APRIL 2015

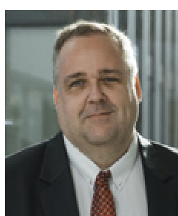
Danske Capital

Why dividend stocks are currently so interesting for portfolios

In an environment of extremely low bond yields, dividend stocks stand out as an interesting asset class with attractive yield and risk attributes.

KEY CONCEPTS

- Bond yields are at historically low levels. Dividend-paying stocks are currently an interesting asset class generating continuous income, with dividend yields now exceeding bond yields in many countries.
- The yield on dividend stocks is currently at a historically very high level vs. high yield and investment grade corporate bonds in both the US and Europe.
- Stocks with a high dividend yield have historically provided better risk attributes than stocks with no dividend.
- More retirees and greater longevity in the coming years will increase the demand for income products – a role previously fulfilled by fixed income.



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EXECUTIVE SUMMARY

Central bankers around the world have rewritten the rules of engagement in this post-crisis environment, manipulating interest rates to abnormally low levels. Bond yields are in many cases close to zero or even negative, and with large output gaps in many economies, high debt levels, fear of deflation, extreme liquidity levels in the global financial system and structural and geopolitical challenges plus aging populations across the globe, "normal times" are nowhere to be seen. In an environment like this, companies that pay substantial dividends may assume a greater importance for long-term investors.

A world of low returns

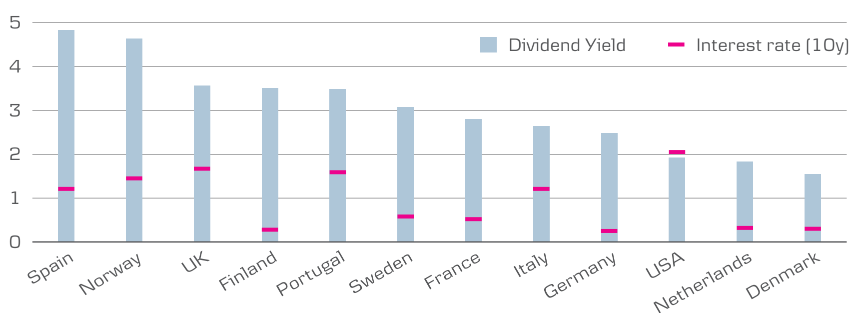
Investing is not what it used to be. According to a recent report from Research Affiliates, an investor who invested in a 60/40 portfolio (equities/bonds) in 1915 and continuously reinvested all cash flows for the next century earned an annual nominal return of 8.4%, composed of 10.3% on US equities and 5.6% on US bonds.

But as we all know history is no guarantee of the future – merely a guide and sometimes a misleading one at that. Take for example the period between 1965 and 1974. That was a difficult period for the 60/40 strategy, which generated a nominal annual return of just 2.3%. The poor return was related to high equity valuations and low bond yields at the beginning of the period.

Now, in 2015, we have a similar situation of high equity valuations and very low bond yields – in fact, even lower than they were in 1965. In view of the gloomy economic prospects on many fronts this could very likely presage a new era of low returns. Research Affiliates have their own view on this. According to their models, the expected return for the 60/40 portfolio over the next ten years is a meagre real 1.2% per year. Not everyone subscribes to this view, but it is hard to deny that the bond bull market in place since 1981 appears to be ending. In the search for yield one particular asset class currently stands out – dividend-paying stocks.

CHART 1: Attractive dividend yields in Europe

Dividend yields vs. interest rates on 10-year government bonds.



Past performance is not an indication of future results.
Source: Danske Capital and FactSet, as of 17.03.2015.

Companies that can most easily afford to maintain a high dividend payout ratio tend to be established, mature firms with consistent revenues that are not particularly sensitive to economic cycles. Many companies in sectors like utilities, ***telecommunications*** *and consumer staples are known to consistently offer relatively high dividend payout ratios.*

Dividends constitute a large share of the return on equities

But how large a role have dividends actually played over time in return on equities? There are a number of studies on this subject. Robert D. Arnott, the founder of Research Affiliates, has provided the lengthiest study, published in the Financial Analysts Journal in 2003. Arnott pointed out that from 1802 to 2002 dividends were by far the main source of return from equities, dwarfing the other constituents, which included inflation, rising valuation and real dividend growth. From 1802 to 2002, the average annual return from equities was 7.9%, which broke down as follows: 5.0% from dividends, 1.4% from inflation, 0.8% from real dividend growth and 0.6% from rising valuations.

