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Dividend yield or Capital growth on the Nairobi Stock Exchange (NSE)?

by PK Mwangi

This article looks at the Nairobi Stock Exchange (NSE) to identify which from a number of strategies would produce winning stocks on a consistent basis. The article involves a study in which six hypothetical investment dates are considered between 2008 and 2010 and stocks picked on the basis of three strategies for four annual and two eight-month periods prior to these investment dates.

Stocks are picked on the basis of their outperformance in the investment periods prior to the investment dates. The strategies include a dividend yield strategy, a capital growth strategy and a total return (hybrid) strategy to identify which among these would provide the highest number of winners in the period following the investment dates.

The investment dates considered are:

- 17 January 2008
- 14 November 2008

- 2 March 2009
- 20 May 2009
- 29 July 2010
- 9 September 2010

For ease of computation and because of a lack of adequate data on dividends paid for the some of the small cap. stocks, the dividend yield is taken as a proxy for the dividend paid for the period to arrive at total return. It is quite conceivable that a high yield for a stock may exist alongside a high dividend and vice versa.

Research

High dividend yield strategy

A number of stocks were picked on the basis of a high dividend yield on the investment dates. High dividend yield stocks[1] were those with yields of above 4 per cent and which showed this consistently over the six periods considered. Stocks that consistently showed high yields (in at least five of the six periods considered) were East African Breweries Ltd., British American Tobacco Ltd., Kenya Commercial Bank Ltd., Kenya Oil Ltd.[2] , Total Kenya Ltd. and KenGen Ltd. Energy stocks in particular posted very impressive yields during all six periods averaging well over 30 per cent for Kenya Oil Ltd. and well over 8 per cent for Total Kenya Ltd. British American Tobacco Kenya Ltd. consistently yielded in excess of 6 per cent for the periods considered.

However, picking stocks on the basis of a high dividend yield did not prove to be a winning formula. Only East African Breweries Ltd. and British American Tobacco Kenya Ltd. managed to outperform (in terms of capital growth) in at least five of the six periods following the investment dates. Total Kenya Ltd. and KenGen Ltd. were particularly poor only managing to outperform in two of the six periods following the investment dates. This means that of the six stocks picked on the basis of a high dividend yield only two stocks were able to consistently outperform i.e. in at least five of the six periods considered- a success rate of 33 per cent.

[1] Also hereon referred to as high yield stocks.

[2] This stock posted the highest dividend yields in all the periods considered.

On the other hand, however, a good number of the low-yielding (2 per cent or less) stocks in Athi River Mining Ltd., Diamond Trust Bank of Kenya Ltd. and Equity Bank Ltd. managed to outperform in at least four of the six periods. Picking stocks on the basis of high yields seems not to be a perquisite for outperforming the market. However, none of the non-dividend paying stocks were able to outperform in more than three of the six periods following the investment dates with most of them only managing to become winners in one period of the six. This suggests that the prospect of receiving a dividend has a positive impact on share prices allowing dividend-paying stocks to form the bulk of the winners. Dividends, therefore, seem to be a necessary but not sufficient condition for outperformance.

Capital growth strategy

Stocks that had outperformed on the basis of capital growth prior to the investment dates were considered under the second strategy to identify whether these would yield a higher return than those picked under the alternative strategies. Most stocks, however, were unable to consistently outperform on the basis of capital appreciation during the six periods considered making a strategy of picking stocks on that basis a difficult one to implement. Most stocks outperformed on the basis of capital growth in only three periods or less during the six periods considered. Only Athi River Mining Ltd. consistently outperformed- in five of the six periods- while Total Kenya Ltd and Eagads Ltd. outperformed in four of the six periods. In the investment periods that followed the relevant investment dates, Athi River Mining Ltd. outperformed in all six periods in terms of capital growth, Total Kenya Ltd. outperformed in only two of the six periods while Eagads Ltd. outperformed in only three of the six periods.

A strategy based on picking stocks that had shown the greatest capital appreciation in the lead up to the investment date would not have provided winners in the subsequent investment period. Out of three stocks picked on the basis of capital appreciation, only one stock was able to outperform in at least five of the six periods subsequent to the investment date- a success rate of 33 per cent.

However, stocks that had not outperformed on the basis of capital growth in the one year period leading up to the relevant investment dates (and hence would have been excluded from a strategy based on picking stocks on the basis of their capital performance) did manage to outperform in the periods after the investment dates. These stocks included Williamson Tea Kenya Ltd., Diamond Trust Bank of Kenya Ltd., Jubilee Insurance Co. Ltd., ScanGroup Ltd. and TPS Serena Ltd., which despite showing weak capital appreciation in the lead up to the investment dates considered, managed to outperform in five of the six periods thereafter. East African Breweries Ltd. managed to outperform in all six periods considered despite showing poor capital performance in the lead up to each of the investment dates considered.

