MORNINGSTAR®

Dividends and Buybacks Paint a More Complete Picture Together

Large U.S. companies often rely on both channels to return cash to shareholders.

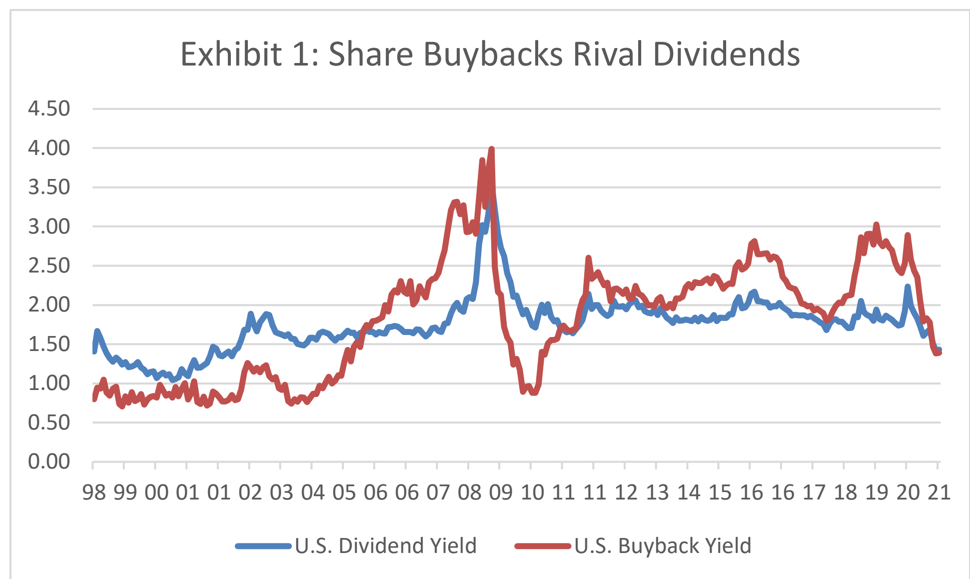
Morningstar Inc.
March 2021

Alex Bryan, CFA
Director of Product Management, Equity Indexes
+1 (312) 244-7042
alex.bryan@morningstar.com

https://indexes.morningstar.com/

Dividends are easy to love. They provide income, weed out the most speculative stocks, impose discipline on corporate managers, making it harder for them to engage in value-destructive empire-building, and often give investors the fortitude to stick with stocks through their rough patches. Historically, dividends were also the primary means by which managers returned cash to shareholders. However, they don't tell the full story of any investment. As share buybacks have become more common, dividends alone have become less representative of firms' dedication to returning cash to shareholders.

Share buybacks have come to rival dividends as the largest channel through which U.S. stocks return cash to shareholders, as Exhibit 1 shows. Share repurchases may not be as noticeable as dividends, but they are equally important, though not for the reason many think.



Source: Morningstar Indexes. Data as of January 2021.

There is a common misconception that share repurchases directly increase stock prices. That's intuitive, as repurchases increase demand for the stock and reduce the supply of shares outstanding, increasing earnings per share. But just like dividend policy, the mechanics of a share repurchase should have no

direct impact on a stock's net return, if the price is fair[1]. That's because a firm must either spend cash or take on more debt to finance the repurchase, reducing the value of the enterprise by an offsetting amount. Remaining shareholders have a bigger slice of a smaller pie, but the value of each stake should be unchanged.

So, what is the benefit of share repurchases? There are a few. Share repurchases facilitate:

- **Tax Efficiency**
  This is a more tax-efficient way to return cash to shareholders than dividends, as tax liabilities accrue only to those who sell their shares.
- **Flexibility**
  Investors often punish stocks that cut their dividends, but there is less stigma associated with reducing share repurchases, making them an ideal way to distribute residual cash flows.
- **Enhanced Resource Allocation**
  Share repurchases allow investors to earn higher returns on a firm's excess cash than corporate managers.
- **Opportunistic Value Creation**
  Repurchases increase intrinsic value when the stock is undervalued.
- **Screening**
  Stocks with healthy dividend and repurchasing activity tend to be profitable firms with shareholder-friendly management teams.

Better Together

Just as dividends don't tell the full story of any investment, neither do share repurchases. Considering them together provides a more complete view of a firm's commitment to returning cash to investors than either in isolation. That was the impetus behind the Morningstar US Dividend and Buyback Index.
This index targets stocks of all sizes making 90% of the total shareholder distributions (excluding negative shareholder yields) from the broad Morningstar US Market Index. Stocks that make the cut are weighted in proportion to the value of their shareholder distributions, subject to a 5% cap.

