Investment Strategy

The dividend trap

Mutual funds give back investors' own money unlike companies, which distribute profit

Investors fancy companies distributing high dividends. Dividend is an additional incentive apart from capital appreciation. Dividend is generally part of profit shared by the company with its shareholders. Also, dividend is tax-free in the hands of investors. Though yield from dividend is generally not as attractive as yield from fixed income options like fixed deposits and bonds, high dividend paying stocks are always on investors' radar.

Dividend yield is calculated by taking the percentage return investors can fetch through dividends. Capital appreciation is ignored. For instance, company ABC with face value Rs 10, trading at Rs 20, proposes to pay a dividend of 15%. The dividend yield is 1.5 x 100/20, that is, 7.5%. Here the appreciation or deprecation in the market value of the share is totally ignored.

For mutual funds, dividends can be the cherry on the cake but hardly making any difference to the overall taste of the cake. Like in equity shares, dividends from mutual funds are announced in advance. Many mutual fund distributors use the dividend announcement to push investments in such funds. Often mutual fund agents calculate dividend yield of the scheme and trap retail investors, who fall to the bait very easily. For instance, if a fund with NAV of a Rs 25 announces dividend of 30%, it is portrayed that the fund gives a dividend yield of 12%. As dividends from mutual funds are tax-free, a yield of 12% post-tax looks very attractive.

Investors may not be aware that it is their own money that the mutual fund gives back as dividend. This is because the NAV of the fund declines in line with the dividend amount after the record date. Thus, in the above example, the NAV of the fund will drop by Rs 3 post the record date of the

Dividend option in debt funds for the short term

dividend. So if the market movement is ignored, the investor will get Rs 3 as dividend but will suffer a loss on NAV by Rs 3. If an investors invests at an NAV of Rs 25, the value of his holding after dividend is declared will be the same. He will gets Rs 3 in cash on account of dividend but the basic NAV of the investment will fall to Rs 22. Also, it is not necessary that the investor gets dividend when the mutual fund scheme has made profit. For instance, in the above case, an investor who had invested at an NAV of Rs 26 will also receive a dividend even though there is a marked-to-market loss of Re 1 per unit in the fund.

Moreover, the NAV will decline only for investors who have chosen the dividend option. The NAV of the growth option of the same fund remains at Rs 25. Thus, dividend from mutual funds is like redeeming part of your own fund. Also, future growth prospects are lowered in the dividend payout option. For instance, if the fund gives a return of 10% over the next one year from the date of dividend, then the NAV of the fund under the dividend option will be Rs 24.2 (22+ (22 x 10%)). Assuming that the dividend received is not reinvested, the net gain from the investment is Rs 2.2, i.e., a loss of Rs 0.8 on the NAV and gain of Rs 3 on account of the dividend. On the other hand, investors who opt for the growth option end up with a net gain of Rs 2.5, which is on account of capital appreciation as the fund has given a return of 10%.

Sacrificing growth

Dividend payouts restrict long-term growth of NAVs of mutual funds

FUND NAME	NAV GROWTH OPTION (Rs)	NAV DIVIDEND OPTION (RS)
HDFC Equity Fund	251.50	38.62
Reliance Growth Fund	411.09	44.77
DSP Blackrock Top 100	95.50	19.20
ICICI Dynamic Plan	102.80	16.86
Franklin India Prima Plus	211.29	22.94
Birla Sun Life Equity	227.74	57.37
Sundaram Select Midcap	139.30	15.77

Mutual fund agents sell funds with lower NAV to attract investors. They give a wrong impression that funds with lower NAV are available cheap. In fact, NAV has nothing to do with the valuation of the fund as NAV always depict the book value of the units. It is the value an investor will get for one unit if the fund is liquidated on that day. Also, frequent dividends restrict the growth of NAV. If dividends are ignored, there will be no difference in the return of the growth option and the dividend option of a scheme.

Similarly, if there is a marked-to-market loss in the NAV, investors who opt for the dividend option lose less money than investors who opt for the growth option. Over a longer run, however, equities tend to give a decent positive return. Thus, it is better to opt for the growth option as regular dividend may not allow the corpus to build over a period of time.

Choosing the dividend option in debt funds may prove beneficial when the investment is for less than a year. Short-term gain from debt funds is added in the investors' income and is taxed at the rate applicable. Dividend from debt funds (other than liquid funds) are tax-free in the hands of investors but are subject to a dividend distribution tax of 12.5% plus applicable surcharge. Thus, investors falling in the 20% or 30% tax bracket should opt for the dividend option if the investment horizon in the debt fund is less than one year. For others, growth is always a better option.

— Rahul Mantri