

Dividends

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Tacit strategies have a core of investments whose investment approach can be described as dividend investing. The investment approach focusses on dividend levels and growth prospects as a good predictor of future performance of a stock. Dividends are paid out of cashflows a company generates but what exactly are they?

When a company earns a profit, it essentially has two options:

1. Re-invest in the business

This is the option chosen by many high-growth companies. They pay down debt or expand their operations to make more profit in the future.

2. Issue a dividend to shareholders

A dividend is a share of after-tax profit of a company, distributed to its shareholders according to the number and class of shares held by them.

Both the amount and timing of dividends is determined by the Board of Directors usually for public companies, dividends happen on a quarterly or annual basis. Most dividends are declared by large and established “blue chip” companies (i.e., Diageo, BP, Microsoft, McDonald's).

Dividends are often paid if a company is unable to reinvest its cash at a higher rate than shareholders. Most importantly for investors, dividends from good companies should be predictable and sustainable. Some companies like Coca-Cola have been paying out uninterrupted dividends for over a century.

The first company to ever pay a dividend was reputedly a French bank called Société des Moulins du Bazacle, which was formed in 1250. During its life beginning in the 1600s the Dutch East India Company paid an average annual dividend of 18%.

Microsoft is an interesting example in this case study. For 28 years leading up to 2003 it did not pay a dividend as it reinvested its profits to grow the business for the future. It finally began to pay a dividend in 2003 and has since grown this dividend from 59 cents a share to \$2.72 a share. This is a 460% increase whilst inflation has increased by 65.57% during the period.

The power of dividends relates to compounding. Most investors are aware of the power of compound interest – and dividends work in a similar way, especially when dividends get reinvested back into the company. For example, over a 50-year period investing £10,000 in Coca-Cola in 1972 would have returned more than £2 million by 2022. Now most investors would not have had £10,000 to invest in 1972 but the compounding effect of a disciplined investment strategy over the longer term is quite clear. Over shorter periods this can be ignored in the hunt for capital gains, but history shows that dividends provide around half of your total return in most decades.

Over the past 10 years dividend investing had been pushed to the side-lines as investors chased growth at any cost. The above is a reminder that in more normal market conditions dividends and compounding are the most important factors.

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