The above showed that capital growth as an investment strategy in picking winners would not have successful in doing so. Some of the well-performing stocks in terms of capital growth in the lead up to the investment periods (the likes of Total Kenya Ltd. and Eagads Ltd.) performed dismally in the periods after in terms of capital growth. As will be seen later past winners have a tendency to become future losers and vice versa.

Total return (hybrid) strategy

A strategy to pick stocks on the basis of total return in the periods preceding the investment dates identified Athi River Mining Ltd. and Standard Chartered Bank Ltd., in particular, as possible winners as these outperformed in terms of total growth in all six periods considered. Other stocks that were picked on the basis of this strategy included East African Breweries Ltd., City Trust Ltd., Total Kenya Ltd., ScanGroup Ltd. and Eagads Ltd. all which outperformed in terms of total return in four of the six periods considered.

Following the relevant investment dates, Athi River Mining Ltd and East African Breweries Ltd. outperformed in all six periods while ScanGroup Ltd. and Standard Chartered Bank Ltd. outperformed in five and four periods respectively in terms of capital growth in the years following the investment dates. This means that of the seven stocks that were identified by a strategy based on total return to pick winners, four stocks managed to outperform in the years following the investment date- a success rate of 57 per cent.

Thus a strategy based on identifying stocks that had outperformed on the basis of total return and including these in the investor's portfolio would have provided a higher incidence of winners in the subsequent investment periods (here one year) in terms of share performance beating alternative strategies based on high yields and capital growth.

Although a number of individual stocks that were excluded under all three strategies- dividend yield, capital growth and total return, did indeed outperform in the six periods following the relevant investment dates- Kakuzi Ltd., Williamson Tea Kenya Ltd., Bamburi Cement Ltd., Crown Berger (K) Ltd., Equity Bank Ltd., Jubilee Insurance Co. Ltd. and TPS (Serena) Ltd.- it is difficult to identify a strategy that would have picked these stocks ex-ante to deliver a winning portfolio.

Analysis

Total return

Dividend yield represents the return from owning a share at the prevailing market share price. However this is not the only return achieved from holding stock as capital growth also needs to be taken into account. Thus the investor needs to consider the total return in assessing the full extent of his equity investment. Total return is what really adds up and compounds for investors over time.

To identify dividend-paying stocks that are going to give good total return over time the investor needs to study stock total return long-run averages. Further, what the investor is not getting from yield needs to be sought in growth and vice-versa. Where the dividend is also growing this has a positive impact on the share price giving the investor a further return in capital growth. Thus the ideal combination is that of a decent yield coupled to both an increasing dividend and rising share price. This would help maximise total return for the investor. The total return (hybrid) strategy considered above managed to identify a number of stocks that were able to outperform in the periods leading up to the relevant investment dates namely Athi River Mining Ltd. and Standard Chartered Bank Ltd..

Capital gains over time are thus correlated to dividends paid as well as correlated to the earnings which pay the dividends. So it's not just a capital growth story, it's also a matter of the income from holding the stock as well as the growth of that income over time. Despite the need for dividend growth, however, low yielding Athi River Mining Ltd., Eagads Ltd. and City Trust Ltd. were still able to outperform on the basis of total return in the lead up to the respective investment dates hence earning a place in the total return strategy portfolio.

Age profile and risk

How the investor picks out his mix of yield and growth in a portfolio to achieve a decent total return will be guided by his age profile and therefore appetite for risk. If the investor is relatively young with a long period of saving and investment ahead of him the ideal will be to seek a lot more growth in exchange for taking a lower yield.

For those investors closer to retirement a total return strategy that seeks out more of the high yield stocks and less of capital growth would be key. However, this kind of investor will need to watch out for stocks that start out with a relatively low yield but go on to grow their dividend on an annual basis thereby revealing a much higher yield in future years. The compounding nature of such growth (dividend yield rising as the dividend grows) in dividends should see off decent pay cheques in retirement.

Further, for the impending retiree it is important to hold stock in a company with a consistent history of paying out dividend (for example Kenya Commercial Bank Ltd., Kenya Oil Ltd., East African Breweries Ltd., British American Tobacco Kenya Ltd. and KenGen Ltd.). For him a total return strategy that emphasises more of the dividend element also brings with it reduced risk were a capital depreciation to take place. This means that since the dividend is more or less given this offers a secure form of income even were the stock to suffer from a loss in value. Utility companies[3] in particular, due to their large cash reserves, may well be able to sustain constant dividends even in the face of declining share values and would be an interesting area to hold stock for investors approaching retirement.

