

**ALEX RIVAS**

Investment Analyst,  
Global Asset Allocation  
Team

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## HARNESSING INCOME FROM EQUITIES

### Introduction

Investors have been on a search for investments that can produce sustainable long-term income streams ever since central banks cut interest rates to zero in the aftermath of the Global Financial Crisis (GFC). Globally, current bond yields are at historic lows, with many countries even seeing negative yields. One solution investors have turned to are dividend-paying equities. In this paper, we will review the dividend yield premium over time to show how investors can benefit from including equity-income focused strategies in their portfolio.

### History of dividends

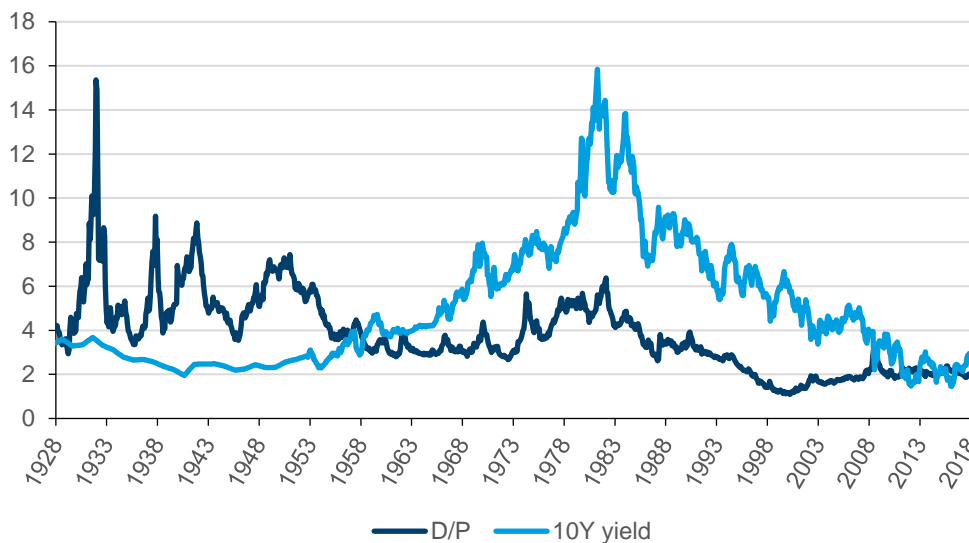
The first dividend payments can be traced to the early 1600s when the Dutch East India Company began paying regular dividends to its shareholders. Since then, dividend policy has played a critical role in the financial evolution of a company (e.g., Microsoft and Apple). Dividend policy can be key to how a company is perceived by outsiders; and projecting dividend streams is a key component of the dividend discount model. In their seminal book “Security Analysis,” Graham and Dodd noted that “the prime purpose of a business corporation is to pay dividends to its owners. A successful company is one that can pay dividends regularly and presumably increase the rate as time goes on.”

Dividend yield has historically been highly correlated with other value factors, and most income-focused equity funds have a positive exposure to the value factor. However, income-focused investing can be more than just identifying undervalued stocks. Companies that can sustain a growing dividend policy are generally seen as financially healthy (as long as the dividend is not built on mounds of debt). Because of this, dividend growth focused strategies can be more defensive than the pro-cyclical nature of common value strategies.

Investors have historically turned to fixed income products to generate income, while investing in stocks for growth of principal. However, as U.S. yields have fallen since the 1980s, income has grown more difficult to source. Additionally, any investor fortunate enough to have held high-coupon 30-year bonds from the 1980s has seen those bonds mature and has had to reinvest in lower-coupon bonds throughout this past decade.

Since the GFC, the yield available from the U.S. 10-Year Treasury bond has been nearly identical to the dividend yield available from the S&P 500. In this current low-yield environment, an active strategy may be especially effective in helping investors generate sustainable income in their portfolios.

