

# Why Do Dividend Strategies Tend to Outperform?

In an earlier article, we addressed how we look for companies that have an ability and willingness to pay increasing dividends. We illustrated how high and rising dividends tend to outperform the market and briefly described how independent academic and practitioner research has shown that just because a company pays a dividend does not mean the company cannot grow its earnings. In this paper, we delve deeper into the supportive research. The importance of these findings is to illustrate how we look to pay a rising dividend over time. The way we accomplish this is to buy companies that are able to grow their earnings power and increase the dividend along with the increase in earnings.

One primary role of a public company's management team is to allocate capital among various projects to maximize returns for shareholders. Unfortunately, conflicts can arise between management and minority shareholders. For instance, a CEO may have a pet project that continually loses money yet receives annual funding. Another conflict is that the highest returning projects may entail more risk than the manager wants to take, for risk of losing his or her job. This can hurt shareholders if the

risk versus reward trade-off is in favor of taking the project. Finally, management teams may engage in empire building, acquiring companies at a premium in order to grow their own organizations. This occurs from ego as well as the likelihood that the management team is compensated more for managing a larger company.

The managers of the Thornburg Investment Income Builder Fund believe capital allocation decisions are one of the critical long-term driving forces for company success and, ultimately, stock performance.

How can we determine if a company is allocating capital correctly? Without perfect foresight, we have to rely on history, current decisions, and management guidance. One indication that management takes capital allocation seriously is through its dividend policy. A dividend monetizes a portion of earnings for minority shareholders, which retained earnings do not. This brings the present value of future cash flows forward, and all else being equal, raises the value of the firm. Companies with good business models generate higher metrics of profitability such as return on equity (ROE) as well as cash flows. This cash needs to be deployed, and when a company

**Surprise! Higher Dividends = Higher Earnings Growth**  
Real Subsequent 10-year Earnings Growth

		Average	Worst	Best
<b>S&amp;P 500 Index 1946-91</b>				
Lowest	Quartile 1	-0.40%	-3.40%	3.20%
	Quartile 2	1.30%	-2.40%	5.70%
	Quartile 3	2.70%	-1.10%	6.60%
Highest	Quartile 4	4.20%	0.60%	11.00%

Source: Robert D. Arnott and Clifford S. Asness, "Surprise! Higher Dividends = Higher Earnings Growth", Financial Analysts Journal, Jan/Feb 2003. Data analyzed: 1946-2001.

has a high ROE, it takes less retained earnings to grow the business relative to those with lower ROE. Along with many subjective and qualitative factors, we look for these companies that have strong business models as well as the ability and willingness to allocate capital prudently.

We've often discussed the original study by Arnott and Asness titled "Surprise! Higher Dividends = Higher Earnings Growth." The authors were the first to find that companies with higher payout ratios actually had higher real earnings growth over the subsequent 10-year period. This is counter-intuitive, as one would expect a dividend-paying stock to translate into low growth. The table above provides the results of the study, clearly illustrating that companies paying

out more cash as dividends (quartile four) had the highest subsequent 10-year EPS growth.

In every case over these rolling 10-year periods from 1946 to 1991, the highest dividend payers had the highest earnings growth. These results were not just on average, but were robust through the strongest and weakest markets as well. We share the authors' opinion that it is possible to have high earnings growth without paying dividends. In fact, most growth companies that have annual growth rates of 20%, 30%, or more typically do not pay dividends since they need this capital to sustain their investment opportunities. However, we believe growth rates of this magnitude are few and far between and not sustainable over the longer

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term. A growth manager skilled at analyzing high-growth companies should be able to navigate this segment of the market. The point of this study is not to diminish growth as an investing style, but rather to show that historically, dividend-paying stocks on average do indeed grow earnings over the long term at higher than average rates.

The relationship between dividends and growth is not confined to domestic companies. The same study was replicated in multiple markets, including Canada, Australia, France, Germany, Japan, Netherlands, Switzerland, and United Kingdom. The results are listed below and on the right. In Canada and Australia, the study focused on the ten-year subsequent earnings per share (EPS) growth, while the

others used five-year growth rates.