During bear markets, identifying high dividend yield stocks becomes a better strategy as the market struggles with negative capital growth. However, where improving yields are driven by falling share prices and not increasing dividends key will be to differentiate between those stocks that are yielding better because of a growing dividend (e.g. Bamburi Cement Ltd. between 2008 and 2011) and those where the share price is falling (e.g. Mumias Sugar Ltd. between 2008 and 2011). If the bear market is coupled with prevailing low interest rates, dividend yields may therefore present the only offer of a decent income for investors as yields on bonds (which run in tandem with prevailing interest rates) will also be low. This strategy may be given even more impetus where the investor purchases or continues to hold stock of a company paying a constant dividend and hence offering a more predictable return.

The macro- environment

- Inflation

An inflationary environment will require that total return compensates the investor for the loss of purchasing power. Managing the inflationary environment may require a rebalancing of the portfolio away from cash, non index-linked bonds and equities towards asset classes that will hold value over time e.g. certain hard commodities like gold, benchmark currencies and commodity currencies[4]. In a deflationary environment the converse will hold true. However, even in a depressed economy investing in dividend-paying firms with a trackable dividend policy and/or share buyback policy can ensure that some decent return is achieved.

[3] In frontier markets some of these companies are able to benefit from political patronage (sometimes in the form of tax concessions) thereby managing to maintain profitability even in difficult times or difficult markets.

[4] Commodity currencies are currencies of countries which depend heavily on the export of certain raw materials for income. These countries are either developing countries like Burundi (Burundi Franc- BIF) and Tanzania (Tanzania shilling- TZS) or developed countries like Australia (Australian dollar- AUD), Canada (Canadian dollar- CAD), New Zealand (New Zealand dollar- NZD) and South Africa (South Africa rand- ZAR).

In situations where governments are tempted to use inflation to escape a fiscal deficit (high debt levels) inflation may persist over the medium to longer term. This could threaten the real value of cash and bond investments- and make the capital growth potential of equities more attractive.

Owning stocks in sectors like utilities and other industries whose revenues (and by extension distributable profits) are tied to inflation can act as a near perfect hedge since as inflation goes up so do utility bills; the investor getting an automatic pass-through of inflation to revenues and earnings. As a consequence dividend payouts rise in line with inflation.

- Interest rates

The setting of low interest rates to manage a deflationary environment could kickstart a movement away from cash savings to equities and hence increased equity market activity. This can lead to a surge in share prices and increased capital growth

Conversely, rising interest rates (say to manage inflation) mean increased borrowing costs for consumers and businesses, which in turn affect the ability of companies to grow and expand. This hurts earnings reducing the possibility of a dividend payout. Also as interest rates rise bond investors will require a higher coupon to convince them to purchase any new bond issues thereby making bonds and cash more attractive alternative to stocks. Decreased demand for stocks could depress their prices.

Further, a rise in interest rates will lead to rises in both income and equity yields as investors seek the higher return in cash. Both the prices of bonds and equity will fall raising their yields in the near term. A rise in interest rates also suggests that the investor will need to pick high yielding stocks comparable to those offered by bonds. The upside to this is that these stocks will generally have greater capital-appreciation potential than the alternative bonds and bond funds.

Volatility risk

Volatility risk refers to the potential for asset prices to fall during adverse market conditions. Small-cap stocks are particularly vulnerable and significant losses in a short space of time are usually common, regardless of how skilled the investor or fund manager is. Volatility can harm portfolios in a number of ways. Following market turbulence, for example, retirees or those paying into pension funds will see their retirement savings fall considerably. Although the market eventually recovers, retirees' portfolios will have less time to recover before they are required to support lifestyles. Loss of value in equity portfolios therefore inadvertently reduces the amounts that can be paid out as income (dividend) or withdrawn as profit (capital gain).

However, the most insidious aspect of volatility is its impact on investor behaviour. When markets gyrate emotions can get the better of investors and tempt them into making the counterintuitive move of buying high and selling low. The same also happens in bull markets when corporates and funds post impressive results and investors pile in enthusiastically. Such funds may however be taking oversized risks and when the markets correct and investors jump ship prices may hit a downward spiral thereby returning volatility to the market. Thus a herd mentality can harm portfolios and the investor will need to hold his nerve even in seemingly treacherous times. Following the global financial crisis in 2008/09, the ensuing herd mentality saw a major equity sell-off on the NSE that saw the shares of some blue-chip firms lose more than half their values. Notable were Equity Bank Ltd., Unga Group Ltd., East African Cables Ltd. and CMC Holdings Ltd. despite showing relatively stable underlying performance during the period.

To guard against such behaviour, the investor needs to have a clear understanding of his own capacity to endure volatility. Arming himself with an honest appraisal of his capacity for risk allows the investor to invest intelligently. For the cautious investor, avoiding volatile sectors like Technology, Media & Advertising, Agriculture and potentially Transport would be advisable alongside constructing a portfolio of minimally correlated stocks.

The need to minimise volatility becomes paramount the closer the investor gets to his investment goal(s). This may mean a preference for more stable investments represented by bonds (in particular investment grade government bonds) and cash deposits bearing in mind, however, the level of inflation since this could erode the returns that can be achieved.

