

# INVESTMENT STRATEGY COMMENTARY

## DIVIDENDS: MORE INTERESTING THAN BONDS

### SUMMARY

September 28, 2012

Northern Trust  
Global Investments  
50 South La Salle Street  
Chicago, Illinois 60603  
northerntrust.com

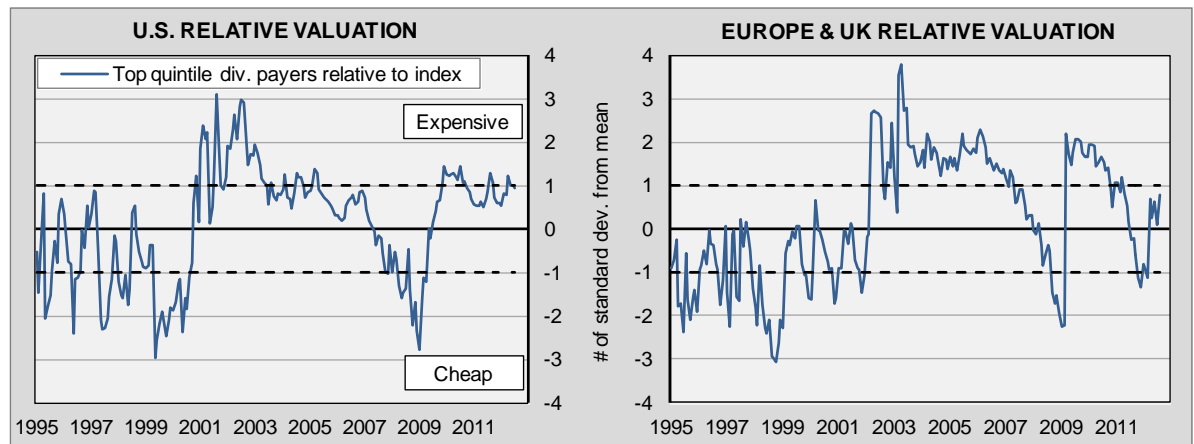
James D. McDonald  
Chief Investment  
Strategist  
jxm8@ntrs.com

Daniel J. Phillips, CFA  
Investment Strategist  
dp61@ntrs.com

Phillip B. Grant  
Investment Analyst  
pbg1@ntrs.com

Dividend-paying stocks have handily outperformed the broad market over the last two years, as interest rates have fallen and yield-starved investors have sought income wherever they could get it. Has this rendered dividend-payers too expensive? Relative to history, the highest dividend-paying stocks are expensive based on price-to-earnings ratios – and they border on expensive on a price-to-book basis (see Exhibit 1). Relative to bonds, however, they have rarely been cheaper over the last 50 years (see Exhibit 2). Taxable investors today face significant tax policy uncertainty surrounding the year-end expiration of the Bush-era tax cuts, as the tax rate on dividends is likely to increase by an undetermined amount. While a significant jump in this tax rate could lead to some underperformance of these stocks, a more moderate increase will likely be shrugged off by the market. As such, while valuation and tax law uncertainty do argue against outperformance of dividend-paying stocks over the near-term, the longer-term still looks constructive. Dividend payers, especially those raising their dividends over time, are proven outperformers. In addition, the increasing number of retirees in developed markets globally, at a time of rock-bottom government bond rates, means there will be a continuing hunger for income. Therefore, while the near-term outlook for the relative performance of dividend paying stocks has some uncertainty, the positive long-term potential means that investors are likely best off holding on through any short-term volatility.

### EXHIBIT 1: EXPENSIVE ... OR A NEW NORMAL?



Source: Northern Trust, Compustat, Worldscope, Factset. Indices: Russell 3000, MSCI Europe (inc. UK).

