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WATCHLIST THE GLOBE AND MAIL

Investors should seek good companies – not dividends

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I am constantly surprised by many investors' fixation on dividend yields – a tendency that I believe is misguided.

I can understand the allure of receiving a regular cheque. In fact, dividends have historically represented a significant percentage of total investment returns. But blindly buying only stocks with large dividends can get you in trouble.

Some high yield stocks are underpinned by unsustainable payout ratios – the portion of profits that are paid out as dividends. When a dividend payout ratio is greater than 100 per cent, a portion of the payout is actually a return of capital, not a return on capital. I don't consider getting paid back with my own dollars to be an attractive proposition.

My view on dividends is based on the investment principles espoused by Charlie Munger and later adopted by Warren Buffett. I like to invest in companies with high returns on equity and on invested capital. These are usually businesses that possess exceptional economics. In these situations, if management can reinvest the business's free cash flow in the company's core business my ideal dividend is zero.

A case in point: In October, 2008, I bought shares of Starbucks Corp. The stock was trading at $9.87 (U.S.) and did not pay a dividend. Starbucks was shrinking its North American business by closing stores but was continuing to expand in China and internationally. I thought Howard Schultz, the founder who had recently returned as CEO, could return the company to its former glory.

Starbucks' cash was being retained and reinvested in a business that had generated historical returns on equity in excess of 20 per cent. By retaining all after-tax net profit in the business and reinvesting it on my behalf at high returns, the company was actually working for me. I avoided the tax bill that would ensue had a dividend been paid out to me and I was also spared the difficult task of reinvesting the money at equally attractive rates. Starbucks closed yesterday at $48.09.

More recently, I purchased shares in Home Capital Group. As with my former purchase of Starbucks, the stock was cheap for reasons that I believe were erroneous. Home Capital has maintained a return on equity of more than 25 per cent for the past nine years. It sports a modest dividend yield of 1.9 per cent, maintains a very low payout ratio and at yesterday's close of $51.35 (Canadian) is trading at only 8.9 times this year's earnings. I'm not worried about the relatively low yield, because I believe the company is reinvesting its profit where it should – in its own business.

Mr. Buffett has often said that if a company can create more than a dollar of market value for every dollar retained then the proper decision is to retain the capital in the business. His company, Berkshire Hathaway, has never paid a dividend despite its massive cash flows. Most, though, would agree that it has created outstanding value for shareholders.

Unfortunately, most great businesses will eventually generate so much cash that management is unable to reinvest it wisely in the company's core business. Most blue chips fall into this camp. For this reason, it is important to ensure that management is shareholder-friendly.

Many managers are tempted to expand their business empires through questionable acquisitions (e.g. Microsoft's $8.5-billion (U.S.) purchase of Skype). Retaining capital in the business can also make it easier for executives to increase their company's earnings per share – and the value of their stock options.

That's why a shareholder-friendly management team is vital. If attractive internal uses for the company's excess cash are not available, they will do the sensible thing and return the money to shareholders either through dividends or share repurchases. In these situations, dividend payments are healthy because they prevent management teams from frittering away corporate cash.

The only way to know what a dividend truly means is to look at factors such as the payout ratio and management's history of creating value over the long term. There is nothing necessarily wrong with investing in dividend-paying companies, but relying on simple strategies based solely on dividends can get you in trouble as an investor. When searching for yield, going a little deeper in your analysis usually pays dividends down the road.

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