COINVESTOR CLUB

Dividend Yield

Dividend yield is a ratio that tells investors the amount of dividends per share a company pays out divided by its current stock price. For example, if XYZ pays a $0.50 quarterly dividend ($2 annualized) to shareholders and it's currently trading at $50 per share, the dividend yield will be calculated as follows:

Annual dividend / Current stock price = Dividend yield

$2/$50 = 0.04 = 4%

This will give investors an idea of the yield offered by the company for just continuing to hold the equity throughout the year, assuming the dividend remains constant. Some companies will also distribute a "special dividend," which is a different distribution (that is non-recurring) to shareholders that typically results from some extraordinary event within the company. Special dividends cannot be anticipated but are seen as a positive development given that the board of directors must approve it to be distributed. This gives investors confidence that management believes the company is in a solid financial position for the future and does not need the additional cash on its balance sheet.

The payout ratio is another ratio that tells investors the proportion of earnings being paid out as a dividend. The payout ratio can give investors an idea of how sustainable the dividend payout is moving forward. For example, suppose the company is paying over 100% of its earnings. In that case, there may not be much room for dividend increases, and the company may run into financial distress if they continue to prioritize the dividend payout at that rate. On the other hand, if the payout ratio is only 10% of earnings, the company may have more room to grow the dividend to make it a more significant percentage of their earnings.

Let's continue with the example of XYZ company:

If XYZ is paying out $2 per year in dividends, let's assume that their EPS for the year is $6.00:

The calculation for the payout ratio would be Dividend per share/ Earnings per share= $2/$6= 33%

A ratio of 33% will give an investor confidence that the dividend is safe for the time being as long as earnings per share continue to be strong.

In bull markets like the one experienced from 2009-2021, dividends are often given little thought because the rise in stock prices contribute more to return than dividends received. However, over more difficult markets and cycles, dividends often contribute a significant portion of the return in holding a security. As investor and strategist James Montier wrote in January of 2008—advice that could just as easily be given today—dividends can be especially important when fundamentals start to get more attention from investors: “If earnings risk and valuation risk are coming back to the fore, then investors are likely to be well served by concentrating on stocks with a degree of return certainty. That means concentrating on dividend yield.... Over a longer time period the importance of dividends is indisputable. The long-term evidence clearly shows that dividends have accounted for well over two-thirds of investor’s total returns.”