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Should Corporate Dividends Matter to Investors? Part II

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Summary of Discussion

Many studies of U.S. stock returns suggest that over the long term, more than 50% of total return comes from the receipt of dividend payments and the growth in these payments. So the short answer to the title's question is "Yes." From SKBA's perspective, this observation nevertheless begs these further questions:

1. Why do companies establish, sustain and grow their dividend payments?
2. What do dividend payments imply about a company's earning power compared to its reported EPS?
3. What causes a company to cut its dividend?
4. Under what circumstances and market environments do dividend-paying companies offer desirable investment returns?

In Part I we dealt with the first three questions. In Part II, we discuss question 4: what are the return opportunities available in dividend-paying companies, and when do they perform well and poorly?

In Part I, we arrived at the following conclusions:

- Established dividend policies are often useful proxies for the earning power of companies.
- Corporate reports of operating and/or pro-forma earnings often overstate underlying earning power due to the recurrence of supposedly "non-recurring" charges and the failure to expense options.
- Much of the decline in the dividend payout ratio of the S&P 500 is the result of the substitution of non-dividend payers for dividend-payers in the index and of the severity of the "Great Recession."
- While payout ratios change with the cyclical volatility of corporate earnings, the average payout ratio of dividend-payers in the index has repeatedly returned to the 40-45% range on more normal earnings, suggesting that managements view earning power as more stable than reported earnings.

In examining data since 1980 to answer question four above, in Part II we conclude the following:

- The stocks with the highest dividend-yield in the S&P 500 at the beginning of each year generally have produced lower returns and higher volatility than the next three deciles of yield.
- The highest decile of yield is the most sensitive to interest rate changes, acting much like a bond substitute.
- The 2nd, 3rd, and 4th deciles of dividend yield displayed the lowest volatility of average return.
- Average returns by yield group are not stable over time and varying economic environments.
- The "above-average yield" group (2nd, 3rd, and 4th deciles of dividend yield) tends to have the least impact on return from rising and falling interest rate environment.

In summary, dividends are primarily based on company earning power (Part I) and moderate dividend yields tend to point to out-of-favor stocks with attractive risk/return characteristics (Part II).

Part II – Under what circumstances do dividend-paying companies produce desirable return patterns?

It is SKBA's view that ***high dividend yield alone contains little information value*** *as to the attraction and likely future return of individual stocks. Yet there are useful perspectives one can draw from the ranking of yield deciles as to which environments are favorable or unfavorable for dividend-paying companies relative to non-dividend payers.* The data in the following three tables is intended to be illustrative of the issues involved.

Figure 1: Performance of S&P 500 Stocks Ranked by Yield Since 1980

Compound Equal-Weighted Average Performance of S&P 500 Stocks

Dividend Yield Deciles	% Average Yield	% Annual Total Return by Yield Group	% Standard Deviation by Yield Group	Yield Group Characterization
	As of 12/31/2012	1980-2012	1980-2012	
1st	5.2%	13.1%	18.0%	High Yield
2nd, 3rd, & 4th	3.0%	13.5%	15.4%	Above Average
5th & 6th	1.8%	15.0%	17.5%	Market Yield
7th & 8th	0.7%	12.5%	19.8%	Low Yield
9th & 10th	0.0%	16.4%	26.3%	No Yield

Source: Factset, Compustat - Historic periods do not contain data on all S&P stocks.

Figure 1 compares the equal-weighted total return and volatility characteristics of annual yield deciles for S&P 500 companies ("as was" membership at the beginning of each year) since 1980. The 1st decile contains the highest dividend-yield stocks at the beginning of each year and the 10th decile the lowest. This 33-year period covers up and down markets, periods of weak and strong economic growth, booms and busts, varying tax rate regimes, and high and low inflation rates. Thus, we deem it to be a worthwhile period to examine return characteristics. At the beginning of each year, the dividend yield of individual companies was ranked, and each stock placed in its respective yield decile. The deciles were further combined into five groups: the first (highest) decile of yield by itself, the next three deciles together, and then the 5th and 6th, 7th and 8th, and 9th and 10th, each as a separate group. For purposes of illustration, the average dividend yield of each group at the end of 2012 is displayed on the left side of the table. The right-hand column provides a description of the yield groupings, and in recent years, non-dividend payers (0% yield stocks) represent all of the stock membership of the 9th and 10th deciles of yield.

Since 1980, low and no yield stocks (9th and 10th deciles of yield) produced the greatest overall return, but also by far the greatest level of volatility (as measured by the annual standard deviation of the mean return of each group). This is not surprising as zero and low-yield stocks are generally viewed as more aggressive "growth" stocks that typically produce high volatility. For most groups, the higher the yield, the lower the volatility, with one exception. Quite interesting is the fact that over the entire period, the highest yield decile of stocks had far greater volatility (18% annually highlighted in red) than the next lower yield group (highlighted in green), which had the lowest overall return volatility.

Why is this outcome the case? *From our examination, while the highest decile of dividend yield includes defensive stocks that always have high yields (such as electric utilities), it also includes distressed companies that are near the point of slashing their dividends due to fundamental deterioration or excessive balance sheet leverage.* The dividend cuts by companies experiencing financial distress in any year are likely to come from stocks in this grouping.

In contrast, the "Above Average" yield group appears to be a decent "fishing pond" for stock investments with the third highest total annual return and the lowest volatility. One of the worst groups appears to be the 7th and 8th, which perhaps represents many maturing growth stocks with which investors have become increasingly disenchanted (hence the lower return while still producing higher volatility).