Core Value

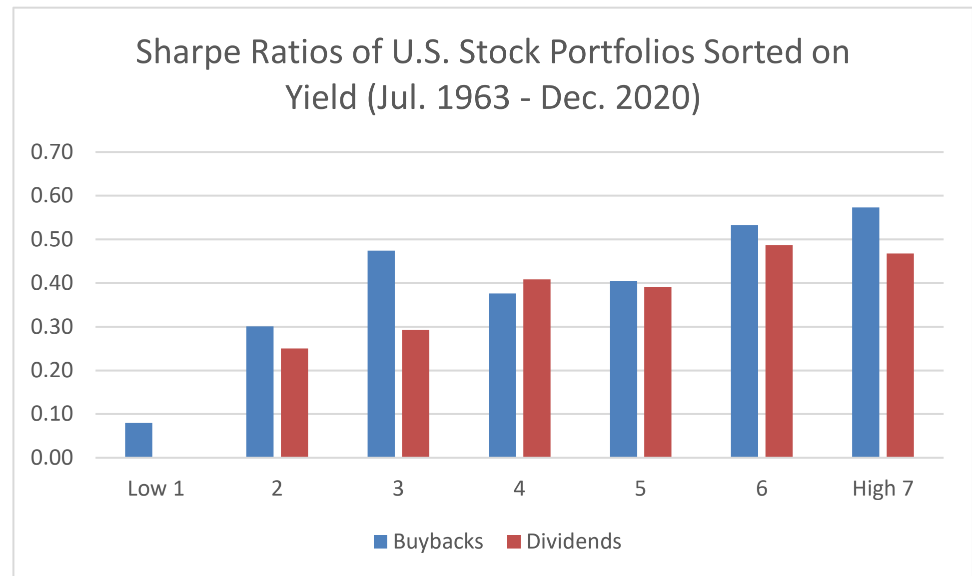
This produces a well-diversified portfolio that could serve as a core value holding. Like most yield-oriented strategies, this index has a value tilt, as stocks trading at lower valuations tend to offer higher shareholder yields. However, it tends to favor more profitable firms than traditional value benchmarks, like Morningstar US Market Broad Value Extended Index. The dividend yield here tends to be slightly higher, too, though not as high as some traditional dividend strategies, like the Morningstar Dividend Yield Focus Index.

The Morningstar US Dividend and Buyback Index casts a wide net, which has tended to sweep in more than 300 stocks. While most of the portfolio is invested in dividend-paying stocks, it picks up some non-

---

1 When stocks pay dividends, their prices tend to drop by about the amount of their dividend payments.

dividend payers with buybacks, like Alphabet and Berkshire Hathaway, that traditional dividend strategies miss.



Source: French Data Library, Author's Calculations.

This strategy isn't going after the shareholder yield leaders so much as it is cutting out the laggards—firms that are diluting shareholders or making minimal cash distributions. Many of these are fast-growing stocks with lofty valuations that are reinvesting heavily in their businesses. Sometimes those investments pay off, but historically lower-yielding stocks (measured by dividend yield or share-issuing activity) have tended to underperform, as Exhibit 2 shows.

Key Takeaways

- Dividends don't tell the full story of any investment.
- Considering share buybacks with dividends paints a more complete picture of firms' shareholder distributions.
- Morningstar US Dividend and Buyback Index can serve as a core value strategy. It attempts to carve an edge by omitting stocks with meager or negative shareholder yields. M

About Morningstar Indexes

Morningstar Indexes combine the science and art of indexing to give investors a clearer view into the world's financial markets. Our indexes are based on transparent, rules-based methodologies that are thoroughly back-tested and supported by original research. Covering all major asset classes, our indexes originate from the Morningstar Investment Research Ecosystem — our network of accomplished analysts and researchers working to interpret and improve the investment landscape. Clients such as exchange-traded fund providers and other asset management firms work with our team of experts to create distinct, investor-focused products based on our indexes. Morningstar Indexes also serve as a precise benchmarking resource.

To learn more about Morningstar Indexes, visit: http://global.morningstar.com/indexes

Contact:
indexes@morningstar.com
U.S. + 1 312 384-3735
Europe: +44 203 194 1401
Japan: +81 3 5511 7540
India: +91 22 6121 7123
Hong Kong: +852 2973 4680
Singapore: +65 6340 1285
Australia: +61 2 9276 4446

© 2021 Morningstar. All rights reserved. The information, data, analyses and opinions contained herein (1) include the proprietary information of Morningstar, (2) may not be copied or redistributed, (3) do not constitute investment advice offered by Morningstar, (4) are provided solely for informational purposes and therefore are not an offer to buy or sell a security, and (5) are not warranted to be correct, complete or accurate. Morningstar has not given its consent to be deemed an "expert" under the federal Securities Act of 1933. Except as otherwise required by law, Morningstar is not responsible for any trading decisions, damages or other losses resulting from, or related to, this information, data, analyses or opinions or their use. Past performance does not guarantee future results. Before making any investment decision, consider if the investment is suitable for you by referencing your own financial position, investment objectives, and risk profile. Always consult with your financial advisor before investing.

22 West Washington Street
Chicago, IL 60602 USA

©2020 Morningstar. All Rights Reserved.