Professors Elroy, Dimson and Marsh at London Business School make a similar point in their study of dividends published in the Credit Suisse Annual Yearbook 2011. An investor entering the US stock market in 1900 with a particular amount would by the end of 2010 have seen an annualised gain of 5%. However, including reinvested dividends the annualised return would amount to 9.4%.

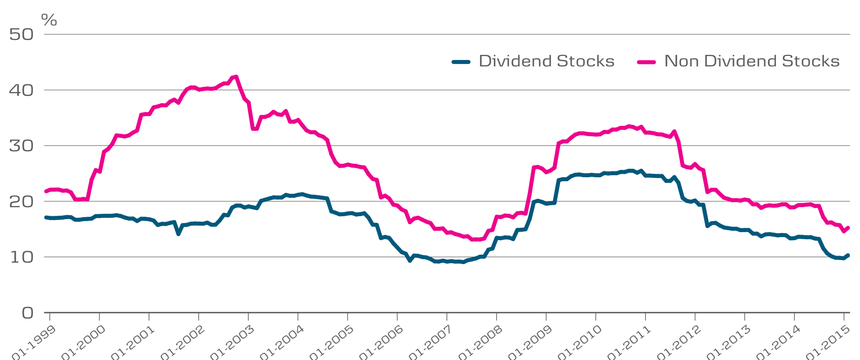
The same point holds for all markets around the world. As the professors put it, "for the seriously long-term investor, the value of a portfolio corresponds closely to the present value of its dividends".

Dividend stocks carry less risk and provide stronger downside protection

It is commonly expected that attractive returns come at a price in the form of higher risk. However, this is not the case with high dividend stocks. Stocks with high dividend yields have historically provided better risk attributes than stocks with no dividend – including lower volatility and stronger downside protection in declining markets. The standard deviation of returns on high dividend stocks has been significantly lower than the standard deviation of stocks not paying a dividend over various long-term periods.

CHART 2: Dividend-paying stocks tend to be less volatile

36-month rolling standard deviation of returns on European dividend-paying companies and non-dividend paying companies[1].



Note: [1] Among the 1000 largest stocks, monthly, equally weighted. Source: Danske Capital and FactSet, as of 30.01.2015. Past performance is not an indication of future results.

According to a 2014 report by Henderson Global Investors ***North American companies contribute 37% of total global dividend pay-outs****, European companies contribute 33%, Japanese 5%, Asia-Pacific companies 11%, while companies primarily listed in the Emerging Markets contribute 14%.*

Even more attractive has been the downside protection. According to a study conducted by International/Global Equity Funds, a member of Deutsche Bank Group, high dividend stocks have since 1927 held up better than the broader market during downturns. In fact, the downside capture ratio of high dividend stocks has been 81% or lower over various long-term periods. In other words, during months when the S&P 500 Index declined, high dividend stocks declined by nearly 19% less than the broader market.

The steady income from stable dividend-paying companies offers a measure of protection to investors against capital losses. Furthermore, companies with a consistent dividend policy are often higher quality, defensive companies with stable earnings. Given these defensive qualities, it is no surprise that dividend stocks tend to outperform in markets with moderate or falling returns or lower growth environments, where they can make all the difference to total returns.

More surprising is the evidence that suggests dividend stocks do not necessarily underperform in bull markets. A study conducted by Fidelity shows that in the last 10 bull markets, US dividend-paying stocks outperformed their non-dividend-paying counterparts by over 3% a year on average. Fidelity suggests that a plausible explanation is behavioural; dividend-paying stocks are less likely to be overvalued than non-dividend payers. The latter category includes "growth" stocks, which tend to be more prone to excessive levels of investor optimism.

High dividend stocks provide better yield than bonds

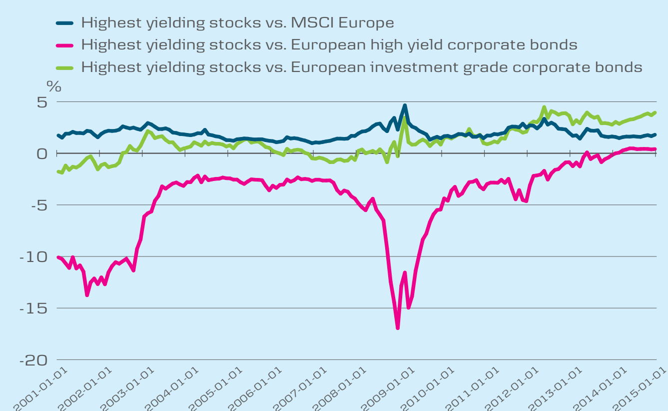
In the current low interest rate environment another factor is drawing attention to high dividend stocks. High dividend stocks provide better yield than government bonds in many countries and the current valuation of high-dividend-yield stocks compared to corporate bonds is attractive. The current yield spread for high dividend stocks vs. high yield and investment grade corporate bonds is at a very high level in both the US and Europe.

