Income investing – a value approach

Nick Hamilton
Head of Global Equity Products
Invesco Perpetual

Investing in an equity income style is a value approach to investing. When it comes to dividends, we believe that: they are an important component of total return, growing dividend streams are worth more than high static yields, dividends must be sustainable to be valuable and dividend behaviour can be a signal of management confidence.

What is equity income investing?

We believe that income investing is about building portfolios, which in aggregate exhibit above market dividend yield and, just as importantly, underlying dividend growth. The powerful combination of dividend yield and dividend growth has been known to investors for decades, with research to support the notion that this combination can produce above market average returns[1].

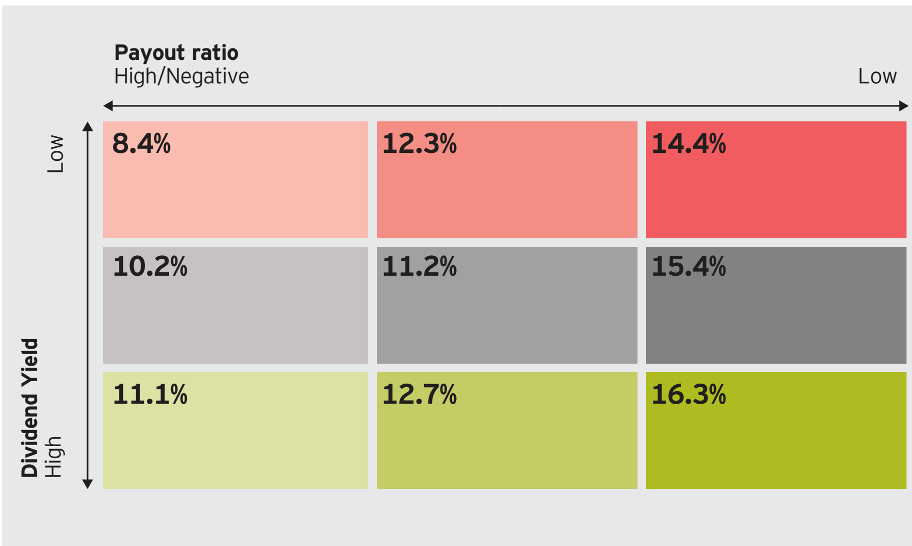
However, it would be unwise to discount the risks of focusing solely on high dividend yield. A dividend yield can appear high (albeit temporarily) when a company becomes distressed. The combination of a falling share price paired with an historical dividend payment can create an attractive illusion. This illusion tends to be most dangerous around periods of economic crisis. It is for this reason that dividends must be considered in the context of a business' ability to sustain and pay that dividend into the future.

As per Figure 1, a study by Credit Suisse has shown that on average, the lower the payout ratio (the amount of earnings that are paid out in the form of a dividend), the better the performance of companies has been. And within each payout range (i.e. low, medium and high), companies with a high dividend yield have, on average, outperformed companies with a low or medium dividend yield. Capacity to pay the dividend is clearly a critical factor. The best combination on average (+16.3% per annum) is high dividend yield with a low payout ratio.

Why do dividends matter?

In theory, a company's decision to pay a dividend should not alter the intrinsic value of

Figure 1: Annualised returns
Dividend Yield & Payout Ratio – January 1990 to June 2011



Source: Credit Suisse Quantitative Equity Research, June 2011. Annualized returns

“The powerful combination of dividend yield and dividend growth has been known to investors for decades” the business. This is known as the dividend irrelevance theory – first proposed by Miller & Modigliani in the 1960s. In practical terms, dividends are a rather more powerful contributor to stock performance. The theory relating to why a company that pays and grows its dividend tends to outperform centres on the idea that a dividend is a signal of management confidence. The idea of signalling was first discussed in 1973 by Nobel Prize winning economist Michael Spence. This and subsequent work identified the proposition that asymmetric information in equity markets means the dividend can provide a "signal" to markets of management confidence. Over time, academic research including that by Miller and Modigliani (1985) has supported the idea that because of information asymmetry, stocks outperform after a dividend rise and underperform after a dividend cut.

