Stocks: A Superior Source of Investment Income

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Introduction

The S&P 500 delivered powerful price gains of about 15% per year in the 1990s. At the other end of the spectrum, stock prices fell almost 60% in 2007/08, with the onslaught of the financial crisis and Great Recession. When greed and fear push prices to extremes, investors give little thought to the growing stream of dividend payments stocks provide over the long term. From 1920-2019, dividends have grown at an annual rate of roughly 5%. But it is important to know whether dividends kept up with inflation, because the latter erodes the purchasing power of money. Fortunately for long-term investors, dividends outpaced inflation. Since inflation was a bit less than 3%, the real (inflation-adjusted) dividend growth was 2.1% over the last 100 years (Carlson, 2020).

Resilience of Stock Dividends

Of course dividends do not rise in a straight line. Companies sometimes reduce their cash distributions to shareholders in times of economic adversity. But even during downturns, dividends do not fall as much as stock prices and are quick to resume their upward trend.

Robert Shiller calculated that from September 1929 to June 1932, the overall stock market[1] plummeted 81% on a real (inflation-adjusted) basis, but real dividends only fell 11 percent. Dividends were amazingly resilient even when faced with the worst economic disaster ever experienced by the United States. In the 1973-74 bear market, stocks dropped 54% on a real basis, but companies cut their dividends by only 6% in real terms. During the 2000-02 bear market, real dividends were little changed, decreasing only 2% while the stock market lost about 50%, real (Carlson, 2016).

In the Financial Crisis and Great Recession, stocks declined about 60% between October 2007 and March 2009. Surprisingly, dividends rose slightly in this timeframe, but then declined roughly 19% about six months

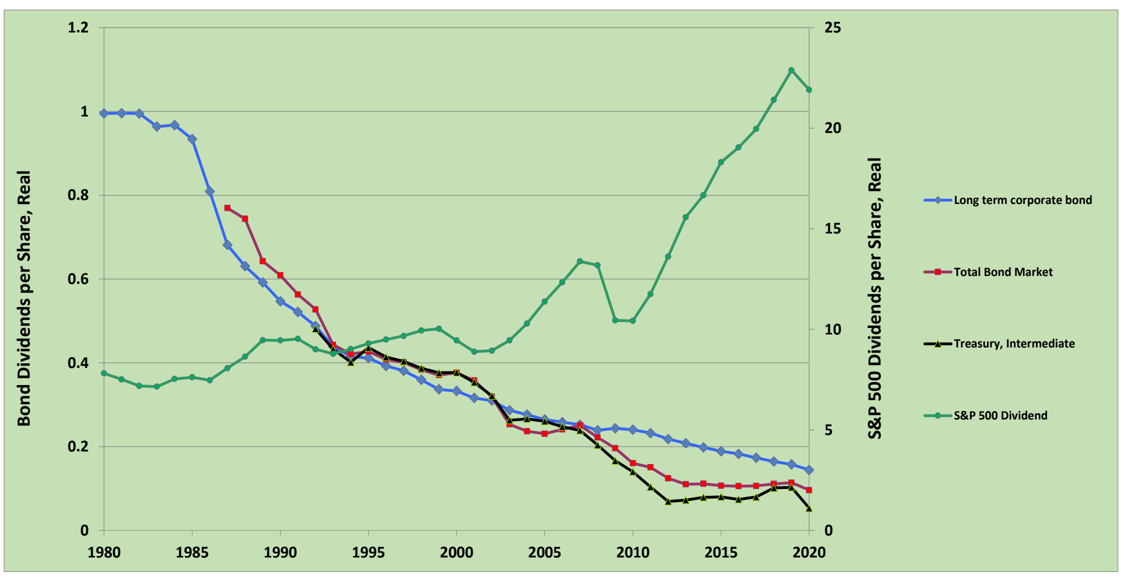
[1] The overall market, i.e. the combined value of all publicly traded stocks, is the best gauge of investment outcomes. The argument exists that the Dow and the S&P do not represent the overall market. Interestingly, IBM was removed from the Dow in 1939 and was only returned to the Dow in 1979, 40 years later. According to Hulbert (2009), the overall market recovered quickly from the crash that began in 1929. "An investor who invested a lump sum in the average stock at the market's 1929 high would have been back to a break-even by late 1936." Hulbert includes the impacts of deflation and dividends, while making a distinction between the Dow and the overall market.

after the stock market bottomed. Dividends staged a sharp recovery thereafter, and by 2020 had almost doubled its 2008 peak (Carlson, 2016). The coronavirus pandemic inflicted incredible intra-year volatility in 2020, as the Index briefly contracted 34%. Despite massive disruptions to economic activity, dividends declined roughly 4%.

