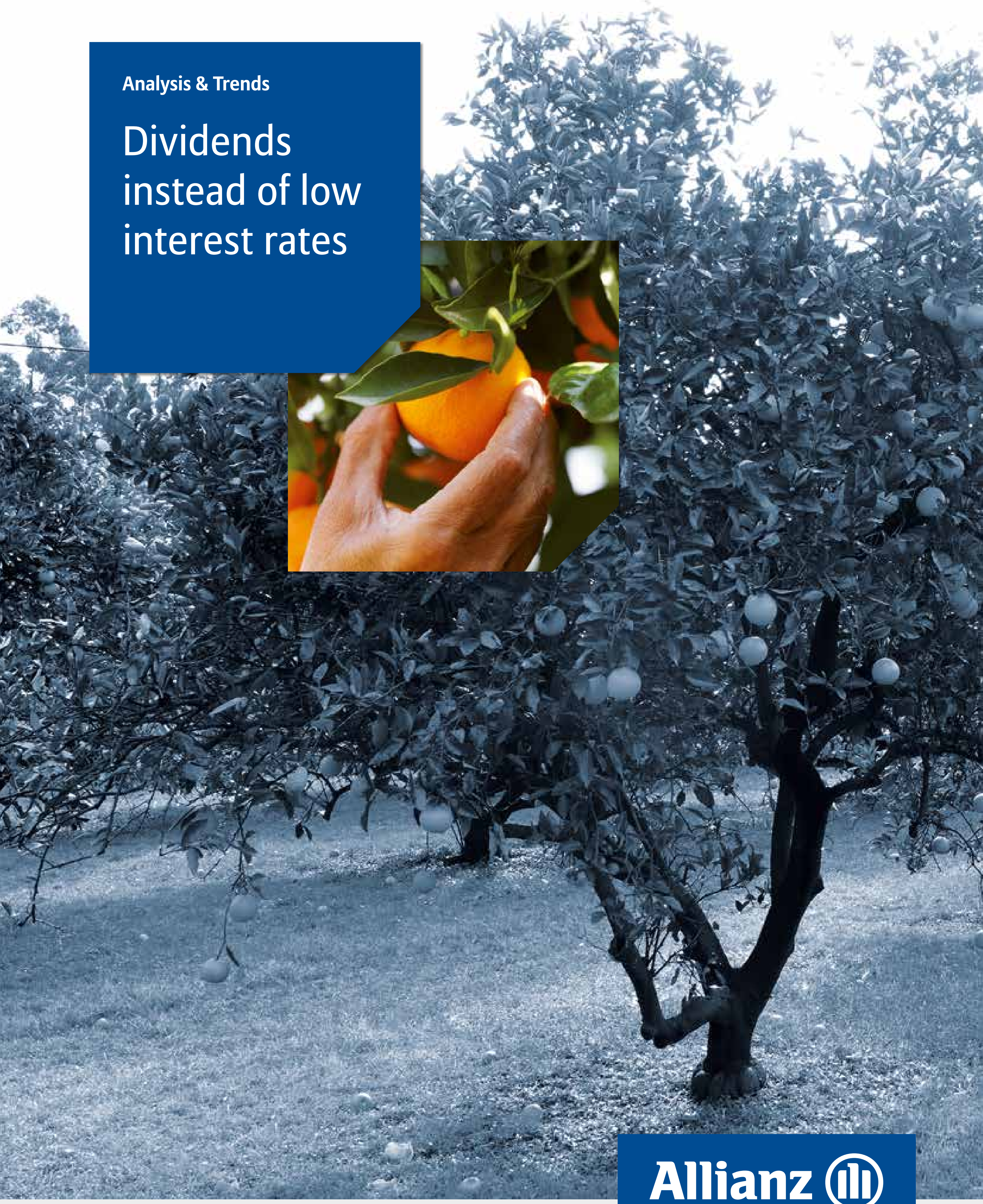
Analysis & Trends

Dividends instead of low interest rates



Allianz Global Investors

Understand. Act.

Content

Imprint

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Dividends instead of low interests

Historically low interest rates – not to say negative – and a need for the developed world to lower its debt all create a good environment for taking advantage of the benefits offered by dividend strategies – especially in times of financial repression.

We are currently witnessing a turning point where the huge debts of industrial countries and global imbalances have to be eliminated in order to restore confidence among market players. The process of restoring equilibrium is accompanied by a phase of financial repression where investors are faced with a prolonged period of low or even negative real interest rates in the developed world.

