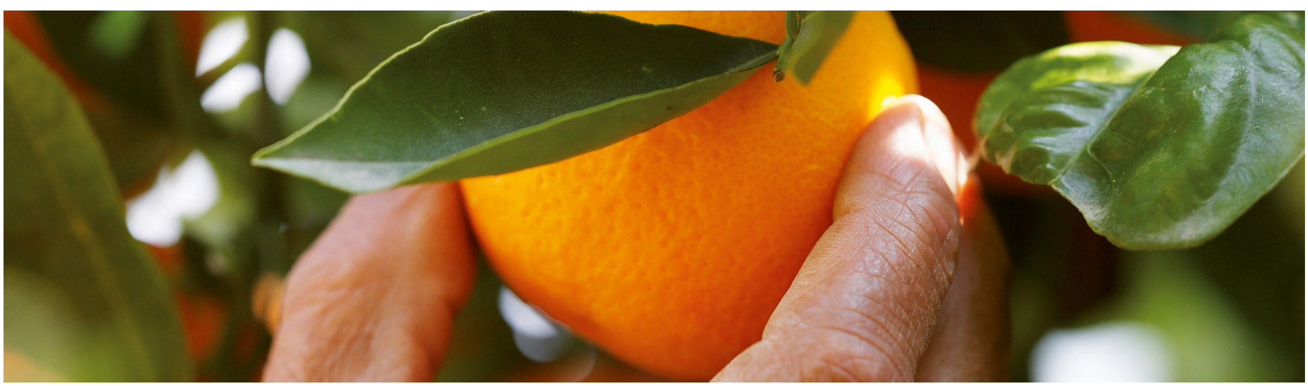
Dividend strategies drawing increased attention

by Hans-Jörg Naumer | 24/01/2017



Summary

In today's low-yield environment, dividend strategies can be a key performance driver for investors' portfolios – and they can play a role as an anchor of stability amid increased market volatility. Moreover, with "reflation" gearing up and corporate profits looking strong, dividends may become even more relevant.

Capital income: Dividends

In a large number of advanced countries, the current yields of governments bonds are hovering in negative territory or, at the very least, are at an insufficient level to preserve capital. Consequently, attention is increasingly shifting to dividends as a way of generating capital income. Indeed, dividends are becoming even more relevant as the issue of "reflation" comes to the fore with a gradual uptick in inflation rates.

As at the end of 2016, approximately 28 per cent of all government bonds of advanced economies in circulation sported negative yields, as shown by our Allianz Global Investors QE Monitor. The situation is particularly dramatic in Japan and Europe. However, by the time investors factor in the effect of inflation, it becomes clear that nominal yields in other parts of the fixed-income universe are not sufficient to preserve real purchasing power, either. Although current yields may well be positive in the US, for example, real yields (nominal yields minus the inflation rate) are negative, and this even applies to maturities of up to 10 years. If you save in this way, you are certain to lose purchasing power. An investment such as this is not appropriate for maintaining purchasing power and most definitely not suitable for accumulating capital. Thus, it is understandable that dividends are increasingly viewed as the new "interest on equities", despite volatility being a fact of life with equity investments.

Dividend strategies certainly appear interesting amidst an environment of negative, or at least low, yields. Divergence between dividend yields and yields on government and corporate bonds has never been as large as it is today by historical standards, at least as far as European companies are concerned. For investors, there are two key questions that are important to consider before any assertions can be made about the future success of dividend strategies:

