

# The cult of dividend investing faces a crisis of faith



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Ever since interest rates began rising from near-zero three years ago, dividend-paying stocks have fallen short.

What for decades was viewed by legions of investors as a sure thing has faltered in an era of higher rates. The dividend faithful are left to wonder if this is the end of a golden era, or just an interruption before the inevitable comeback.

Or maybe this is a good opportunity to start thinking about dividends in an entirely different way, one in which investors don't obsess over them slavishly.

For many years, finance academics have been trying to convince investors that dividends don't matter. That they are a distraction. An illusion.

"This is one of the most controversial topics in personal finance," said Benjamin Felix, chief investment officer at PWL Capital Inc.

"There is no credible theory or evidence supporting dividends as an investment strategy. But the psychology behind it is just so powerful."

Weather market storms with these stable dividend stocks

Dividends can seem like free money. It's easy to see the appeal of receiving a cheque every month just for owning a company's shares, especially for those who need the income, like retirees.

But there's a tradeoff when a company sends cash your way. That money comes off the balance sheet, reducing the value of the company, and its stock, by an equivalent amount.

It can be difficult to perceive the negative effect of dividends on share price, because stocks bounce around all the time for all kinds of reasons. But it's there, by definition.

Receiving a dividend has the same effect as selling some of your shares. Many investors fail to grasp that some of their capital has simply been returned to them.

“Investors rarely reinvest dividends, and trade as if dividends are a separate, stable income stream,” a pair of researchers from the University of Chicago and Boston College wrote in a 2018 paper called *The Dividend Disconnect*.

A dividend doesn’t magically create any value. The net effect should be zero.

Why, then, are so many investors attuned to the siren call of the dividend? Many of them would say the proof is in the performance.

For a few decades or so, dividend stocks in Canada paid off handsomely. Benchmarks like the Dow Jones Canada Select Dividend Index easily outperformed the broader Canadian stock market.

Five dividend-paying stocks with activist investors’ attention

Going back to 1977, an investment in high-yielding Canadian equities would have grown to more than four times the same amount of money parked in the TSX, according to data compiled by Norman Rothery, founder of *StingyInvestor.com*.

No wonder so many Canadian investors have flocked to dividend-paying securities. With a track record like that, who cares what the academics say?

Unless that performance has nothing to do with dividends themselves. This is exactly what numerous studies have shown. Dividend stocks have beaten the market because many of them are value stocks or defensive stocks in disguise – what are known in investing jargon as “factors.”

“The outperformance can be entirely explained by a set of common quant factors,” researchers from Boston-based wealth management firm NVDR wrote in a recent paper in the *Journal of Asset Management*.

You would be better off scouring for companies with those characteristics, whether or not they pay dividends. “Using dividends to pick stocks simply does not make sense,” Mr. Felix said.

It also hasn’t really worked for the past few years. The Dow Jones Canada Select Dividend Index has badly trailed the Canadian stock market since early 2022, when the Bank of Canada started raising interest rates to rein in runaway inflation.

The powerful dividend benefit nobody talks about

“The inconvenient truth for anyone managing or investing in dividend-focused strategies is that all those years of falling yields and steady or relentless inflows were the golden age,” Craig Basinger, chief market strategist at Purpose Investments, wrote in a note.

“It helped support dividend payers in times of trouble, made capital for these companies relatively cheap and easy to access.”

The game has changed. Higher interest rates have made it more costly for companies to borrow and carry debt. And many dividend payers happen to be highly leveraged.

There is much more divergence between dividend-focused investment funds this decade so far, Mr. Basinger said. In an ultralow-interest-rate world, pretty much all of them did well. Investors didn't need to be picky. Now some are performing and some aren't.

Blindly chasing dividends is no longer paying off as it did for so long.

But to a core contingent of Canadian dividend diehards, this is always going to come across as heresy.