The Power of Compounded Growth and Reinvested Dividends

What's the allure of dividend-paying stocks? Dividends provide a segment of return that is always positive. Increases in dividends provide an increased positive cash return and, consequently, increase the value of the instrument producing that return. Positive fluctuations are normal in the world of cash payments to shareholders; negative fluctuations are a rarity.

Over time, reinvesting income that increases can result in yield from income alone that's far higher than anyone can reasonably expect from the total return in the equity market.

The concept at play is yield on original investment (YOI). YOI is simple; it's the income yield you'd have today on an investment you made some time in the past. Harnessing this concept, an investor can achieve annual income returns of 10%, 20%, 30%, 50%, and more on original investment during an ordinary adult life. These are not "gains" in the usual sense. These are repeatable cash flows, each and every year. It's not rocket science. Just two ingredients—sensible analysis and patience—are required. In other words, the best way to get a high yield on capital is to wait for it.

Harnessing the Power of Compounding

What's the best way to harness this compounding? Lower yield and higher growth of yield? Or high yield with more modest growth of yield? OR highest yield alone, forgetting about growth? What's the optimal combination of yield and/or growth of yield in order to reach a given YOI goal, such as the retirement income return on a pool of capital invested today?

These seemingly simple questions haven't been that easy for an adviser or investor to answer. There are two parts to any answer: What's the math? And what will the world be like in 20 years or 40 years?

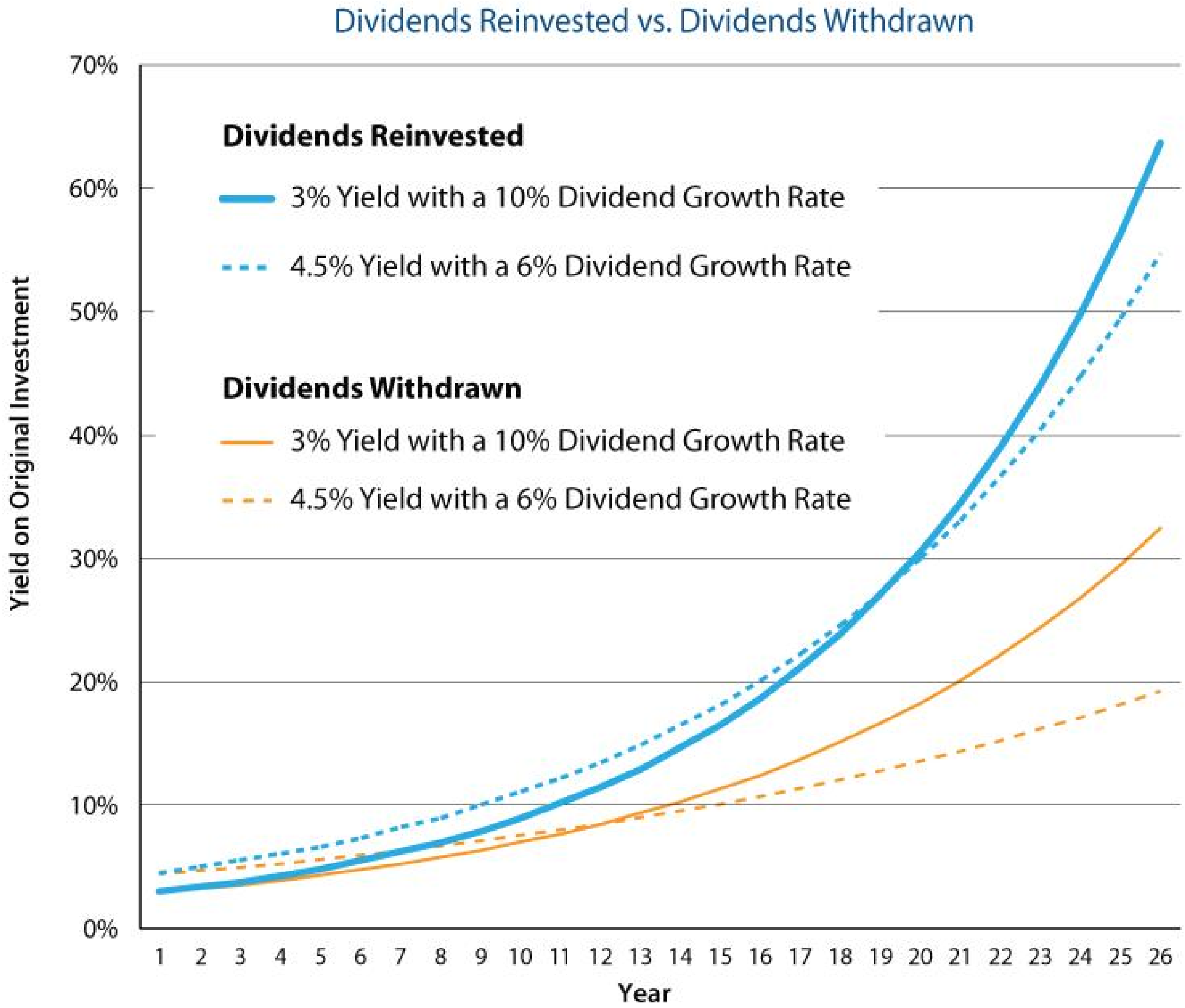
For the math part, Miller/Howard Investments, a boutique investment manager, developed a future income-yield calculating tool. You can try it out at the firm's website at **www.mhinvest.com/YOI**.