Yet, these results are not stable over time. Figure 2 examines this history over three separate decade-long (or more) periods, and the annual returns by yield group vary greatly. All yield quintiles produced "winners" as high average total annual returns ranged from 18.0% to 24.1% in a decade of falling inflation rates during the 1980s. Investors who owned stocks after 1982 should have been happy with these high absolute returns, and stocks in and around the yield of the market (likely 5th and 6th deciles) produced the best returns.

The 1990s, however, was clearly a decade in which the winners were growth stocks, and the lower the yield the better. The 9th and 10th decile group gained 27.3% annually, more than twice the 12.9% average return of stocks in the highest yield decile. Although total stock market returns in the 1990's were high, the highest growth (highest risk, in retrospect) stocks were by the far the winners. Returns for the broadly-defined middle deciles (2nd through 8th) were not much different and substantially lower than the zero-yield growth stocks.

Figure 2: Total Annual Return by Yield Grouping and By Decade

Compound Equal-Weighted Average Performance of S&P 500 Stocks

Dividend Yield Deciles	% Coumpound Annual Total Return by Yield Group		
Period	**1980-89**	**1990-99**	**2000-12**
Winners?	**All**	**Growth**	**Defensive/Yield**
1st	**18.0%**	**12.9%**	**10.8%**
2nd, 3rd, & 4th	**19.0%**	**15.7%**	**8.6%**
5th & 6th	**24.1%**	**14.4%**	**9.3%**
7th and 8th	**20.5%**	**16.2%**	**4.4%**
9th & 10th	**19.4%**	**27.3%**	**8.3%**

Source: Factset, Compustat - Historic periods do not contain data on all S&P stocks.

This picture was turned on its head with the turn of the century. Since 2000, the most defensive, highest-yield decile of stocks has had the best average annual total return. Interestingly, lower yield stocks (7th and 8th decile group) performed by far the worst on average at only 4.4% annually. The zero-yield stocks (mostly likely having the highest earnings growth rates) lagged the other groups, but not by nearly as much.

These differences in returns are better captured by examining what occurred in rising and falling interest rate environments. Figure 3 below attempts to capture this perspective by dividing each of the 33 years into periods in which interest rates (represented by 10-year T-Bond yields) rose by more than 50 basis points (0.5%), fell by more than 50 basis points, or changed by less than or equal to 50 basis points.

From September of 1981, when 10-year Treasury bonds yielded over 15%, through 2012 when they bottomed below 2%, the market appears to have essentially concluded a 30-year bull market run in bonds. Nearly half of the years (15 years in the table) saw yields decline by more than 0.5%. Only eight experienced more than 0.5% increase. Yet the results by yield decile grouping are starkly different.

The far right column of the table offers our characterization of the type of stocks found in each yield grouping. The 9th and 10th deciles of dividend yield were the winners in the eight years in which interest rates rose by more than 50 basis points (highlighted in dark green in the left-side column). The first decile of yield, however, produced the worst relative performance in rising interest rate environments with average gains of only 11.1% annually (red shaded). In contrast, in years of falling rates, the bottom two groupings of yield performed the worst with the 7th and 8th deciles gaining only 11.7% annually on average (red highlighted). The best explanation for this is likely to be that more than any other group, the 1st decile of yield performs much like a "bond substitute," significantly outperforming in the years when interest rates fell more than 50 basis points (dark green highlighted right-hand column) and underperforming when rates rose by more than 50 basis points. The desirability of "fishing" in the high yield "pond" is highly dependent upon your forecast of the interest rate environment.

Figure 3: Performance of S&P 500 Stocks by Yield Group and Interest Rate Changes (1980-2012)

Equal-Weighted Average Performance of S&P 500 Stocks

	Rates Rising	Rates Stable	Rates Falling	Performance Under Varying Interest Rate Environments
Year T-Bond Yield	Up >0.50%	Inbetween	Down<-0.50%	
Number of Years	8	10	15	
Dividend Yield Deciles	% Average Annual Total Return by Yield Group			Characterization
1st	11.1%	13.5%	17.4%	Bond Substitutes
2nd, 3rd, & 4th	15.4%	13.3%	15.0%	Dividend Opportunities
5th & 6th	22.2%	12.8%	15.7%	Market Performance
7th and 8th	23.4%	11.0%	11.9%	Maturing Growth
9th & 10th	37.0%	14.1%	13.3%	Growth Stocks

Source: Factset, Compustat - Historic periods do not contain data on all S&P stocks.

The above-average grouping (2nd, 3rd, and 4th deciles of yield) was the only area in the S&P 500 in which the average stock performance was NOT impacted by the yield environment. It produced the most stable returns across all three interest change environments. This is a remarkable outcome. When a dividend-paying company reports disappointing results, its price falls and dividend yield rises, often to an above-average level represented by the 2nd, 3rd, and 4th deciles of yield. Yet the yield doesn't rise so far as to fall in the 1st decile where most corporate dividend cuts are found that reflect a company's distress rather than simply being out of favor. So even with the lower volatility of the "Dividend Opportunities" group, the depressed valuations tend to produce attractive rates of return across a range of environments.

No matter what the environment, corporate dividend policies do reflect a company's view of its earning power. We have often stated: from companies with established dividend payment policies, we as investors, get a public view into the private mind set of management and the board of directors regarding the company's earning power by the way it sets and grows its dividend rate. Yet, no particular grouping of stocks will always outperform. In the view of SKBA, however, the answer to the fourth question posed at the beginning of this report is this: An above-average dividend yield (but often not the highest decile of yield) often suggests a company's valuation is attractive compared to its earning power. Sounds like a good "pond" in which to "fish" for investment opportunities.