Looking For Dividend Yield? Try Asset Allocation Instead

By Eng Tiang Chuan

Asset allocation can offer investors cash flows similar to dividends stocks with lower risk

Many investors buy dividend stocks. This usually means buying 'blue-chips' that have a track record of paying dividends. Such investors are typically 'buy and hold' type of investors who don't actively manage at all. While investing in dividend yielding stocks may generate a stream of cash flows, the usual risks associated with equities remain.

ISSUES WITH DIVIDEND STOCKS

Dividend yield is the amount of dividends divided by the share price. Although the div-

idend yield can provide useful information, investors can be mis-lead by the numbers. If the share price drops, the amount of dividend drops even when the yield remains the same. For example, a 5% dividend yield on a $100 share will give $5 dividend. A sharp drop of 50% in share price would give just $2.50 in dividends even though the dividend yield remains at 5%. A high dividend yield does not necessarily mean a high dividend payout, it could simply mean a lower share price.

As the recent troubled British Petroleum (BP) has shown, companies may stop paying dividends when faced with the need for cash. A track record of paying dividends does not mean that the company will continue to do so or continue to exist. A big corporation may close down or be taken over by another company who may not have similar dividend policies.

Collecting dividends can be seen as a form of profit taking. When the dividend is given out, the share price tends to drop by approximately the same amount. Thus, the investment value drops as well. When viewed from a portfolio perspective, collecting dividends can also be a form of Rebalancing. Rebalancing is the reallocation of the portfolio's allocation to the desired proportions. However, in contrast to the Asset Allocation portfolio, the amount to rebalance (dividends) is out of the investor's control.

HOLDING POWER

Like all equities, a dividend stock can suffer massive price losses during market crashes. For instance, the share price of OCBC bank dropped 56% during the period from May 2008 to March 2009. Some 'buy and hold' investors are not fazed by such drastic moves in share prices and will continue to hold on to the stocks. The common explanation is that they have 'holding power' and does not need the liquidity. As history has shown, the share price of many battered stocks did recover eventually. However, some may never recover. Citigroup was trading more than USD $50 before the financial crisis. Today, it is trading at around USD $4. When compared to an Asset Allocation investor, the 100% equity portfolio 'buy and hold' investor with' holding power' is subjected to more risk.

RISK AND REWARD

The capital of the dividend stock portfolio is subjected to higher risk compared to an Asset Allocation portfolio. During a bear market, a portfolio with an allocation to bonds would have suffered lower losses compared to an all equities dividend stock portfolio. A smaller loss would enable an easier climb back. A 20% drop would need a 25% return to get back to the original position. In contrast, a 50% drop would need a 100% return!

No investor has a crystal ball and is able to time the market consistently. The best times to invest are during market downturns. However, most investors typically do the opposite; they sell during downturns and buy during bull markets. The 'buy and hold' investor would probably do nothing and sit out the bull and bear. There may not be excess cash or other liquid assets to switch into equities as the dividend stocks would have fallen in tandem with the market. On the other hand, an investor with an asset allocation would have low risk assets, which would have done even better during market panics, to be able to get a bargain in a depressed market. Thus the 'buy and hold' investor sacrifices upside potential.

To illustrate the effects of asset allocation and rebalancing, let's look at Figure 1. Figure

