Active is:

Generating capital income with dividends.

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Content

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Active is: Generating capital income with dividends.

In a large number of advanced countries, the current yields of governments bonds are hovering in negative territory or, at the very least, are at an insufficient level to preserve capital. Consequently, attention is increasingly shifting to dividends as a way of generating capital income; and they are becoming even more relevant as the issue of “reflation” comes to the fore with a gradual uptick in inflation rates.

Figure 1: Negative yields are a global phenomenon

Generic government bond rates, in %

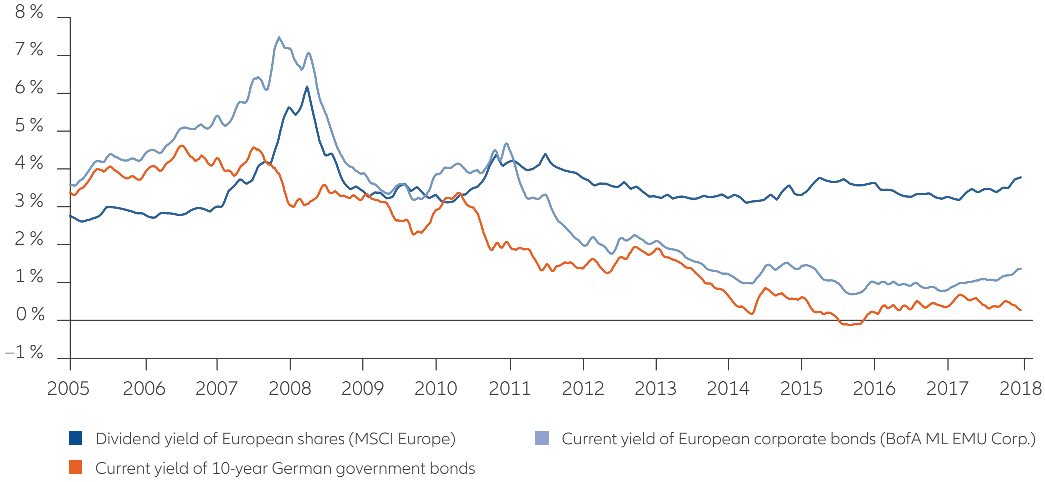
	3M	1Y	2Y	3Y	4Y	5Y	6Y	7Y	8Y	9Y	10Y	15Y	20Y	30Y
Germany	−0.68	−0.58	−0.62	−0.59	−0.49	−0.37	−0.28	−0.18	−0.07	0.04	0.17	0.44	0.61	0.80
France	−0.86	−0.63	−0.48	−0.33	−0.17	0.00	0.07	0.23	0.38	0.46	0.65	1.08	1.21	1.60
Italy	−0.06	0.38	0.44	1.02	1.35	1.75	2.01	2.27	2.26	2.48	2.69	2.99	3.27	3.50
Netherlands	−0.85		−0.66	−0.60	−0.46	−0.32	−0.16	−0.03	0.09	0.22	0.32			0.84
Belgum	−0.80	−0.54	−0.54	−0.42	−0.29	−0.05	0.06	0.24	0.43	0.58	0.71	1.16	1.47	1.73
Austria		−0.45	−0.54	−0.52	−0.33	−0.23	−0.08	0.08	0.25	0.33	0.42	0.89		1.28
Finland		−0.56	−0.51	−0.49	−0.35	−0.20	−0.12	0.09	0.17		0.48	0.84		1.07
Switzerland*		−0.92	−0.75	−0.79	−0.70	−0.63	−0.52	−0.44	−0.38	−0.32	−0.25	0.11	0.25	0.37
Sweden*	−0.45		−0.41		−0.24	−0.07		0.10			0.40			
Denmark*	−0.57		−0.59			−0.28					0.16			
UK*	0.72	0.75	0.72	0.72	0.75	0.84	0.89	0.93	1.00		1.21	1.44	1.69	1.78
US	2.43	2.60	2.50	2.47		2.50		2.56			2.66			2.99
Japan	−0.15	−0.18	−0.14	−0.14	−0.14	−0.14	−0.14	−0.14	−0.12	−0.07	0.00	0.24	0.49	0.72

