The Road Ahead for Dividend Investing

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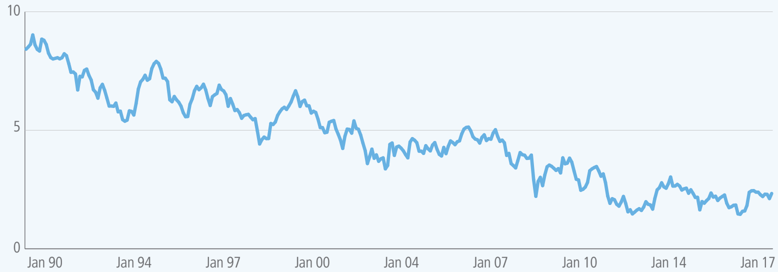
As interest rates in Canada and the US move higher, many Canadian investors are likely wondering whether dividend-paying companies will remain a sound investment going forward. If yes, what types of dividend-paying companies might perform well? This paper explores answers to these questions.

Overview

Over the last 30 years there has been a secular decline in interest rates across developed markets. The yield on the US 10-year Treasury bond, an asset against which many other assets are measured and priced, and one that is regarded as "risk-free", fell from roughly 9% in 1990 to 1.5% in 2016 (see chart below). This longer term trend has been driven primarily by lower expectations for far-ahead future inflation and real rates.[1] Shorter term, changes in the yield on these bonds is predominantly driven by current economic sentiment. When there are perceived risks to economic growth and inflation, or when investors are fearful and seeking safe haven, demand for these bonds increases, raising the price investors are willing to pay and lowering the yield (the interest coupon divided by the price paid for the bond). The opposite holds true when market participants believe economic growth and inflation will be robust and higher returning investments can be found elsewhere.

US 10-Year Treasury Note Yield (%)



Source: Bloomberg, Mackenzie Investments, as of September 30, 2017

The trend of lower rates was perpetuated after the 2008 Global Financial Crisis when central banks around the world lowered short-term interest rates to near zero, or even below zero in some instances, in an effort to stimulate economic growth. This precipitous decline in both shorter-term rates (central banks) and longer-term rates

[1] Michael D. Bauer, Glenn D. Rudebusch, What caused the decline in long term yields? (Federal Reserve Bank of San Francisco, FRBSF Economic Letter, July 2013)

(future expectations) drove investors to seek yield elsewhere in the market, as the coupons received on government bonds delivered less attractive (or in some cases negative) real returns when factoring for inflation and income tax. The result was high-yielding equity securities became increasingly more attractive. Higher yielding real estate investment trusts (REITs), utilities, staples and telecommunication companies, often referred to as “bond proxies”, were used as investment income substitutes. Like bonds, however, these investments are also vulnerable to interest rate movements.

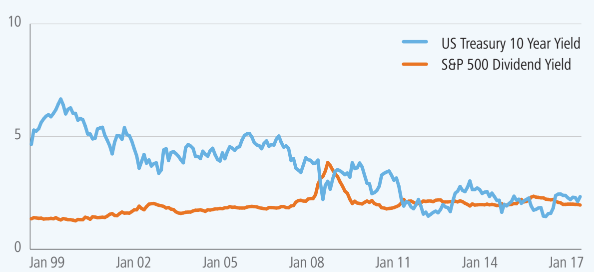
Current State of Yields

The US Federal Reserve announced an increase in the overnight lending rate in December 2015, giving markets a signal. It was a signal that US employment was back on somewhat stable footing for the first time since the Global Financial Crisis and that inflationary signs were present in the economy. In 2016 and 2017, the US Federal Reserve raised short-term rates again and detailed a plan to tighten the money supply. The Fed is unwinding its unprecedented stimulus program post-crisis as the world’s largest economy moves closer to full employment and the inflation rate inches above the long-stated target of 2%. The Bank of Canada has also raised its rate as the Canadian economy showed signs of strength. Although major central banks in Europe have not initiated interest rate increases, they are likely to follow a similar tightening path if data in Eurozone economies continue on a positive trajectory.

Dividend Yields Remain Attractive

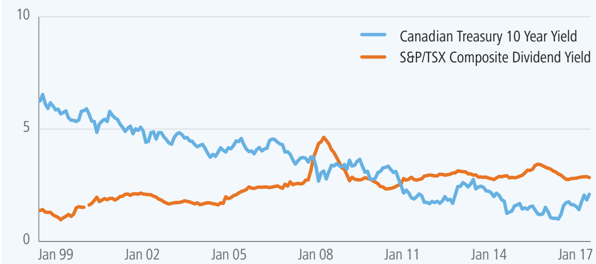
As long term interest rates have also trended up in both Canada and the US, an examination of the spread between yields on dividend-paying equities and government bonds in Canadian and US markets shows that dividend-yields remain attractive on a relative basis. Rates have a long way to go before the historical spread between bond yields and dividend yields normalize (see below charts).