In summary the investor is better off populating his portfolio with dividend-paying stocks rather than non-dividend paying ones. The former's ability to pay a dividend provides greater income stability as well as offering a small cushion against capital losses. However, looked at it in the wider scheme of things dividend-paying stocks' volatility profile is substantially higher than that for bonds. Where the investor is seeking regular income and stability of the principal, bonds should form the greater proportion of a well-diversified portfolio since these help to achieve optimal total return especially in retiree portfolios.

Tax considerations

Conventional financial-planning wisdom holds that the best time to rebalance a portfolio is at tax-year-end, with an eye toward harvesting any losses suffered during a market downturn to offset against capital gains elsewhere in a portfolio.

The two components to total return--dividends and capital gains--have two totally different tax treatments. Dividends are immediately taxable while taxes on capital gains aren't due until the stock is sold, creating a tax deferral that aids in wealth accumulation. The suspension of capital gains tax in Kenya for the last two decades has meant that investors have not been subjected to taxes on gains made on acquisition and subsequent disposal of equities or fixed-income securities. However, these become taxable when invested through a mutual fund as taxable profits. Thus equities with low dividend yields are particularly attractive to higher-rate taxpayers who are able to combine a low dividend- and hence a relatively lower tax burden- with a substantial tax-free capital gain.

In choosing between a dividend yield strategy and a capital growth strategy, however, the investor's personal tax treatment will be an important consideration. For the lower income investor not much difference, from a tax perspective, will be obtained by adopting either of the strategies. However, for the higher income earner, substantial saving can be achieved by opting for a capital growth strategy as opposed to a dividend yield strategy.

Further, rather than pay their earnings directly to shareholders as dividends, some companies may opt to reinvest those earnings in their businesses returning money to shareholders via less direct means such as share buybacks. This has tax advantages as shareholders are in effect receiving a capital gain through these share buy back schemes. As seen above investors in the country are exempt from capital gains tax. However, in Kenya, company law prohibits share buy-back by companies.

Maintaining a long-term view

As a portfolio manager it is a big mistake to focus too much attention on short-term performance; rather the focus should be longer-term numbers i.e. each holding's return over the past three and five years relative to that of other offerings within the same category. In this case a key consideration would be a comparison of the return on a portfolio constructed on the basis of total return and that constructed on some other basis (say a value strategy).

The portfolio manager will also need to take note of absolute returns paying attention in particular to security holdings that have contributed the most--or detracted the most--from his portfolio's bottom line. Continued underperformance can be an indication that something's amiss with the holding although this can also provide an opportunity to buy more of the holding on the cheap and expect to benefit from a reversion to the mean over time. Some of the financial stocks, in light of the global financial crisis in the last three or so years, have continued to underperform and continue to provide attractive valuations, notably Barclays Bank Ltd., National Bank of Kenya Ltd. and CFC Stanbic Ltd.

The portfolio manager's overriding principle, however, should be to adjust his asset allocation to match investors' investment horizons through time rather than trying to time the market's ups and downs. One of the easiest traps for investors to fall into is buying and selling at the wrong times. Human nature would have investors buying when market conditions seem favourable and selling when they deteriorate but such human intuition can seriously impede overall return.

Following bear markets like the recent global financial crisis[5], loss of capital may become a major concern for investors. However, these are essentially paper losses and do not constitute permanent capital loss unless the holding is liquidated. This means the long-term investor will need to stay focused for the long haul even when the markets take a tumble. Those investors who have the discipline to stick with their long-term investment plans will reap the benefits that materialise over the course of complete market cycles i.e. boom to bust to subsequent boom. Most of the stocks on the NSE have managed to recover from their March/ April 2009 lows with some bellwether stocks like Athi River Mining Ltd., Mumias Sugar Company Ltd. and Kenya Airways Ltd. growing in excess of 100 per cent between their March/ April 2009 lows and July 2011 and others like Kakuzi Ltd. managing a 200+ per cent growth during the same period.

Further, in bear markets, strategic asset allocation (rebalancing) becomes crucial and will involve an increased exposure to cash, bonds (in particular long-dated government bonds), gold and certain other hard commodities as safe havens. The suggestion here is that of an inverted yield curve (due to depressed market conditions) in the near-term with short-run securities (equities) carrying a higher risk and investors preferring longer-term exposure.

Diversification

Where the investor decides to adopt either a dividend yield strategy, capital growth strategy or total return strategy, he will need to be aware of the dangers of huddling his holdings in a single investment style. He may need to take note of the market sector weightings (sectors more represented within the benchmark index) and those identified by his strategy should not be far away from this. Also he will need to ensure that the portfolio, even with his adopted investment strategy, is not disproportionately skewed toward one or two individual stock holdings, sectors or industries. It is often the case that if one company in a given sector runs into trouble and has to cut its dividend, its peers may not be far behind. At the same time, indeed, some investments and asset classes will perform well while others will struggle. A particular year's winning investment is quite likely to become the following year's loser. Thus it becomes necessary to diversify across sector, industry and also asset class.