The results were consistent with the original Arnott and Asness study, providing very robust evidence that this is a phenomenon worthy of attention when analyzing the long-term expectations of stocks. They validate our pursuit of companies that have an ability and willingness to pay dividends.

These studies were built off the Arnott and Asness research and were tested to ensure statistical validity (e.g., accounting for high payout due to temporary earnings weakness, which could result in earnings recovering faster than the market). Although history is not a perfect indicator of the future, it is comforting to have the above

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### Do Higher Dividends Lead to Higher Earnings Growth? By K.C. Parker

Real Subsequent 10-year Earnings Growth

		Average	Worst	Best
<b>TSX Composite Jan-56 to Sep-05 (Canada)</b>				
Lowest	Quartile 1	-4.1%	-16.7%	5.8%
	Quartile 2	-0.1%	-17.0%	7.9%
	Quartile 3	3.2%	-16.2%	7.1%
Highest	Quartile 4	6.3%	-21.0%	34.6%
<b>S&amp;P 500 Jan-56 to Sep-05 (United States)</b>				
Lowest	Quartile 1	-0.3%	-3.4%	4.1%
	Quartile 2	1.4%	-3.0%	6.0%
	Quartile 3	2.5%	-1.0%	6.6%
Highest	Quartile 4	3.2%	0.9%	7.1%
<b>ASX Composite Jul-69 to Sep-05 (Australia)</b>				
Lowest	Quartile 1	-3.0%	-10.2%	-0.9%
	Quartile 2	0.6%	-5.3%	6.2%
	Quartile 3	1.3%	-6.6%	6.7%
Highest	Quartile 4	3.3%	-2.8%	12.7%

Source: K.C. Parker, "Do Higher Dividends Lead to Higher Earnings Growth?", Simon Fraser University, 2005.

### International Evidence on the Payout Ratio, Earnings, Dividends, and Returns

Real Subsequent 5-year Earnings and Dividend Growth

		Earnings	Dividends
<b>France 1973-04</b>			
Lowest	Quartile 1	6.2%	2.9%
	Quartile 2	8.7%	18.1%
	Quartile 3	9.7%	8.9%
Highest	Quartile 4	20.1%	14.8%
<b>Germany 1973-04</b>			
Lowest	Quartile 1	3.5%	-0.8%
	Quartile 2	-0.6%	6.7%
	Quartile 3	9.3%	6.1%
Highest	Quartile 4	17.1%	18.2%
<b>Japan 1973-04</b>			
Lowest	Quartile 1	-6.5%	-2.3%
	Quartile 2	3.1%	-2.6%
	Quartile 3	7.4%	9.2%
Highest	Quartile 4	12.3%	12.1%
<b>Netherlands 1973-04</b>			
Lowest	Quartile 1	3.8%	2.5%
	Quartile 2	9.0%	19.2%
	Quartile 3	15.3%	14.4%
Highest	Quartile 4	21.3%	8.9%
<b>Switzerland 1973-04</b>			
Lowest	Quartile 1	0.7%	-0.7%
	Quartile 2	2.2%	8.2%
	Quartile 3	14.5%	7.4%
Highest	Quartile 4	17.0%	19.4%
<b>United Kingdom 1973-04</b>			
Lowest	Quartile 1	5.8%	-1.4%
	Quartile 2	11.4%	13.6%
	Quartile 3	8.6%	11.9%
Highest	Quartile 4	13.0%	14.6%
<b>United States 1973-04</b>			
Lowest	Quartile 1	7.7%	6.6%
	Quartile 2	6.1%	5.0%
	Quartile 3	3.3%	10.9%
Highest	Quartile 4	16.8%	11.4%

Source: Owain ap Gwilym, James Seaton, Karina Suddason, and Stephen Thomas, "International Evidence on the Payout Ratio, Earnings, Dividends, and Returns", Financial Analysts Journal, Jan/Feb 2006.

studies support our belief that capital allocation and payout policy matter. This goes to the core of our investment philosophy in the Thornburg Investment Income Builder Fund.

