DO HIGH-DIVIDEND STOCKS PROVIDE A SUPERIOR INCOME STREAM TO GOVERNMENT OF CANADA BONDS?

For many investors, a stable cash flow over time is highly desired. A widely held perception exists that bonds, including Government of Canada bonds, can better satisfy these income needs than can dividend-paying stocks. Bonds are perceived to provide a less risky cash flow, and dividend yields appear to underperform relative to bond yields. Bonds are therefore perceived to provide a higher level of income at a lower level of risk. However, these beliefs are based on static (single period) measures of risk and return, and they ignore tax effects and inflation properties. Our study attempts to provide a more systematic and comprehensive analysis in examining whether holding bonds is preferable to investing in high-dividend yielding stocks. In comparing these investment strategies, we examine risk, return, tax, and inflation characteristics. We find, contrary to conventional wisdom, that high-dividend stocks tend to provide a superior income stream.

If an investor desires a stable cash flow over time, it is important that measures of risk and return focus on attributes over time rather than on the current period. In expectation, the income returns from debt (interest) are constant. The same is not true for dividends. Over time, dividends are expected to grow. What is the implication? Assume that the current bond yield is higher than the current dividend yield. If one today invests an equal amount in bonds and a portfolio of high dividend paying stocks, the yield in the current year will likely be higher for the bonds. However, at some point in the future, one would expect that dividend income would exceed the interest income.

Two further elements should be considered in determining whether individuals seeking an income stream should hold bonds or high-dividend yielding stocks – tax consequences and inflationary protection. In Canada, interest and dividends are taxed differently both at the corporate level (where interest is deductible but dividends are not) and at the individual level. For individuals (the focus of our study), dividends are tax favoured relative to interest income. That is, given an equal before-tax return, the after-tax return on dividends will be higher than on interest income. It is also relevant that the difference in the tax rates between dividends and interest income increases as the taxpayer’s marginal tax rate declines. Therefore, in discussing after-tax cash flows, it is important to include the individual’s marginal tax rate. Finally, most individuals want either constant or increasing real returns over time. High-dividend yielding stocks, at least in theory, can provide a hedge against inflation that bonds will not in general provide.

The after-tax high-dividend portfolio over our sample period of 1980-1999 offers significant income growth opportunities for individuals. After only 5 years, an individual at the highest marginal rate was receiving more after-tax income from the dividend portfolio than from the bond portfolios. The effect is that, after a relatively short number of years, the disposable income from dividends will be greater than from bonds. It is further important to note that the high-dividend portfolio acts as a successful inflation hedge that is not true for bonds. Finally, we find that almost all the risk associated with the high-dividend portfolio is “upside” risk – particularly for longer holding periods. Over a twenty year period, we find that there is a 98% chance that the investor will experience positive average growth – recall that for bonds, in expectation the theoretical growth rate is zero.