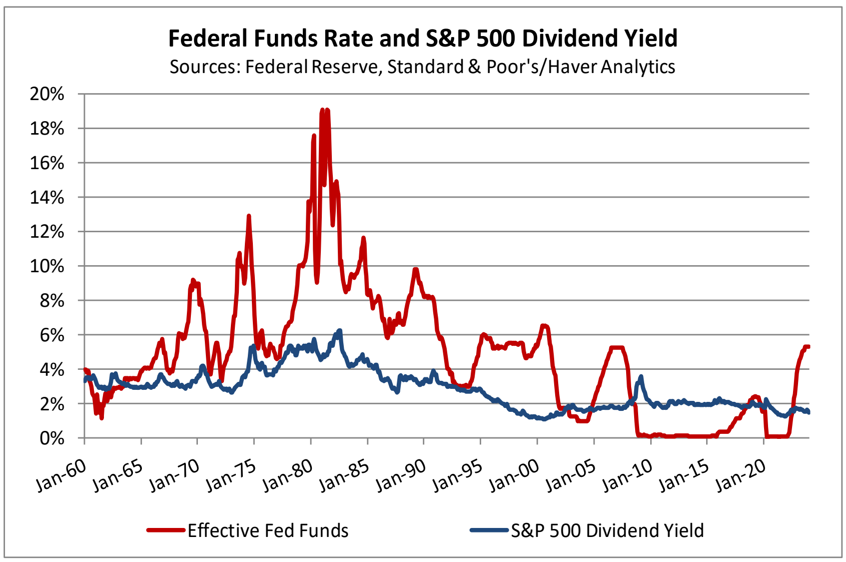
Back to the Future:
The Advantages of Dividend Income Over Interest Income

Over the past 15 years, dividend income has often exceeded what could be earned in a money market account. But as seen in the chart below (*Figure 1*), with the fed funds rate now at 5.5%, the relationship between dividend income and interest income has gone back to what was common before 2008 — where the S&P 500 dividend yield (the blue line) is 2-3% below what could be earned in a money market account invested in U.S. Treasury bills (the red line).

Figure 1



This begs the question:

Why should an income-oriented client still invest in a dividend income-focused stock portfolio yielding 3% when they can now earn 5% in a low-risk money market account?

Higher inflation is causing interest rates to rise on short-term fixed income and money market instruments, and now investors have more choices in generating income returns. While current yields are appealing, **we believe it would be short-sighted for long-term investors to abandon the compounding benefits of a growing income stream that can protect purchasing power while also providing for growth of principal**.

In this *Value Equity Insights* report, we highlight some of the potential advantages of growing dividend income through a portfolio of quality, growing businesses — factors which might be underappreciated in the current environment.

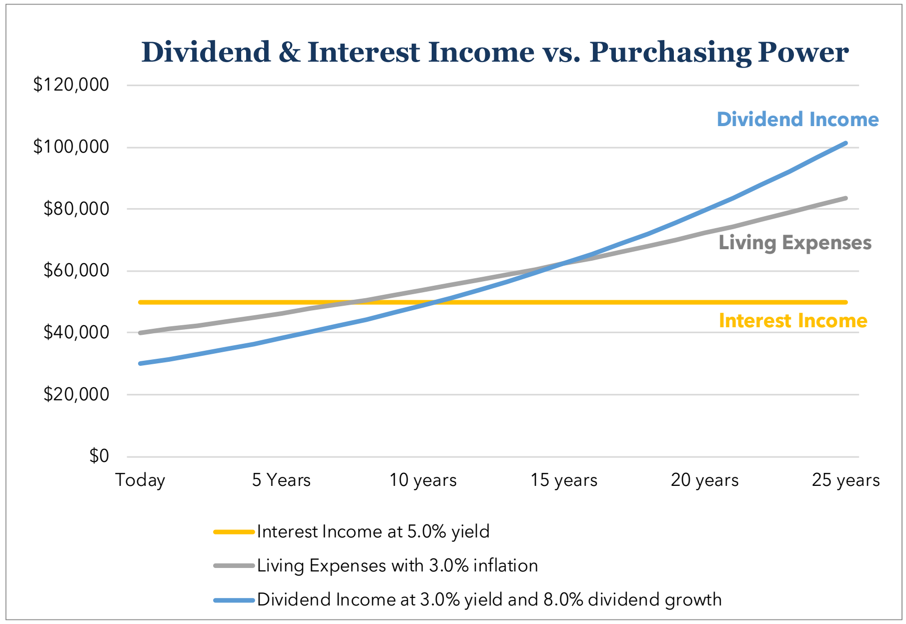
Growing Investment Income to Protect Purchasing Power

While earning interest income of 5% in a money market account is appealing compared to a lower dividend income yield from a stock portfolio, **a significant distinction is that, over time, dividend income can grow dramatically!**

For example, in the illustration below, a dividend income-focused stock portfolio currently yielding 3.0% on a $1 million portfolio would produce annual dividends of $30,000 versus $50,000 of interest income from a money market cash account yielding 5.0%. However, the key difference is that **the account balance of a dividend income portfolio can grow because it is invested in high-quality businesses that can grow their earnings and dividends over time** versus a money market account that is akin to cash sitting in a bank account.

