WEEKLY REPORT
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Private Asset Management Ltd

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DIVIDENDS – WHAT ARE THEY GOOD FOR? – Part 2

A couple of weeks back we looked at the reasons why so many investors focus on dividend yield as a an important factor when assessing the attractiveness or otherwise of a stock, fund or ETF. Today we will look at some research which examines whether this strategy works, the possible implications of a high yield strategy on the riskiness of portfolios and focus on some examples, both locally and overseas, of how the fund management industry has responded to retail investors' love affair with yield.

One of the better analyses of dividend investing's success or otherwise in generating higher returns was done back in 2014 by Andrew Smithers of the London based economic consulting group Smithers and Co. Andrew looked at various valuation methodologies and his report kicked off saying that the worth of any valuation model obviously must be measured by its ability to forecast market returns. For example if the stockmarket's PE ratio is low or the dividend yield is high is this a reliable signal of relatively high stockmarket returns in the future? He wrote "forecasting ability cannot be judged over a single time period as these returns will depend as much on the level of the market at the end of the period as at the starting point. We avoid this with "hindsight" which measures the average return over a large number of future years. This allows us to put values on the market in earlier years provided enough time has passed".

So as a first step to test each valuation model, for each year Smithers compared the average real return of the subsequent 30 years and those years with the best average real return will be the years where the market was relatively cheap and will thus have a high "hindsight value". He then calculated the R^2 for each of the variables (R^2 is a statistical measure that represents how much of one variable is explained by another – in this case for example how much of the subsequent return is explained by the dividend yield). Confused! An example will make it clearer. In 1916 the US stockmarket was cheap according to the price earnings ratio model as the PE then was just 6.4x which is barely half of the average valuation over the 84 year period. If PE's were a good valuation model you would expect high returns over the next 30 years but returns over that period were less than 1% real. Similarly in 1921 the market PE was 25.2x - about twice the average - yet market returns were a high 11.5% pa real for the next 30 years. Prospective PE's produce even worse errors leading Smithers to comment that "the comparison of prospective PE's with hindsight values shows that their use by investment bankers and, quite disgracefully by Janet Yellen, to make claims about stockmarket values is nonsensical and would presumably be illegal if rules on

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"truth in advertising" were applied to their comments". In the same way the dividend yield in 1916 of 5.7% was 20% above the average dividend yield yet real returns for the next 30 years were less than 1% real. Smithers concluded that dividend yields, whilst better than price earnings multiples, had little predictive ability.

Other research confirms the lack of information implicit in high dividend yields on stocks, funds or ETFs. Boudoukh et al in a paper in the Journal of Finance published in April 2007 (On The Importance Of Measuring Payout Yield) found that dividend yield does a poor job predicting future returns in a sample that runs from 1972 through 2003. They conclude "our results suggest that a better approach would be to look at the growth of total payouts". In addition Goyal and Welch in a paper in the Journal of Financial Economics (Predicting The Equity Premium With Dividend Ratios) also conclude that dividend yield has little utility as an indicator of future returns.

Whilst opting for the highest income return in the fixed interest area is now pretty well acknowledged as being a risky strategy, thanks to the finance company disaster, it is not so well recognised that choosing stocks or markets via an ETF with the highest yield can also increase risk and often reduce returns. As far back as 1974 academics were of the view that a focus on dividends led to sub-optimal portfolios – in a paper back then Black and Scholes argued that investors who concentrate their portfolios in stocks with a high yield will reduce the degree of diversification without an offsetting benefit in terms of higher expected return. They suggested that investors simply ignore dividend yield in making portfolio decisions.

Furthermore it's not even clear that a focus on high yield stocks will maximise dividend income over the long term. It may simply result in prioritising income today over income tomorrow as low yielding stocks/markets tend to grow their dividends more quickly than higher yielding stocks. Back in 2020 I had a quick look at the income growth performance of global equities versus NZ equities. Whilst only looking at a 10 year period lower yielding global equities grew their dividends much more quickly than NZ equities - a 136% increase versus 62% for NZ shares. This result should not surprise as its consistent with the efficient markets hypothesis: the market assigns lower valuations (and thus higher dividend yields) to stocks with lower profit growth outlooks.

So it is pretty obvious from the research that buying high yield doesn't improve returns but the reality is that many investors still focus on high yield stocks/funds. As fund managers are primarily in the business of making their funds look as attractive as possible to prospective investors a high dividend yield is frequently employed as a key marketing tool. This was particularly the case in the last few years when interest rates got to very low levels and we saw a number of fund managers originate managed funds with the words "income" and "high yield" in their names. A few years back the Chairman of one fund noted enthusiastically in the interim report that "based on the current shareprice the annual dividend yield of approximately 9.6% is one of the most attractive on the NZX". This was despite the fact that the profits of the company, after fees were deducted, was virtually zero.

There are several ways that fund managers can artificially manufacture yield: in the UK a number of listed funds allocate expenses like fund management fees to capital instead of through the profit the profit and loss account, thereby boosting earnings and thus permitting the payment of higher dividends. In NZ Fisher Funds has, for its NZX listed funds, taken that a step further by simply returning a certain proportion of its capital to shareholders each year by way of dividend. A number of income funds locally also invest in high yield debt (also known as junk bonds). This increases dividends but the downside is that risk also increases and in market crises the bond market bifurcates whereby safe bonds go up in price and junk bonds crash along with the share market. These practices underline the importance of being wary of high yields – it is not enough to just look at the number – one must do the mahi to understand how the dividend is funded.

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.