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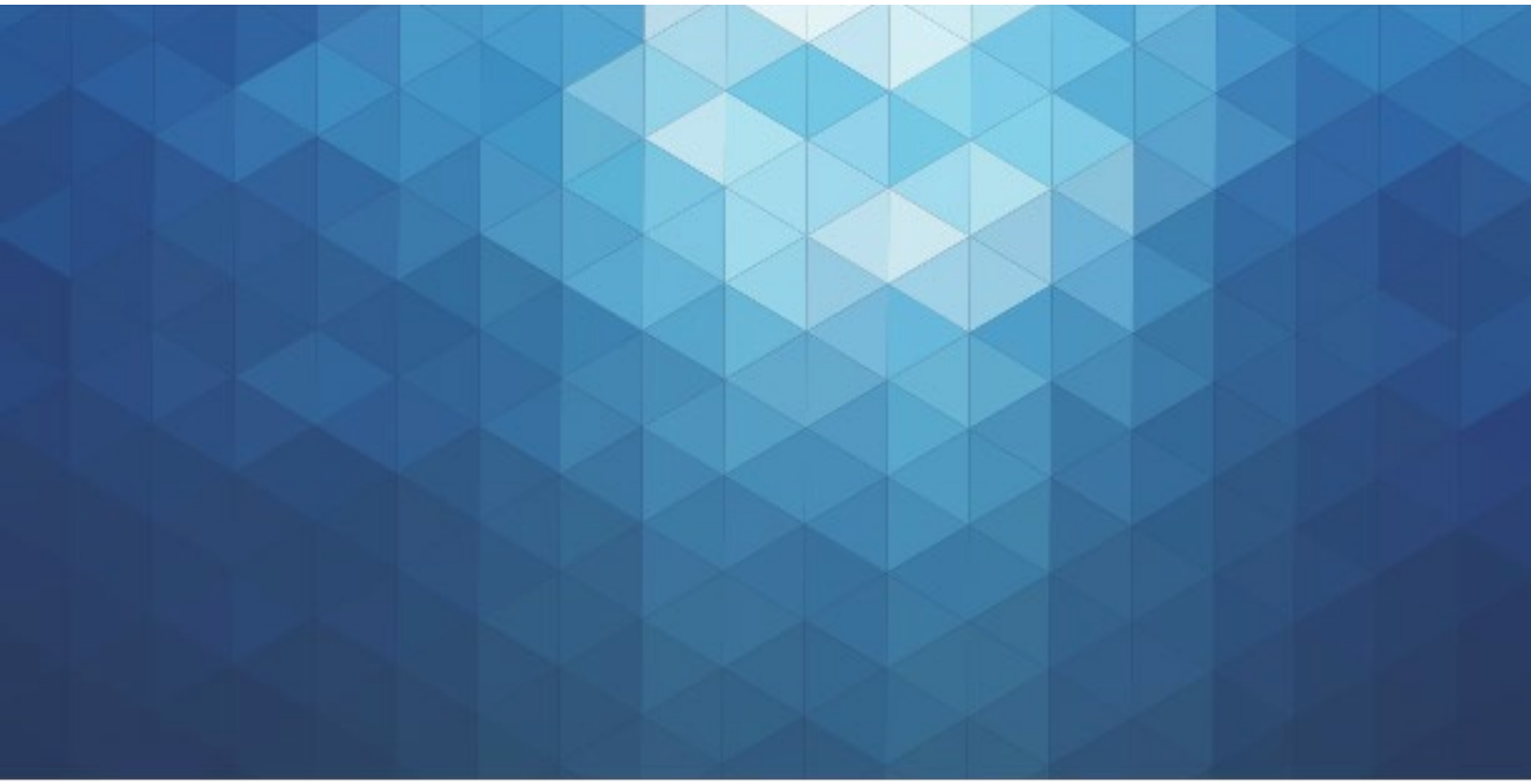

Is the Best Dividend Strategy to Avoid Them?

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Table of contents

*A special thanks to Phil DeMuth for his research and ideas presented in his book, *The Overtaxed Investor: Slash Your Tax Bill & Be A Tax Alpha Dog*, which served as the inspiration for this white paper.