*Non-EWU Countries
Generic government rates monitor yield changes for government benchmark bonds. Past performance is not a reliable indicator of future results. Sources: Bloomberg, AllianzGI Global Capital Markets & Thematic Research, Data as of 2 January 2019

Dividend strategies certainly appear interesting. Divergence between dividend yields and yields on government and corporate bonds has never been as large as it is today by historical standards, at least as far as European companies are concerned.

Figure 2 a: European shares offer attractive dividend yields

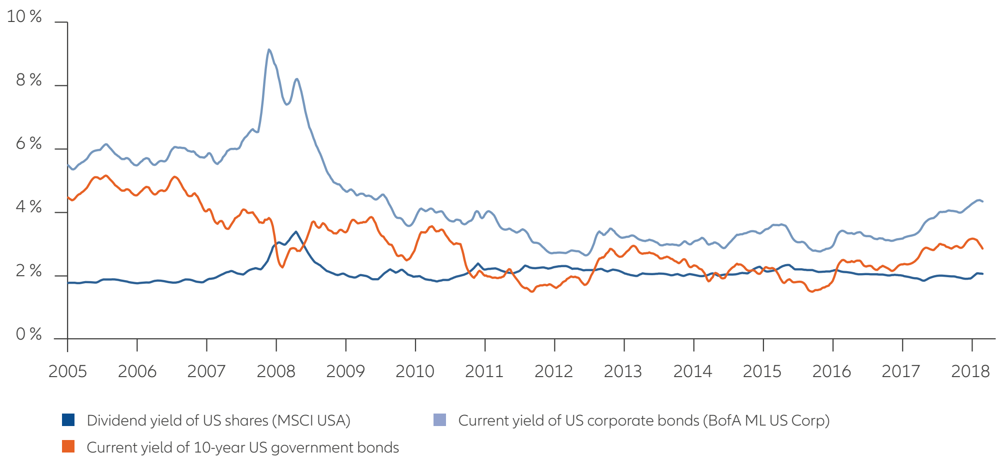
Dividend yields (MSCI Europe) versus yields of German government (10 year) and European corporate bonds



Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of 4 January 2019

Figure 2 b: Dividend yields of American shares

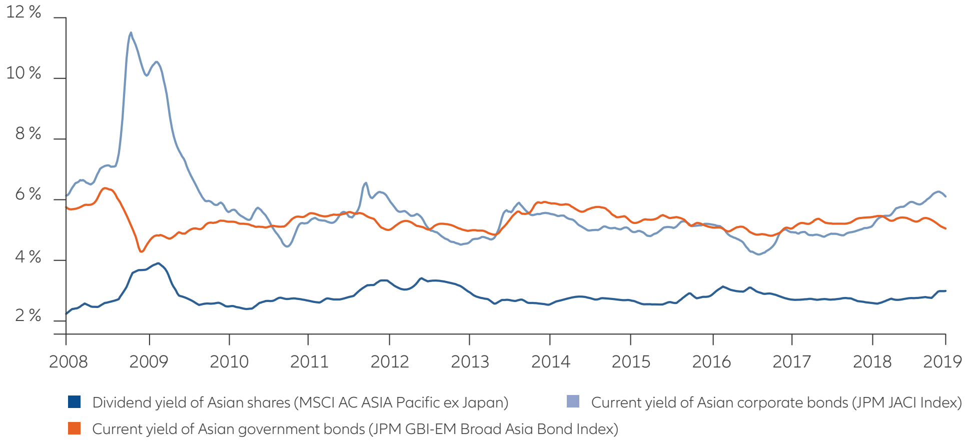
Dividend yields (MSCI USA) versus yields of US government (10 year) and American corporate bonds



Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of 4 January 2019

Figure 2 c: Dividend yields of Asian shares

Dividend yields (MSCI ASIA ex Japan) versus Asian government and Asian corporate bonds



Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of 4 January 2019

For investors, there are two key questions that are important to consider before any assertions can be made about the future success of dividend strategies:

1. What advantages can dividend strategies offer the long-term investor?
2. Taking the current market environment as a starting point, what can be expected in terms of the future performance of dividend yields?

