Trading the Dividend Seasons

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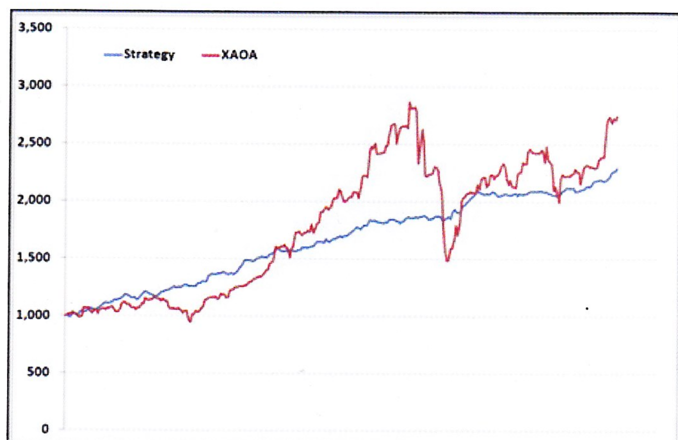
It's well known that share prices tend to move upward ahead of their respective dividend dates. Under the right circumstances this bias offers a great opportunity for earning some extra income.

As an example, take a look at the following Bank of Queensland (BOQ) chart. Each arrow denotes the ex-dividend date and as at writing we have another dividend coming up in late November. There are two points of interest here. Firstly, the share prices exhibits upside strength ahead of the ex-dividend dates. Secondly, after that time prices decline by some degree or move sideways.

Now it's important to understand that not every stock will travel this journey, and in certain market environments this is not a pattern worthy of trading. However, our research based on 15 years of price and dividend data across the ASX-20 universe shows a definite upside bias of around 63%. This may not sound like a lot, but a small edge like this, coupled with sound risk management, allows some nice profits to be generated.

The following chart shows a non-compounded view versus the growth of the All Ordinaries Accumulation Index (XAOA). On first glance this may not look overly appealing, but on closer inspection we can see some benefits. Firstly, the growth in equity is low in volatility providing a very pallatable and low stress journey. That said, one can soup up the outcome by using leverage. Next, there is very minimal exposure to the market itself. We're only interested in the month or so ahead of the major dividends and when they're not in season we stay in cash and in comfort.



There is a time and place for leverage and whilst it can generate large profits, it can also lead to large losses. That said, because of the low volatility and exposure of this strategy, coupled with the relative safety of the ASX-20 universe, we thought it appropriate to investigate the use of leverage and dividend momentum. Below is the non-compounded equity growth versus the XAOA using a Loan to Valuation Ratio (LVR) of 20%.

An important element of the strategy is how it avoided the GFC. This was simply because there was no momentum leading into the dividend date, and is an important reminder that one shouldn't buy a stock simply because a dividend is coming up. A capital loss exceeding the size of the dividend will send an account spiralling backward - exactly what happened to many investors during 2008.

These charts show a variety of interest rate and equity market environments that provide a solid test of the strategy's robustness. However, in the current environment of extremely low interest rates, is there a greater influence from this dividend bias? Our real time research suggests there is.

Since July 2013 there have been 30 possible trades within the ASX-20 universe. These trades must meet a certain momentum criterion and the company must exhibit a minimum 4% dividend, therefore, the likes of BHP and RIO do not make the cut.

Of these 30 trades, the success rate of a rise into the ex-dividend date is 80% - well above the long term average of 63%. The average profit is over three times the average loss which is also well above the long term average of 1.25. If we look at it from a total return basis, since July 2013 through October 2014, excluding compounding, leverage and interest earned on cash, the return has been 17.6% versus the XAO of 15.5%.

In summary, there is a definite and considerable edge to be found in the current low interest rate climate and I would suggest this bias will remain in place for some time yet. Even so, our research back to 2000 suggests this strategy offers a great vehicle for investors looking to add a little income to their existing portfolios.

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