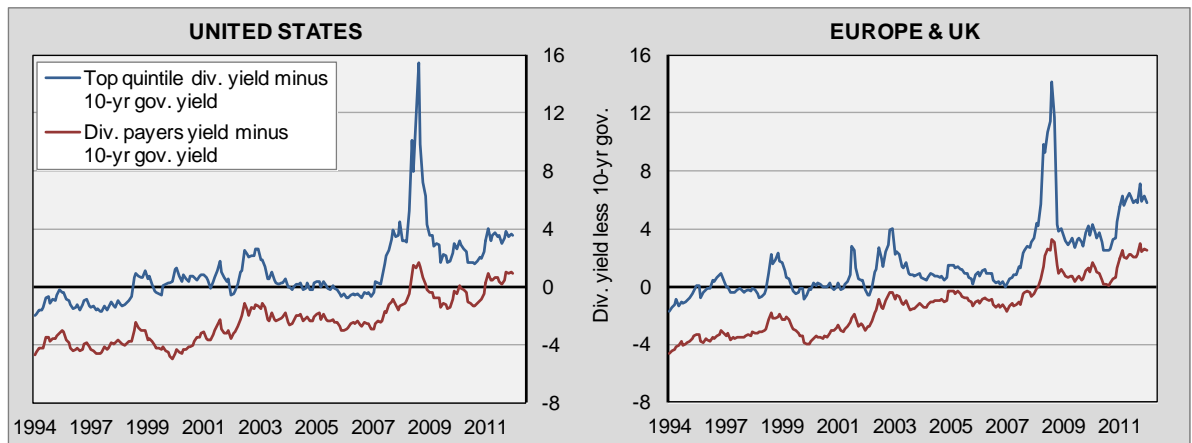
Exhibit 1 displays the relative valuation, on a price-to-book basis, between the top-quintile dividend payers and the entire index. The zero level corresponds to the mean relative valuation since 1995, with each incremental number representing a standard deviation move away from the mean. We consider dividend-paying stocks to be expensive when they are more than 1 standard deviation above the mean, and vice versa. Examination of the data shows that the stocks tend to go through valuation regimes, where they can be relatively cheap or expensive for sustained periods. It is our belief that we are in a regime where the top dividend payers will remain “expensive” relative to



broad stock indexes for some time. Valuation on a price-to-earnings basis shows the stocks as more expensive, with the relative trailing P/E ratio of the highest-yielding stocks at its second highest level in the last 60 years (Empirical Research Partners, Portfolio Strategy August 2012). Within the U.S. equity market, the highest relative valuations have been accorded to the most stable groups – consumer staples, telecommunications and utilities. Conversely, the valuation of high dividend payers in some growth and cyclical sectors – such as technology and industrial commodities – are cheap relative to history. Performing the same measure in Exhibit 1 on the entire universe of U.S. dividend-paying stocks shows that group to be only slightly above its long-term mean.

Within the world of equities, the highest dividend-paying stocks are expensive as compared to the equity market as a whole. But what about the attractiveness of dividend-paying stocks in the context of an entire portfolio – especially in the all-important allocation between stocks and bonds? In this case, the valuation of dividend-paying stocks (and, admittedly, stocks in general) looks compelling. As shown in Exhibit 2, the top quintile of dividend-yielding stocks in both the United States and Europe is near normalized highs (throughout this report, we have combined the United Kingdom with continental Europe to gain a broader data set). While yield differentials spiked during the bottoms of the bear market in early 2009, the current yield differentials of 3.5% in the United States and 5.8% in Europe are still very high as compared with a post-World War II history. From 1900 through the mid-1950s, the dividend yield on U.S. stocks was almost always above the 10-year bond as the economy was more volatile and financial markets had yet to globalize in a meaningful way.