Do You Pay Taxes? Then Avoid Dividends and Do this Instead

To the great dislike of the church in the early 1600s, Galileo was expanding upon Copernicus' idea that the earth revolves around the sun.

In short, things escalated… The Pope got involved… There was a trial… The threat of torture…

Eventually, Galileo was found "vehemently suspect of heresy" and sentenced to imprisonment. And to punctuate its point, the church required Galileo to "abjure, curse and detest" his heliocentric opinions.

You may feel a similar impulse to abjure, curse, and detest this white paper by the time you're done reading.

Why? Because it calls into question an investing strategy that's so beloved, it borders on sacrosanct. And just as the church found a heliocentric model blasphemous, similarly, if you worship at the altar of this wildly popular investing strategy, you too may find this paper's contents equally blasphemous.

Yet if you find yourself feeling that way, try and keep an open mind, for rejecting what you'll read today would only shortchange yourself. That's because the alternative approach has the potential to increase your returns significantly. And that's just the start because it also carries benefits that could result in even more significant improvements for taxable investors.

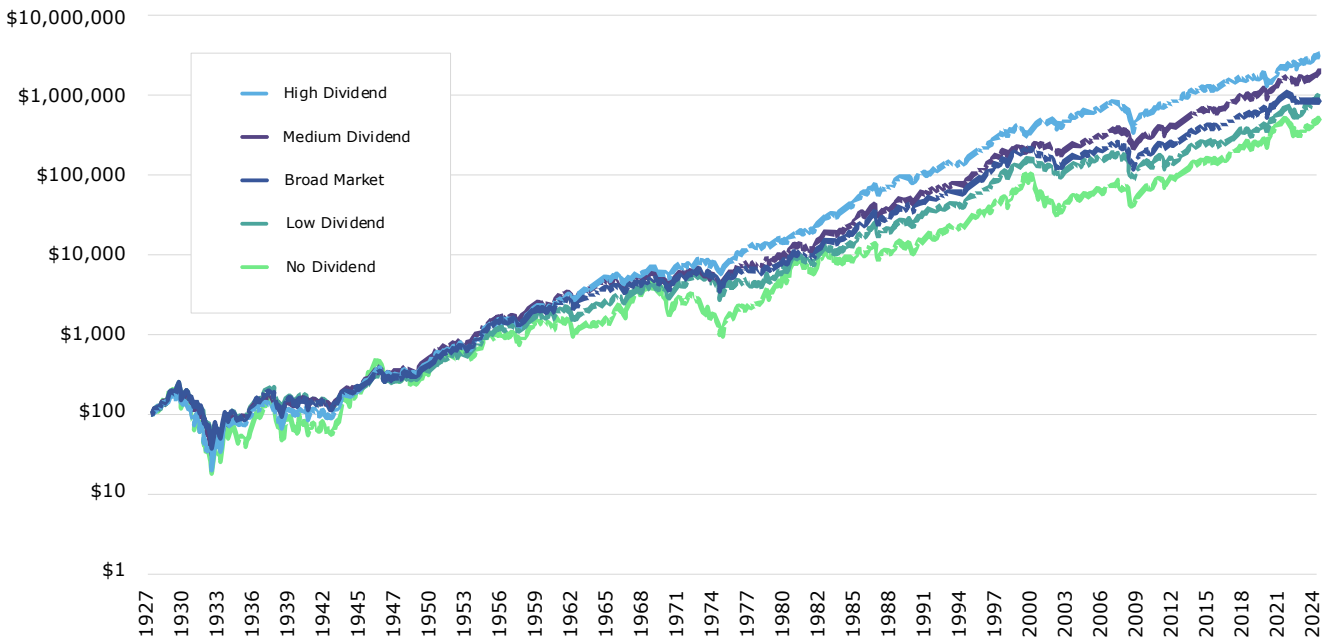
One can only hope this does not end with the threat of torture, or the modern equivalent, lots of grumpy emails and anonymous hecklers across the internet.

Killing Our Sacred Cows

The idea that might label us as an investing heretic involves the beloved dividend-focused investing strategy.