The old adage of diversify, diversify, diversify thus holds true whether the investor is following an income, capital growth or hybrid strategy. The advantages of diversification will, of course, be better achieved in opting for a dividend-focussed fund rather than picking individual dividend-paying companies; although this will come at an added cost in management and other fees

[5] Frontier markets like Kenya have not been immune from this with the NSE-20 index falling 20 per cent in the last three years (August '08 to July '11) and the NSE All-share index falling 15 per cent during the same period. These losses are of course magnified by the month-on-month inflation rise in Kenya in excess of 5 per cent (on average) during this period.

Actively Managed Fund and associated costs

For those investing through an actively managed fund, costs are always a key consideration when shopping for an investment vehicle. This is also the case when the investor's objective is take-home yield. That's because a fund's expense ratio is deducted directly from its yield. Where yields within the fund are only slightly above the fund's expense ratio, dividend-focussed funds can provide very poor income for the investor. The expense ratio could eat up every bit of the fund's yield often leading the manager to go for higher-yield higher risk stocks to offset the fund's built-in expense disadvantage.

An appreciation of the expense ratios exhibited by the mutual funds operating in Kenya will be instrumental in deciding between the variety of mutual funds and fund managers available here especially where these invest heavily in dividend-paying stocks. Some of the investment banks and fund managers showing competitive total expense ratios include the likes of NIC Capital Ltd., Afrika Investment Bank, Standard Investment Bank, Dry Associates Investment Bank and Apex Africa Investment Bank.

Total return is not the only game in town

As was seen in the study above, including in a portfolio stocks that have outperformed on the basis of total return in previous periods to determine winners in subsequent periods can be a largely successful strategy. However, merely seeking total return is not a panacea for maximising shareholder return. Ultimately, it is the identification of undervalued stocks that should provide winners both in the long-term as well as on a consistent basis. This is especially so within the small cap space as these stocks in particular receive little analyst attention and therefore tend to exhibit low but attractive valuations.

Agriculture stocks- Williamson Tea Kenya Ltd. and Kapchorua Tea Company Ltd. (both small cap stocks on the NSE) would have provided decent returns in the periods following the investment dates considered above due to their prices which remained well below fair value. In the case of these two stocks, however, the relatively weaker balance sheets associated with small cap stocks is supplemented by the inherent risk associated with the Agriculture sector due to its heavy reliance on uncontrollable exogenous factors- world demand and climatic conditions. These represent a constant deterrent to holding the stocks by investors who continually shy away from them. However, for the less risk-averse investor, such stocks provide an opportunity to achieve substantial capital growth within his portfolio. Having said that though it is the small cap stocks that are the most volatile and suffer the most during a market downturn.

Investment style

Fund managers normally run their funds using a combination of top-down analysis (macro-investing) and bottom-up credit selection. To develop their top-down perspective, the managers look at factors such as inflation, interest rates and credit cycles[6] and position the portfolio accordingly. Within their bottom-up stock selection, however, they will need to watch out for sectors or stocks- laggards- that come into favour merely because money has come back to equities (following increased risk appetite in a returning bull market) not because their fundamentals have improved. They will also need to be aware of chasing sectors or stocks that did well in a downturn as these will have low yields and hence low returns (income) while those that did not perform well may hold attractive valuations and yields. Yields on higher quality securities, in particular, will have been driven down sharply suggesting that further price appreciation isn't on the cards.

Most listed companies on the NSE continued to pay dividends even during the height of the financial crisis revealing dividend yields at their highest for most of these stocks as prices tumbled. As share prices have recovered dividend yields have continued to fall reflecting their historical values.

Occasionally in really bearish markets high-quality companies' shares may become so lowly valued that they feature higher yields than their bond counterparts[7]. Although representing greater risk these stocks offer more capital-appreciation potential than most bonds. As the bearish run nears its end investors may continue to view dividend-paying stocks as offering an attractive mix of current income and growth potential.

Funds that focus on dividends vary widely in their approaches. Some buy dividend-paying stocks whose yields are high, either in absolute terms or relative to the broad market or a market index. Others focus less on a company's current dividend yield and more on its ability to increase its dividend in the future. Which approach is the better will depend on the investment rationale of the investor with the former strategy appealing more to investors in search of current income, whereas the latter approach is the way to go for investors seeking financially strong companies with future growth potential but who care less about yield.