Historical Yields on S&P 500 and US 10-Year Treasury (%)



Source: Factset, Mackenzie Investments. As of September 30, 2017.

Historical Yields on S&P TSX Composite and Canadian 10-Year Treasury (%)

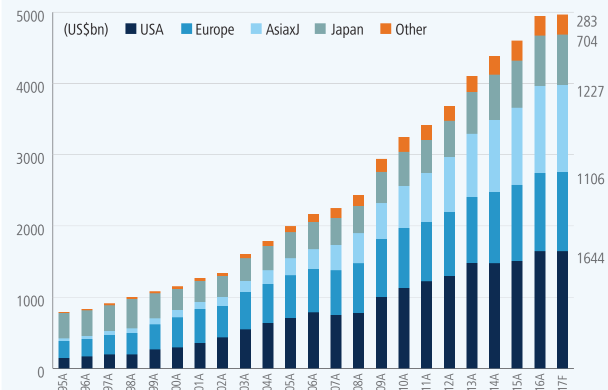


Source: Factset, Mackenzie Investments. As of September 30, 2017.

Corporate Cash Levels Remain High

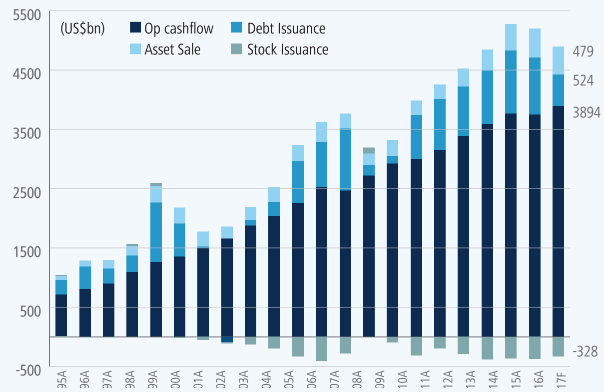
Cash levels are also supportive of current dividend yields and potential dividend growth as global corporations have been squirreling vast amounts of cash away on their balance sheets. This increase in cash levels has been driven predominantly by strong operating cash flows, low capital expenditure growth and borrowing at historically low rates. Although the trend of growing cash on balance sheets has been taking place for decades, it accelerated after the Global Financial Crisis and has now reached almost US$5 trillion (see below charts).

Global Corporations Growing Cash on Balance Sheet



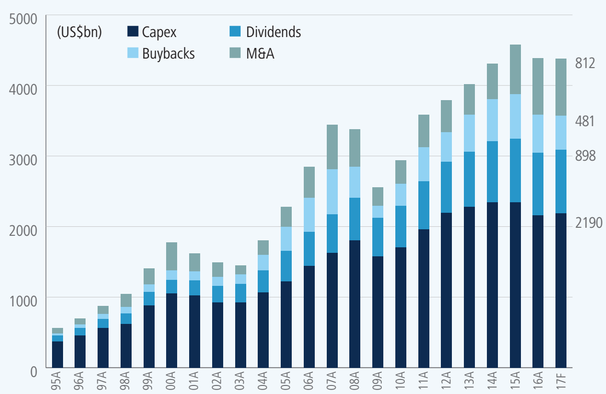
Source: CLSA, as of September 2017. A = Annual, F = Forecast.

Sources of Cash on Balance Sheet



Source: CLSA, as of September 2017. A = Annual, F = Forecast.

Low Capital Expenditure Growth a Source of Cash Build-Up



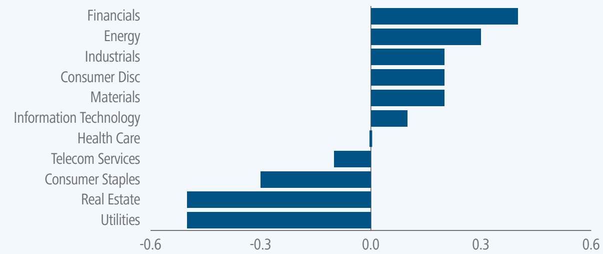
Source: CLSA, as of September 2017. A = Annual, F = Forecast.

Dividend Investment Strategies for Rising Rates

Approach Bond-Like Equities with Caution. All Dividends are Not Created Equal.

