Instant Insights

Dividend investing

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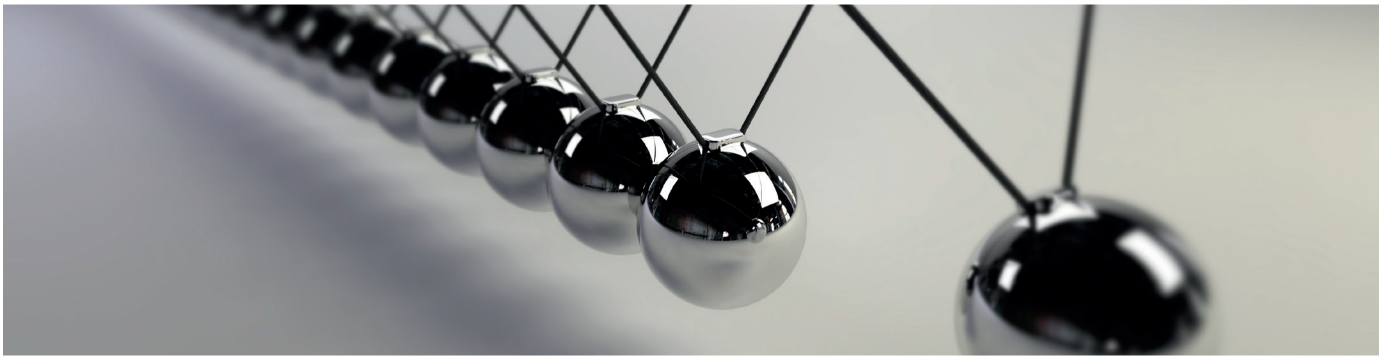

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Idea in brief: dividend investing

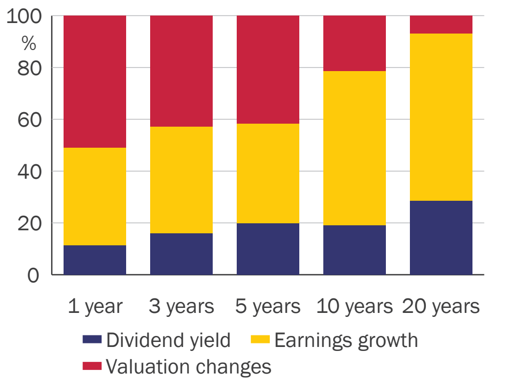
Navigating a negative yielding environment
In a low-yielding environment, understanding how to invest in dividend-yielding companies is increasingly relevant.

The power of dividends
Dividends can represent a significant portion of total equity returns, especially for longer investment horizons.

Beware of the highest dividend yield
High, but not the highest, dividend yielding companies with low pay-out ratios have historically seen higher risk-adjusted performance.[2,3,4]

Figure 1: Dividends are a key driver of long-term equity returns

Decomposing global equity returns over different time horizons



Source: MSCI Research, decomposition of MSCI ACWI Index total return, analysis over period Dec 1994 to Sep 2015, Rothschild & Co

When the Dutch East India Company in 1610 paid a dividend, it was the first time a publicly listed company distributed wealth to investors in this form.[1] More than 400 years later, dividends have become an integral part of modern investors' portfolios.

Rewards for capital and trust

A company can distribute a share of its profits or retained earnings to investors in a number of ways, mainly via cash dividends or additional shares. The most common form of distribution to shareholders – and the one we focus on in this edition of *Instant Insights* – is the cash dividend with the dividend yield calculated as below:

$$\text{Dividend yield} = \frac{\textit{Annual Dividend per Share}}{\textit{Stock Price per Share}} \times 100$$

The power of dividends

The benefits of dividends are plentiful and reflected in their pivotal role in driving total equity returns. To fully understand the inherent power of dividends, we can decompose total equity returns into three parts: (i) dividend yield, (ii) earnings growth, and (iii) valuation changes. Valuation changes represent on average half of the total returns for global equities held up to one year. When we expand the investment horizon, however, we see a significant shift in the drivers of returns.

For global equities held up to 20 years, earnings growth and dividend yields are increasingly significant contributors to total returns (see Figure 1). As such, dividends and earnings growth become more important for investors with long-term investment horizons as at Rothschild & Co Wealth Management.