The best dividend-paying investments, however, balance income with capital appreciation and good risk controls. If seeking a dividend-focussed fund primarily for current income, the investor will need to check its actual dividend payout first. Is the payout

[6] These refer to the access to credit by borrowers. Credit cycles first go through periods in which funds are easy to borrow; these periods are characterized by lower interest rates, lowered lending requirements and an increase in the amount of available credit. These periods are then followed by a contraction in the availability of funds during which time interest rates climb and lending rules become stricter. The contraction period continues until risks are reduced for the lending institutions, at which point the cycle starts again.

[7] High dividend yields above those offered by bonds are usually a signal to buy equities.

ratio sustainable going forward without hampering capital reinvestment and organic growth? Very high dividend yields backed by high payout ratios serve as a warning sign that the market views a firm's payout level as unsustainable[8]. This notwithstanding the most straightforward way to include dividend income in a portfolio is to buy shares with high dividend yields, or funds that buy dividend-paying stocks. Tobacco and utility companies- the likes of British American Tobacco Kenya Ltd. and KenGen Ltd- generally pay hefty dividends and are a good place to look for high-yields although, as stated, a very high yield could also signal a risky stock.

There are good reasons why the investor might want to hold dividend-paying shares in his portfolio. Dividends are generally more reliable than capital gains—the investor knows exactly how much he is getting and when he is getting it. As a result, dividend-paying shares often perform relatively well in a volatile market and are especially popular among investors nearing retirement who are seeking a stable source of income. By the same token high yield dividend-paying stocks put cash directly in the investor's pocket and tend to provide a much more stable source of return than price appreciation which depends on the market movements which at times can be very unstable. However, one can still achieve better returns by buying into low yielding stocks that show good capital appreciation as well as paying a regular dividend. In particular income-seeking investors will prefer the distributing funds (which distribute dividends to fund holders) over capitalising funds (which reinvest dividends). It is, however, essential to keep tax considerations in mind when choosing between these two.

Another option for dividend-hungry investors is preferred stock as it acts as a mix of stocks and bonds. Like a stock, it represents an ownership stake in a company, but like a bond, it pays a fixed dividend and its value is very sensitive to interest rates. The value of shares in companies with a preferred stock element tends to vary greatly with changes in interest rates.

When seeking dividend –paying stocks it may become necessary to search the small cap space to identify small cap companies that pay dividends as opposed to concentrating on large caps that pay no dividend at all. Agriculture stocks Eagads Ltd. (a small cap stock) and Sasini Tea & Coffee Ltd. (a large cap stock) are prime examples. With Eagads Ltd. the investor has the added advantage of receiving a dividend on top of any capital appreciation. During bear markets this strategy may yield higher returns as there is little to be achieved in the way of capital appreciation by holding Sasini Tea & Coffee Ltd.

[8] Nation Media Group Ltd. with an average yield of 4 per cent in the last three years and a dividend cover averaging 1.3 times during the same period suggested a payout ratio of 77 per cent. The market's view of the unsustainability of this in the long run has led to a fall of 125 per cent in its share price in the last three years. Centum Investment Ltd. posted losses in financial years 2008 and 2009 but continued to pay dividends suggesting a drawdown on past reserves. Its share price has more or less stagnated in the last three years falling 19 per cent during the period.

Safety of principal

In all investing decisions, the final consideration should be safety of principal. High yields will always be indicative of a high dividend or a principal reduction or both. A high or increasing dividend that is not sustainable in the long run and/or a reduction of principal both have undesirable effects for the investor.

While comparing dividend yield with that on a benchmark security like the 10-year treasury bond, the long-term investor will need to bear in mind that although the former may be higher, at least with the treasury bond the investor knows exactly what he is getting- i.e. a semi-annual income as well as the principal on maturity. This suggests that in bear markets where share price appreciation is absent, seeking debt yields as opposed to equity yields has the added advantage of protecting one's principal. Thus dividend-paying stocks should be seen as a way of rearranging an equity portfolio rather than a substitute for a fixed-income holding especially for investors approaching retirement. For stability purposes, fixed-income holdings should remain the cornerstone of a well-diversified investment portfolio.

Safety of principal is further enhanced by seeking margin of safety. This involves looking for low risk investments in general and assessing what could go wrong even in what appears to be a low risk situation. Paying less through a low share price or a high yield upfront is a good way to protect oneself from or minimise the downside risk.

Company dividend policy

Returning cash to shareholders is a critical part of the investment process. A stock's value is given by the present value of its future dividends. Even though capital gains provide the impetus for investors to hold stocks, it is the stock eventually returning cash to the owners that will spur its upward price movement. Furthermore, dividends provide a useful insight into the quality of a business. While it may be possible to manipulate earnings by using different accounting treatments, this cannot be done with dividends which means that these give a more accurate picture of a company's wealth.