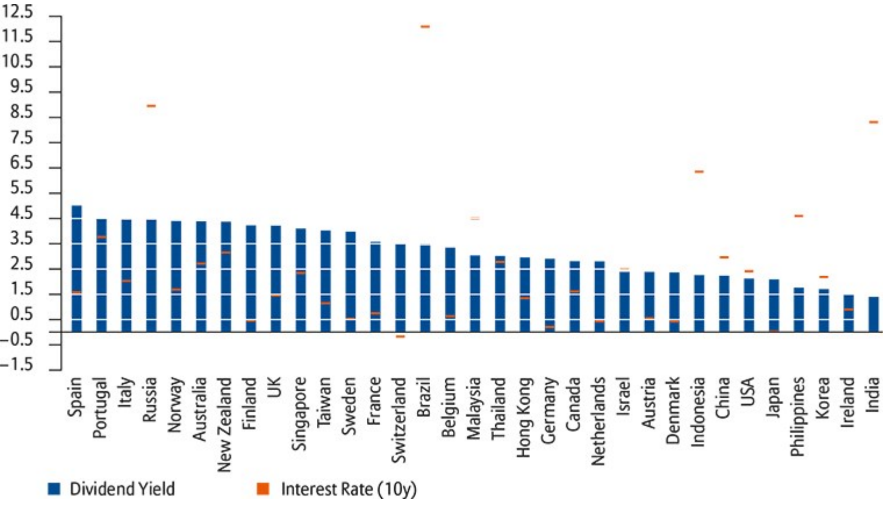
1. What advantages can dividend strategies offer the long-term investor?
2. Taking the current market environment as a starting point, what can be expected in terms of the future performance of dividend yields?

Dividends: A key performance driver in a low-interest and low-yield environment

European companies, in particular, have an investor-friendly dividend policy compared to their international peers. At the end of 2016, their average dividend yield across all market segments was around 3.5 per cent based on the MSCI Europe Index. Focusing on high-dividend stocks meant that the expected dividend yield in portfolios rose even further. However, in some cases the dividend yield in other regions is considerably higher than that on 10-year government bonds, too. (See Exhibit 1.)

Exhibit 1: Dividend yields are attractive around the globe

Dividend yield (MSCI Indices) and interest rate of 10 year government bonds in comparison



Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of 30.12.2016

Companies from the euro countries of Spain, Portugal and Italy are heading the field, which can be explained by the fact that these markets still have low valuations. The dividend yield on the MSCI USA Index seems positively modest in comparison, although you have to bear in mind that US companies, in contrast to European ones, for instance, have a stronger tendency to launch share-buyback schemes than to pay out dividends. Share-buyback schemes, though, are nothing other than corporate profits being paid out to a smaller, residual circle of shareholders.

Dividends: Stability for portfolios

At the same time, what is noticeable is that dividends can potentially help achieve additional stability in portfolios. In the past, investors in European equities were the main beneficiaries of high-dividend payouts that also helped in stabilizing the overall performance in years of declining stock prices. Dividends were able to partially or even totally compensate for any price losses. From 1971 through 2016, the performance contribution of dividends to the annualized total portfolio return for the MSCI Europe Index was approximately 38 per cent. But in other regions, such as North America (MSCI North America Index) and Asia-Pacific (MSCI Pacific Index), around a third of overall performance was determined by dividends, albeit the absolute dividend yield was lower here.

However, dividends alone cannot ensure more stability with equity investments. High-dividend equities in themselves seem to have a less-volatile performance than those of companies with lower dividend payouts. This is demonstrated by analysing the past performance of US stocks, using the longest available time series. This analysis shows that since 1972, the volatility of US equities (measured in terms of a 36-month rolling standard deviation as a gauge of price fluctuation) has been lower among companies paying out a dividend than among stock corporations that did not distribute any profits. Analogous behaviour is also discernible for European dividend stocks since the 1990s.

Reasons for the value and price stability of dividend-bearing equities include, among others:

- Dividend policy is often an active component of a company's strategy. The dividend sends out an extraordinarily strong signal. Reaction on the market to reductions in or the absence of dividend payouts is very negative, since they sow doubts as to the future viability of the company. Consequently, companies go to great lengths to guarantee continuous dividend payments. A comparison of dividends and profits of members of the S&P 500 Index since 1956 shows that corporate profits have been subject to far greater volatility than dividends. Particularly in the last 10 years, the volatility of profits has been considerably larger, at almost 60 per cent on an annualized basis, than the fluctuation observed in the case of dividends, which has been around 6 per cent per annum.
- Higher dividend payouts and a desire to reliably and continuously maintain them due to the signal they send out have a tendency to discipline companies. They are forced to manage their financial resources prudently and to use them efficiently. In contrast, share-buyback programmes, due to their discretionary nature, neither have a comparative signal effect nor a similarly disciplining impact on the company.
- Companies with high-dividend yields usually have sound balance-sheet ratios with a relatively high level of equity capital and stable cash flows.

