Viewpoint

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The Power of Dividends: Global Equity Income Investing

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Executive Summary

Amid modest return expectations for most major asset classes, we recently spoke to James Harries, who is the lead manager of Newton's Global Equity Higher Income Strategy, about growing interest in income-focused investing. Harries believes investors are rediscovering the potential power of dividends as an important part of the pursuit of long-term total returns. Global dividend yields are attractive at the moment, he says, relative to other sources of investing income. Moreover, as developing markets mature, more companies in those regions are beginning to issue dividends. Harries points to numerous studies that document the compounding power of reinvested dividends. In addition, he says, focusing on dividend yields can be a useful barometer for identifying outperforming companies that are disciplined and efficient in their capital allocation and cash flow management.[1]

Question: James, why do you think there is growing interest among investors in companies that pay dividends?

James Harries: I think there are a couple of reasons. First, the income levels on many assets have fallen since the global financial crisis amid low interest rates and low government bond yields in many markets. At the same time, investors have become wary of other sources of income in the form of securitized products such as collateralized debt obligations and mortgage-backed securities. For investors who lost money on those types of securities during the global financial crisis, I think there is renewed interest in unlevered, transparent and understandable investments that can yield income and longer-term capital growth.

Question: So are investors "rediscovering" dividends as part of a general trend of getting back to investment basics following the global financial crisis?

James Harries: There may be an element of that, as more exotic investments have disappointed some investors. I think, though, there have always been two main compelling reasons for considering an income-focused approach to equity investing. One is that a number of studies have shown that equity income in the form of reinvested dividends

*See disclosure on last page.

1 It is important to note that currency exchange rate fluctuations can add or detract from global dividends.

can comprise an essential component of long-term total returns.[2] Secondly, by concentrating on income-bearing shares, investors may benefit from a number of positive qualities companies issuing those shares tend to demonstrate. In addition, we believe dividend yields can be used as an aid to timing purchases and sales of stock. When the yield on the stock rises and the price falls, we think that may be a more favorable time to buy; conversely, when the yield falls and the price rises, that may be a more favorable time to sell.

So for the long-term investor, attractive equity returns are derived not simply from the receipt of dividends but from the accumulation of shares as a result of the reinvestment of those dividends. The compounding of investment returns by way of income reinvestment can be a powerful driver of equity returns over the long run.

Perhaps one of the best-known discussions of the power of dividends was Rob Arnott's article in the *Financial Analysts Journal* some years ago.[3] He took the combined historical data from works by William Schwert and Jeremy Siegel and sought to show the contribution of dividend income to the growth of $100 invested in U.S. equities over 200 years from 1802 to 2002. According to his calculations, 5% of the overall total return for the entire 200 years of 7.9% was attributable to dividends. He concluded that unless corporate managers could provide sharply higher real growth in earnings, dividends would be the main source of the real return from stocks. Moving beyond the U.S., a more recent study from MSCI Barra decomposed the equity returns of the MSCI World Index from 1975 to 2009 into inflation, price to book growth, real book value growth and dividend income. The analysis showed that after inflation, dividend income was the most important part of equity returns for the majority of markets.[4]

So for the long-term investor, attractive equity returns are derived not simply from the receipt of dividends but from the accumulation of shares as a result of the reinvestment of those dividends. The compounding of investment returns by way of income reinvestment can be a powerful driver of equity returns over the long run.

Investors should also benefit from the fact that, if a dividend continues to be paid after a share has fallen in price, they receive a greater number of shares upon reinvestment of that income than if the share price had not fallen. The combination of income distribution and reinvestment at attractive valuations can be an effective way to accumulate capital with relatively low risk over the long term. This is why dividends serve not only to offer some downside protection in bear markets (if they remain relatively stable, then they grow in size relative to the capital value of an investment) but also to accelerate returns when markets recover by leading investors to buy shares inexpensively during depressed periods in markets.[5]

Question: What are some of the characteristics of companies that pay regular dividends?

James Harries: We believe that a focus upon companies that tend to pay a regular cash dividend may lead to a portfolio comprised of companies that are reasonably valued, that generate cash flow in a sustainable manner, that are sensibly managed and financed and that allocate shareholders' funds with a view to long-term returns on capital.