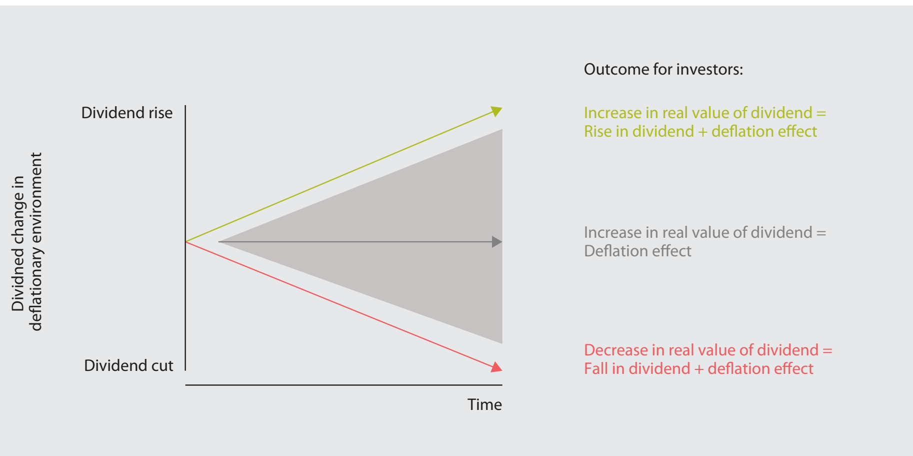
Research by Aharony & Swary (1980) also concluded that firms which increased their dividends experienced, on average, higher subsequent earnings growth. Concurrently, firms that decreased dividends experienced lower subsequent earnings growth. The idea that earnings growth can be higher for companies that raise dividends is contrary to the perception about dividend-paying companies generally. However, the evidence is supportive that dividends are not a signal that a company has gone ex-growth and has no alternative use for its cash flow.

As investors, we believe that dividends exert discipline on companies, in that they represent a periodic cash payment. It is this discipline that we see as linked to wider corporate discipline and as the empirical evidence supports, higher long-term earnings growth.

A low interest-rate world and the role of dividends

Interest rates in many parts of the global economy are at either "emergency" settings or are low relative to any measure of near-term or long-term history. If the current debt-deleveraging cycle continues, which we anticipate it will, and lower growth is the outcome for many global economies, then interest rates will potentially stay low for longer. Historically, low economic growth from financial de-leveraging has been disinflationary, however today we continue to see inflationary pressures. In this scenario, investors exposed to low interest rates, with any level of inflation, will see their real wealth eroded.

Figure 2: The real value of dividends in periods of deflation



Source: Investco Perpetual, as at 4 October 2011. For illustrative purposes only.

Inflation as we know it today was largely non-existent until the 1950s. Since then we have seen persistent rising inflation. From a company investment perspective, inflation will lead to rising nominal (if not real) earnings. If a company maintains a broadly even dividend payout policy, then dividends should rise broadly in line with inflation. The evidence over the last 110 years supports that notion, with nominal dividends rising in line with inflation. Whilst the precise outlook for inflation is not clear, equity dividend yield has proved a strategy to hedge against inflation.

Dividends and deflation

Today, inflationary pressures vary globally. In some developed economies where inflation has been persistent, there are reasons to believe that it is dissipating with deflationary forces being exerted. For investors, deflation can be a significant threat. The risk to dividends in a deflationary period is the risk of falling earnings and the impact on dividends thereafter.

As Figure 2 shows, companies that can maintain their dividends in disinflationary periods become increasingly valuable as the real value of their future dividend rises. However, deflation is an economic outcome that we believe the authorities would aggressively fight and as we have seen after earlier quantitative easing, inflation typically picks up thereafter. Focusing therefore on dividend sustainability, thorough testing of the sustainability of cash flow is an important component of dividend investing for inflationary and deflationary environments.

Rising dividends, falling bond yields

Today, we see that many companies' dividend yields are higher than their corresponding bond yields. Where a company is distressed this makes sense. However, where a company is a global multinational with a diversified revenue base, with ample capacity to pay and even grow its dividend, then we believe that this is anomalous.

Figure 3 illustrates the point by taking 30 of the world's most recognised global companies, the constituents of the Dow Jones Industrial Average. If you take those companies' dividend yields and subtract a proxy for their current corporate debt yield, you see that in most cases the companies' dividend yields are above their equivalent corporate bond yield.

