stocks because, if the regular payments can meet most or all of their cash flow need, then there is no need to sell and "lock in" a loss if the stock price declines.

While this logic attracts many investors, it has empirical flaws. Dividend payments are not created out of thin air. Rather, they come from a company’s earnings or assets. When dividends are paid, the distributions reduce the value of the company stock by the amount of the dividend.[1]

Part of the conventional wisdom mentioned above is that a high dividend yield may help you avoid encroaching on capital to generate cash flow. However, a dividend distribution encroaches on your capital (assuming you don't reinvest the dividend), and the company is doing it for you! You may not have to take action and sell stock, but the economic impact is essentially the same as if you had.

Another common misconception is that dividends offer protection on the downside and mitigate the drop in down markets. For example, if you own a stock yielding 5%, your portfolio will be buoyed by this amount if the stock price drops. However, consider that if the company did not pay a dividend, the price would have dropped less. You would obviously be out the cash from the dividend payment, but in both the dividend and no-dividend scenario, the total portfolio has dropped by more or less the same amount.

A company's dividend policy should not affect the overall value of your portfolio. However, while dividends don't matter, what the company does with the cash in lieu of paying the dividend (i.e., its investment policy) does matter. The following passage from Nobel laureates Merton Miller and Franco Modigliani ("M&M") succinctly sums up the concept:

"Like many other propositions in economics, the irrelevance of dividend policy . . . is "obvious, once you think of it.". . . [Company] Values are determined solely by "real" considerations—in this case, the earning power of the firm's assets and its investment policy—and not by how the fruits of the earning power are "packaged for distribution."[2]

Dividend irrelevance is one of the M&M propositions, though more recent papers suggest that dividends can impact firm value because the dividend conveys information to investors. The signaling models, however, relate more to changes in a firm's dividend policy (i.e., the dividend is being cut, increased, or initiated) rather than to the binary dividend versus no-dividend decision of the dividend irrelevance proposition.

Risk and Return

While M&M describe dividends as merely a form of "packaging" the fruits of the firm's earning power for distribution, dividends are often erroneously considered synonymous with profits. This misconception leads to the view that high dividend yielding companies are more profitable and less risky than non-payers when, in fact, dividends often are not related to profits.

Dividends are cash distributions and may not necessarily correspond directly to profits. Very profitable firms may not pay dividends (e.g., Berkshire Hathaway, Apple, etc). Conversely, some companies (or income trusts) have paid dividends (or trust distributions) in excess of their profits for a period of time. However, the latter case is unsustainable over the long run, and dividends must ultimately reflect a return of investors' capital or some of a firm's earnings to shareholders.

Furthermore, high dividend yielding stocks may in fact be riskier companies. Market efficiency suggests that the price, rather than the dividend, contains the information about the prospects for a company and its expected future cash flows. Consequently, a high dividend yield (D/P) could be considered a reflection of a low price rather than a high dividend.

The dividend discount model shows how a high yield can result from a high required return, a low expected growth rate, or a combination of the two. Therefore, high yielding stocks are considered riskier companies to the extent that their low price (i.e., higher yield) is a function of a higher required return.

Dividend/Price = Required Return - Expected Growth

Asset pricing theory suggests that "value" stocks trading at low prices relative to their fundamentals have higher expected returns as compensation for an increased level of risk. The price of a stock is a function of the expected future cash flows, discounted at a rate reflecting the relative risk attributed to those cash flows. The discount rate is the required return on the stock, which is also called the company’s cost of equity capital. In a well-functioning capital market, the required return and the expected return should be equal. Economic principles suggest that a riskier enterprise will have a higher discount rate applied to its expected future cash flows, resulting in a lower price. Therefore, a lower price means a higher cost of capital to the firm and corresponding higher expected returns for investors as compensation for bearing the higher risk.

Sorting stocks in the US on dividend yield does not produce significant differences in average returns. This may suggest that a higher D/P ratio results from a combination of a higher required return and a lower expected growth rate. On the other hand, dividends had been disappearing in the US in favor of share repurchases, due to their adverse tax treatment amounting to double taxation. Only 20% of US companies paid dividends in 1999.[3] This number increased to 37% as of June 30, 2009, possibly due to the Bush tax cuts, although the percentage may decline if the tax cuts are allowed to expire. The small size of the dividend payer universe in the US and its shifting nature may explain why sorting on D/P does not produce the spreads in average returns to support the proposition that a high yield results from a higher required return due to higher risk.