We took a closer look at the 200 highest yielding stocks among the 1000 largest stocks domiciled in, respectively, developed Europe and the US since 2001.

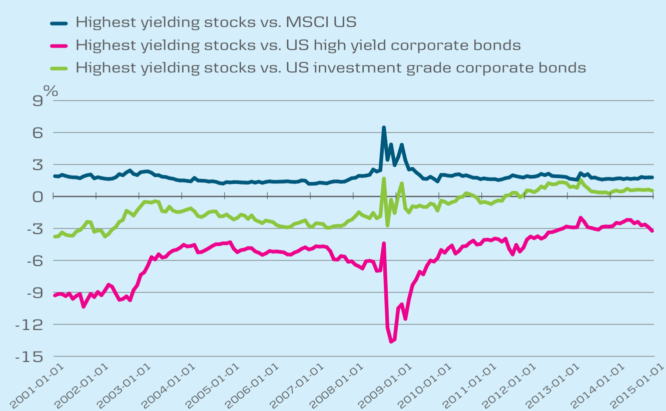
In the European market, high dividend stocks actually have a higher direct return than high yield corporate bonds, and the yield spread for high dividend stocks vs. bonds is at the highest level in the analyzed period since 2001. In the US, the yield spread vs. high yield and investment grade bonds is also at a very high level, although it has been declining slightly recently.

CHART 3: Valuation of high-dividend-yield stocks compared to corporate bonds and the broader stock market

EUROPE: Yield spread on 200 highest yielding dividend stocks vs. European corporate bonds and the broader MSCI Europe stock index. High dividend stocks actually now have a higher direct return than even high yield corporate bonds



US: Yield spread on 200 highest yielding dividend stocks vs. US corporate bonds and the broader MSCI US stock index. In the US, high yield corporate bonds still provide a higher direct return than high dividend stocks.



Note: The yield of the 200 highest yielding stocks (equally weighted) among the 1000 largest stocks domiciled in, respectively, developed Europe and the US in recent decades, compared with, respectively, the yield on MSCI Europe and European corporate bonds, and the yield on MSCI USA and American corporate bonds. Source: Danske Capital as of 31.12.2014. Past performance is not an indication of future results.

Relative to the dividend yield of the broader equity markets, as defined by MSCI Europe and MSCI US, the additional yield on high dividend stocks is at present close to the average for the years since 2001 both in Europe and in the US.

It should be noted that the buyback yield is higher in the US than in Europe, as American companies favour buying back stocks more than their European counterparts. Our analysis focuses only on the direct yield received by shareholders and not on the effect of buybacks. If buybacks were to be included, the US would look relatively better.

Valuation vs. other equities

We have also looked at the valuation of high dividend stocks vs. the broader equity market using three measures: Price-to-Book Ratio, Price-Earnings Ratio and Price-to-Cash-Flow. We looked at the history of these numbers for the 200 highest yielding stocks vs. the 1000 largest stocks (including the high dividend stocks and also equally weighed returns) since 1990 in, respectively, developed Europe and the US.

Even though spreads have narrowed since 2000, high dividend stocks are still cheaper than the broader market on all three measures in both Europe and the US.

However, it would seem relevant to take a closer look at developments since March 2009, when the stock market bottomed out. Since 2009 interest rates have remained at very low levels. One might expect that investors in the difficult search for yield would increasingly have turned their attention to high yield stocks, but the valuation measures for that specific time frame suggest that this is not the case.

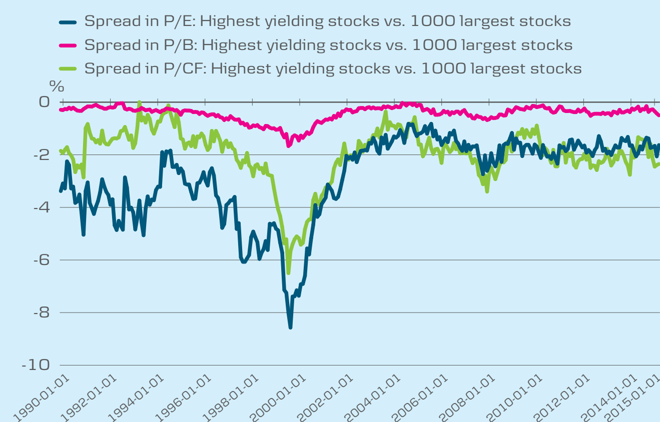
According to our calculations, the P/E spread for Europe is close to the average since March 2009 and both the P/B and P/CF spread is close to the highest levels in that period – indicating that European high yield stocks currently are reasonably priced compared to the broader stock market.

