Navigating a Changed Landscape for Dividend Stocks

We believe a focus on companies with solid balance sheets and established dividend-payment histories may be worthwhile in the current environment.

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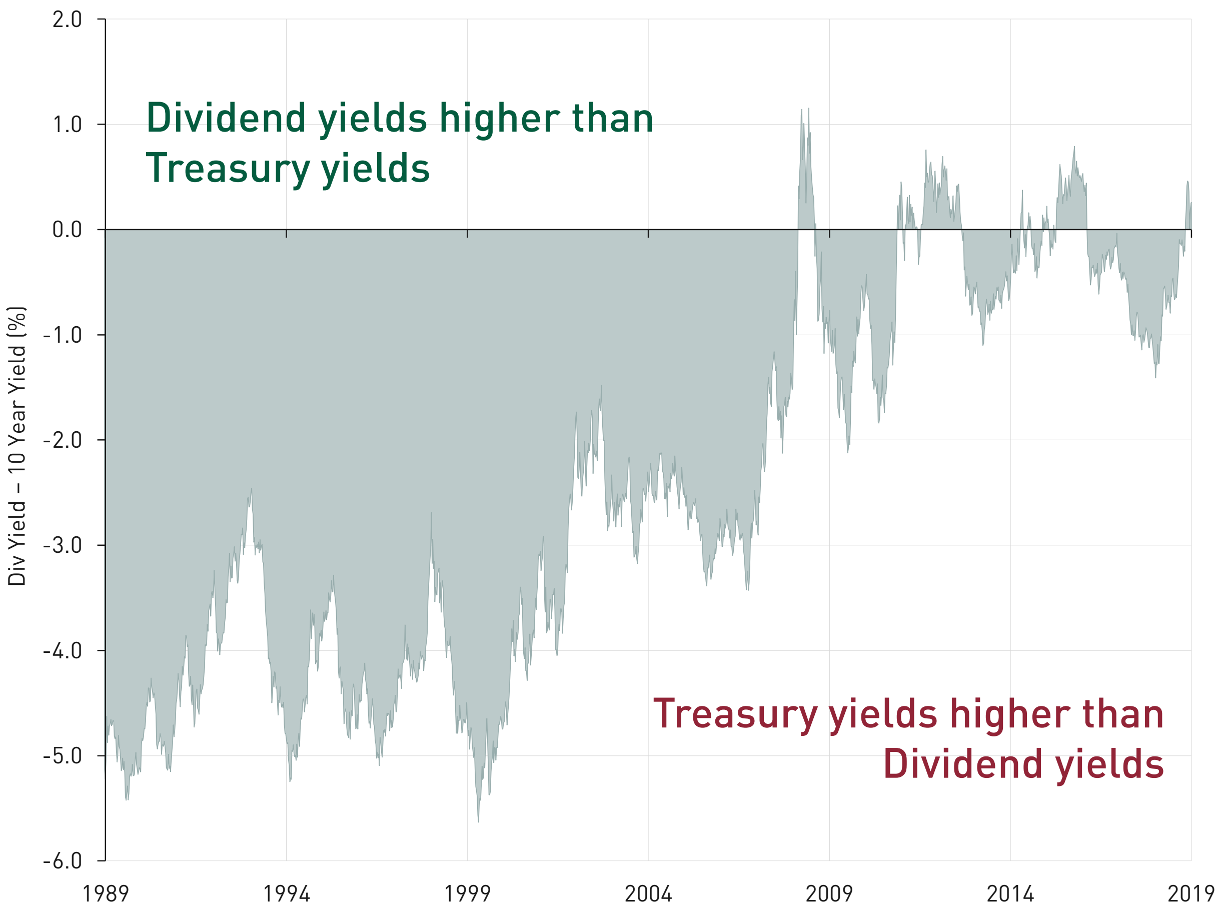
Figure 1. U.S. Dividend Yields Continue to Exceed 10-Year U.S. Treasury Yields
Difference between S&P 500 dividend yield and 10-year U.S. Treasury yield, September 22, 1989–April 30, 2020



Source: Bloomberg. Data as of April 30, 2020.
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Past performance is not a reliable indicator or guarantee of future results.