There is abundant research supporting the historical outperformance of investing in dividend-paying stocks, especially high-yielding dividend stocks.[1] If you Google "dividend stocks performance" you will find hundreds of research pieces and charts demonstrating the historical outperformance of investing in dividend stocks. Below is one such figure highlighting how stocks with high and mid dividend yields outperform the broad market. And depending on how you weight the high yield portfolio, outperformance ranges from approximately one to three percentage points per year over a broad index like the S&P 500.

FIGURE 1 Various Dividend Strategies (1928 - 2024)



SOURCE: *French Farma, Meb Faber*
As of August 31, 2024

But from time to time, we've had a real-world, implementation question…

Research shows that a significant portion of the total returns of a dividend strategy comes from the reinvestment of the dividend payment itself. However, over the years, dividends have been subject to various tax treatments, and we all know Uncle Sam will not be denied. At times, high tax rates have substantially reduced this portion of returns. While currently taxed at 15%, dividends have been exempt from taxes at times, but at other times, taxed at the individual's income tax rate up to, and we're not kidding, 90%.

[1] For an interesting aside on the cult of dividend growth investing, as opposed to simple high- yield dividend investing, please see our article "The Dividend Growth Myth". In short, we found that high dividend yield strategies tend to outperform dividend growth strategies. But how many marketing pieces have you seen advertising the billions of dollars in high fee mutual funds that follow a dividend growth strategy?

Given this, what if we could create a strategy that replicates a dividend strategy's total return and outperformance—but without the actual dividend? If so, could we sidestep injurious tax treatments altogether and increase our after-tax returns?

Put another way: Can we create a superior dividend strategy… by avoiding dividends?

Now, for those readers who find this question distasteful and are about to stop reading, we humbly request you try to stomach the following section. If you decide to stop reading at that point, at least you'll be doing so with a more informed awareness of a bias that might be influencing your allegiance to dividends – possibly to a far greater extent than you're aware.

The Behavioral Challenge with Abandoning Dividends

Many dividend investors reading this may be skeptical of a strategy suggesting they avoid dividends. This is understandable, so before detailing the replacement strategy that's the focus of this white paper, let's directly address the challenge that accompanies this strategic shift.

It starts with a question: Why do so many investors have a love affair with dividends? Thinking back to the 1980s may help provide an answer.
Beginning in the 1980s, Pepsi started running the Pepsi Challenge—television commercials featuring taste tests pitting their soda against Coca-Cola. Tasters took sips of each unmarked beverage and were asked to declare which soda they preferred.

Invariably, Pepsi was the favorite choice. Coke conducted its own trials and astonishingly found similar results. The oft-cited reason was that Pepsi's formula was sweeter, which led to the conclusion that Coke needed to change its formula—which resulted in the disastrous abomination called New Coke.

What's fascinating is that even though people prefer Pepsi when tasting blind, people still buy more Coke, to the extent that it commands a much larger share of the soda marketplace than Pepsi. More pointedly, in tests, researchers found that foreknowledge of the brand led to the results changing—people responded differently, the majority claiming to prefer the taste of Coke.

Why is this? Are people irrational? Or are there other factors at play – childhood memories of drinking a Coke with Grandpa, sitting on the front porch swing. Or perhaps you have warm fuzzy feelings from watching the polar bear commercials during the Super Bowl. Regardless, the simple conclusion is that there is more at work than taste, or even logic alone. Brand means something.

Is there any reason to believe it would be different with investing?

Dividends also have a great "story." You may have learned about them from your parents, or perhaps when you took an investing course in college, or perhaps you simply associate them with passive income. And chances are, your dividend investments performed well for you.

One could argue that dividends have developed a great brand. Much like Coke, thoughts of dividend stocks immediately conjure images of regular checks arriving in the mail from profitable, established companies as you lounge on a white-sand beach sipping a Pina Colada.

It's hard to overcome this deeply grooved, neural association between "dividends" and "good" – just ask the person who overruled the preference of their own taste buds when seeing the name "Coke" on the side of a can.

So, what's an investor to do?

It starts with awareness. In this case, simply being aware of the extent to which your first reaction is to reject the information you're about to receive. Then, do your best to evaluate it objectively, based on the numbers you'll see – not your preconceptions.

You will likely find that dividend investing—while generally a solid market strategy with a great brand—is not necessarily the best wealth-building strategy.