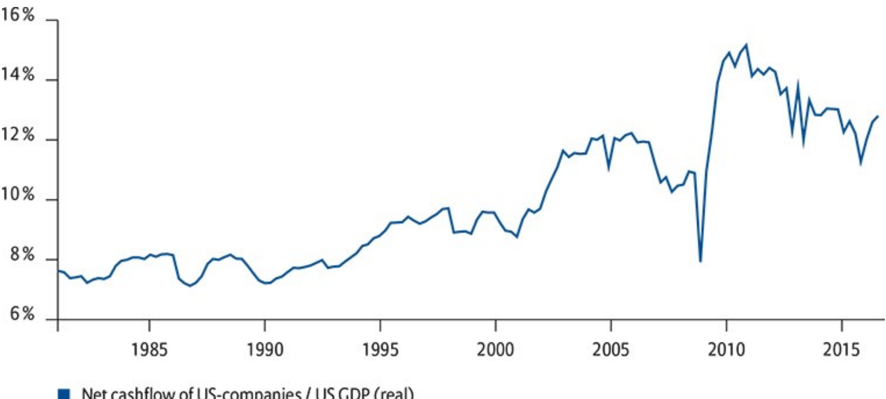
Looking ahead: How sustainable are dividends?

The lessons of the past, however, must be put into the perspective of expected future performance. Current dividend yields only describe the status quo, but not what an investment in equities can actually achieve.

Factors suggesting stable or even rising dividend yields in the current market environment are:

1. While the ratio of dividend payout to earnings per share, at around 80 per cent, is considerably above its pre-crisis level in Europe at the moment, the distribution ratio in the US and Asia, at approximately 50 per cent and about 45 per cent, respectively, is more modest. Therefore, there is still scope for companies in these markets to boost dividends in the future.
2. Currently, companies have a large amount of free cash flow at their disposal. For example, the net cash flow of US companies in relation to US gross domestic product is 12 per cent, and may be approaching the record level seen in 2011. (See Exhibit 2.)

Exhibit 2: US companies holding substantial cash
Net cash flows of US companies relative to US gross domestic product



Sources: Datastream; AllianzGI Global Capital Markets & Thematic Research, Data as of 03.01.2017

3. Our global market outlook suggests that capital markets are gearing up for reflation, as economic indicators are improving, not least thanks to an expected fiscal stimulus in the US. These factors mean better prospects for corporate profits. At the same time, additional interest-rate hikes can be expected from the US Federal Reserve. The latter, coupled with inflation rates, which are once again on the rise, underpins expectations of weaker bond markets and stronger equity markets.
4. Solid yet low global economic growth and the prevailing (as at December 2016) valuation data for the world's major equity markets suggest that dividends will contribute a significant share towards the overall performance of equities.
5. In respect of the profit outlook for 2017, supportive factors outweigh negative ones. In the US, a recovery in the energy sector, expected tax cuts and spending programmes, among other things, should leave their mark on profits. On the other hand, the appreciation of the US dollar and pressure on margins as a consequence of higher unit labour costs will have an adverse effect. Companies in the European Union should also benefit from the US fiscal stimulus, albeit only indirectly through higher economic growth, as well as from a recovery in the energy sector and – most likely – the banking sector. Political uncertainty should have a negative impact. It is unlikely that analysts' consensus estimates in relation to profit increases will be fully met.
6. Since increased volatility can be expected in the context of monetary policy and the global geopolitical situation, dividends could potentially play their part as an anchor of stability.

Hunting solely for high-dividend payments, though, can be misguided. Rather, in addition to a shareholder-friendly policy, it is particularly a company's business model that can justify expectations of sustainable returns. Factors such as market share, market-entry barriers or the power to dictate prices play an important role in this regard. The right business model would also allow such companies to cushion the effects of inflation by raising prices.

Contributing author: Dennis Nacken.

For more information, read ***Capital Income: Dividends***.

