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Thesis Market Commentary

"It pays dividends." The very phrase has entered the language to denote something which is rewarding or worthwhile. We instinctively see income-paying investments as desirable. So it should be; as shareholders we are co-owners, putting our capital at the disposal of a business, and the dividend is our portion of the profit. It is a bird in the hand while market prices are continually changing. Despite or perhaps because of this, investing for dividends can sometimes seem less glamorous than seeking the next hot growth stock. With the FTSE 100 index now yielding 4.75% however, is it time to reconsider that view?

Ten years ago it would have been astonishing to think that the equity market could offer such a high yield at a time when gilt yields are at the extremely low levels we are currently seeing. The 10 year Gilt currently yields less than 0.75%. At that time, in most investors' experience equities usually always yielded less than bonds. This made sense; equities have the potential to deliver long-term growth as well as income, so it was logical that bonds would offer a higher rate of income to compensate for the fact that in the long run they produce no growth. This has not always been the case however. Prior to the late 1950s it was normal for equities to yield more than bonds. Whichever you think should be the normal state of affairs, the current yield gap demonstrates one thing very clearly: bonds are expensive relative to equities.

Dividends fuel total return

We often encourage clients not to focus solely on the income from their investments. While interest rates are low and the rate of capital gains tax is less than income tax[1] it can often be sensible to fund the income you take from your investments from a mixture of natural income (interest and dividends) and capital. The key measure is the total return, the combination of capital returns and income.

However dividends do form a large proportion of the total return to equities over the very long term. One hundred pounds invested in the UK equity market in 1899 would have been worth £203 in inflation-adjusted terms by the start of 2018 without reinvestment of dividends. With dividends reinvested the portfolio would have grown to £34,758.[2]

Dividends can point to strong companies

Can dividends tell us something deeper however, making them attractive in their own right?

In order to pay a dividend a company has to have retained profits on its balance sheet from a current or previous accounting year. It also has to have sufficient cash to fund the payment. These are not just accounting niceties. By choosing a dividend paying company we are selecting one which is profitable, or at least has been profitable in the past, and which takes in enough cash not just to finance itself but to have some left to pay out. By picking a dividend-paying

1 Once the relevant allowances have been used, gains are taxed at 20% for a higher rate taxpayer, versus 40% for interest and 32½% for dividends.

2 Source: Barclays Equity Gilt Study 2018

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company we have already gone some way towards buying a healthy company. Contrast this with new tech company floatations such as Uber, Spotify, Pinterest and the like, all of which have never yet made a profit and are still burning through their investors' capital. The link goes deeper still. By committing to paying a dividend the management of a company is aligning its actions firmly with the interests of shareholders. Funding the dividend means that costs must be kept under control and capital projects only considered where they are likely to yield good returns. This means a consistently-paid dividend can be a good indicator of corporate governance and strong alignment of interests between management and shareholders. This can be especially significant in emerging markets, where standards of corporate governance can generally be lower than in developed countries.

Dividends must not be at the expense of investment

There can be a dividend trap however. If too great a proportion of profits is paid out as dividends then the company will be starved of capital to invest in new equipment or in research and development. This will hamper its growth, and may make the dividend itself unsustainable in the long run. We need a balance.

It can often be helpful to look at the rate of dividend growth rather than just the dividend yield to find companies that are likely to provide a sustainable level of dividend payments. A close look at a company's dividend policy can also be informative. Many companies will commit to paying out a set proportion of profits. Some companies in cyclical industries will pay a low ordinary dividend but add special dividends when profits are high.

What we certainly do not want to see is a company that retains a large proportion of its profits when it cannot invest them at a high level of return on equity. The history of markets is littered with companies that have over-paid for takeovers of other firms at the peak of a market cycle because cash was burning a hole in their pockets and their boards were over-confident in the level of returns that the transaction could provide. It is often much better for them to stick to their core business, return the cash to shareholders as a dividend and let them reinvest it in the area of the market where they see the most attractive returns.

Dividend-paying stocks can be attractive in market downturns

Dividend-paying equities can also provide a cushion should markets fall. With the dividend payment providing an element of certitude among fluctuating valuations, yielding stocks can become more attractive to investors, giving an element of support to their prices. To the extent that dividend paying stocks tend to be skewed towards more defensive sectors of the market, with more defensive earnings profiles, they can also naturally be more attractive to investors during recessions. Think of utilities, tobacco stocks or pharmaceutical companies, which are unlikely to see a dramatic drop in demand when the economy turns.

Many Thesis clients, especially those with lower risk portfolios, will have seen income funds as a long-standing component of their portfolios, notably the JPM US Equity Income and Emerging Markets Income funds. We have recently added two more income funds to our buy list, aiming to take advantage of dividend growth while markets are doing well and to provide a cushion if equities hit a tougher period. These are Franklin UK Equity Income and M&G North American Dividend.

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