And with that realization as a foundation, you can then ask yourself whether your allegiance is really to dividend investing or, instead, to the brand of dividend investing.

Building a Better Mouse Trap

Let's illustrate with a quick example. Let's say you could invest in the S&P 500, but without receiving any dividends. So, you generate the same total return as the S&P 500, but with 0% yield. How would that impact your after-tax returns? We ran simulations at various tax levels and found that you could improve after-tax returns up to 1.2 percentage points per year – just by avoiding that dividend check each quarter.

But, we think we can do better.

Historically, dividend and value stocks share many similarities. Investing in dividend stocks and high yielders has historically worked since dividend stocks have traded at a valuation discount to the overall market, which we discussed in this 2016 piece, "What You Don't Want to Hear About Dividend Stocks". So in this effort to find a "non-dividend dividend" strategy with similar returns to a normal dividend strategy, we used traditional value factors.

To test the results, we partnered with our old friends at Alpha Architect, Wes Gray and Jack Vogel. Below is a table that examines various strategies back to 1974. The results are quite stunning.

The first column is the S&P 500, which represents the broad market. The S&P is a market capitalization weighted index, which means that the largest companies, like Apple and Amazon, receive higher percentage weightings in the overall index than smaller companies, which receive smaller percentage weightings.

In the next column, we expand the universe to the top 2000 stocks equal-weight to demonstrate a broader universe that isn't market cap-weighted.

The third column is the top 100 stocks ranked by dividend yield and equally-weighted.

Next, we sort on a simple value ratio composite, followed by three variations of this value composite where we then exclude increasing amounts of the dividend universe. One can define "value" any number of ways. For our purposes in this white paper, we constructed our value composite by selecting the top stocks as identified by a combined rank of price-to-earnings, price-to-sales, price-to-book, and EV to EBITDA.

Notice value's massive outperformance over the broad market and the dividend portfolio. We see this resulting in an obvious takeaway: Focusing on value can be a much better value strategy than relying solely on dividend yield!

FIGURE 2 Various Strategies (1974 - 2022)

1974-2022	S&P 500	2000 stocks EW Size	Top 100 EW Div Yield	Top 100 EW Value Comp	Top 100 EW Value Ex Top 25% Divs	Top 100 EW Value Ex Top 50% Divs	Top 100 EW Value Value Ex All Divs
Returns	10.87%	12.49%	13.97%	16.78%	16.31%	15.24%	13.20%
Volatility	15.36%	20.94%	16.46%	20.33%	20.87%	22.29%	23.06%
Maximum Drawdown	-50.95%	-56.00%	-55.20%	-56.52%	-52.66%	-52.11%	-52.02%

SOURCE: *Meb Faber/GFD/Alpha Architect*
As of December 31, 2022

What can we take away from this research?

Simple: Each of these particular value strategies examined beat the dividend strategy.

We were hoping to find a strategy that might approximate the returns of a dividend strategy as a starting point before factoring in any tax advantages. But as it turns out, by focusing on value and avoiding or eliminating dividends entirely, we were already miles ahead.

But it was about to get better, because now it was time to include the tax-effect. When we account for Uncle Sam, the outperformance of the dividend-avoidance, low-valuation strategy is even more pronounced.

While those fat 4%, 6%, 8% or even higher dividend yields sound great on paper, realize you must pay taxes on that income every year.

We ran two simulations using real, historical tax rates at the lowest and highest tax brackets. We found that the benefit of avoiding dividend stocks, while adding a value tilt, reaped huge rewards over time.

First, we look at an investor who paid no dividend taxes or liquidation tax upon sale. This may be a person who invested in a retirement account and then donated the shares to charity. As you'll see below, a simple value composite won the day, while a broad market equal-weighted index results in the lowest returns.

Next, we examine an investor in a taxable account but again assume he donated his shares. We look at both a low and a high tax rate.

And lastly, we examine two more simulations - an investor taxed upon liquidation at rates of 15% and 35%, respectfully - and then, analyzing both simulations with low and high dividend tax rates. As before, for each row, we color code the best (green) and worst (red) returns across the five strategies.

As you look below, notice that a value approach outperforms the other strategies, in some cases by a significant amount. And particularly for investors in the higher tax brackets, the best approach was avoiding high-yielding stocks but adding a value tilt.