#### Exhibit 1: Yield comparison between S&P 500 and U.S. 10-Year Treasury bond



Source: Columbia Threadneedle Research, Macrobond; through July 31, 2019

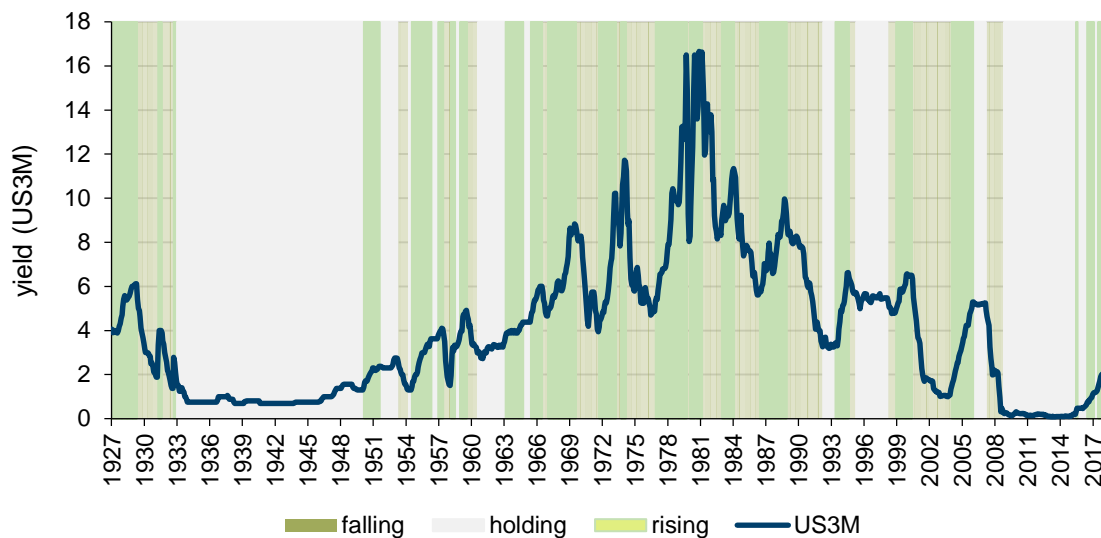
#### Dividend yield over time

To analyze how a company's dividend policy might impact its stock returns, we leveraged a dataset created by Eugene Fama and Kenneth French as proxy for the U.S. equity market. In this dataset, Fama and French use all firms incorporated in the U.S. and listed on the NYSE, AMEX or NASDAQ and separate the stocks into quintiles; portfolios are created based on the dividend/price (D/P) ratio, also known as dividend yield. In this paper, we compare the performance of these portfolios during varying rate cycles.

Given the Fed's reversal in rate policy this year, we looked at the performance of the dividend yield factor in periods when interest rates were either rising, falling, or holding steady. The chart below highlights these periods (using the U.S. 3-Month T-bill as a proxy for U.S. interest rates). Looking at interest rates in relation to an equity-income strategy is important for two reasons: 1) as

interest rates rise (fall), companies have less (more) cash on hand to payout in dividends and 2) investors may turn to the fixed income markets for income as rates rise.

### Exhibit 2: Interest rate cycles



Additionally, falling interest rates generally coincide with low economic growth and market uncertainty. Investors may tend to seek safe havens and prefer stocks with steady dividend payments. In today's environment, where the S&P dividend yield is greater than the U.S. 10-year Treasury bond yield and markets are pricing in multiple rate cuts, earning income from equities versus bonds looks to be attractive. Conversely, rising interest rates usually coincide with strong economic growth and investors are less risk-averse.

The results show that companies that have the highest dividend yield (i.e., top 20<sup>th</sup> percentile of dividend yield) tend to outperform during periods of falling rates. Conversely, when interest rates are rising, companies in the bottom 20<sup>th</sup> percentile tend to outperform. This may occur because companies which offer low dividends have more cash on hand as borrowing becomes more expensive.