As a rule, dividend strategies are characterised by companies that:

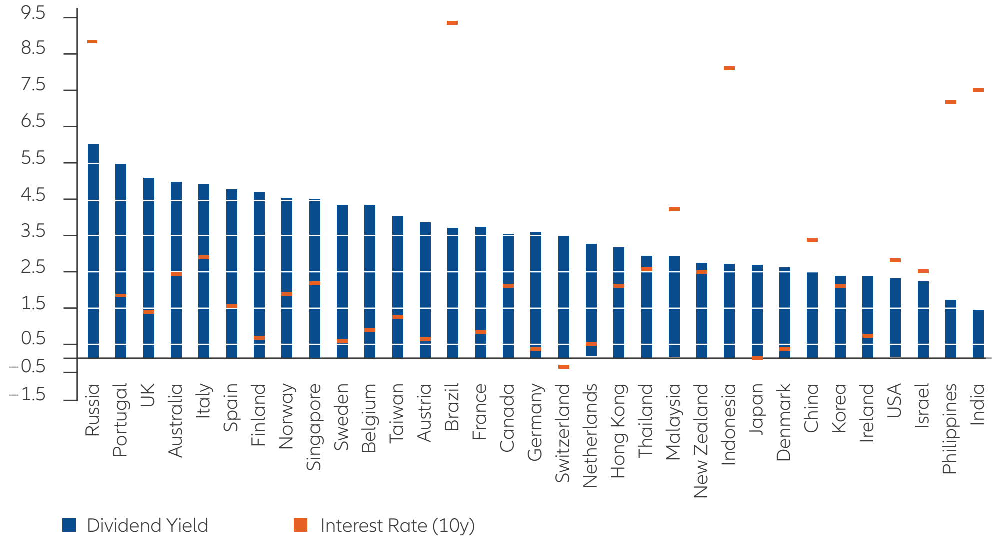
1. can be expected to generate an above-average dividend yield on the respective market index,
2. have potential for growing future dividends while simultaneously
3. providing a reliable dividend policy and dividend track record.

Dividends – a key performance driver in a low-interest and low-yield environment

European companies, in particular, have an investor-friendly dividend policy compared to their international peers. At the end of December 2018, their average dividend yield across all market segments was around 3.8 % (basis: MSCI Europe). Focusing on high-dividend stocks meant that the expected dividend yield in the portfolio rose even further. However, in some cases the dividend yield in other regions is considerably higher than that on 10-year government bonds, too (see figure 3). The dividend yield on the MSCI-USA seems positively modest in comparison, although you have to bear in mind that US companies, in contrast to European ones, for instance, have a stronger tendency to launch share buyback schemes than to pay out dividends. Share buyback schemes, though, are nothing other than corporate profits being paid out to a smaller, residual circle of shareholders.

Figure 3: Dividend yields are attractive around the globe

Dividend yield (MSCI Indices) and interest rate of 10 year government bonds in comparison