In Brief

- In the wake of recent market volatility, the dividend yield on the S&P 500 has exceeded the yield on the benchmark 10-year U.S. Treasury note.
- But investors who may be intrigued by the high dividend yields available on certain stocks may wish to think twice. Stocks with outsized yields may actually be on the cusp of reducing or suspending their dividends, as a number of companies have already done.
- Also, the highest-yielding stocks historically have underperformed the broader universe of dividend-paying stocks over the long term.
- For dividend investors, we believe active management and rigorous stock selection is of particular importance in the current environment.

DIVIDEND

The U.S. Federal Reserve and other central banks around the globe have responded to the economic disruptions caused by the coronavirus pandemic by cutting interest rates to near zero. In this environment, the differential between the nominal 10-year U.S. Treasury bond yield and the dividend yield on the S&P 500® Index may appear increasingly attractive to investors (see Figure 1).

With the spread of the coronavirus, the U.S. economy has largely stalled. Many companies are facing an acute slowdown in revenue growth—or revenue declines—and, in return, are looking to preserve liquidity and fortify balance sheets. Against this backdrop, one expense some companies may be paying close attention to is dividend payments on common shares. While quarterly dividends paid by S&P 500 companies historically have increased steadily each year, they are not guaranteed; they are paid at the discretion of the company.

How Has Economic Disruption Affected Dividends?

The economic shock caused by the global pandemic has led to both dividend suspensions and dividend cuts. Month-to-date through April 24, nine companies within the S&P 500 had suspended their quarterly dividend and nearly half a dozen others announced a decrease over the month-to-date period, according to a Barron's report. Further, companies may be pressured to suspend their dividends if they accept financial aid from the government. Terms of the Coronavirus Aid, Relief, and Economic Security (CARES) Act prohibit stock buybacks and dividend payments by companies that accept assistance under the program until 12 months after the loan is repaid.

In Europe, the political pressure against returning capital to shareholders is even greater. On March 31, the Prudential Regulatory Authority (PRA) encouraged British banks to preserve capital in order to support the wider economy through the period of economic turmoil, according to a cnbc.com report. On March 27, the European Central Bank (ECB) recommended that banks delay dividends until October 2020. While this appears to pose a threat globally to dividend investors, the stringent regulations in Europe may be a tailwind for U.S. dividend-paying stocks, in our opinion, as international investors may flock to the United States in search of yield. Further, we anticipate that in the United

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States, share buybacks will be more heavily scrutinized and more widely reduced than dividends as buybacks may be perceived as inherently discretionary and opportunistic.

During the 2008-2009 Global Financial Crisis (GFC), the S&P 500 saw a 24% decrease in dividends and a 50% decrease in EPS, according to BofAML research. The financial sector, which at the time contributed around 25% of total dividends from the index, saw the most dividend cuts. Today, however, the backdrop is different. The energy and retail sectors have come under particular stress amid the economic shutdown and oil price volatility. However, index dividends are currently most heavily concentrated in the information technology and financial sectors. In our view, both sectors overall have solid balance sheets, and banks are substantially better capitalized than during the GFC. Further, banks have served as a transmission mechanism between government lending programs and their intended recipients, small businesses, and individuals; therefore, there may be reluctance to pressure these institutions, in our opinion.

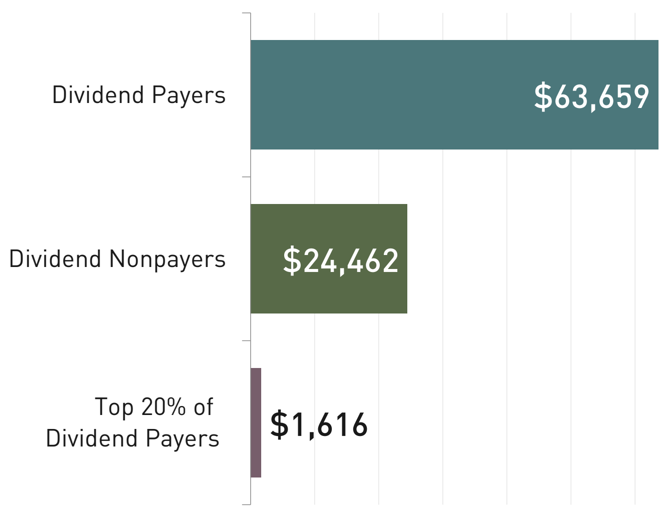
Why High-Yielding Stocks Might Not Be So Attractive After All