Companies pay dividends because this is really what corporations are meant to do. Stocks carry an implicit promise of future returns of cash to shareholders. High payout ratios will in themselves help attract investors with a long-view on holding the shares. Additionally, reviewing the dividend history of a firm will help establish the security of long-term income. Where the company has consistently paid out a dividend (as opposed to a firm that occasionally pays out dividend), this will have a positive effect on the company's stock price and hence increase the possibility of capital gain.

In any one market different dividend-paying companies will tend not to be equally distributed across the marketplace. Some types of companies and industries will tend to favour paying out dividends more than others who may hold back their earnings in order to finance growth or in some cases, to offset losses. Most listed companies on the NSE do indeed pay dividends with the distinction appearing in the levels of dividend paid between the high yield and low yield companies. High yields are prevalent in the Industrials, Energy and Utilities sectors while Financials and Consumer Services have more of the lower yielding stocks. However, just because a company or an industry is paying a high dividend doesn't mean that the business is good or that the stock is worth owning. Key will be to establish whether the company has a progressive dividend policy i.e. it can continue to support a high and growing dividend. In recent years the likes of Nation Media Group Ltd, Centum Investment Ltd. and East African Cables Ltd. have continued to pay substantial dividends in the face of a declining dividend cover in the case of Nation Media Group Ltd. and falling earnings in the cases of Centum Investment Ltd.[9] and East African Cables Ltd. raising the prospect that such dividends may become unsustainable in the long run.

In picking stocks solely on the basis of dividend yield, however, the investor will need to bear in mind that new companies and those still at the stage of rapid growth may opt not to pay dividends as their shareholders would rather that the funds be invested in further growth of the business through retained earnings. A dividend yield strategy may thus ignore stocks that promise good returns since these are not paying out dividends. Despite this however it was difficult to identify winners among the non-dividend paying stocks on the NSE during the periods considered. At best Sasini Tea and Coffee Ltd., Unga Group Ltd. and National Bank of Kenya Ltd. (all non-dividend paying stocks) outperformed in only three of the six periods referenced.

As indicated above, investors ought to be aware of the respective dividend cover figures for companies selected to populate a portfolio. A high dividend yield without a corresponding high dividend cover may suggest that the company is paying too high a dividend in light of its earnings. Where the divided cover is near 1 or below, this is indicative of a company paying its dividend out of prior year earnings thereby impairing its future growth. This may cause concern to investors and impact its stock price. Conversely, a high dividend cover in excess of 2 times- associated with high levels of reinvestment within new or growing companies or associated with high beta companies requiring adequate cash for volatile market periods- is an indication that the firm is inadequately leveraged. These stocks will therefore carry low multiples but attractive valuations.

In the last three financial years (2008-10) NIC Bank Ltd. and Car & General (K) Ltd. have continued to show relatively high dividend covers- 3+ times and 4+ times respectively- with correspondingly relatively low multiples; that for Car & General (K) Ltd. has averaged 4.5 per cent while that for NIC Bank Ltd. has averaged 11 per cent during the period. These companies can therefore be considered to be inadequately leveraged and holding large cash reserves that would rather be distributed to shareholders to boost price performance. Their valuations have, as a consequence, remained relatively low well below their fair values.

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[9] Following losses in 2008 and 2009, Centum Investment Ltd. managed to return to profitability in 2010.

A cautionary note, however, is that dividend potential is not solely driven by growth of the underlying business. In fact, rapid growth in certain capital-intensive businesses can actually be a drag on dividend prospects. It may mean that cash needs to be re-invested to keep pace with the growing company rather than getting paid out as dividends. A case in point is Olympia Capital Holdings Ltd. which has seen considerable growth in the last decade but little or no dividends paid to its shareholders. This lack of cash return to investors may partly explain the 70 per cent fall in its share price within the last three years.

Investors who continue to focus solely on revenue or earnings growth--or even just the appreciation of the stock price—without focusing on the dividend therefore stand to miss the big picture. A company that isn't paying a healthy dividend to them may be setting them up for an unfortunate fate as it becomes harder to achieve a price growth going forward. Ultimately, a solid dividend helps reduce the stock's volatility, and acts as a check on management's capital-allocation practices.

Compounding

Paying dividends proves that a company is solvent. It has to have cash in order to pay out cash. Management is demonstrating that they are committed to rewarding shareholders directly. If the dividend is growing that's going to produce even more of a return and add this to any capital appreciation and the return is even greater. Again, as an investor, it pays to think in terms of total return not just capital gains or dividend yield in isolation.

An opposing investor ideology, however, to that of investing in firms that pay out significant dividends is the idea that income should be let to compound. Where dividends are reinvested the long-term picture will be that returns will be higher, due to compounding[10], than in situations where firms pay out large portions of their profits as dividends. Some dividend-paying companies may run Dividend Reinvestment Plans (DRIPS) which offer shareholders the option to automatically reinvest or convert dividends into additional shares. DRIPs allow investors to benefit from pound-cost averaging[11] and some plans even offer a discount to the market price of the shares on the payment date.