### EXHIBIT 2: DIVIDENDS LOOK MORE INTERESTING



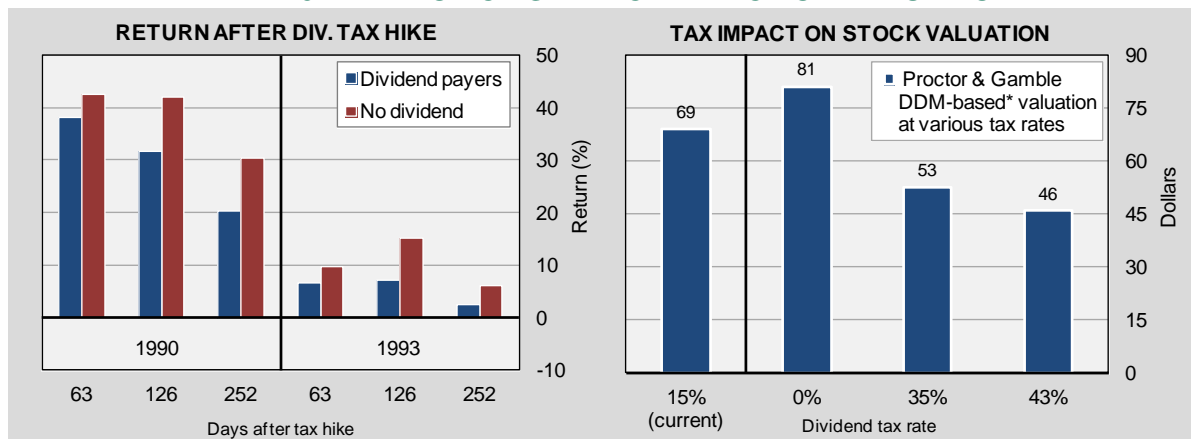
Source: Northern Trust, Compustat, Worldscope, Factset, Bloomberg.

So what explains these differentials, and what does it mean for investment strategy? Clearly the “lower for longer” interest rate environment engineered by developed market central banks is a key driver. We believe central banks – especially the Federal Reserve – are trying to push investors out of fixed-income assets and into riskier assets like stocks. Going forward, we think investors will increasingly reallocate from investment-grade fixed income toward stocks, which led us to increase our 5-year U.S. equities forecast this year from 7.5% to 8.5% annually. What could cause dividend-paying stocks to underperform government bonds, even with this valuation cushion? Most likely, it would be the development of a severe global recession and ensuing deflation. This would lead to an increase in the real purchasing power of government bonds beyond the current low nominal yields, generating capital gains.



An additional factor weighing on current valuations is investor uncertainty around potential tax policy change. The evidence of tax changes on stock market behavior is fairly sketchy. A paper by Federal Reserve economists Amromin, Harrison and Sharpe (*How Did the Dividend Tax Cut Affect Stock Prices*, October 11, 2005) asserts that the dividend tax cut of 2003 didn't affect stock prices at all. One convincing element of their argument was the nearly identical performance of U.S. and European stocks at a time when the reduced taxation should have favored U.S. shares. Prior to 2003, dividends received no special tax treatment as they were taxed as ordinary income. But we can gain some insight by looking at periods where the ordinary income (and therefore dividend) tax rates changed. In 1990 the top rate increased from 28% to 31%, in 1993 the top rate increased from 31% to 40%. In the 1990 episode, dividend payers measurably lagged non-dividend payers in the stock market rally that occurred after the tax hike. Not only is this outcome expected in such a strong market, but dividend payers had outperformed in the prior year (by only declining 13% as compared to a 31% decline in non-dividend payers). In 1993, dividend payers lagged in the more sedate market environment, but they significantly lagged in the prior year (rising 18% as compared to the 31% jump in non-dividend payers).