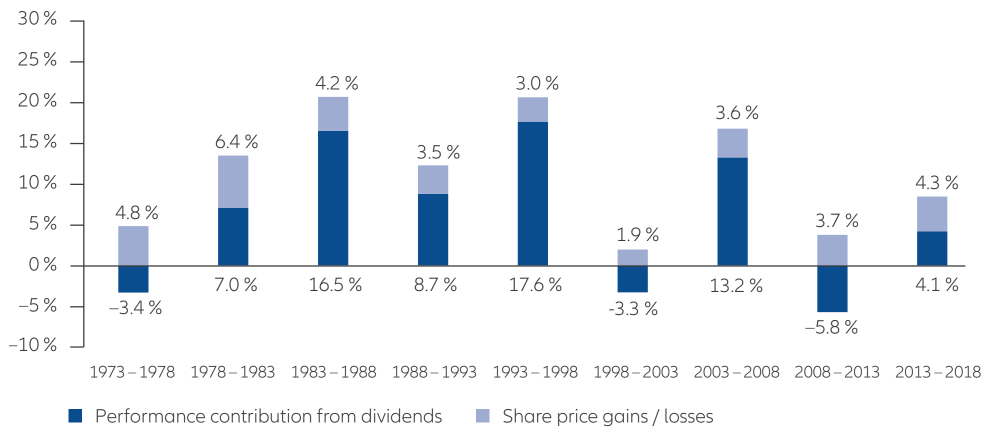
Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of 31 December 2018

Dividends – stability for the portfolio

At the same time, what is noticeable is that dividends can potentially help achieve additional stability in the portfolio. In the past, investors in European equities were the main beneficiaries of high dividend payouts that also helped in stabilising the overall performance in years of declining stock prices. Dividends were able to partially or even totally compensate for any price losses (figure 4 a – c). Over the entire period (1973 – 2018), the performance contribution of dividends to the annualised total portfolio return for the MSCI Europe was approximately 41 %. But in other regions, such as North America (MSCI North America) or Asia / Pacific (MSCI Pacific), around a third of overall performance was determined by dividends, albeit the absolute dividend yield was lower here (see figure 4 a – c).

Figure 4 a: Dividends – a stabilising factor for investors

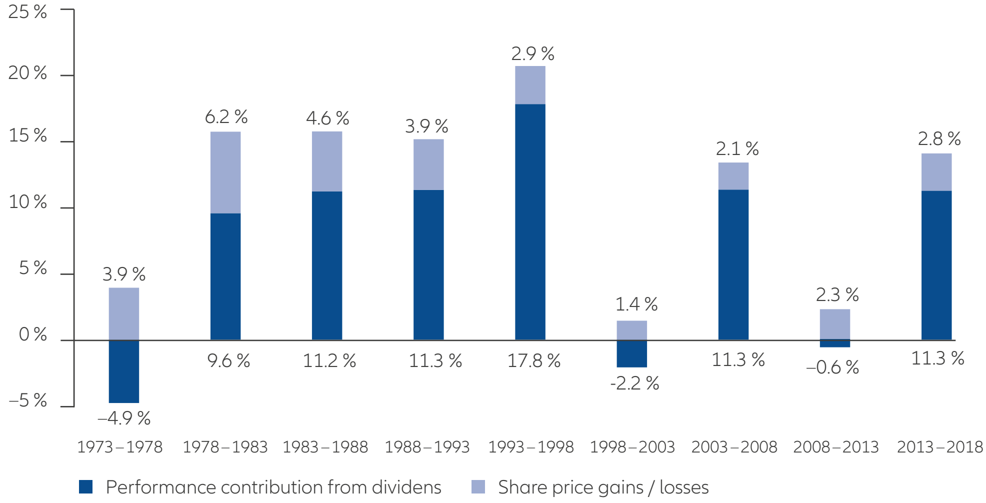
Performance contribution from dividends and MSCI Europe share prices since 1973 in five-year periods (% p. a.)



Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of 31 December 2018

Figure 4 b: Dividends – a stabilising factor for investors

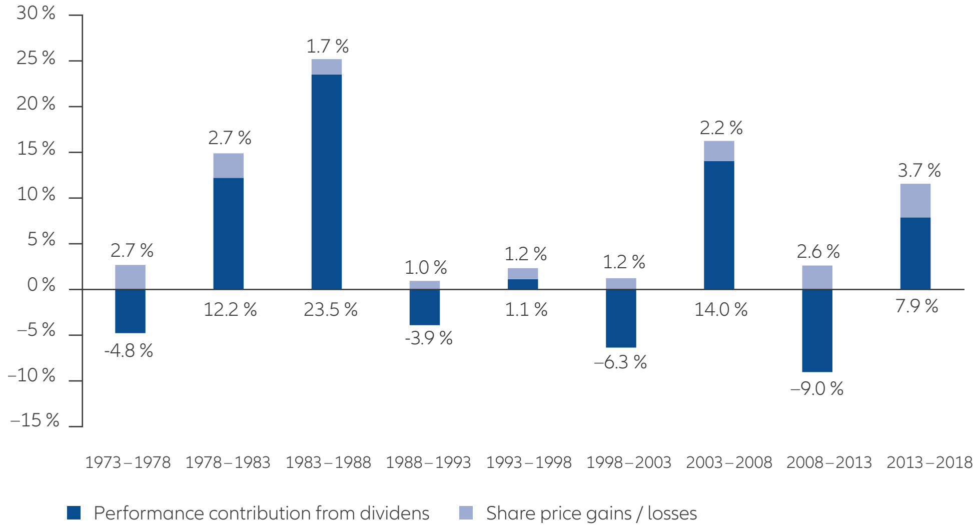
Performance contribution from dividends and MSCI North America share prices since 1973 in five-year periods (% p. a.)



Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of 31 December 2018

Figure 4 c: Dividends – a stabilising factor for investors

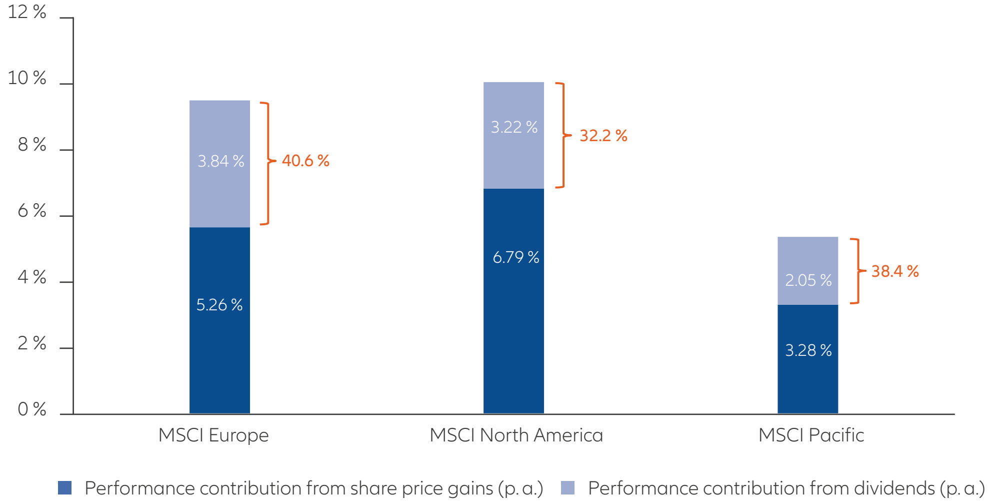
Performance contribution from dividends and MSCI AC Asia ex Japan share prices since 1973 in five-year periods (% p. a.)



Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of 31 December 2018

Figure 5: Shareholder-friendly dividend policies, especially in Europe

Global comparison of how dividends and share price gains contributed to performance between 1973 and the end of December 2018 (annualised)