As far as the US market is concerned, all three valuation measures are quite close to the average since March 2009 – another indication that the hunt for yield in a world of abnormally low interest rates has not resulted in a demand for high yield stocks that has made them pricey compared to the broader market.

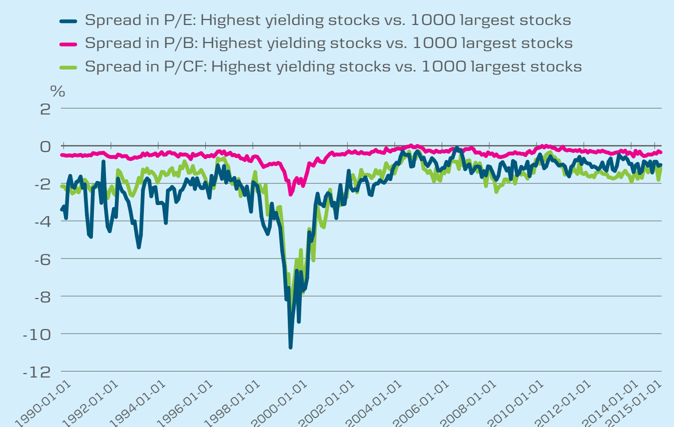
Having said all that investors should also bear in mind that if we enter a scenario of rising interest rates, there is a risk that dividend stocks could underperform the broader stock market.

CHART 4: Dividend stocks are still cheaper than the broader stock market...

EUROPE: Spread in valuation measures on 200 highest yielding dividend stocks vs. 1000 largest stocks in Europe. The larger the spread in negative numbers, the cheaper the high dividend stocks are compared to the broader market.



US: Spread in valuation measures on 200 highest yielding dividend stocks vs. 1000 largest stocks in the US. The larger the spread in negative numbers, the cheaper the high dividend stocks are compared to the broader market.



Note: We looked at the history of three risk measures - Price-Earnings Ratio (P/E), Price-to-Book Ratio (P/B) and Price-to-Cash-Flow (P/CF) - for the 200 highest yielding stocks (equally weighted) vs. the 1000 largest stocks (including the high dividend stocks) in, respectively, developed Europe and the US.
Source: Danske Capital as of 31.12.2014. Past performance is not an indication of future results.

More retirees will increase the demand for dividend stocks

Looking forward, another factor is worth taking into consideration regarding high dividend stocks. Demographic trends are a powerful force on economic and investor behaviour, and average life expectancies have increased markedly in the last fifty years. Individuals being born in developed nations now can expect to live well into their 80s on average – in fact two thirds of today's newborns can expect to live to be a 100 years old according to recent estimates.

However, the coming decades will see a significant demographic shift in the world, particularly in the developed countries. The influential "baby boomer" generation is now moving towards retirement, and according to estimates by the UN the total global retirement population will surge from 800 million in 2011 to 2 billion by 2050.

People living longer means they will require income streams that can support them for longer. This is forcing a major reassessment of how much capital/income pensioners need in retirement.

Greater longevity not only increases the need for retirement income, it also requires a material change in how people save for retirement. Retirement portfolios need to provide stable income streams for retirements that can last over thirty years – and to this we must add that pensioners nowadays are more active in retirement and have higher expectations with regard to living standards.

With an increasing number of baby boomers (born 1946-1964) retiring every day, demand for current income products is expected to increase in the years ahead. In the past, these investors relied overwhelmingly on fixed income, but as the yields on most of these products are insignificant we should expect to see a higher demand for dividend stocks.

CONCLUSION

Healthy companies with consistent high dividend payouts deliver attractive returns in the long run and have historically provided better risk attributes than stocks with no dividend – including lower volatility and stronger downside protection in declining markets.

Dividend stocks provide better yield than government bonds in many countries. The current valuation of high dividend stocks compared to corporate bonds is interesting. The current yield spread for high dividend stocks vs. high yield and investment grade corporate bonds is at a high level in both the US and Europe.

The prospects for dividend stocks in the coming years appear interesting, supported by the increased demand for income assets by aging populations and also the lack of alternatives offering attractive yields in a low growth world with abnormally low interest rates.