Also, dividend investors may find it surprising to see the top 100 dividend yield strategy, along with the broad market strategy, were often the lowest performing strategies in every simulation.

FIGURE 3 Pre- and Post-Tax Returns of Various Strategies (1974 - 2022)

1974-2022	S&P 500	2000 stocks EW Size	Top 100 EW Div Yield	Top 100 EW Value Composite	Top 100 EW Value Ex Top 25% Divs
No taxes	10.87%	12.49%	13.97%	16.78%	16.31%
Div% at Low Tax Rate	10.60%	12.29%	12.53%	16.41%	16.19%
Div% at High Tax Rate	9.67%	11.66%	9.62%	15.11%	15.67%
No Div w/liquidation 15%	10.49%	12.11%	13.59%	16.40%	15.92%
No Div w/liquidation 35%	9.88%	11.50%	12.97%	15.76%	15.29%
Div% at Low Tax Rate w/liquidation 15%	10.21%	11.91%	12.15%	16.02%	15.80%
Div% at High Tax Rate w/liquidation 15%	9.29%	11.28%	9.24%	14.73%	15.28%
Div% at Low Tax Rate w/liquidation 35%	9.61%	11.29%	11.53%	15.39%	15.17%
Div% at High Tax Rate w/liquidation 35%	8.69%	10.67%	8.64%	14.10%	14.65%

SOURCE: *Meb Faber/GFD/Alpha Architect*
As of December 31, 2022

You simply can't ignore the significant impact of taxes. Perhaps that's why a Vanguard research piece titled "Tax-efficient equity investing: Solutions for maximizing after-tax returns" reports: "Vanguard research has shown that, of all the expenses investors pay, taxes can take the biggest bite out of total returns."

Many investors, including retirees, value those quarterly dividend checks. But recognize the huge opportunity cost ones pays for them. The "bird in the hand," so to speak, is costing about three or four in the bush.

This line of thinking can apply to any income focused approach in investing.

What is another notoriously high yielding strategy? Investing in Real Estate Investment Trusts (REITs).

We ran a similar simulation with REITs, and found compelling evidence here as well. If one could replicate the total return stream of REITs, but without the income, it could be a massive benefit to the taxable investor.

FIGURE 4 Pre- and Post-Tax Returns of Various Strategies (1974 - 2022)

1974-2022	REITs
No taxes	10.00%
Div% at Low Tax Rate	9.18%
Div% at High Tax Rate	6.95%
No Div w/liquidation 15%	9.62%
No Div w/liquidation 35%	9.02%
Div% at Low Tax Rate w/liquidation 15%	8.79%
Div% at High Tax Rate w/liquidation 15%	6.52%
Div% at Low Tax Rate w/liquidation 35%	8.19%
Div% at High Tax Rate w/liquidation 35%	5.93%

SOURCE: *Meb Faber/GFD/Alpha Architect/NAREIT*
As of December 31, 2022

Why Hasn't this Been Done? It Has…

Would it help to know that Warren Buffett would likely agree with this non-dividend strategy?

Warren Buffett's Berkshire Hathaway has never paid a dividend. Actually that's not entirely true – they paid one single $0.10 dividend in 1967 and Buffett later joked, "I must have been in the bathroom when the decision was made."

He later punctuated his no-dividend stance with a colorful quote, "All you get with Berkshire stock is that you can stick it in your safe deposit box, and every year you take it out and fondle it."

So why does Buffett – someone who regularly invests in dividend-paying companies – avoid paying dividends to his own Berkshire shareholders?

In answering, let's start with a different question – what does Buffett seek?

Buffett's focus is on creating "value" for himself and his shareholders. His letters to shareholders are filled with practical advice on how managers create value – and destroy it. (They create it by buying mispriced, quality assets… They destroy it by repurchasing company shares at prices above intrinsic value, and so on. You can read one of his, and our, favorite investing books on managing cash flows in The Outsiders.)

Through this "value" lens, dividends appear different to Buffett than they do most investors. While the common opinion is that dividends are always valuable, to Buffett they can fall into the value-destroyer camp if there is a better use of that capital elsewhere.