### EXHIBIT 3: TAX POLICY'S DIRECT IMPACT ON VALUATION



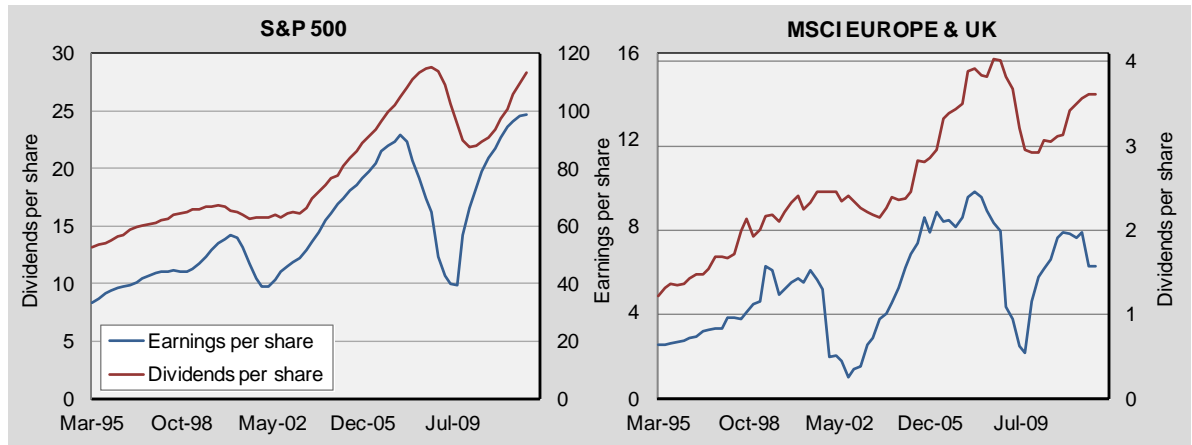
Source: Northern Trust, Ned Davis Research, Bloomberg. \*Note: DDM – Dividend-discount model.

There has been a lot of noise in some quarters about the significant hit to the value of dividend-paying stocks, should the tax rate rise in the New Year. We ran a simplified dividend discount model on a high-profile dividend-paying stock (Procter & Gamble), with scenario analysis around the impact to “fair value” based on changes in dividend taxation. In our view, these represent worst-case scenarios that will not be realized for several reasons, including: First, the large community of non-taxable investors (such as non-profits and pensions) will not view the value of P&G any differently based on changing taxation of dividends. Second, this exercise assumes that investors are solely basing their valuations on a dividend-discount model framework, as opposed to growth in the equity value of the company. Third, the scarcity of yield may just cause investors to pay more for the high-quality companies that generate it.

The valuation comparison between dividend yields and government bond yields shown in Exhibit 2, while highlighting the attractiveness of dividends, doesn't delve into the relative instability of dividends versus interest payments. Dividends can be cut by companies when earnings are under pressure, and the recent financial crisis certainly provides a fresh reminder of this. As shown in

Exhibit 4, during the second-worst financial crisis of the last century, aggregate dividends fell by 24% and 28% in the United States and Europe, but are now only 2% and 10% from their prior peak levels. We believe investors should be impressed with the relative durability of dividends across the whole market, as very few companies eliminated their dividends and many turned to increasing their dividends within a relatively short period of time.