Our approach to dividend investing

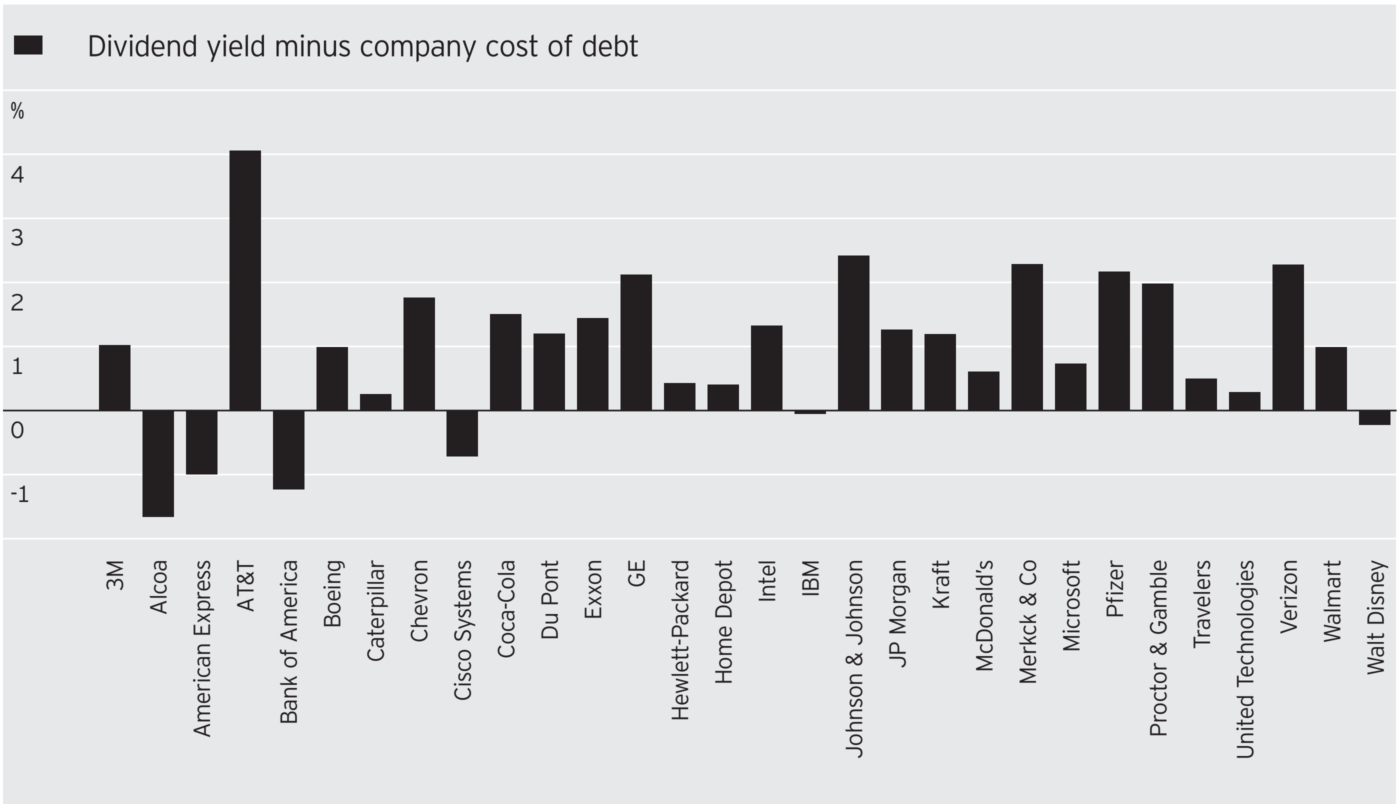
As advocates of dividend investing, we believe that the approach taken is very important. Investing into stocks with high dividend yields alone can be an unwise strategy. Dividends are cash payments and as such the approach that we believe has the potential to generate the highest long-term return is to focus on free cash flow generation – the source of the sustainable dividend.

Conclusion

The dividend characteristics of companies are an important determinant of performance. The practical evidence suggests that dividends are a signalling tool of management confidence and that rising dividends equate to higher earnings growth and performance in general. As investors, we believe we should differentiate between sustainable and unsustainable dividends, and examining corporate cash flow is a means by which this can be approached.

1. Societe Generale, the Global Income Investor, January 2011.

Figure 3: Dow Jones industrial average universe – dividend yield versus cost of debt



Source: Bloomberg, as at 4 October 2011.