The Investment Income Builder Fund paid a \$0.50 per share dividend in 2003 and for the year ending 2011, the fund paid \$1.17. We could not have achieved this increase without investing in companies with growing earnings. We scour the globe looking for companies that we believe can balance the goals of paying an attractive dividend and

finding future growth projects. Other unsustainable means of generating income include 1) writing covered call options; 2) buying companies with increasing payout ratios, which will come to an end once the average payout reaches 100%; 3) constantly trading up for higher-yielding investments. None of these are sustainable in our opinion and are not how we manage the Thornburg Investment Income Builder Fund. Fortunately, there are historical studies that support our view on the importance of capital allocation in meeting the long-term goals of the Fund. ■

### Thornburg Investment Income Builder Fund Class A Share Performance as of 12/31/11

	Average Annual Total Returns			
	1-Yr	3-Yr	5-Yr	Incep.
Without sales charge	0.49%	15.90%	3.76%	10.73%
With sales charge	-4.05%	14.13%	2.81%	10.16%
Blended Index	-2.06%	10.44%	0.18%	6.52%
S&P 500 Index	2.11%	14.11%	-0.25%	5.98%

30-Day SEC Yield: 5.48%

*Performance data shown represents past performance and is no guarantee of future results. Investment return and principal value will fluctuate so shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than quoted. For performance current to the most recent month end, visit [thornburg.com](http://thornburg.com) or call 877-215-1330. The maximum sales charge for the Fund's A shares is 4.50%. The total annual fund operating expense ratio for A shares is 1.21%.*

\* 75% MSCI World and 25% Barclays Aggregate Bond Index.

Following a dividend-focused strategy does not assure or guarantee better performance and cannot eliminate the risk of investment losses.

Data presented are the most recent available. Inclusion of subsequent periods could change the results.

The views expressed by the Portfolio Managers reflect their professional opinions and should not be considered buy or sell recommendations. These views are subject to change.

There is no guarantee the fund will meet its investment objectives. Investments in the Fund carry risks including possible loss of principal. Investing outside the United States involves additional risks, such as currency fluctuations. Additionally, the Fund invests a portion of the assets in small capitalization companies, which may increase the risk of greater price fluctuations. As with direct bond ownership, funds that invest in bonds are subject to certain risks including interest rate risk, credit risk, and inflation risk. The principal value of bonds will fluctuate relative to changes in interest rates, decreasing when interest rates rise. Investments in the Fund are not FDIC insured, nor are they deposits of or guaranteed by a bank or any other entity.

*This communication is not authorized for distribution to prospective investors in the Fund unless preceded or accompanied by an effective prospectus. Investors should consider the Fund's investment objectives, risks, charges and expenses carefully before investing. The prospectus contains this and other information about the Fund.*

Dividend Payout Ratio — A fraction that expresses dividend payments as a percentage of per-share earnings.

Earnings Per Share (EPS) — The total earnings divided by the number of shares outstanding.

S&P 500 Index — An unmanaged broad measure of the U.S. stock market.

The Blended Index is composed of 25% Barclays Capital Aggregate Bond Index and 75% MSCI World Index. The Barclays Capital Aggregate Bond Index is composed of approximately 8,000 publicly traded bonds including U.S. government, mortgage-backed, corporate and Yankee bonds. The index is weighted by the market value of the bonds included in the index. The MSCI World Index is an unmanaged market-weighted index that consists of securities traded in 24 of the world's most developed countries. Securities are listed on exchanges in the U.S., Europe, Canada, Australia, New Zealand, and the Far East. The index is calculated with net dividends reinvested, in U.S. dollars.

The performance of any index is not indicative of the performance of any particular investment. Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Investors may not make direct investments into any index.

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2300 North Ridgetop Road  
Santa Fe, NM 87506  
877.215.1330  
[www.thornburg.com](http://www.thornburg.com)