#### EXHIBIT 4: RESILIENT DIVIDENDS

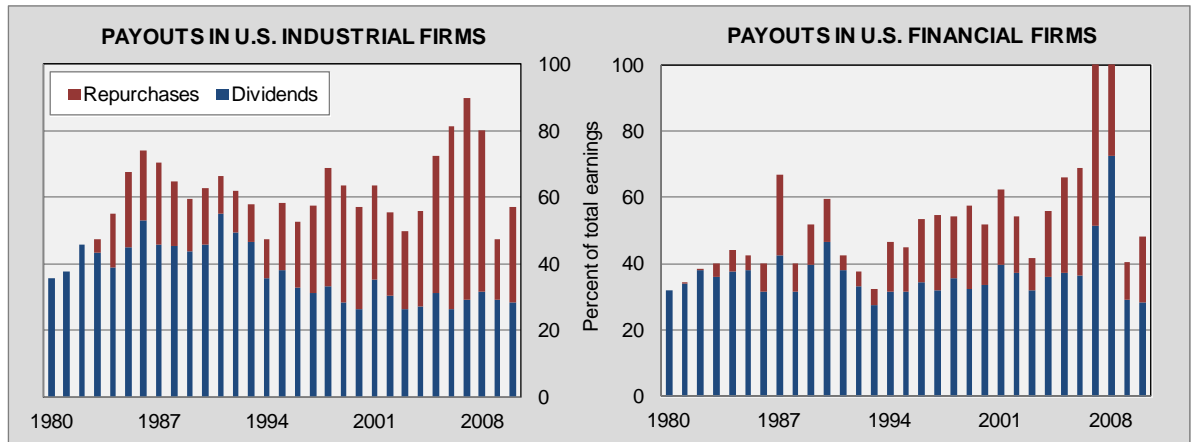


Source: Northern Trust, Bloomberg. Data through 6/30/2012.

A working paper titled: *Payout Policy Through the Financial Crisis: The growth of repurchases and the resilience of dividends* (Floyd, Li and Skinner, October 2011) examined some of the empirical and behavioral influences on corporate decisions on dividends and buybacks. Theoretically, shareholders benefit more from the utilization of free cash flow to repurchase stock (which doesn't create a taxable event) than from payments of dividends. In practice, investor interest in dividend income has significantly influenced corporate behavior around capital allocation. Floyd, Li and Skinner speculate that some of the support for dividend payouts may be tied to the long-term commitment they require of management, reducing the agency problems tied to the prudent allocation of free cash flow.

As mentioned earlier, there is a theoretical paradox surrounding the utilization of free cash flow. Management teams may prefer to return cash to shareholders through buybacks, which do not create a taxable event and let the companies retain maximum flexibility. Investors seem to prefer the tangible signs of dividends, as they provide income, more stability to share prices, and put some constraints on management behavior. We do think the increasing payout of excess cash in repurchases versus dividends makes the current dividend yield of the markets incomparable to levels of decades ago. In 2010, U.S. industrial companies used as much capital to buy back stock as to pay dividends – meaning that a 2% dividend yield in the market equated more closely to a 4% total payout yield. While this is overstated, to some extent, as the buybacks can be partially offset by share issuances, we do believe that looking solely at dividend yields understates the benefit to shareholders of corporate cash generation.

## EXHIBIT 5: LONG-TERM INCREASE IN BUYBACKS



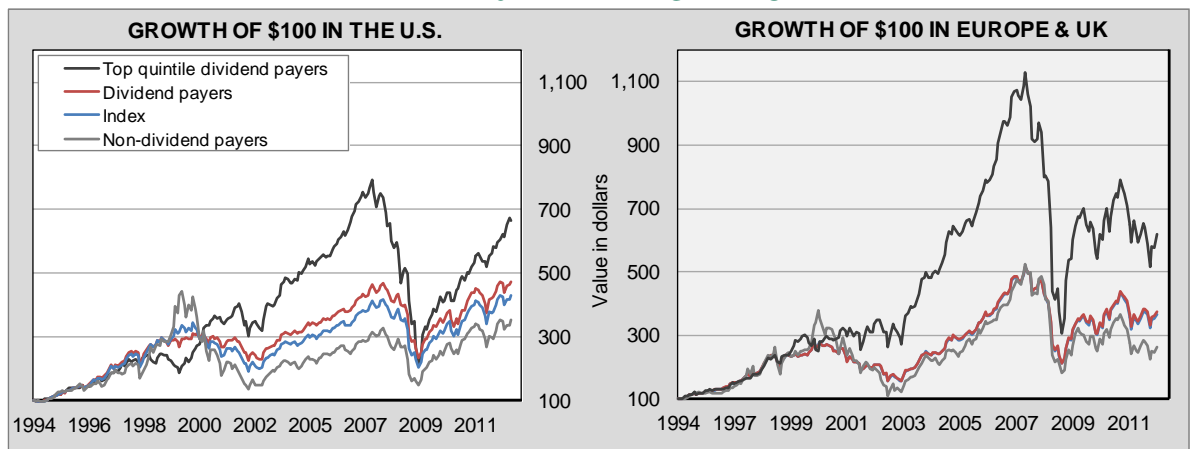
Source: Northern Trust; Floyd, Li and Skinner, 2011.

