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Payout ratio tells a tale

It's human nature to want it all.

As investors, we want dividends, we want profit growth, and we want our stocks to go up. At first glance, those goals may seem to be at cross-purposes, since the more a company pays out in dividends, the less it can afford to invest in its business to grow profits.

While investors cannot truly have *everything*, there are some stocks that seem capable of helping you obtain dividends, profit growth, and capital gains. To find such stocks, consider the payout ratio, or percentage of earnings paid out in dividends, from two different viewpoints:

1) *Companies that plow cash back into the business have higher growth potential.* Supporters of this theory may refer to the sustainable growth rate, which provides a rough estimate of profit-growth potential. To calculate the sustainable growth rate, multiply the earnings-retention ratio (the percentage of earnings *not* paid out in dividends) by the return on equity (income divided by stockholders equity).

To be sure, the sustainable growth rate is not a perfect measure. It assumes that every dollar of profits not paid out in dividends is reinvested in the company, and that those investments will generate a return on equity (ROE) in line with that of existing projects. Neither assumption is safe.

2) *High-payout companies make better use of their money.* A 2003 study by Robert Arnott and Clifford Asness found that after periods from 1946 through 2001 when the S&P 500 Index had a low payout ratio, it tended to deliver weaker 10-year profit growth than it did after periods with high payouts. The researchers cited two possible reasons for this trend.

First, companies hate to cut dividends, and a high payout ratio may suggest executives willing to pay generous dividends are more confident in their earnings outlooks. Second, companies with high payouts have less to invest, which could make them more picky about how they spend their money. Such companies presumably focus only on the most profitable projects, while companies with lots of cash may feel compelled to deploy that money on acquisitions or dubious projects.

While the arguments in favor of high-payout companies have merit, the study cited above does not tell the whole story. The market's payout ratio tends to hit its highest level during earnings troughs, and it makes sense that profits would rise quickly during the recovery. *Dow Theory Forecasts'* research, as presented in the chart below, suggests that S&P 1500 Index stocks with modest payout ratios delivered superior returns since 1994 — and currently earn higher Quadrix® scores.

With neither viewpoint on payout ratios completely correct, how should investors use the ratio as an investment tool? Try skimming off the best ideas from both camps.