For the question as to what to expect in 20 years, it's best to consider the yield on investment calculation in view of the uncertainties that the future always contains. (For example, in theory, highest growth of income will always eventually win the day. But for any given investment, how long can the assumed income growth rate last?)

The Miller/Howard YOI Calculator directly illustrates the results of dividend investing over time. It was designed to provide a basic roadmap to help investors who may have, for instance, a certain level of future dividend income from their investments in mind.

Using the calculator involves entering your beginning principal, beginning portfolio dividend yield, projected portfolio growth of dividends, and whether you plan to reinvest your income or not. The YOI Calculator then generates a timeline of expected future portfolio income based on these assumptions—an estimated future yield on original investment. Further, the income timeline can be compared to another investment with different yield and yield growth parameters.

Comparative results are often counterintuitive. Most investors would think that a starting yield of 3% growing at 10% per year will eventually provide a higher yield than a starting yield of (to use a familiar profile) 4.5% with income growth of 6%. After all, won't that rabbit of faster growth outrun the tortoise of slower growth?



IMPORTANT: Projections regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. The projections are based on assumptions. There can be no assurance that the projected or simulated results will be achieved or sustained. Actual results will vary, and such results may be better or worse than the simulated scenarios. Investors should be aware this chart is only demonstrating hypothetical dividend growth. Since dividends cannot be negative, there can be no losses. However, income could be less than projected and the potential for loss (or gain) may be greater than demonstrated in this projection.

This example is not individualized, nor intended to serve as the primary or sole basis for any investment or tax-planning decision. As with all investments, individuals must make their own determination whether an investment in any particular security or securities is consistent with their investment objectives, risk tolerance, financial situation, and their evaluation of the security. Investors should review their decisions periodically to make sure they are still consistent with the investor's goals. It is recommend that individuals contemplating any investment consult a professional tax or financial advisor about their individual situation.

Source: Miller/Howard Investments Inc.

Figure 1

In fact, with dividends reinvested, the income YOI from the first example (3% growing at 10%) will not exceed the annual income from the slower grower until year 20 (as shown in Figure 1). With no reinvestment, it will take 12 years for the rabbit to exceed the tortoise, in terms of yield on original investment.

This raises a few issues. First, you should not underestimate the value of a high starting yield base in achieving a high future income YOI. Second, many would be right to question whether or not the rabbit can keep running at 10% for 20 years. Life is hard. Business is hard. Events intervene. The Law of Large Numbers casts a shadow, as the bigger a company gets, the more difficult it is to maintain a high growth rate that would fund a high rate of distribution increases. This is why “moderate sustainable growth” is appealing: In constructing a pro forma plan, you’d like to know that the result is reasonably possible—not just that it glows in a reality that is not especially probable. Seasoned quality companies with a great business model and durable markets can keep the compounding going. Frisky newcomers or over-leveraged companies, not so much.

Even at year 15, the reinvested tortoise has an income yield on original investment of about 18%. Do you really want to chase riskier stocks in search of an even higher future positive cash flow from an investment made today?

Obviously, in the uncertain world of the future, there’s many a slip between cup and lip. Extrinsic factors such as interest rates or plunging commodity prices can temporarily inhibit a company’s ability to grow its distributions. In order to approach the pro forma plan, you need to avoid distribution decreases—and therefore focus on financial strength whenever possible.

But the YOI Calculator provides a kind of roadmap or theoretical approach. You may find it interesting to play around with various combinations, testing your intuition and gaining a sense of the scale of time required for income compounding to do its job. For yield-oriented investors, the first step would surely be to test nearly any combination of reinvested yield and growth against a fixed-income investment (no yield growth). It should provide a kind of antidote to the illusory sense of security that bonds may provide.

Also, bear in mind that the YOI Calculator is only dedicated to discerning income yield on original investment. The slopes are smooth because the income portion of return is always (or almost always) positive. The calculator doesn’t deal with total return, since Mr. Market is sometimes manic and sometimes depressive, and the overall pattern of ups and downs has significant impact on total return. The assumption is that with long-term income growth, the price of the instruments producing that income will respond in kind.

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This article originally appeared in the ***June 2015*** *issue of the* AAII Journal.

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