[1] The Origins of Value: The Financial Innovations that Created Modern Capital Markets William N. Goetzmann and K. Geert Rouwenhorst Oxford University Press, 2005

The pursuit of steady earnings

Another benefit of dividend-paying companies is the relative stability of their share price, especially during times of falling equity markets. Compared to the broad market, dividend-paying companies have seen fewer years with negative total returns.[2] Inevitably, persistent and growing earnings are prerequisites in order to sustain a stable dividend yield over time. In light of this, it should come as no surprise that dividend-paying companies exhibit persistently higher earnings, which can contribute to higher valuations.[3]

The art of not treating all dividends equally

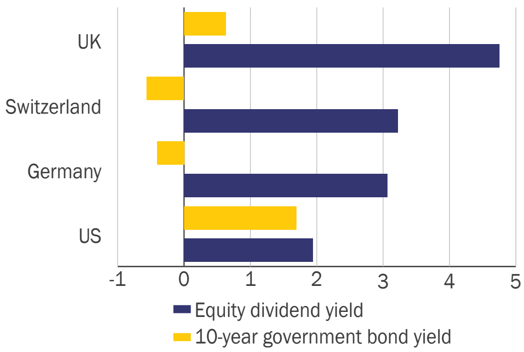
The investment strategy to own companies with above average dividend yields (dividend investing), has generally outperformed the broader market on a risk-adjusted basis.[2,3,4]

However, as not all dividends are equal, a number of aspects must be added to the analysis. Firstly, a high dividend yield should not be viewed in isolation. Companies with unsustainably high dividend yields have not been the best performers historically, while companies ranking in the eighth decile* have seen the strongest risk-adjusted returns.[2,3]

Secondly, dividend sustainability is closely related to the pay-out ratio, a measure of dividends paid relative to net income. A high, but not the highest, dividend yield combined with a low pay-out ratio, improves the prospect of dividend sustainability.[3]

Figure 2: Many equity dividend yields are now exceeding those of bonds

Comparing equity dividend yields with bond yields (%)



Source: Rothschild & Co, Bloomberg
Data as of 31 October 2019.

Thirdly, an investment strategy too dependent on finding the highest paying dividend stocks can also lead to an unwanted bias in the portfolio, towards a specific region or sector (see Figure 2).

With this in mind, investors should focus on a high – but not the highest – dividend yield and also look for companies with a sustainable and persistent dividend over time while keeping a vigilant eye on unintended biases.

From 17th century Amsterdam to date

Since dividends have been an important contributor to investors' total returns over centuries, why are we talking about them now?

Many dividend yields of equities are now exceeding those of bonds (see Figure 2). As an example, when we put pen to paper, the 10-year UK gilt yields less than 1%, while the estimated dividend yield on the FTSE 100 is over 4%. Whilst this may sound attractive, investors need to be aware of potential biases and not focus single-handedly on the level of dividend yield. With more than $12 trillion of negative yielding debt in the global economy, understanding how to invest in equities with sustainably high dividend yields is increasingly important in this day and age.[5]

Keeping in mind both the opportunities and caveats surrounding dividend investments, our Investment & Portfolio Advisory team at Rothschild & Co Wealth Management can advise you on the most appropriate ways of implementing dividend ideas in client portfolios.

For an in-depth article on dividend investing, please request a copy of the *Mosaique Insights* Autumn edition from your Client Adviser.

*top 80% measured by level of dividend yield, i.e. decile 8 has 80% of the observations falling below it with lower dividend-yield. Decile 10 is the highest-yielding decile.

[2] Clemens, Michael, Dividend Investing: Strategy for Long-Term Outperformance (April 22, 2012).

[3] Patel, Pankaj N. and Yao, Souheang and Barefoot, Heath, High Yield, Low Payout (August 15, 2006)

[4] Brzeszczynski, Janusz and Archibald, Kathryn and Gajdka, Jerzy and Brzeszczynska, Joanna, Dividend Yield Strategy in the British Stock Market 1994-2007 (February 28, 2008).

[5] Bloomberg Barclays Global Aggregate Negative Yielding Debt Market Value USD.

Important information

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