How, then, might a dividend investor approach the current landscape? Following the equity market sell-off, dividend yields on some stocks may look compelling on the surface. But we think investors might want to take a closer look. Rather than an increasing per-share payment, the current dividend yield may be higher than in prior periods because the company's share price (the denominator in the yield calculation) has fallen—a condition that may be attributable to the market's perceptions of the firm's declining prospects. In fact, the highest dividend yielders may be the most at risk for a potential cut or suspension of their dividends.

This might be an issue for those who invest in dividend-focused passive investment strategies such as exchange-traded funds (ETFs), which, in their attempt to mirror the composition of a benchmark index, may be purchasing high dividend yielding stocks with large capital losses. In fact, investing in the top 20% of dividend yielders has actually eroded value over time, as Figure 2 shows.

Figure 2. Investing in the Highest-Yielding Dividend Stocks Has Been a Recipe for Underperformance

Hypothetical value of $10,000 invested on December 31, 1989, as of March 31, 2020



Source: Morningstar.

Dividend payers=All dividend-paying stocks in the S&P 500 Index. Dividend nonpayers=Stocks in the S&P 500 that do not pay dividends. Top 20% of dividend payers=Top 20% of S&P 500 stocks with the highest dividend yield.

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An Active Approach to Dividend Portfolios

We believe active management and rigorous stock selection is of particular importance in the current environment in order to assess the sustainability of a company's dividend. We believe it is imperative that an active equity manager continuously monitor the constituent stocks across the dividend universe, with a particular focus on companies' balance sheet strength; ideally, the investment team would be able to call upon the expertise of in-house fixed income professionals to gain a deeper understanding of a dividend payer's financial fundamentals. Moreover, if a company cuts or suspends its dividend, active managers typically have the flexibility to sell the position at the time of their choosing. Alternatively, passive funds will usually hold companies that no longer fit their mechanical and rigidly defined rules and criteria for longer periods of time, as they typically reconstitute once a year.

It is also worth noting that there is a sizeable percentage of equity-income assets under management (AUM) in formulaic dividend strategies, based on Lipper data. As dividend suspensions and cuts potentially become more commonplace, the price impacts on companies making such decisions likely will become more easily anticipated by the market. The inefficiencies in prices caused by predictable sales could present an opportunity for exploitation for active managers within the equity income space, in our view. We believe an active approach to managing dividend strategies leveraging rigorous fundamental research into companies' financial strength may potentially provide the best way of gauging their dividend-paying capability.

A Note about Risk: The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. While growth stocks are subject to the daily ups and downs of the stock market, their long-term potential as well as their volatility can be substantial. Value investing involves the risk that the market may not recognize that securities are undervalued, and they may not appreciate as anticipated. Smaller companies tend to be more volatile and less liquid than larger companies. Small cap companies may also have more limited product lines, markets, or financial resources and typically experience a higher risk of failure than large cap companies. The value of an investment in fixed-income securities will change as interest rates fluctuate and in response to market movements. As interest rates fall, the prices of debt securities tend to rise. As rates rise, prices tend to fall.

No investing strategy can overcome all market volatility or guarantee future results.

Dividends are not guaranteed and may be increased, decreased, or suspended altogether at the discretion of the issuing company.

Forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

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Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes.

Dividend yield is equal to the dividend divided by the stock price. Dividend yield is one measure of a stock's value. A high dividend yield may indicate that a stock is relatively inexpensive.

Dividend policy: A stock is classified as a dividend payer if it paid a cash dividend any time during the previous 12 months, a dividend grower if it initiated or raised its cash dividend at any time during the previous 12 months, and non-dividend payer if it did not pay a cash dividend at any time during the previous 12 months.

Exchange Traded Fund (ETF) is a security that tracks an index, a commodity or a basket of assets like an index fund, but trades like a stock on an exchange. ETFs experience price changes throughout the day as they are bought and sold.

Yield is the annual interest received from a bond and is typically expressed as a percentage of the bond's market price.

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