Sorting on D/P does produce this "value" effect in international markets, similar to the sorting of stocks scaled on other fundamental measures such as book value and earnings. Therefore, a high dividend yield may be mostly attributable to a higher cost of capital as compensation for risk, rather than as a result of low expected growth.

Yet many investors seek companies with a high dividend yield because they want income from their portfolio and they consider these companies to be less risky. However, these investors need cash flow, not income, and in this instance their pursuit of income biases their asset allocation toward stocks of riskier companies. There is nothing inherently wrong with an asset allocation biased toward riskier low-priced stocks in search of higher expected returns, but this investment decision should reflect a risk preference rather than a desire for an income stream.

Synthetic Dividends: Taxes, Costs, and Rebalancing

The alternative to meeting a cash flow need through dividend payments is to create "synthetic" dividends by selling securities in the portfolio. This approach is often deemed undesirable because selling is considered an encroachment on capital that may result in "locking in" a loss if the stock price has dropped. As discussed earlier, this view is not empirically sound, as the dividend payment amounts to "packaging" and doesn't necessarily change the underlying (pre-tax) value of the portfolio.

On the other hand, the tax impact of synthetic versus regular dividends may result in a different after-tax value depending on the relevant tax rates applied to dividends and capital gains.

The highest marginal tax rate in Canada varies across provinces, but rates by type of income are roughly as follows:

Eligible dividends from non-Canadian companies	46%
Dividends from Canadian companies	27%
Capital gains	23%

Synthetic dividends are more tax efficient than ordinary dividends from either Canadian or non-Canadian companies because generating cash flow from selling securities produces capital gains/losses that are taxed at lower rates. Furthermore, the lower tax rate is only applied to the portion of the cash flow that represents a capital gain (if any), whereas the higher tax rate for dividends is applied to the full amount of the dividend.

While generating cash flow from security sales is more tax efficient than dividends, any potential tax savings must be weighed against corresponding transaction costs incurred in a sale. There aren't likely to be any costs associated with receiving interest and dividend payments, but there may be transaction costs when selling securities. All else being equal, the priority should be to sell securities that trade without a direct transaction cost (e.g., most mutual funds in Canada)[4].

A final consideration in the income versus cash flow decision is the implication for rebalancing. Generating cash flow from securities sales not only results in more efficient tax management, but also provides an opportunity to rebalance by selling assets that are overweighted relative to the strategic target. Conversely, dividends only allow for rebalancing when the amount of the dividend payment in excess of the cash flow need is reinvested into assets that are underweight.

Bonds—Another Take on Income vs. Cash Flow

The income versus cash flow decision should be considered in other asset classes as well. In fact, one could argue that bonds are a component of the portfolio where this distinction is paramount because it is where investors often seek to meet their cash flow needs by the income being generated.

The income from bonds is the regular coupon payments from the issuer. Bonds with coupon rates that are lower than prevailing yields will typically trade at a discount to their par value. In some countries, the discount is amortized and taxed on an annual basis as interest income. However, Canadian tax rules allow for the discount to be treated as a capital gain, so it is taxed when the bond is sold, or upon maturity, at the lower capital gains rate. Assuming two bonds are identical in every respect except coupon rate, there is a significant tax advantage in reducing the income generated from the bond portfolio by purchasing low coupon bonds. However, the transaction costs associated with selling parts of a segregated bond holding to create cash flow can be significant. A commingled bond fund that is able to reduce income could provide some of the tax advantages, yet enable regular withdrawals from the asset class with little or no transaction costs.

Nonetheless, many investors think of yield to maturity rather than coupon rate when referring to the income from a bond portfolio because it represents a number that is comparable to prevailing interest rates. The current low interest rate environment has prompted many income-oriented investors to pursue higher yielding bond portfolios, yet an increase in yield is not a free lunch because yield is merely an inverse function of price. Therefore, bonds with higher yields are those trading at lower prices.

Market equilibrium suggests that higher yielding bonds have lower prices for a reason. They are deemed riskier by market participants, and their higher yield is compensation for bearing this risk. There is nothing inherently wrong with taking more risk in your bond portfolio, provided it is well diversified, low cost, tax sensitive, and prudently managed. On the other hand, rather than increasing the risk profile of a bond portfolio in pursuit of income per se, risk decisions should consider the total portfolio and an investor's overall risk preference.