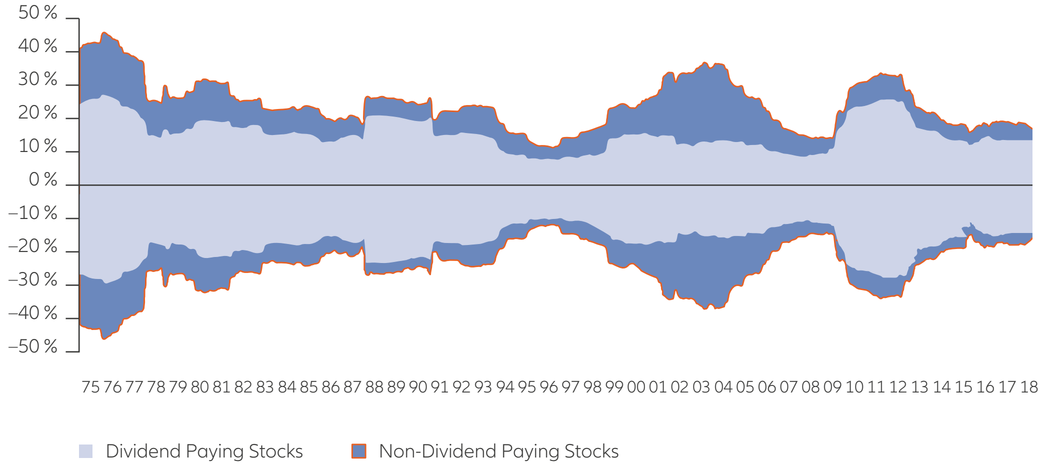


Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of 31 December 2018

However, dividends alone cannot ensure more stability with equity investments. High-dividend equities in themselves seem to have a less volatile performance than those of companies with lower dividend payouts. This is demonstrated by analysing the past performance of US stocks, for which the longest time series are available. This analysis shows that the volatility of US equities (measured in terms of a 36-month rolling standard deviation as a gauge of price fluctuation) has been lower since 1975 among companies paying out a dividend than among stock corporations that did not distribute any profits (see figure 6). Analogous behaviour is also discernible for European dividend stocks since the 1990s.

Figure 6: Share prices of dividend securities tend to be less volatile

36-month rolling standard deviation of S&P 500 companies that did and did not pay dividends (Jan. 1975 – End of Sept. 2018)



Past performance is not an indication of future results.
Source: Datastream, Ned Davis Data, NFJ Research, Allianz Global Investor, Data as of 30.09.2018.

Reasons for the value and price stability of dividend-bearing equities include, among others:

– Dividend policy is often an active component of a company's strategy. The dividend sends out an extraordinarily strong signal. Reaction on the market to reductions in or the absence of dividend payouts is very negative, since they sow doubts as to the future viability of the company. Consequently, companies go to great lengths to guarantee continuous dividend payments. A comparison of dividends and profits of members of the S&P 500 index since 1958 shows that corporate profits have been subject to far greater volatility than dividends. Particularly in the last 10 years, the volatility of profits has been considerably larger, at 55% on an annualised basis, than the fluctuation observed in the case of dividends of around 5.5% p.a. (see figure 7).

– Higher dividend payouts as well as a desire to reliably and continuously maintain them due to the signal they send out have a tendency to discipline companies. They are forced to manage their financial resources prudently and to use them efficiently. In contrast, share buyback programmes, due to their discretionary nature, neither have a comparative signal effect nor a similarly disciplining impact on the company.

– Companies with high dividend yields usually have sound balance sheet ratios with a relatively high level of equity capital and stable cash flows.

Dividends – a reliable source of income

As our calculations show, dividends develop much more reliably than corporate profits and thus have a stabilising effect on income from equities. The driving force behind this development appears to be company CFOs who tend towards a markedly conservative dividend policy. A 2005 study[1] shows that chief financial officers (CFOs) strive to achieve a long-term payout ratio while avoiding cuts in dividends, as 94% of them stated in the underlying survey. 65% of respondents agreed that they would also borrow in order to maintain stable dividend payouts. This is understandable, since 90% of CFOs anticipate negative consequences for their company's share price in the event of a dividend cut. Decisions on investments and dividends are considered to be of equal importance in two thirds of cases.

In contrast to dividends, share buyback programmes are seen as a much more flexible instrument.

