

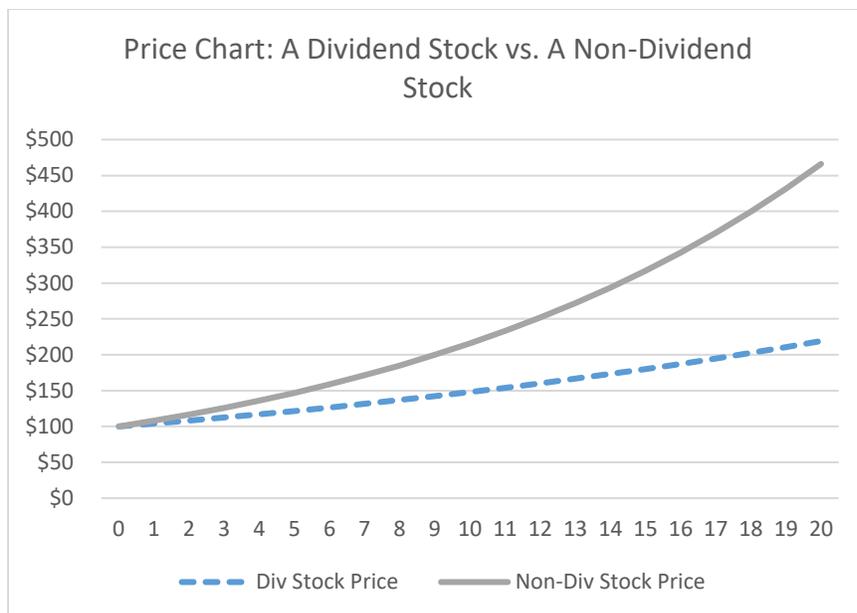
How's your portfolio doing? Do you really know?

In a prior post, I questioned whether relying exclusively on Total Return—the industry standard of measuring the results from publicly traded financial assets—was actually a good idea. Setting that heretical idea aside for a moment, it's worth taking an additional step back to make sure that investors understand how they are counting, regardless of what they are counting. Specifically, in a world dominated by stock price charts, investors need to be reminded that price changes and total return are two separate things, and in the case of dividend-oriented stocks or portfolios, they can be very separate. So let's review the basics.

When a dividend-paying stock goes “ex-dividend” on a particular date—meaning that only shareholders as of the previous trading day have the right to collect the upcoming dividend—the share price generally adjusts downward by the amount of the dividend, all other things being kept equal. The shareholder has an income receivable in the amount of the dividend payable in a day or two (in the case of many mutual funds) or up to a few weeks or even months (in the case of some foreign stocks). For example, Roadrunner stock is trading at \$100 per share and pays a \$1.00 dividend quarterly. On its ex-date, it would, if there were no other factors involved, open up at \$99 per share, plus the shareholder knows that they have a \$1.00 check on the way. (The math is *exactly* the same whether the owner is taking the dividend or reinvesting in more shares. In the latter case, instead of getting cash, he or she receives those additional shares worth \$1.00 at the close of business the prior day.)

Now let's look again at how total return is calculated. It is the change in share price plus any dividend income (or other distribution) received, divided by the starting price. It is expressed as a percentage. So if Roadrunner closes the day that it went “ex-dividend” at \$99, it has had a total return of zero that day. Although the share price went down by \$1 (-1%), the shareholder now has a \$1 (+1%) receivable on the way. They offset each other. It is rarely the case that share prices are that stable. In fact, they tend to go up or down each day. So if Roadrunner closes at \$99.50, it will have a total return that day of 0.50%. Price change of -0.5% plus distribution of +1% equals total return of 0.50%. Should the shares have fallen from \$100 to \$98, the total return would be -1% for the day, based on a -2% price change and a +1% income receivable. You get the basic idea: companies that pay large dividends see their share prices go down by that same large amount when they trade ex- the dividend payment.

Two *really* important consequences result from this basic reality. First, looks are deceiving, and I mean visually deceiving. The price chart of a dividend paying stock with the same total return as a stock that does not pay a dividend will look quite different. In the chart below, I've tracked two stocks over a twenty-year period. Both have the same annual return: 8%. The tech stock's return is all share price-based. The dividend stock starts with a 4% yield at time of purchase and increases the dividend by 4% a year. The share price (therefore) increases by 4% per year as well. The total return is *identical*, but after two decades, the price charts have diverged sharply. The tech stock is trading at a price of \$466. Nicely done. Pat yourself on the back. An 8% annual return compounded over 20 years equals a 366% return, which turns \$100 into \$466. The dividend stock is at, ughh, \$219, less than half the tech rocket. A 4% annual gain in the price translates into a lesser 119% return. That may not seem like a good deal, but it is an illusion. In terms of total return, they are identical. In terms of stock market sentiment, for traders, and for individual investors who bring all the psychological biases that flesh is heir to, it can mean a lot.



This is where the stock people usually chime in that the total return equivalence is only due to dividend reinvestment. That reinvestment function, so they say, is the source of the attractive long-term total return of dividend-paying securities. Wrong, wrong, wrong. Total return is total return is total return, and it is fully independent of whether an investor takes the dividend as cash out of the system or reinvests it back into the stock or portfolio. Let's revisit the basics once again. Total return is the calculation in any given period—as the stock market is open daily, it is usually daily in the case of stocks—of the share price paid and the dividend received (or gone ex-, more narrowly). That return is then geometrically linked to the next day, and to the next, and to the next. The dividend “counts” on the day it is added to the total return. And then the total return clock is reset for the next day's calculation. (The calculations can be done weekly, monthly or quarterly, but the returns will be slightly lower due to the less frequent compounding.)

There is a very good reason for this calculation methodology based on frequent measurement and then geometric linkage: Cash inflows or outflows to a portfolio are completely separate from the return generated by the stock or the portfolio itself. Whether Grandma takes the dividend or not does not affect how the portfolio operates in the market. Whether the client takes out \$2000 per month or adds \$5000 per quarter to the portfolio has no impact on the returns generated by the investments in the portfolio. Those inflows or outflows (including taking the dividend) just change the amount of capital available for tomorrow's total return calculation.

So while dividend reinvestment (and other capital inflows or distributions) have no impact on the calculation of daily total return, they of course have a direct impact on the amount of money in an account. You put more money to work, the account will be larger. If you skim off the dividends the account will be smaller. That's also just common sense. Let's go back to our example. If Grandma's portfolio consisted of just the dividend-paying stock generating an 8% annual return, and she reinvests the dividends, her \$100 initial investment will have turned into \$466 by year 20, not the \$219 that she would have had had she kept the dividends. Same total return; different account values.

When investment manuals talk about the power of dividend reinvestment and compounding as a miracle of wealth creation, they are correct. It is a great tool, but it is only meaningful at the account level, not at the security or portfolio total return level, which is calculated on a daily basis and geometrically linked to show those long-term returns. There is a lot of “this makes sense once you think about it” here. The problem is that too few people do stop to think about it. With your retirement savings at stake, it is worth thinking about, or at least making sure your financial advisor has.