QS Investors

COMMENTARY

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Know When to Hold Them: Dividend Sustainability

The Importance of High Sustainable Dividends

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Introduction

Investors tend to think of investing in stocks for capital appreciation. However, a closer look reveals that dividends can play a more important role than appreciation. In a 2003 article (i.), Rob Arnott showed that over a 200 year period, U.S. stocks provided an average annual return of 7.9%, with nearly two-thirds of that return coming from dividends! [2]

Dividends are a good thing for investors, and can provide important signals. Rob Arnott and Cliff Asness argued in a 2003 paper (ii.) that companies tend to pay out a higher proportion of their earnings when they are confident about the future, and these higher payout ratios also indicate that they choose their investments carefully. However, high dividend yields are not always better. Remember that dividend yield is calculated by dividing dividends by stock price. As a result, a company can have a high yield because it is reluctant to cut its dividend, even as its business is in distress and the stock price is falling. Companies that are able to sustain their dividends should be better performers. A 2006 research study by Pankaj Patel (iii.) confirms this intuition that a strong dividend policy coupled with high dividend sustainability leads to the strongest returns. These findings are consistent with our approach to Defensive Equity Income strategies, with both income and dividend sustainability playing key roles.

If investors have sometimes taken dividends for granted, they certainly are not doing so in today's environment of low bond yields. With yields on 10 year US Treasuries hovering around 2%, investors can earn comparable yields on an equity portfolio indexed to the S&P 500[3]. However, while interest on government bonds is backed by the full faith and credit of the United States, equity investors need to ask themselves if their dividends are sustainable. We look at a few different segments of the stock market to provide some perspective on this question.

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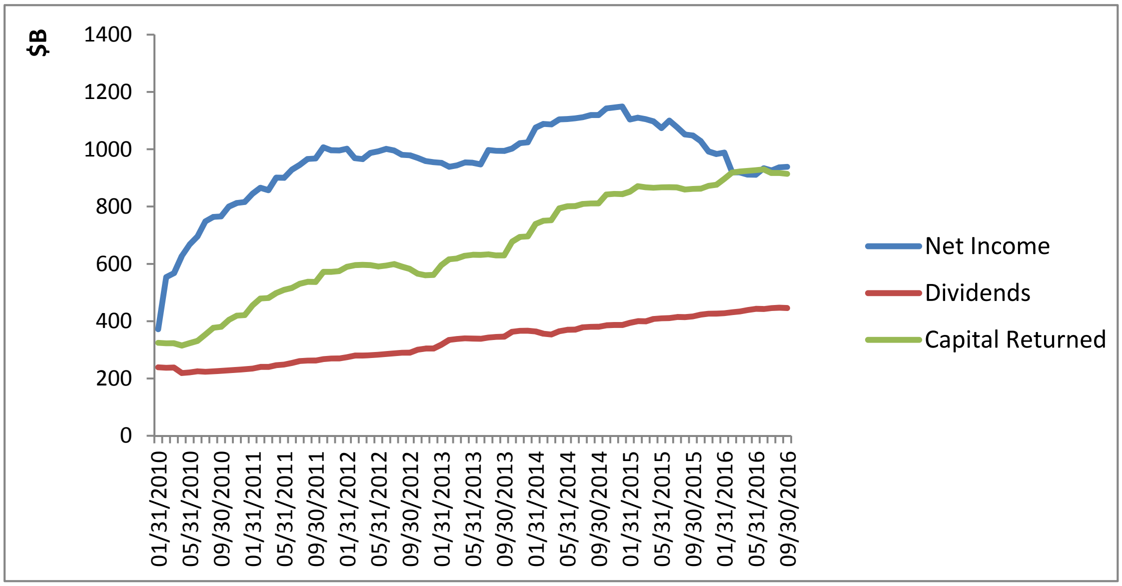
[2]If no dividends were spent, if no taxes were taken out, and if market returns were earned without fees or expenses.
[3]Source: Bloomberg.

US Equities

Figure 1, shows trailing 12 month net income, dividend payments, and total capital returned to shareholders (which includes dividends and share repurchases) for a diversified basket of large capitalization, US stocks (the Russell 1000 index).

Figure 1: US Large Cap Equities

January 2010 to September 2016



Source: Thomson Reuters Fundamentals: Russell 1000 Index (Net Income, Dividends & Capital Returned).