Investing involves risk. The value of an investment and the income from it will fluctuate and investors may not get back the principal invested. Past performance is not indicative of future performance. Investments in commodities may be affected by overall market movements, changes in interest rates, and other factors such as weather, disease, embargoes and international economic and political developments. Investments in smaller companies may be more volatile and less liquid than investments in larger companies. Investments in emerging markets may be more volatile than investments in more developed markets. Dividends are not guaranteed. Bonds are subject to interest rate risk and the credit risk of the issuer. This is a marketing communication. It is for informational purposes only. This document does not constitute investment advice or a recommendation to buy, sell or hold any security and shall not be deemed an offer to sell or a solicitation of an offer to buy any security.

The views and opinions expressed herein, which are subject to change without notice, are those of the issuer or its affiliated companies at the time of publication. Certain data used are derived from various sources believed to be reliable, but the accuracy or completeness of the data is not guaranteed and no liability is assumed for any direct or consequential losses arising from their use. The duplication, publication, extraction or transmission of the contents, irrespective of the form, is not permitted.

This material has not been reviewed by any regulatory authorities. In mainland China, it is used only as supporting material to the offshore investment products offered by commercial banks under the Qualified Domestic Institutional Investors scheme pursuant to applicable rules and regulations.

This document is being distributed by the following Allianz Global Investors companies: Allianz Global Investors U.S. LLC, an investment adviser registered with the U.S. Securities and Exchange Commission; Allianz Global Investors GmbH, an investment company in Germany, authorized by the German Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin); Allianz Global Investors Asia Pacific Ltd., licensed by the Hong Kong Securities and Futures Commission; Allianz Global Investors Singapore Ltd., regulated by the Monetary Authority of Singapore [Company Registration No. 199907169Z]; Allianz Global Investors Japan Co., Ltd., registered in Japan as a Financial Instruments Business Operator [Registered No. The Director of Kanto Local Finance Bureau (Financial Instruments Business Operator), No. 424, Member of Japan Investment Advisers Association]; Allianz Global Investors Korea Ltd., licensed by the Korea Financial Services Commission; and Allianz Global Investors Taiwan Ltd., licensed by Financial Supervisory Commission in Taiwan.

99035

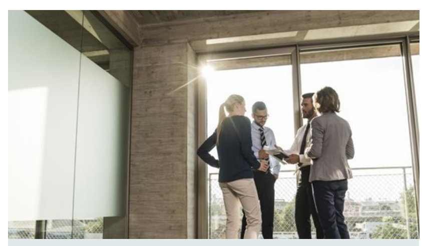
About the author

Hans-Jörg Naumer
Ph.D., Global Head of Capital Markets & Thematic Research

Hans-Jörg Naumer is Global Head of Capital Markets & Thematic Research with Allianz Global Investors which he joined in 2000. The focus of his work is on analysis relating to strategic and tactical allocations, specific investment opportunities and the identification of long-term investment trends. Before joining the firm, he worked for Société Générale, where he became the Head of Research Germany and was part of the French investment bank's international research team. From his vantage point as an analyst and economist, he observed the establishment of the Economic and Monetary Union and thus ranked among the prime "ECB Watchers". He started his professional career in the corporate banking division of Deutsche Bank in 1994. Hans-Jörg studied economics at the University of Mannheim, one of the leading universities for economics and business studies in Germany. During his studies, he worked at the Chair for Macroeconomics.

→ VIEW DETAILS

Want to view more?



Investment themes & strategy

A shared vision is vital for a sustainable recovery

→ DISCOVER MORE

by Deborah Zurkow | 27/08/2020

Investment themes & strategy

How will private debt be changed by Covid-19?

→ DISCOVER MORE

by Deborah Zurkow | 11/08/2020

Investment themes & strategy

Why the coming months are critical to a decisive green transition

→ DISCOVER MORE

Beyond the statue - Why board diversity is important

15/05/2017

Summary

On March 7 in celebration of International Women's Day, the 7,000 pound charging bull sculpture, which has reigned alone for 27 years in Lower Manhattan as a potent symbol of Wall Street, woke up to some company. Investment firm State Street Global Advisors (SSGA) had placed the statue of a young girl

standing in defiance opposite the bull. “Fearless Girl” was placed to introduce and promote its campaign for increasing the number and role of women in corporate leadership positions.