The Case for Dividend paying Common Stocks in an Inflationary Environment

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When asked where best to invest in an inflationary environment, the common investor typically responds with “real estate’ or “gold.” But, there are reasons to considering investing in a high-quality dividend paying stocks in anticipation of an inflationary environment. Those reasons would include accounting, growth, savings’ strategies and capital structure.

Accounting

The Board of Governors of the Federal Reserve Bank defines inflation as, “a general increase in the overall price level of the goods and services in the economy.[1]” To understand this from an accounting perspective, let’s consider a hypothetical statement of cash flow (see below).

[1] Board of Governors of the Federal Reserve Bank (https://www.federalreserve.gov/faqs/economy_14419.htm)

Statement of Income		
Year	20XX	20X1
Revenues	$ 10,000,000	$ 10,400,000
Costs	$ 9,000,000	$ 9,360,000
Pre-tax Profits	$ 1,000,000	$ 1,040,000
Taxes (34%)	$ 340,000	$ 353,600
Profit (After-tax)	$ 660,000	$ 686,400
Dividend (30% pay out)	$ 198,000	$ 205,920
Retained earnings	$ 462,000	$ 480,480
Rate of Inflation (π^e)	4%	
Shares outstanding	200,000	200,000
Stock Price	$ 39.60	$ 41.18
Dividend	$ 0.9900	$ 1.0296
Dividend Yield	2.50%	2.50%
P/E Ratio	12	12 [2]

Our hypothetical company is operating in a 4%, year-over-year, inflationary environment. It has issued and has outstanding 200,000 shares of its stock and has a dividend payout policy of 30% of net income to the common stock holders, thus it reinvests 70% (the plowback or retained earnings) of net income into the company. The company is paying a 2.5% dividend yield on its common stock in year 20XX.

Using the Federal Reserve's definition of inflation, both the product prices of our hypothetical company and the materials and associated operating costs rise 4%. As a result, the net income too increased at the rate of inflation and consequently so does the dividend paid to the common stock holders, so long as the company sticks to a dividend payout policy of 30% of net income. If the price of the stock remains unchanged, the dividend yield on the stock would rise from 2.5% to 2.6% and the P/E ratio would constrict from 12 times to 11.53 times. Absent any fundamental changes in the company, this likely would not occur but rather, as expected, one would see a corresponding gain in the stock price

[2] Graphic created by the author. This illustration is hypothetical and shown for illustrative purposes only. The illustration is not intended to predict the returns of any particular investment, which fluctuate with market conditions. Actual results may differ from those depicted in the illustration

maintain the dividend yield of 2.5% and P/E ratio of 12 times earnings. Thus, the stock of company should, in the least, keep pace with inflation.

Growth

Most companies are not content to simply keep pace with inflation, or the growth of the general economy for that matter. Let's assume that our hypothetical company is not only keeping up with inflation but also growing itself another 2% per year. Let's revisit the statement of income under these assumptions (see below).

Statement of Income		
Year	20XX	20X1
Revenues	$10,000,000	$10,600,000
Costs	$ 9,000,000	$ 9,540,000
Pre-tax Profits	$ 1,000,000	$ 1,060,000
Taxes (34%)	$ 340,000	$ 360,400
Profit (After-tax)	$ 660,000	$ 699,600
Dividend (30% pay out)	$ 198,000	$ 209,880
Retained earnings	$ 462,000	$ 489,720
Rate of Inflation (π^e)	4%	
Rate of Growth	2%	
Shares outstanding	200,000	200,000
Stock Price	$ 39.60	$ 41.98
Dividend	$ 0.9900	$ 1.0494
Dividend Yield	2.50%	2.50%
P/E Ratio	12	12

[2]

Again, as expected, with the dividend payout policy remaining unchanged, the market value of the stock would rise at the rate of inflation plus the growth. If stock price remained unchanged, the dividend yield on the stock would go from 2.5% to 2.65% and the P/E ratio would be reduced to 11.32

times earnings. This is not likely to occur but rather, as expected, the price of the stock would increase so that traditional dividend yields and P/E ratios remained in line.

Savings Strategies

A natural reaction to rising costs is to finds ways to reduce expenses. This would be true in the case of production and operating costs rising as a result of inflation. Reducing frills, rationalizing product lines, not replacing workers that quit or even an outright reduction in the company workforce (RIF). Let's assume that our hypothetical company is successful in reducing costs by 2% in a 4% inflationary environment. This would slow the total effect of rising costs from 4% to 1.96% (1 plus the rate of inflation divided by 1 plus the rate of savings). Let's see how this affects our hypothetical company that is also trying to grow itself at 2% per year.

Statement of Income		
Year	20XX	20X1
Revenues	$10,000,000	$10,600,000
Costs	$ 9,000,000	$ 9,352,941
Pre-tax Profits	$ 1,000,000	$ 1,247,059
Taxes (34%)	$ 340,000	$ 424,000
Profit (After-tax)	$ 660,000	$ 823,059
Dividend (30% pay out)	$ 198,000	$ 246,918
Retained earnings	$ 462,000	$ 576,141
Rate of Inflation (π^e)	4%	
Rate of Growth	2%	
Rate of Savings	2%	
Shares outstanding	200,000	200,000
Stock Price	$ 39.60	$ 49.38
Dividend	$ 0.9900	$ 1.2346
Dividend Yield	2.50%	2.50%
P/E Ratio	12	12 [2]

As expected, we get a significant increase in the dividend as well as in the price of the stock. The dividend increase 24.46¢ per share and the price of the stock increases almost $10.oo per share.

Capital Structure

The previous three sections focused on how inflation can positively affect the equity of a company, particularly if it is committed to growth beyond inflation and cost savings. However, while the equity of the company is increasing nominally, its debt, to whatever extent is has any, is being eroded by the effects of inflation. Therefore, simultaneously, the equity is increasing in value while the debt is worth less and less in real terms so the capital structure (debt to equity) is favoring equity. The company is, by virtue of inflation, improving its debt-to-equity ratio.

Conclusion

High-quality dividend paying stocks deserve strong consideration for investment in an inflationary environment.

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