In our view, a dividend is much more than merely a component of the overall return from a stock. It is tangible evidence of a firm's profitability and represents a commitment by the management of a company to return the cash flow it generates to shareholders on a

2 See, for example, "What Drives Long-Term Equity Returns," MSCI Research Bulletin, January 2010; Dimson, Marsh and Staunton, "Global Investment Returns Yearbook," Credit Suisse Research Institute, 2008; Jeremy Siegel, *The Future for Investors* (New York: Random House), 2005; Robert D. Arnott, "Dividends and the Three Dwarfs," *Financial Analysts Journal*, 2003.
3 Arnott, *Ibid*.
4 "What Drives Long-Term Equity Returns," MSCI Research Bulletin, January 2010.
5 "Dividends Matter," Citibank, October 2008.

regular basis. In addition, we believe the regular payment of a dividend helps align the interests of a company's management with those of its shareholders if management is paid in restricted stock rather than options, so that manager compensation is linked to shareholder returns rather than to stock options that do not give holders a right to a dividend. We also believe a commitment to paying dividends makes it less likely that a company will allow cash to remain idle on its balance sheet or divert it to potentially risky ventures such as a merger or an acquisition. We also think that commitment reduces the possibility of management burdening a business with too much debt.

The proliferation of dividends is a global trend. Our experience is that increasingly companies think about and are ready to discuss their distribution policy regardless of where they are listed.

Question: What trends are you seeing in emerging economies when it comes to issuing dividends?

James Harries: The proliferation of dividends is a global trend. Our experience is that increasingly companies think about and are ready to discuss their distribution policy regardless of where they are listed. We have found many interesting investments in regions and countries where you would not normally associate them with income investing, including Asia and Brazil. In addition, there is an increasing realization on behalf of management teams that investors reward a clear dividend policy. Finally, a feature of emerging market companies is they often still have substantial family share ownership. Having weathered events such as the crisis in Asia in the late 1990s, many families believe the payment of a regular dividend is an effective way of allowing such family members to use that cash to diversify their holdings. One concern a few years ago was that since the establishment of widespread dividends in emerging markets was a relatively new phenomenon, they would be suspended when more difficult times came. Recent events, however, have shown this not to be the case.

Question: Why do many companies continue to pay out dividends during earnings downturns, and what does that say about the stability of dividends in general?

James Harries: I think once a dividend is established, companies want to maintain that to avoid a negative signal to the market when the dividend is reduced or stopped. Research by MSCI and Citibank has looked at the resilience of dividends in periods of global earnings downturns. Focusing on periods of earnings downturns from 1970 to October 2008, they found that corporate earnings on average fell by 25% while dividends rose on average by 2.4%.[6] Of course, a notable exception to this occurred during the financial crisis of 2008/2009 when financial institutions that received government aid were required to slash dividends. On the whole, however, we believe companies that continue to pay dividends in down markets have the potential to outperform, as investors may attach greater importance to the stability of a dividend policy in a downturn.

Question: How do you respond to the argument that the prevalence of share buy-backs in markets like the U.S. renders a focus on dividend yield invalid?

James Harries: In the U.S. in particular, there has been a change of culture that has led to share buy-backs largely replacing (or even augmenting) dividend payments. Proponents of buy-backs argue they are more tax efficient than dividends and that their effect on the capital structure of a company is equivalent to that of dividends. While this might be theoretically true, we think there are still very important distinctions between the two.

6 "Dividends Matter," Citibank, October 2008.

In our view, a share buy-back is equivalent to a dividend only if it is maintained in a downturn. In the event, however, companies tend to carry out share buy-backs when times are good and quietly drop them when conditions deteriorate. To my thinking, this is equivalent to a dividend cut, but it may be less obvious to investors because it is carried out less publicly. We believe this pro-cyclical quality reduces the effectiveness of buy-backs both in enhancing returns and is a less reliable indicator than dividends of a company's overall health.

From an income investor's perspective, if senior managers in a company are compensated with options, there will be a dilution of common shareholders' interests upon the exercise of those options (given that the company's total earnings will be divided by a greater number of shares).

Question: How do you compare companies that prefer to pay management with stock options rather than with restricted stock?