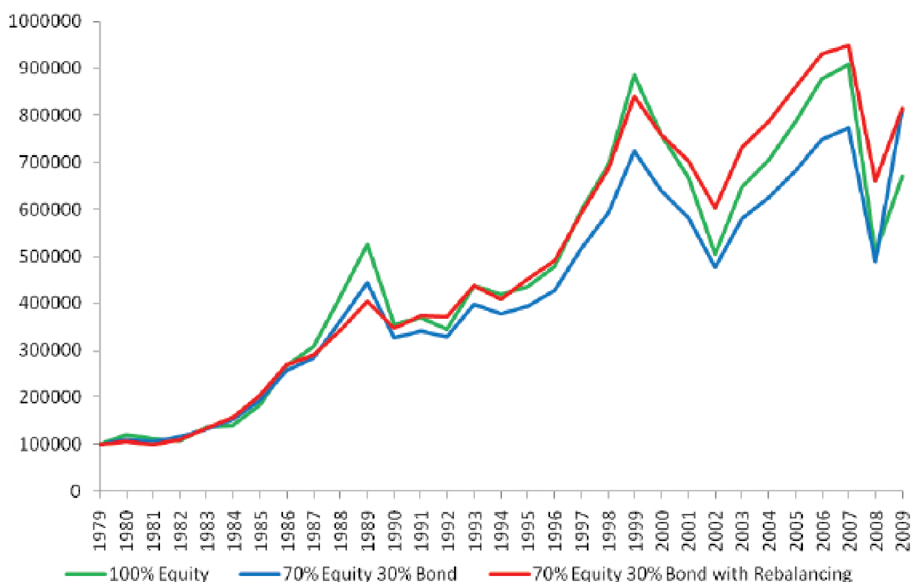

FIGURE 1

1 compares the performance of 3 portfolios[1] – 100% Equity, 70% Equity 30% (7E3B) Bond and 70% Equity 30% Bond with Rebalancing (7E3BR) over 30 years, starting from end of 1979 to end of 2009. The 'buy and hold' portfolio is represented by the 100% equity portfolio. During bull markets, a 100% Equity portfolio would have the best performance. However, during market downturns, it also fared the worst. The 7E3B portfolio as expected underperformed the 100% Equity for long periods of time. After the financial crisis, it actually ended up higher than the 100% Equity portfolio. The volatility is lower for the 7E3B portfolio. Add in rebalancing[2] to the portfolio and a portfolio with the best of best worlds is achieved. The 7E3BR portfolio had the best performance with lower volatility.

A few issues exist for the dividend stock investor who depends on the dividends for his cash flow needs. The dividend is not guaranteed. The company may change the dividend or stop declaring dividends altogether. A bear market would make liquidating the dividend stocks an unattractive option. Also the timing of the dividends is out of the investor's control. Any changes to a company's dividend policy or solvency can have significant effects, both on the cash flow and capital, on investors holding just a few dividend stocks. Holding more dividend stocks for diversification can add complexity to the portfolio. Studies have shown that diversification can be achieved with an equal weighted portfolio of 20 randomly selected stocks. It can be a nightmare to manage and administer so many stocks.

Asset Allocation can offer the investor much more flexibility and control. The investor can decide on the amount, timing and frequency of cash flows by liquidating the portfolio as needed. The market condition would have a much smaller effect as the investor can decide which asset class to liquidate, thereby avoiding selling at a wrong time. Table 1 compares a 100% Dividend Stock Portfolio to Asset Allocation.

CONCLUSION

Although the prospect of receiving dividends is alluring, the objective of receiving an investment cash flow can be achieved from asset allocation. Having a proper asset allocation can offer better control and with lower risk. ■

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	100% Dividend Stock Portfolio	Asset Allocation
Cashflow	Not in control	More Control
Flexibility	Less Flexibility	Flexible
Risk	Higher	Lower
Diversification	Less Diversified	More Diversified
Administration	More complex	Easy

TABLE 1

1. Equity Allocation: US - S&P500 (35%), Europe - MSCI Europe (30), Japan - NIKKEI (15%), Hong Kong - Hang Seng (5%), South Korea – Kospi (5%), Taiwan – TWSI (5%), Singapore – STI (5%) Bond Allocation – Composite Index (From 1970 to 1991, using US 10 Year Bond Yield, from 1992 to 1997, using OCBC Savers Global Bond Return, from 1998 to 2008 using 50% OCBC and 50% DWS Lion Bond Fund
2. Annual rebalancing on the last trading day of the year

Source: iFast Financial

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