The Inferiority of Bonds

Investors often look to bonds for a steady, predictable stream of income. Unfortunately, bonds have a disappointing track record of paying diminishing dividends over time. Figure 1 shows the dividends paid by each share of intermediate term treasuries, long term corporate bonds, and the total bond fund. In every case, dividends are expressed in real, inflation adjusted terms, deflated by CPI-U (1982-84=100).

Figure 1. Dividends Per Share: Bonds and S&P 500, Adjusted for Inflation



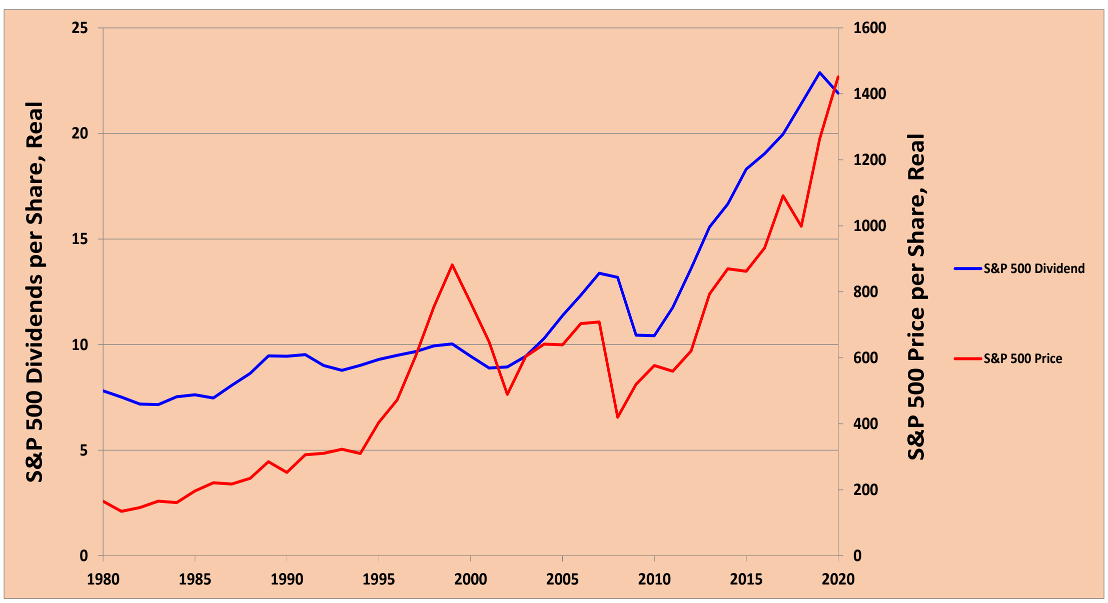
S&P 500 dividends per share are from Aswath Damodaran; Long term corporate bond = Vanguard Long-Term Investment-Grade Fund Investor Shares (VWESX); Total bond market = Vanguard Total Bond Market Index Fund Investor Shares (VBMFX); Treasury, Intermediate = Vanguard Intermediate Term Treasury Fund Investor Shares (VFITX); In every case, dividends are expressed in real, inflation adjusted terms, deflated by CPI-U (1982-84=100). CPI-U is from https://www.minneapolisfed.org/about-us/monetary-policy/inflation-calculator/consumer-price-index-1913-

Intermediate treasuries paid $0.481 per share of real dividends in 1992; five years later, real dividends declined about -16.1% to $0.404 per share. Real treasury dividends continued to trend down through 2012, stabilized for several years thereafter, then hit a new low in 2020 at $0.053 per share. Real dividends issued by long term corporate bonds held up somewhat better, declining "only" about 70% from 1992 to 2020.

Stocks Provide Growing Income Stream

In sharp contrast to bonds, the stock market paid higher and higher dividends over time, vastly outpacing inflation. In 2020, each share of the S&P 500 paid $21.9 in real, inflation-adjusted terms, more than double the amount paid in 1992 ($9.0, real) (Figure 1). But remember, the stock market also provides long term capital gains, not just dividends. As shown in Figure 2, stock prices and dividends have grown in tandem. The total return from ownership of equities includes capital gains as well as dividends that are used to purchase additional shares.

Figure 2. Real Prices and Dividends for the S&P 500



S&P 500 dividends per share and price per share are from Aswath Damodaran; Dividends and prices are expressed in real, inflation adjusted terms, deflated by CPI-U (1982-84=100).
CPI-U is from https://www.minneapolisfed.org/about-us/monetary-policy/inflation-calculator/consumer-price-index-1913-

Final Remarks

The manic movements of stock prices confound individuals lacking resolve. However, stock prices fluctuate far more than dividends because at times prices overshoot, rather than perfectly capture, underlying corporate fundamentals. The market rewards patient shareholders who remain focused on the most resilient aspect of stock investing, i.e. investment income in the form of dividends. These corporate payouts to shareholders grow at rates significantly above inflation, in sharp contrast to bonds that have provided diminishing streams of income. Stocks are among the strongest sources of investment income of any asset class.