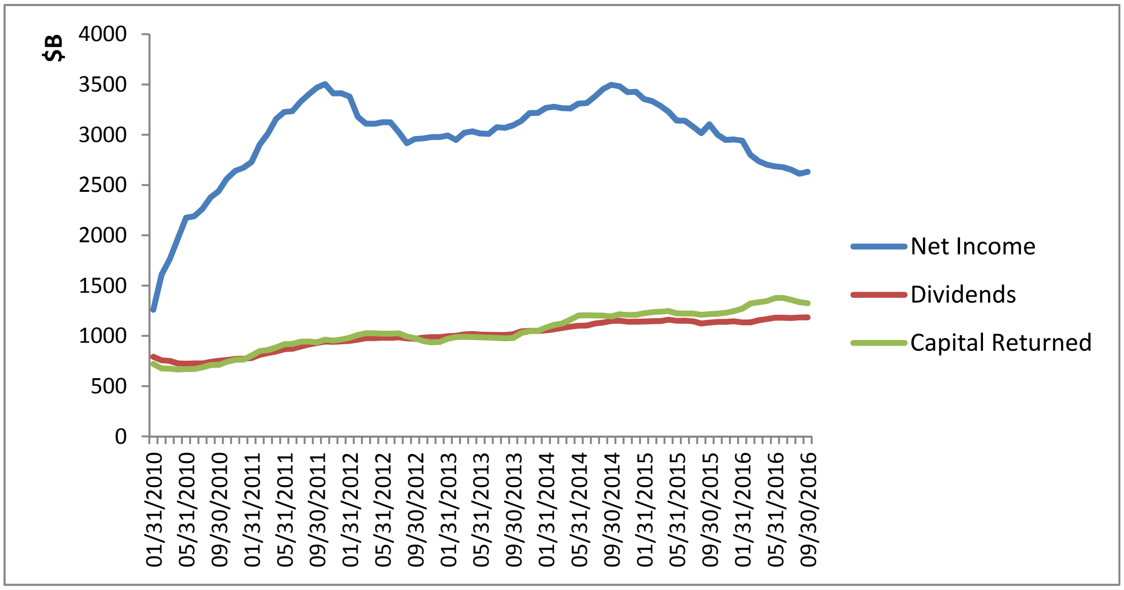
In Figure 1, Net income, dividends and share repurchases increased several years after the 2008 Global Financial Crisis. However, net income retreated over the last 18 months shown. While companies are still earning enough to support their dividends, further dividend growth will probably be constrained and firms will likely have to curtail their share repurchases unless we see a meaningful rebound in corporate earnings.

Global Equities

Figure 2, shows a similar picture for a diversified basket of global stocks (the S&P Global LargeMidCap Index).

Figure 2: Global Equities

January 2010 to September 2016

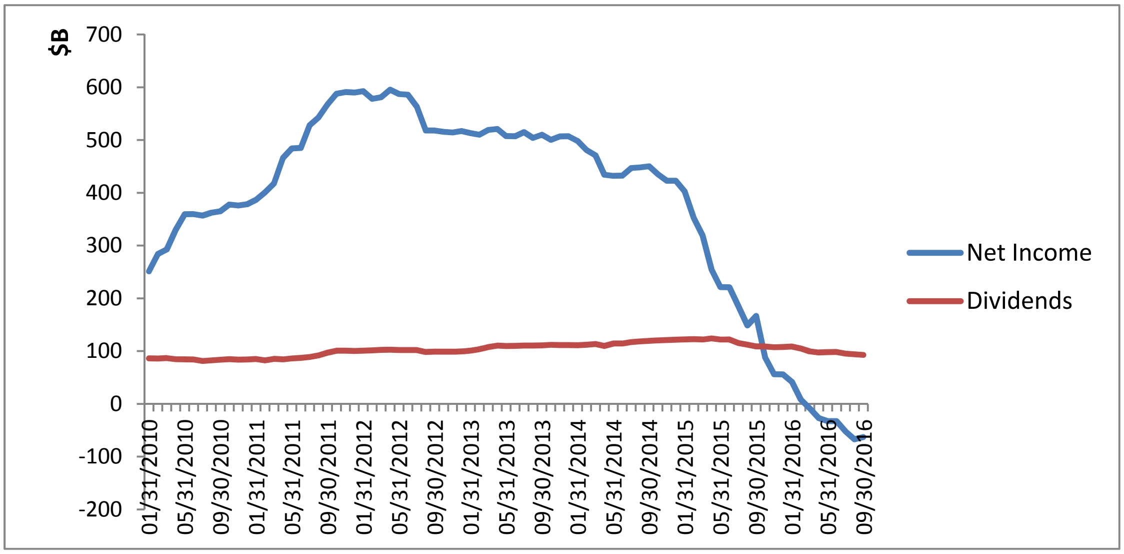


Source: Thomson Reuters Fundamentals: S&P Global LargeMidCap Index (Net Income, Dividends & Capital Returned).