The reason largely reduces to opportunity cost. Dividends are highly tax-inefficient. That's the Achilles heel. So, when compared with the other ways in which a company might use its free cash flow to generate greater value for investors (buying back shares, acquiring a cash-generating business, reducing debt and its carrying costs…) dividends can come up short.[2]

[2] If you're interested in further reading on this topic, here is a discussion summarizing Buffett's thoughts on dividends in his 2012 letter to shareholders.

Buffett isn't the only successful professional money manager who feels this way. On his podcast "Invest Like the Best," Patrick O'Shaughnessy interviewed Will Thorndike in May 2017. Thorndike is the author of the above-referenced book, The Outsiders, which focuses on CEOs who excel at capital allocation.

In the episode, O'Shaughnessy poses a question to Thorndike…

"Dividends have always been popular, always a significant quoted source of total return. What did you find in common between these eight, and maybe beyond the eight, very successful capital allocators as it pertains to their dividend policy, their view toward dividends, whether or not they paid them and so on?"

Thorndike replies, "So they were very unconventional in that regard. Specifically, they generally disdained dividends. They generally either avoided them, or their dividend yield was substantially lower than the peer group. And the reason for that in every case was tax-inefficiency. So one of the common threads across the eight was a real focus on tax minimization. And dividends just are inherently, deeply tax-inefficient."

If you're still unconvinced, a recent research report from Vanguard supports our thesis that focusing on dividends in isolation is a suboptimal approach to maximizing total returns.

Conclusion – It's About Total Returns After All Costs, Fees, and Taxes

We started with a question: By avoiding dividends might we improve "dividend investing"? But by removing the dividend, it inadvertently refocused the selection methodology on pure value. The research turned out to be a backdoor way of reminding that value investing and dividend investing – while often confused as the same thing – are distinct strategies. And more times than not, value wins out.

It turns out that the simple value strategy (which included avoiding high yield stocks) produced higher returns than the dividend strategy – not just similar returns. In other words, before we even get to the tax benefits, "value" had already trumped "dividends." And after factoring in taxes? Even more outperformance.

For any stubborn dividend investors ready to remain faithful to their strategy despite the above data, I hope that you'll at least be willing to concede one point…

You're paying quite a bit for those quarterly dividend payments.

Additional Reading

"How Tax Efficient are Equity Styles?" – Israel, Ronen and Moskowitz, Tobias J.

"What Difference Do Dividends Make?" – Conover, C. Mitchell and Jensen, Gerald R and Simpson, Marc William

"Investors Too Focused on Dividends" – Swedroe, Larry

"Dividend Strategies Fall Short" – Swedroe, Larry

"Investors' Odd Affection For Dividends" – Swedroe, Larry "Irrelevance Of Dividends" – Swedroe, Larry

INFORMATION ABOUT SIMULATED (BACKTESTED) PAST PERFORMANCE

There are several important factors to consider when reviewing backtested, or hypothetical, performance information:

Simulated (Backtested) Performance is Hypothetical. The performance information herein includes performance information that is hypothetical, and is not real. As such, the backtested portion of the performance presentation does not represent the investment performance or the actual accounts or any investors in the accounts. The securities in these hypothetical portfolios were selected with the full benefit of hindsight, after their performance over the period shown was known, and cannot account for all financial risk that may affect the actual performance. It is not likely that similar results could be achieved in the future. The hypothetical performance presented here is purely illustrative, and representative only of a small sample of possible future scenarios.

Simulation (Backtesting) is Subject to Limitations. While it is believed that backtested performance information presented is relevant to evaluating an investment in the strategies, no representation is or could be made that the information presents what the performance results would have been in the past or are likely to be in the future. There are frequently sharp differences between hypothetical performance results and actual performance results subsequently achieved. One limitation of hypothetical performance is that it is generally prepared with the benefit of hindsight. In addition, no hypothetical track record can completely account for the impact of financial risk in actual trading. For example, back-factors that affect markets in general, the impact of fees and expenses, market liquidity and other factors may all of affected actual performance.

Actual Investor Experience Varies. The backtested results are not indicative of the skill of Cambria. Backtested performance shown herein reflects hypothetical performance determined using the current investment strategy of the accounts.