Government-issued bonds of several developed economies, specifically those issued by the United States, are considered risk-free or near risk-free assets as they are backed by the full credit and faith of the issuing government. Naturally, when the interest rate offered on risk-free government bonds increases, the dividend paid by a company that has operating risk, market risk and leverage (debt) becomes less attractive on a relative basis, all else held equal. Not all dividend-paying companies and sectors react the same to such rate movements, however. The chart below shows the sensitivity of different world market sectors to movements in the US 10-year yield. When yields increase, bond-like equities (real estate, utilities, staples, telecoms) generally decrease in value. The opposite happens when yields fall. On the other side of the spectrum, sectors that are levered to economic growth, banks (financials), for example, have historically performed well when interest rates rise because their net interest margin (the spread between the interest paid on deposits and the interest received on loans) increases.

Correlation of MSCI World Sector Returns to Change in US 10Yr Rate

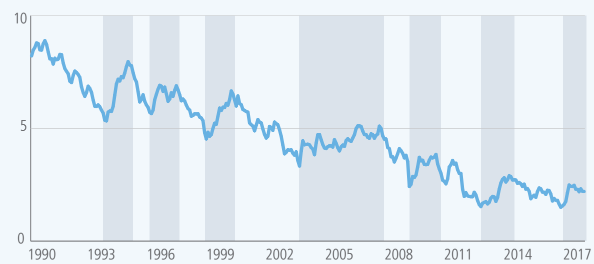


Source: Factset, Mackenzie Investments. Five years as of September 2017

Look for Dividend Growers

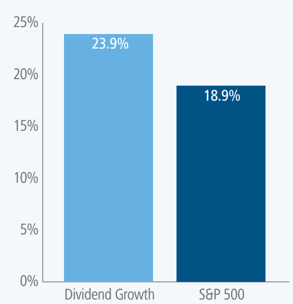
Although interest rates have been in a multi-decade trend downwards, there have been periods where rates increased and they provide us with some insight into how specific equity strategies might perform if interest rates continue to trend upwards. An examination of the S&P 500 during these periods shows that companies growing their dividends delivered the strongest returns. The same companies also delivered these higher returns with less volatility than the broad market (see below charts).

Constant Maturity 10 Year Treasury Rate
shaded areas indicate rising rate cycles

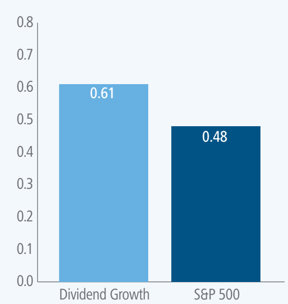


Source: BMO Capital Markets, as of September 2017

Average Annual Total Return During Periods of Rising 10-Year Treasury Yields



Average Sharpe Ratio During Periods of Rising 10-Year Treasury Yields

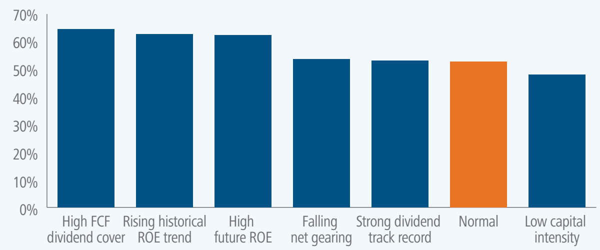


Source: BMO Capital Markets, as of September 2017

Quality Characteristics are a Signal for Potential Dividend Increases

The trick then is figuring out which dividend-paying companies are most likely to grow their dividends. A look at companies around the world which consistently increased their dividends each fiscal year over a 10-year period provides some characteristics to look for. Companies that exhibited high returns on equity, falling net gearing (leverage), a strong track record of paying a dividend and free cash flows well in excess of that dividend were more likely to initiate a dividend increase.

Characteristics of Companies that Grow Their Dividend
% of above median forward yield companies increasing dividend each fiscal year (L10Y avg)



Source: CLSA, as of September 2017
Median yield determined as at December end.

Should economic expansion continue and interest rates move higher, dividend-paying companies will provide dissimilar returns based on sector, as history has shown us. Sectors that offer better opportunities in a falling rate environment will not necessarily be those that perform well in a rising rate environment. It is clear that a dividend investment strategy can still generate attractive returns even when rates rise. The key for investors is to incorporate flexibility into their investment approach.

Key Takeaways

- **Dividend yields remain attractive:** The dividend yield offered on Canadian and US equities relative to the yield on 10-year Treasury notes remains attractive based on historical levels.
- **All dividends are not created equal:** Dividend-paying companies that reside in different sectors of the economy often react differently in an environment of rising rates. An investment strategy focused on higher-yielding bond proxies is likely to underperform when rates are increasing.
- **Dividend growers outperform when rates rise:** Historically, during periods of rising rates, companies that increased their dividends delivered strong risk-adjusted outperformance.
- **Look for quality characteristics:** Companies that exhibited high returns on equity, falling net gearing (leverage), a strong track record of paying a dividend and free cash flows well in excess of that dividend, were more likely to initiate a dividend increase.

Talk with your financial advisor for more information on dividend investing strategies.

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