Mental Accounting

A behavioral bias known as mental accounting may also prompt Canadian investors to overemphasize investment income in their portfolios. Research in behavioral finance has identified the tendency for people to separate their money into different mental accounts. The cognitive biases may encourage decisions based on the source and intended use of the money, which violate the economic principle of fungibility.

An example of mental accounting based on the intended use of funds is putting money for a child's education in a low interest earning savings account while carrying a balance on a high interest bearing credit card. In this instance, the importance of the intended use of the money (i.e., education) means it is not used to pay off expensive debt, even when doing so results in a net economic benefit.

Another example of mental accounting based on the *source* of funds is spending "found" money, such as gifts or tax returns, to a greater extent than an equivalent amount of money that is expected, such as a paycheque.

Consequently, labeling effects influence mental accounting, and this offers one explanation of why firms even pay dividends. If a company wants to distribute earnings to shareholders, it can choose to pay a dividend or it can repurchase shares. These two alternatives have the same economic impact before taxes, but if dividend tax rates are higher than capital gains tax rates, taxable investors would prefer share repurchases over dividends. In this scenario, firms should never pay dividends. Yet, in jurisdictions where these conditions exist (e.g., the US), many firms do!

Meir Statman argues that investors prefer dividends because the regular payment provides a simple self-control rule: Live off the dividend, but don't touch the principal. The dividend becomes like an allowance, whereas, if firms repurchase shares, the investor would have to periodically sell stock to raise cash. The economic impact before taxes is the same, but there wouldn't be a designated amount to view as an allowance, and the stock sales could be seen as a dip into principal.

However, the bottom line is: When you move money from your left pocket to your right pocket, you are no better off; and in some cases, a few coins can slip between your fingers for the tax authority to collect. So, in an attempt to take the mental accounting focus away from the perceived need for investment income to meet cash flow requirements, advisors may want to consider positioning the client's regular withdrawal from the portfolio as an allowance or as a paycheque of sorts. The advisor's role is to ensure the overall drawdown rate is sustainable, and that the volatility of the portfolio has been considered, but to then take responsibility for meeting that cash flow need in the most tax-efficient way as part of the advisor's value proposition. On the other hand, satisfying the behavioral need for income to meet cash flow needs due to mental accounting may be a more palatable solution for non-taxable investors.

Conclusion

The current low interest rate environment and a Canadian obsession for income-oriented investments have led many investors toward riskier portfolios, but investors with a cash flow need should first consider their overall risk profile and the impact of volatility and expected returns on their distribution of total wealth. Biasing a portfolio toward companies with higher dividend yields or bonds with an increased yield to maturity is putting the cart before the horse, unless the decision reflects a risk preference rather than an income preference!

Once the overall allocation decision has been made on the basis of total portfolio risk and return, the income produced becomes a byproduct. In many cases, taxable investors are better off reducing income and periodically selling securities to meet the balance of their cash flow need. However, mental accounting seems to be a powerful force preventing this approach. Satisfying the need for mental accounting comes at the expense of higher taxes or the desire for a portfolio that may not be appropriate for some investors' risk tolerance. Therefore, advisors would be well served by packaging their overall solution in a way that mitigates or addresses the need for mental accounting.

Executive Summary of Key Points

Portfolios should be designed to reflect risk tolerances while considering the impact of expected returns and volatility on sustainable drawdown rates and vice versa. Portfolio management then shifts to implementing the desired asset mix while reducing income for taxable investors.

Here is a summary of the main reasons why:

• Investors have cash flow needs, not income needs.
• Cash flow can come from income and/or security sales.

• Dividends policy doesn't matter; investment policy does.
• High dividend yielding stocks may be more risky.
• Dividends do not protect you on the downside.
• Dividends do not prevent you from encroaching on your capital.
• Dividends can be a less tax-efficient way to generate cash flow.
• Lower coupon rates on bonds have tax advantages.
• A higher yielding bond is a riskier bond.
• Supplementing income with security sales to meet a cash flow need creates regular opportunities for rebalancing.
• Mental accounting is a powerful bias when managing portfolios for investors with a need for cash flow.

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. *Merton Miller and Franco Modigliani, "Dividend Policy, Growth, and the Valuation of Shares," Journal of Business 34, no. 4 (October 1961): 411-33.*

3. *Eugene F. Fama and Kenneth R. French, "Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?" Journal of Applied Corporate Finance 14, no. 1, (Spring 2001): 67-79.*

4. *There are generally no transaction costs to the investor for redeeming units of a fund in Canada. Transaction costs may be incurred within a fund if cash must be raised to meet redemptions.*

Kindest regards,

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