Buyback or pay-out

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Against a backdrop of elevated anxiety, income-producing stocks are often the first place investors turn to for so-called "safe harbour" allocations. This has arguably led to valuations of such dividend payers looking steep, with the US utilities sector, for example, trading at 18.2x P/E in the summer of 2016, following a Brexit-fuelled volatility spike.[2]

Often termed bond proxies, these large cap defensive stocks have enjoyed investor favour due to their higher yielding profiles in an investment environment where as much as US$12 trillion of the fixed income market was negative yielding by October 2016.[3]

The question for 2017 is whether such equities can continue to carry investor support and whether their pay-out ratios are sustainable?

The historical average pay-out ratio of the S&P 500 is 57.3%, with the 1930s marking a peak in ratios of 90.1%.[4] In the 1970s, '80s, '90s and 2000s, the average pay-out ratio dropped significantly below this long-term average and buybacks were more the norm. The pay-out ratio now is around 45% so there is some room before it hits the historical average. Part of the culture of buybacks has been driven by taxation – capital gains were taxed at a lower rate so companies were better off buying back stock. The other important factor has been management compensation, which has been very stock-option orientated. When you're dealing with stock options, the value of the stocks goes down when you pay out dividends. Management compensated largely with stock options are much better off buying back stock and this has encouraged the wider trend of buybacks.

Changing management carrots

Since the financial crisis, the composition of management compensation packages has changed and boards are starting to allocate a higher percentage via restricted stocks. This has prompted management teams to favour a combination of stock buybacks and dividends so we are seeing a slow movement towards more of the latter.

Management teams have seen companies with higher yields obtaining higher valuations on the stock market which is encouraging those teams to think again about dividend distributions. The current low-growth environment has led to company caution when it comes to building out capacity and investment, so firms have over US$4 trillion in cash on their balance sheets.[5] This means companies have ample capital to return to shareholders. In 2016, firms were not shy in doing so: S&P 500 dividends increased 5.2% year-on-year in the third quarter, putting the yield of the index at 2.1%.[6]

If the perception of the market changes and US economic growth starts to look more robust then capex could increase , but it not likely to be taken out of dividend pools. The higher capex goes, the more companies will move out of buybacks. The last thing they want to do is to cut dividends because it is deemed a taboo by the market and share prices tend to suffer as a consequence. The current pay-out ratio of the S&P 500 is not egregious and as such, should not diminish in 2017.

Sector scout

I believe that for the majority of industries, dividend cuts are not a significant threat. A few areas like the energy explorers and producers and the owners of energy infrastructure cut their

Figure 1: Dividend pay-out ratios S&P 500

Decade	Average payout ratio
1930s	90.1%
1940s	59.4%
1950s	54.6%
1960s	56.0%
1970s	45.5%
1980s	48.6%
1990s	47.6%
2000s	35.3%
Historical average	57.3%
Current payout ratio	45.5%

Source: Strategies Research Partners, 1930-2009, Ned Davis Research for historical average (see footnote) and TBCAM for current pay-out ratio, as of 31 December 2016

dividends following the oil price drop, but I believe those cuts have now filtered through.

Meanwhile, financials are an interesting sector from an income investor's point of view and an active manager can find good value in higher dividend yielding stocks, particularly in financials (see Figure 2). The market still treats financials as risky and is sceptical of them due to the overhang from the financial crisis. The valuations of many financials in the sector are at all-time lows, and while governments are forcing banks to hold a lot more capital, in the past five years they are making the best loans they have ever made. Yet everyone still thinks first and foremost of the dividends cut in the wake of the global financial crisis. For example, the Tangible Common Equity ratio (a measure of the losses a bank can take before shareholder equity is wiped out) for financials is at its strongest since the 1930s. So balance sheets are in incredibly good shape even as Comprehensive Capital Analysis and Review (CCAR) severe adverse scenario tests carried out by the Federal Reserve show the banking sector should have resilience in the face of a range of even serious headwinds.

Tax implications

Another potential boon for pay-out ratios in 2017 could be if the new president, Donald Trump, manages to pass a repatriation tax holiday. According to some reports, US companies are holding in excess of US$2.1 trillion in profits overseas, so if even a fraction of that is brought back onshore I believe it would feed into dividends. M&A would also likely be a beneficiary.

Over the longer term, he hopes Washington will work towards reforming the tax code so the corporation rate no longer sits at 35%. We believe it is a bipartisan issue that needs to be fixed.

The tech sector in particular could be ripe for increasing pay-outs if tax reform is agreed. Management teams in big tech are gradually moving to compensation through restricted stocks like the rest of the market, which should hopefully lead to greater pay-outs from the tech sector.

For the long term, sustainability remains key when it comes to dividend payments. Even so, high pay-out ratios should not always be viewed as a red flag. There are some instances when pay-out ratios as high as 90% are sustainable. REITs, for example, are mandated to pay out a high portion of earnings, and some utilities can also maintain such levels. What it comes down to is whether investors can be confident in the company's ability to generate sufficient cash consistently. The main headwinds likely in 2017 could be a further drop in energy prices, which could see more companies in that sector cutting dividends, but this is not necessarily the base case. A lot of that played out in 2016 and I think the rest of the sectors in the US are in pretty good shape.

Figure 2: Financials versus utilities

	Income stock financials	Utilities Select Sector
Dividend yield	3.4%	3.3%
YTD Performance	3.6%	22.4%
Projected 3-yr Dividend Growth Rate	9.9%	5.5%
Historical 3-yr Dividend Growth Rate	21.0%	4.9%
Price/Earnings Ratio (FY2)	11.9x	18.2x
Price/Book Value ratio	1.2x	2.0x

Source: FactSet, 31 July 2016

1. Investment Managers are appointed by BNY Mellon Investment Management EMEA Limited (BNYMIM EMEA) or affiliated fund operating companies to undertake portfolio management activities in relation to contracts for products and services entered into by clients with BNYMIM EMEA or the BNY Mellon funds.
2. *FactSet*, 31 July 2016.
3. *Bloomberg*, 2 October 2016.
4. *Ned Davis Research* – historical average for period 31 March 1926 to 31 December 2015.
5. Cash balances based on S&P 500 balance sheet an includes short-term equivalents as of 30 September 2015.
6. *Evercore*, 4 October 2016.