This chart, when compared to figure 1, shows that stocks outside of the US are much less likely to repurchase shares. Otherwise, the conclusion holds that dividend sustainability will be difficult without a strong rebound in earnings.

We then ask if there are areas of particular concern to income-oriented investors. Figure 3 shows that dividend sustainability for global Energy stocks is much less encouraging than for the market as a whole.

Figure 3: Global Energy Stocks
January 2010 to September 2016

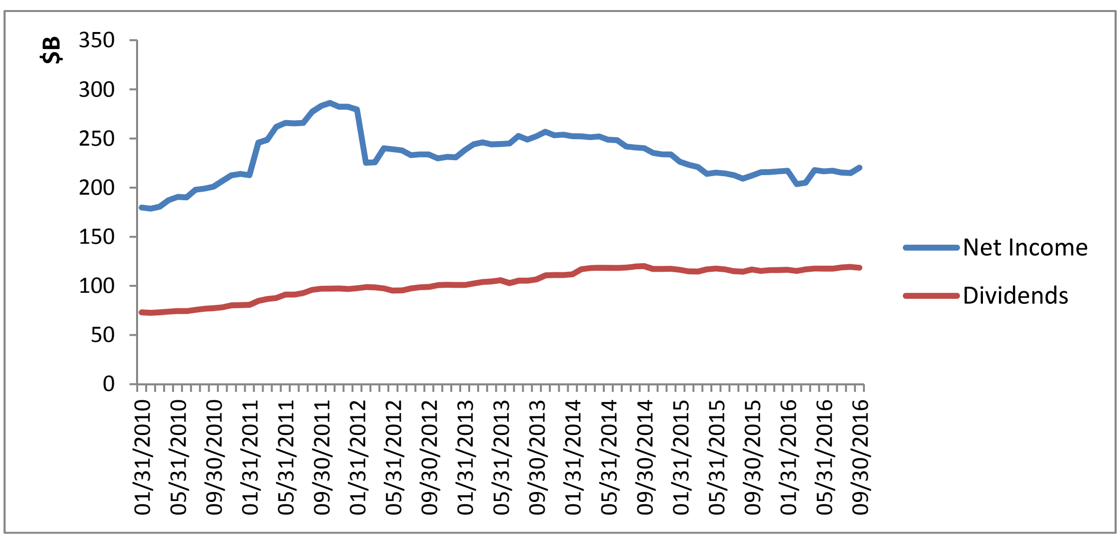


Source: Thomson Reuters Fundamentals: Energy Stocks in S&P Global LargeMidCap Index (Net Income & Dividends).

Energy company earnings have dropped precipitously along with the plunge in oil prices, and the sector is paying out more than it earned during the period, in aggregate. We believe Investors who are counting on dividends from energy stocks may benefit from being highly selective. Not surprisingly, our Defensive Equity Income portfolios tend to be underweight the Energy sector given this apparent problem with dividend sustainability.

Figure 4, shows a much different picture for stocks in the Consumer Staples sector.

Figure 4: Global Consumer Staples Stocks
January 2010 to September 2016



Source: Thomson Reuters Fundamentals: Consumer Staples Stocks in S&P Global LargeMidCap Index (Net Income & Dividends).

While earnings retreated in the Staples sector, the decline was much less severe than in other sectors. Earnings exceeded dividends by a wide margin, with Staples companies paying out roughly half of income as dividends, in aggregate. Any growth in earnings in this sector can support increased dividends, and we are able to find many stocks with strong dividends and the potential for dividend growth.

Investors are right to focus on stock dividends, for their long term contribution to return and because they are a strong alternative to fixed income in the current low interest rate environment. However, we believe that dividend sustainability is key, and can point the way to higher and less volatile returns. This belief is reflected in our approach to Defensive Equity Income investing.

Citations

i. Arnott, Robert. "Dividends and the Three Dwarfs", Financial Analysts Journal, 2003
ii. Arnott, R and Asness, C. "Surprise! Higher Dividends = Higher Earnings Growth", Financial Analysts Journal, 2003
iii. Patel, Pankaj. "High Yield, Low Payout", Evercore ISI research note, 8/15/2006

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