[10] This is the ability of an asset to generate earnings, which are then reinvested in order to generate their own earnings. In other words, compounding refers to generating earnings from previous earnings.

[11] This refers to investing the same amount at regular intervals, imbuing into the investment process a prudent and systematic investment approach that results in smoother and better returns than opposing strategies.

Caveats

- *Assumptions made and 'out-of-sample' testing*

Some of the assumptions made in this study may not hold true in the real world. Dividend yield is not an exact proxy for dividend paid. A high yield may exist alongside a low dividend if the stock price falls sharply. Likewise a low yield may exist alongside a high dividend where the stock price rises sharply.

Further, the study looks at data from the period 2008 to 2010. This period coincides with the global economic meltdown that has persisted into 2011 threatening a double-dip recession at least in the developed economies. As a result market behaviour may differ in more stable economic times and the study here may not entirely reflect stock market behaviour in Kenya under normal conditions.

- *Too high a yield*

During a market downturn, when stock prices are falling, it becomes difficult to differentiate high-yield stocks that represent value and a great return from those that signal a company actually in distress. Usually a keen look at the balance sheet will reveal the risks involved especially where the firm is heavily geared. However, even with well-performing firms, high yields may become unsustainable in a bear run and the danger is that the dividend may have to be cut thereby eating into investor income.

Further in bear markets, where dividend-paying stocks are offering more attractive yields compared to bonds[12] , it is important to note that the two asset classes are not interchangeable. Investors in dividend-paying shares can expect more volatility than investors in high-quality bonds and therefore in terms of income stability and risk reduction no stocks or equity fund will be able to supplant bonds or cash.

- *Mean-Reversion*

With stocks returns past winners become future losers and vice versa. Picking well-performing stocks in one period may not necessarily guarantee future positive returns especially in the case of growth stocks. Returns revert to their mean every three to five years. Past winners lead to these stocks becoming overbought and hence attaining prices well above their fair values. Past losers will become oversold and approach prices below their fair values. These situations in turn provide both selling and buying

[12] Bond yields will be driven downwards as investors seek safety in the fixed-income space due to the relative stability of income and principal that bonds offer.

opportunities thereby reversing the price movements and tending these towards their mean values (long-term averages). Thus capital gain or loss cannot persist indefinitely.

- *Uncertainty of future income*

Unlike fixed income securities which pay a fixed coupon, the dividend paid under an equity-based investment may not only vary from year to year but may not be paid at all. With bonds an investor can discount future income flows- the coupon and capital repayment on maturity to derive a forward-looking and hence more relevant yield to guide an investment decision. However with equity both return flows- the past dividend used to derive the yield and capital growth to date are backward-looking (historic) values and future receipts of the same are uncertain. Thus the total return value for an equity-based investment is a much less relevant and reliable guide to future investment when compared to the total return value (yield to maturity) for a fixed-income based investment.

- *Inflation (inflationary environment)*

The benefits accruing from a rising dividend, rising dividend yield, capital appreciation or even total return are subject to value erosion through inflation. Inflation levels that exceed any of these returns lead to negative real growth. This means that the value of the investor's money at the end of the investment period is less than that at the beginning of the period.

However, investors can take advantage of asset classes that have an inbuilt hedge against inflation e.g. index-linked bonds or stocks of companies that can pass on inflationary increases in prices to consumers. Financial (in particular Banks), Energy and Utility companies are able to pass on to the consumer increased borrowing or production costs. This cushion allows the relevant companies to increase their dividend payouts in line with inflation thereby helping to maintain yield levels that ensure a positive real return.

- *Currency risk*

Holdings of overseas investments and receipts of dividends in an overseas currency can carry significant value depreciation risk where this currency falls in value vis-à-vis that of the investor. As an example, the current economic environment where sovereign debt levels have become a persistent threat to some of the developed economies, deliberate devaluations of their currencies (to better manage external debt or to increase the competitiveness of their exports) will inevitably lead to reductions in the real returns of foreign holders of both equity and debt instruments in their markets.

Conclusion

Investing means owning part of a business and this should come with a need to properly research the firms populating the investor's or fund manager's portfolio. This entails a fundamental analysis of these firms notably analysing their financial statements, studying their business models, noting macro-economic trends and assessing the firms' competitive positionings. This helps identify value and buying opportunities as well as helping to identify exit strategies but with the intention of holding the stock(s) as long as it makes sense.

Investors too often hurt themselves by trying to make short-term tactical shifts. Portfolio rebalancing is necessary but ultimately a well diversified portfolio that minimises short-term tactical shifts and designed to help the investor reach his long-term goals, while keeping risk at a level he can manage, should be the ultimate goal. In this seeking total return will undoubtedly help in the achievement of this goal.

Disclaimer

Views expressed here are solely those of the author and do not represent investment advice.