More importantly, when inflation is taken into consideration the advantages of dividend income become more clear. In this illustration (*Figure 2*), we start with $40,000 of living expenses today and grow it 3.0% per year with inflation (gray line) in order to maintain that purchasing power and standard of living into the future. To help fund those living expenses in the future, we assume a $1 million portfolio today that is invested in either a money market account yielding 5.0% (yellow line) or a dividend income-focused stock portfolio (blue line) that yields 3.0% (about twice the yield on the S&P 500) with annual dividend growth of 8.0% (the 10-year average for higher-yielding dividend growers). This illustration also assumes that the interest and dividend income is not reinvested but withdrawn every year to help cover living expenses, that money market rates stay at 5.0% for the next 25 years, and does not include any management fees or taxes.

Figure 2



(Source: Confluence)

The results of this illustration show that while a 5.0% money market account would produce more current income today, it does not grow, so after seven years it no longer covers inflation-adjusted living expenses. **After 10 years, the dividend stock portfolio actually produces more income despite having a lower yield of 3.0%.** Furthermore, after 14 years, the dividend income catches up to the inflation-adjusted living expenses and goes on to grow to over $100,000 after 25 years, up dramatically from the initial $30,000, because the quality, growing companies in the dividend income portfolio are able to grow their earnings and dividends over the long term, staying ahead of inflation, and quite unlike cash sitting in a money market account.

Lastly, even with the income spent every year, the dividend stock portfolio would still grow to nearly $3.4 million over 25 years (as detailed in Illustration #2 on page 4), while the money market account would remain flat at $1 million. This illustration again demonstrates that **one of the better assets to own in times of elevated inflation is a great business with pricing power** and minimal capital needs, one that can maintain and grow earnings (and dividends!) throughout.

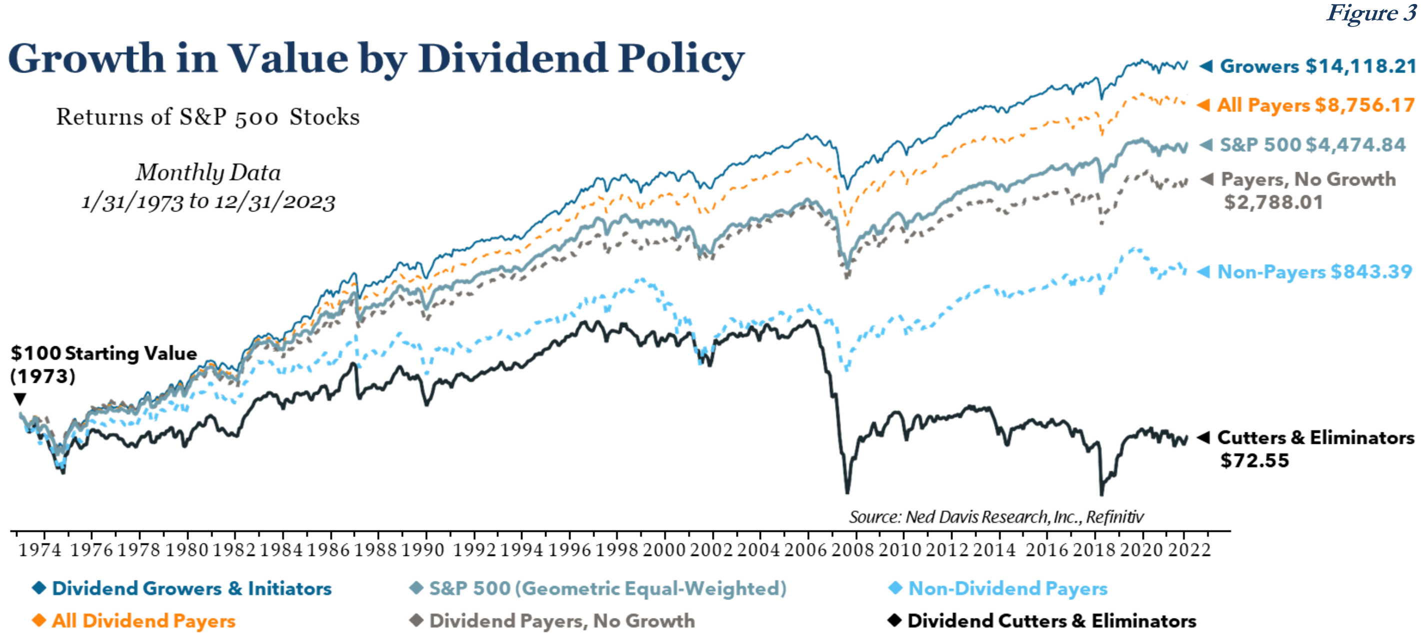
While this illustration is eye-opening, it might also be helpful to provide a specific example of a widely held, growing, dividend-paying business. PepsiCo, Inc. (PEP) is a Consumer Staples company that is well known for beverages, but its snack food business (FritoLay) has been the real growth driver over the past 15 years. As a result, on 12/31/2007, PepsiCo's stock traded at $75.90 with earnings per share of $3.41 and paid a dividend per share of $1.50 (a 2.0% dividend yield). Fast forward 15 years, on 12/31/2022, PepsiCo's stock traded at $180.66 with earnings per share of $6.49 and paid a dividend per share of $4.60 (a 2.5% dividend yield). Over 15 years, PepsiCo's stock price and dividend per share grew almost 3x over…not too far off from the illustrations shown here! As is the case for many high-quality businesses, we believe that PepsiCo's stock and dividend will continue growing in the future — that is the beauty of a quality, growing business owned at a reasonable price.