James Harries: There has been much controversy over the last 20 years over granting stock options to managers and the effect that has on incentives, risk-taking, profitability and shareholder returns. From an income investor's perspective, if senior managers in a company are compensated with options, there will be a dilution of common shareholders' interests upon the exercise of those options (given that the company's total earnings will be divided by a greater number of shares). In addition, there is the possibility that management will then be biased towards share buy-backs rather than dividends, because buy-backs may have a greater positive impact on the value of the stocks underlying the options. But if managers are compensated with restricted stock, they will benefit from dividend payments and also be harmed by dilution, aligning their interests more closely with those of investors.

We also believe using restricted stock rather than stock options reduces the incentives for managers to burden a company with too much debt. Dividends represent the most junior claims upon the capital of a business. As such, whether they like it or not, equity holders are subject to the demands of claimants further up the capital structure. Given this, managers rewarded with restricted stock rather than options will want to ensure the company has sufficient capital to pay a dividend if it has committed to doing so. We believe this means, at the margin, managers compensated with restricted stock at a dividend-paying company are likely to be more conservative in their borrowing than those at a non-dividend-paying company.

Question: How do you respond to a concern that following an income-focused strategy is likely to lead to businesses with low growth potential if you believe that paying a dividend reflects a company's lack of other investment opportunities or ideas?

James Harries: We believe this argument is flawed. A well-known study of U.S. equities by Rob Arnott and Cliff Asness showed actually a positive correlation between a company's pay-out ratio and subsequent earnings growth.[7] A more recent study suggests the same positive correlation hold for non-U.S. equities as well.[8] Furthermore, we should remember that the return from a share is not simply how quickly a company grows its earnings for a given amount of capital employed, but rather how quickly a company can do so in relation to expectations. We believe some investors have a tendency to overpay for growth companies and to underestimate the capital required to finance a company's growth, running the risk of diminishing their long-term returns. In that light, we believe an income bias may shield long-term investors from this particular risk.

7 Robert D. Arnott and Clifford S. Asness, "Surprise! Higher Dividends=Higher Earnings Growth," *Financial Analysts Journal*, 2003.
8 Gwilym, Seaton, Suddason, Thomas, "International Evidence on the Payout Ratio, Earnings, Dividends and Returns," *Financial Analysts Journal*, 2006.

We would never buy stock on the basis of its dividend yield alone. Our foundation for holding any equity is a positive relation to our major themes and strong fundamentals. We believe that allying that yield discipline to a robust global thematic investment process can help generate attractive returns for investors.

Question: Beyond identifying companies with attractive dividend yields, what are the other characteristics you're looking for?

James Harries: We would never buy a stock on the basis of its dividend yield alone. Our foundation for holding any equity is a positive relation to our major themes and strong fundamentals. We believe that allying that yield discipline to a robust global thematic investment process can help generate attractive returns for investors. It also encourages us to be contrarian (i.e., buying companies that have fallen out of favor), discourages us from becoming too closely attached to the stocks we hold (by forcing us to sell once a company has done well), and ensures that each company we hold generates a yield in its own right. We believe applying a yield discipline helps us to time purchases and sales appropriately. Since we believe dividends tend to be less volatile than the economy and the market, we believe they are ideal for this purpose, allowing investors to potentially turn the inherent volatility of equities to their advantage.

Question: In closing, what are the particular risks of income-focused investing and how can investors think about mitigating those risks?

James Harries: To my mind there are two key risks. The first is for a manager to equate yield with value. In the bond market a high yield generally denotes high risk whereas in the equity market that is not necessarily so. This risk can be mitigated by solid fundamental research to highlight companies that are attractive investments in their own right but that have the added attraction of a dividend. Second, income-focused strategies tend to underperform in rapidly rising markets. Investors can lose patience and drop a sound long-term investment strategy in the pursuit of short-term gains. I would argue now is just one of those times.

James Harries

James is a member of Newton's investment management team, specializing in global equities. He joined Newton in 1995, and is a member of the global investment and global model groups. James holds a Master's degree in finance and has completed the Investment Management Certificate. He is a member of the UK Society of Investment Professionals.

Index Definition MSCI World Index

The **MSCI World** is a stock market index of 1,500 world stocks. It is maintained by MSCI Inc., formerly Morgan Stanley Capital International, and is often used as a common benchmark for 'world' or 'global' stock funds. The index includes a collection of stocks of all the developed markets in the world, as defined by MSCI. The index includes securities from 24 countries but excludes stocks from emerging and frontier economies.

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