### Exhibit 3: Average returns during different interest rate environments

Interest Rate Cycle	U.S. Market	Dividend Yield Top 20 <sup>th</sup> percentile	Dividend Yield Bottom 20 <sup>th</sup> percentile	Non-dividend payers
Falling	6.8%	15.9%	8.7%	11.6%
Rising	4.3%	10.2%	12.1%	10.3%
Holding	12.4%	15.1%	13.2%	17.6%
Overall	8.2%	13.7%	11.6%	13.5%

Finally, we look at how changing a dividend policy may impact stock performance. When companies raise their dividends, this is a sign of positive business health and its stock price tends to benefit. Conversely, when businesses cut their dividends, this sends a negative signal to the market. In looking only at the S&P 500 universe, we replicated the previous analysis to highlight how also targeting dividend growers can help boost portfolio returns.

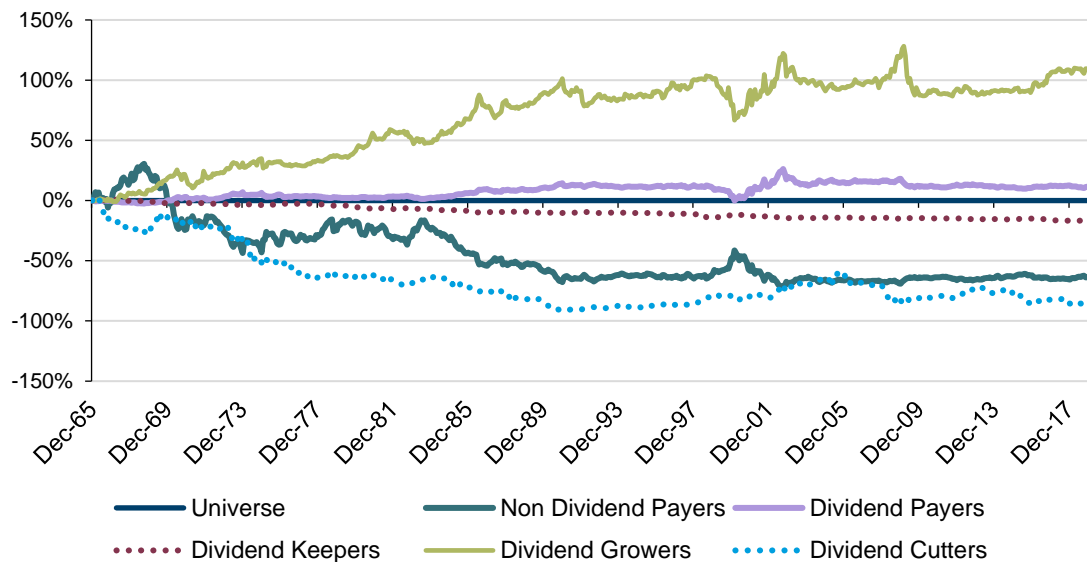
**Exhibit 4: S&P 500 segment returns during different interest rate environments**

Interest Rate Cycle	S&P 500	Dividend growers	Dividend holders	Dividend cutters	Non-dividend payers
Falling	18.7%	18.5%	18.7%	13.2%	18.6%
Rising	5.3%	8.5%	4.7%	1.8%	3.8%
Holding	19.1%	19.4%	18.6%	25.7%	20.7%
Overall	13.6%	14.9%	13.3%	11.7%	13.3%

Note: S&P 500 data from 1966-2019

As noted in the table above, dividend growers outperform dividend cutters, especially during periods of changing interest rates (more so during rising rate periods). Looking at the long-term history, the outperformance of dividend growers becomes even more stark.

**Exhibit 5: S&P 500 – relative performance for different dividend segments within S&P 500 (equally-weighted)**



Note: S&P 500 data from 1966-2019

## Conclusion

With the Fed having cut interest rates for the first time since December 2008, investors should pay more attention to income-focused equity strategies as they search for yield. High-income stocks have tended to outperform the equity market overall during periods of falling rates, by a wide margin. Within the realm of income paying stocks, those growing their dividends tend to offer better returns than those not offering or cutting their dividend.

### **Past performance does not guarantee future results.**

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