The Power of Compounding + Dividends

Albert Einstein is widely credited with saying, "Compound interest is the most powerful force in the universe." While compound interest income is impressive, **compounding returns from a portfolio of quality businesses with growing dividends can be even more powerful**.

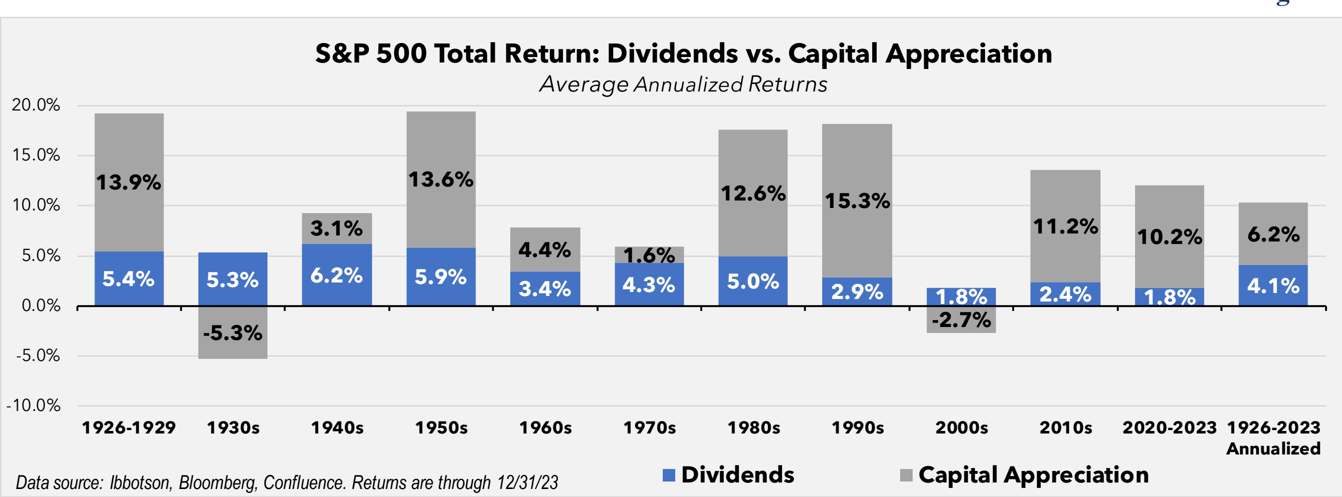
This concept is **true in theory and in practice** as the chart below from Ned Davis Research shows that $100 invested in dividend payers in 1973 has grown to $8,756 in 2023, while dividend growers are worth $14,118. By comparison, the S&P 500 Equal Weight Index and non-dividend-payers stand at $4,474 and $843, respectively, in 2023.

Figure 3



A key component of the outperformance of dividend payers and growers is the fact that dividends **have contributed over half of the total return of the stock market** on average per decade since the 1930s with dividends reinvested (*source: Strategas*), and in some decades they accounted for 100% of any return on investment (1930s and 2000s). Furthermore, as the next chart displays, dividends tend to provide the bulk of the return in decades with higher interest rates or bear markets but are a smaller component during strong bull markets, like the 1950s, 1980s, 1990s, and 2010s.