Note: In 2007 and 2008, financial firms paid out 102% and 137% of earnings respectively.

Dividend-paying stocks have a long history of generating excess returns, and dividends are a meaningful part of the market's overall return historically. From 1930 through 2011, the S&P 500 has generated a total annualized return of 9.4%, of which nearly 45% came from dividend income. This proportion has fallen in recent decades as capital allocation has broadened to share buybacks, but a focus on dividend-paying stocks has continued to be beneficial nonetheless. From 1972 to present, a portfolio of S&P 500 companies that initiated and increased their dividends gained 9.5% per annum, as compared with a 1.5% annual gain in non-dividend paying stocks. Over this period, the S&P 500 increased at a 7.0% annualized rate.

In Exhibit 6, we examine a strategy of investing in the high dividend payers (the top quintile), which handily outperformed dividend payers in general, the overall market, and non-dividend payers. This portfolio of stocks gets updated each month, so a large run-up in the strategy does not necessarily indicate a large run-up in a specific set of stocks.

## EXHIBIT 6: DIVIDENDS PAY OFF

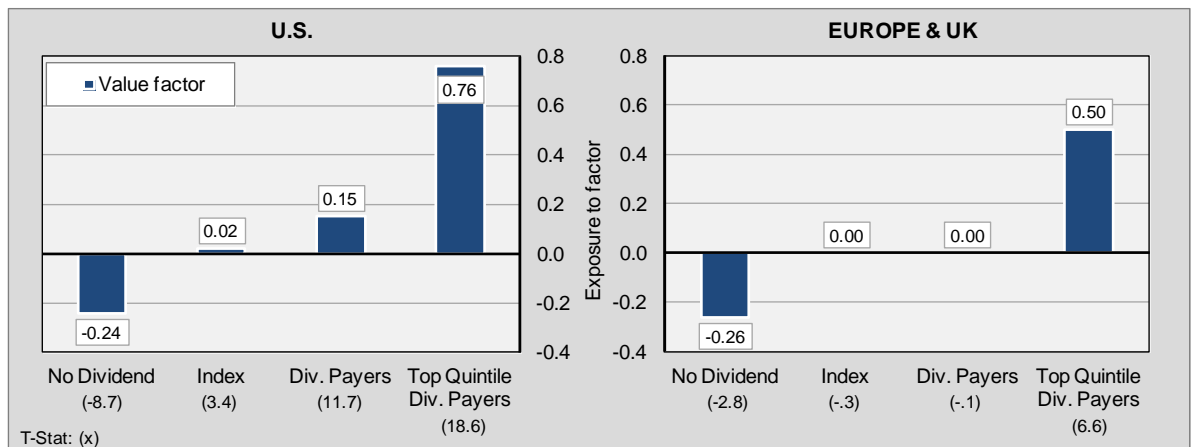


Source: Northern Trust, FactSet.

But implementing a strategy along these lines is much more complex than just buying the highest yielding stocks. One could undertake that strategy, but you would be accepting considerable risk through either position or risk exposure concentration. A focus on the highest yielding stocks alone will likely lead to a significant concentration in certain sectors (like telecom and utilities), and therefore vary considerably from the overall market. One of the most important steps in controlling the risk of a dividend-tilted strategy, therefore, is to control the sector composition. While this will almost certainly lead to a lower dividend yield than an unconstrained portfolio, it will be a lower risk portfolio that should perform better over the long-term.