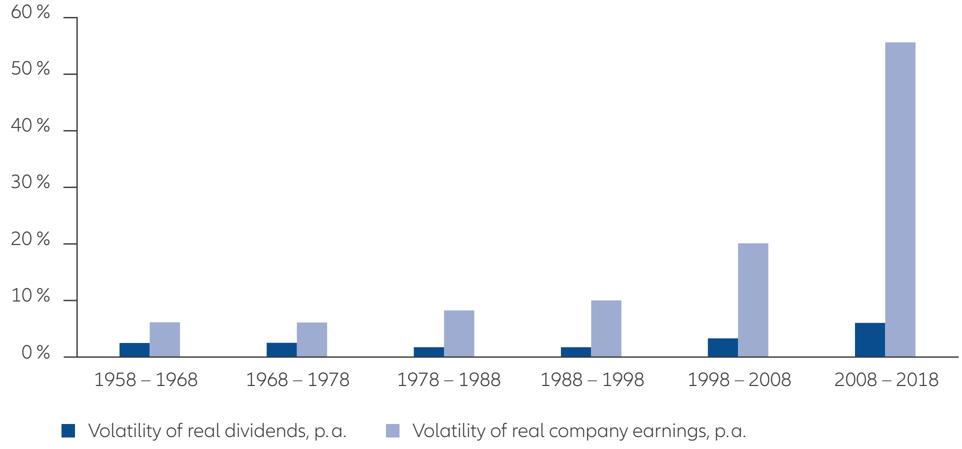
The survey involved managers from 394 US stock corporations, with the sample dominated by dividend payers. The result also reflects our view that dividends – at least in the past – have developed very steadily.

What is also interesting in this regard is a 2011 study[2] by Skinner and Soltes, which examined annual dividend payouts and profits for companies listed on NYSE, AMEX or NASDAQ during the years 1974 to 2005, with the exception of utilities and financial service providers. In their analysis, they come to the conclusion that companies that pay dividends are more consistent in terms of their earnings performance than those that do not. According to them, the amount of the dividends is not even a factor, it only depends on the fact that dividends are paid.

[1] cf. Brav, Alon; Graham, John R.; Harvey, Campbell R.; Michaely, Roni; "Payout Policy in the 21st century"; Journal of Financial Economics; Vol. 77; 2005; pp. 483 – 527.
[2] Skinner, Douglas J.; Soltes, Eugene; "What do dividends tell us about earnings quality?"; Revue of Accounting Studies; Vol. 16; pp. 1-28; 2011

Figure 7: "Exhibited low volatility of dividend payments"

Volatility of company earnings and dividends, S&P 500, from 1958 till mid of December 2018 (% p.a.)



Past performance is not an indication of future results.
Sources: Shiller, R., "U.S. Stock Price Data since 1871"; AllianzGI Global Capital Markets & Thematic Research, Data as of 30 June 2018

Active is: Sharing insights

– In the long run, dividends can deliver added value to the portfolio.

– Stock picking should not be based on the most recent profit distributions, since they may have come from equity capital, but on expected future dividends instead.

– From a historical perspective, dividends make a significant contribution to the total return of equities and have shown steadier performance than corporate profits. This has had a stabilising effect on the portfolio.

– Stocks of dividend-paying companies have proven to be less susceptible to volatility in the past than those of companies that do not pay a dividend.

– A comparison of global bond and dividend yields shows that dividends can be an attractive source of capital income, especially in times of extremely low, even negative bond yields.

– Capital income from dividends could even create an additional "basic income". Example: assuming an investor has 40,000 Euros that s/he invests at a dividend yield of 3 %. If the companies' dividend payouts remain unchanged, s/he can expect a distribution of 1,200 Euros per year – equivalent to 100 Euros a month. It would not mean your pension is in the bag, but it would be a start.

Hans-Jörg Naumer with thanks to Dennis Nacken

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