Figure 4



With the strong contribution from dividends and dividend growth historically, it might be helpful to illustrate how this could compound and provide dividend income into the future versus a higher current yield in a money market account.

Illustration #1: Compounding With Income Reinvested

In the illustration below, $1 million invested in a dividend income-focused stock portfolio (with dividends reinvested) would grow to almost $7 million over 25 years, and assuming a 3.0% yield, the dividend income off the portfolio would grow from $30,000 today to over $200,000 in 25 years. By comparison, over 25 years, a money market account invested in U.S. Treasury bills yielding 5.0% would grow to $3.4 million with the interest income reinvested, and interest income would grow from $50,000 today to $169,000, assuming short-term interest rates stay at 5.0% over that time period. Of course, one important difference to note is that a money market account invested in U.S. Treasury bills is low-risk, while a stock portfolio carries higher risk and can decline in value. Nevertheless, as this illustration demonstrates, **the lesser returns from a low-risk investment can have a large opportunity cost when compounded over decades**.

Dividend/Interest Income Reinvested

Money Market (Cash) Account	Today	10 years	15 years	20 years	25 years
Account Balance at 5.0% return	$1,000,000	$1,628,895	$2,078,928	$2,653,298	$3,386,355
Interest Income at 5.0% yield	$50,000	$81,445	$103,946	$132,665	$169,318

Dividend Income-Focused Stock Portfolio	Today	10 years	15 years	20 years	25 years
Account Balance at 8.0% return:	$1,000,000	$2,158,925	$3,172,169	$4,660,957	$6,848,475
Dividend Income at 3.0% yield:	$30,000	$64,768	$95,165	$139,829	$205,454

While this compounding is impressive, it assumes the investment income is reinvested, but many investors looking for dividend or interest income may want to use that income at some point for living expenses.

Illustration #2: Compounding Without Income Reinvested

In this second illustration, we assume that the dividend or interest income is withdrawn annually. As a result, the advantages of dividend growth and compounding are even more clear as the money market account and interest income remain flat, while dividend income from the stock portfolio triples and the portfolio value increases from $1 million to $3.4 million. **Thus, when it comes to spending investment income, with a growing dividend income-focused stock portfolio it is an unusual situation where you can "have your cake and eat it, too."**

Dividend/Interest Income Withdrawn Every Year

Money Market (Cash) Account	Today	10 years	15 years	20 years	25 years
Account Balance at 5.0% return	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Interest Income at 5.0% yield	$50,000	$50,000	$50,000	$50,000	$50,000

Dividend Income-Focused Stock Portfolio	Today	10 years	15 years	20 years	25 years
Account Balance at 8.0% return	$1,000,000	$1,628,895	$2,078,928	$2,653,298	$3,386,355
Dividend Income at 3.0% yield	$30,000	$48,867	$62,368	$79,599	$101,591

Lastly, these illustrations and historical performance are also a good reminder that long-term wealth creation is not about beating an index every year; rather, we believe **the key to building wealth is having confidence in a portfolio of quality businesses owned at reasonable prices**. Adhering to this process can help investors withstand the bad times (e.g., 1974, 1987, 2002, 2008, 2020) and allow one's investments to grow and compound for decades…truly a "most powerful force."

Tax Advantages

In a taxable investment account, there are distinct tax advantages of dividend income over interest income. Interest income is taxed as ordinary income, with federal tax rates as high as 37%, while qualified dividend income is taxed at 15% or 20%, based on total taxable income.

For example, assuming an account holder is in the top tax bracket, $1 million invested in a 5.0% money market account would earn $50,000 annually, or $31,500 after federal taxes of 37%. Meanwhile, a $1 million dividend income-focused stock portfolio with a 3.0% dividend yield would earn dividend income of $30,000 annually, or $24,000 after federal taxes of 20%.

As a result, a pre-tax income difference of $20,000 shrinks to only $7,500 after tax. Additionally, assuming this income is withdrawn annually for living expenses, the dividend income portfolio would still grow from stock appreciation whereas the money market account would remain at $1 million. Tax-motivated investment decisions can often result in sub-par investment results, but when it comes to qualified dividend income versus interest income it can be a win-win investment decision. [*Please note that an investor's tax rate will depend on several factors, including tax bracket, the type of investment, and (with capital assets, such as stocks) how long they own them before selling.*]

In Summary

A portfolio of quality, dividend-paying businesses can **provide above-average dividend income that grows and helps compound the value of the underlying investment**, all while seeking solid downside protection. So, if we are going "back to the future" where money market rates stay above dividend yields, then it's important to remember the long-term advantages of dividend income. The good news is that you don't even need a DeLorean to make it happen!

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