One explanation for the excess returns of dividend-paying stocks is the exposure to the value risk factor (referred to as Value going forward). The value risk factor was discovered by University of Chicago professor Eugene Fama and University of Dartmouth professor Kenneth French by taking the lowest valued stocks minus the highest valued stocks, as measured by book value (firm assets minus firm liabilities) in relation to market cap. Value has provided a statistically significant risk premium over time (the annualized value risk premium has averaged approximately 4.7% going back to 1926) and, therefore, exposure to the risk factor is desirable. Dividend-paying stocks tend to show statistically significant exposure to Value, as can be seen in Exhibit 7. For example, if Value returns 1%, the top quintile dividend payers in the United States have historically seen a 0.76% average return while non-dividend payers suffered a 0.24% average loss.

### EXHIBIT 7: THERE IS VALUE IN DIVIDENDS



Source: Northern Trust

As we have noted above, investing in dividend-paying stocks has historically provided a proven tailwind to investment returns. However, there are things to keep in mind when investing in such a strategy. First, the exposure to the value factor provides a premium because there is a higher level of risk attached. As such, the collective universe of higher-dividend paying stocks can be more volatile without proper risk management. For clients looking to dampen the level of volatility, a quality overlay may be appropriate. Northern Trust uses a proprietary quality score that looks at company metrics such as management performance, profitability and cash levels. Companies that score high with regard to these metrics both are less volatile and are more likely to meet dividend commitments and grow those commitments over time. Additionally, the quality metric is beginning to be viewed as a factor premium in its own right, though its underpinnings are less understood. Second, investing

in top dividend payers risks excessive sector concentration in the portfolio as dividend payers tend to come from specific industries such as utilities and telecom. Putting in place a sector neutral approach can eliminate these concentrations. Third, to the degree dividend payers go into and out of the “Q1” bucket, a certain level of turnover is implied in the strategy, which needs to be addressed through the portfolio management process. Finally, we would like to note that, while we have touched on a few of the practical issues surrounding the implementation of a dividend strategy above, a thorough review of the key issues surrounding constructing a dividend-oriented portfolio is beyond the scope of this report.

## CONCLUSION

An examination of current valuations confirms only some of the current market worries. The highest-yielding dividend-paying stocks appear expensive relative to their history, but the entire universe of dividend-paying stocks does not. In addition, the yields of both the highest yielding stocks and the entire dividend-paying universe are attractive when compared with investment grade bonds. This valuation phenomenon is a direct consequence of the current easy money policies that have started to force money into higher yielding risk assets. The Federal Reserve likely won’t feel it is nearing its goals until there is a broader movement from government bonds into broader risk assets.

The current worries about the potential negative impacts of tax policy changes on dividend paying stock valuations seem overdone. The market’s historical reaction to tax policy changes is far from clear. While there is some credible evidence to suggest that the market will not react to a moderate change in rates, it seems more prudent to assume some short-term negative reaction. Our long-term enthusiasm for dividend payers, however, remains intact. Their performance profile is bolstered by their value orientation, and we think investor interest in income will create an active audience for these stocks for many years to come.

*Special thanks go to John Ferguson, Michael Huntstad and Mark Sodergren for research insights; and to Sanford Carton for data research.*

IRS CIRCULAR 230 NOTICE: To the extent that this message or any attachment concerns tax matters, it is not intended to be used and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed by law. For more information about this notice, see <http://www.northerntrust.com/circular230>.

IMPORTANT INFORMATION: This material is for information purposes only. The views expressed are those of the author(s) as of the date noted and not necessarily of the Corporation and are subject to change based on market or other conditions without notice. The information should not be construed as investment advice or a recommendation to buy or sell any security or investment product. It does not take into account an investor's particular objectives, risk tolerance, tax status, investment horizon, or other potential limitations. All material has been obtained from sources believed to be reliable, but the accuracy cannot be guaranteed.

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. Periods greater than one year are annualized except where indicated. Returns of the indexes also do not typically reflect the deduction of investment management fees, trading costs or other expenses. It is not possible to invest directly in an index. Indexes are the property of their respective owners, all rights reserved.

No bank guarantee | May lose value | NOT FDIC INSURED



Northern Trust