INVESTOR CLINIC

The powerful dividend benefit nobody talks about

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In every introductory psychology course, students learn about a concept called operant conditioning. In its simplest terms, the theory holds that behaviours are shaped by the consequences they produce.

The most familiar form of operant conditioning is called positive reinforcement. When a rat presses a lever that releases a piece of cheese, or a hockey player puts in a gritty shift that earns a pat on the back from the coach, the behaviours are more likely to be repeated because they've been rewarded by a pleasurable response.

I've long believed that a similar behavioural dynamic is at play with dividend investing. I also believe it helps to explain why many dividend investors, despite not always earning the highest returns in any given year, are able to ride out periods of extreme volatility and achieve excellent long-term results.

Most discussions of dividend investing don't delve into the psychological and emotional benefits of the strategy, which I'll elaborate on in a moment. Instead, investors typically focus on the more tangible benefits – for example, that dividends are taxed favourably, generate extra cash flow in retirement and are often a sign of a strong, profitable company. The last point is especially true when the dividend grows year after year along with the company's cash flow, out of which dividends are paid.

These are all valid reasons to own dividend stocks. But some criticisms of dividends are also valid. For example, it's true that dividends, per se, don't actually create wealth. Rather, they simply transfer cash from a company's balance sheet to the investor's account. All else being equal, when a $1 dividend is paid, the stock price should fall by $1, so the investor is no further ahead. The drop in the stock price rarely matches the dividend exactly, because myriad other forces also affect stock prices.

So, if receiving a dividend doesn't actually make you richer, what is the point? I would argue that a dividend makes you feel richer, which is what matters from a behavioural standpoint.

Let me provide a recent example from my own experience.

During the market turmoil triggered by U.S. President Donald Trump's erratic tariff policies, investors never knew if the market would rally or plunge from one day, or even hour, to the next. Based on the magnitude of the market's ups and downs, it was clear that many investors were selling out of fear, only to rush back in when the market rebounded. This kind of in-and-out trading can be hazardous to one's financial – not to mention emotional – health.

Me? I just watched my dividends come in.

Even during the volatile months of February, March and April, I got "paid" by more than 20 different companies, including banks, utilities, power producers, real estate investment trusts, pipelines and consumer companies. Several exchange-traded funds were also nice enough to send me cash while global markets were coming unglued. These dividend payments were a reminder that, for all the economic turmoil sweeping the globe, the businesses I own were still making money – and sharing it with me.

To extend the hockey analogy, it was as if an invisible investing coach was giving me a monetary pat on the back for sticking with my investing plan. Or, if you prefer the rat analogy, I received a steady flow of cheddar as a reward for not pressing the "sell" lever.

It didn't hurt that many of the companies I own, both personally and in my model Yield Hog Dividend Growth Portfolio, also raised their dividends in the past few months. They included Telus Corp.

The psychological and behavioural benefits of dividends don't end there. With money in general, people often engage in "mental accounting." As an example, some investors are reluctant to sell a losing stock because they are determined to wait for a rebound so they can "break even." This form of mental accounting can be counterproductive – hanging on to a troubled company could lead to further losses – but in other ways, mental accounting can be beneficial.

With dividends, many investors mentally segregate their wealth into two different accounts – one for their capital (stocks) and the other for their income (dividends). This leads them to treat their dividend cash flow as suitable for spending, while leaving their capital untouched so it continues to grow. This form of mental accounting enforces a discipline that prevents investors from running down their savings.

This is not a new idea. In their influential 1984 paper, Explaining Investor Preference for Cash Dividends, Hersh Shefrin and Meir Statman observed that "money is not treated as a homogeneous item. It can be treated in a variety of ways depending on its source, or the use to which it will be put."

"Consequently, an individual who wishes to safeguard long-run wealth against a compulsion for immediate gratification might employ a rule that prohibits spending from capital. Such an individual may be better off by allowing current consumption to be determined by the dividend payout from his stock portfolio."

Not everyone has the luxury of leaving their capital untouched. But for those who don't need to sell assets, the mental segregation of capital and dividends provides a method of self-control that allows investors to satisfy their spending needs without the emotional discomfort associated with selling shares.

Dividends aren't perfect. Many dividend-paying companies are mature, slow-growing enterprises. What's more, the total returns of many dividend stocks have badly lagged other sectors, such as technology, that pay little or no dividends. That's why I believe dividend investors should diversify with index funds that provide exposure to higher-growth sectors.

But when it comes to reinforcing buy-and-hold behaviour and helping to control one's emotions, dividend stocks are hard to beat.