The risk/return profiles of dividend strategies definitely look interesting in precisely this situation. They combine the benefits of currently high dividend yields with historically low share price volatility, while at the same time protecting against inflation. Historically, the gap has rarely been so wide between dividend yields and the yields on government and corporate bonds, at least as far as European companies are concerned (see Chart 1).

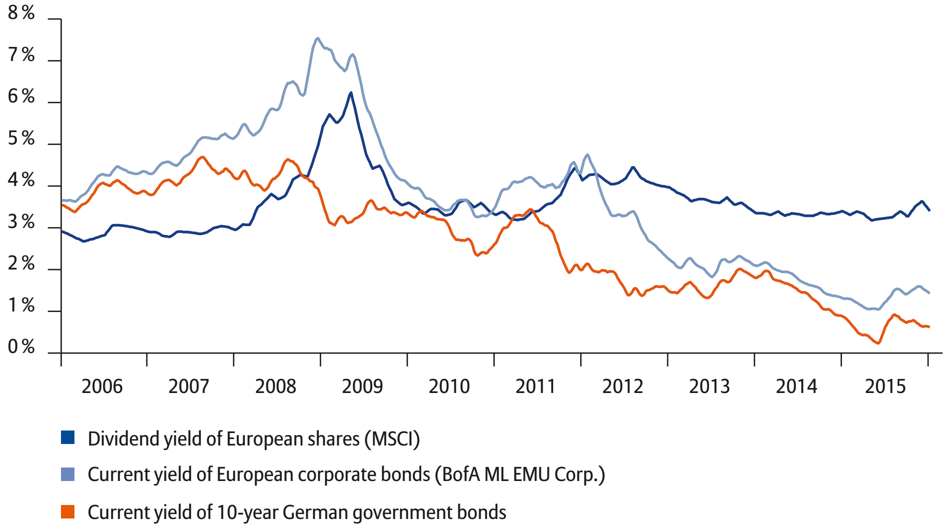
When it comes to predicting the future success of dividend strategies, investors are focusing on two issues in particular: how sustainable are the relatively high dividend yields in the present market environment? And what are the benefits of dividend strategies for investors with a long-term horizon?

As a rule, dividend strategies are characterized by companies

1. that are expected to generate superior dividend yields within their respective market index,
2. that have potential for future increases in dividends and, at the same time,
3. have a reliable dividend policy and dividend track record.

Chart 1: European Shares Offer Attractive Dividend Yields

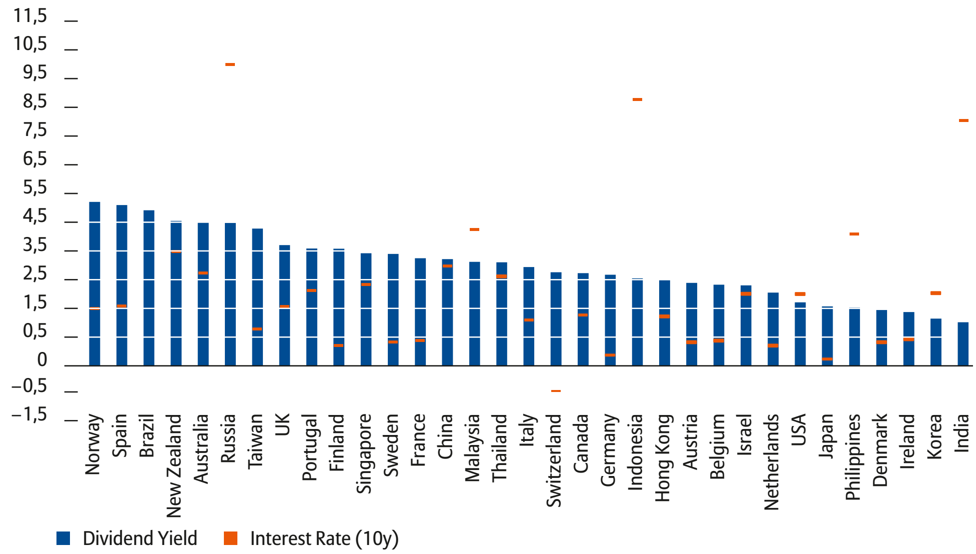
Dividend yields (MSCI Europe) versus yields of German government (10 year) and European corporate bonds.



Past performance is not an indication of future results.
Source: Datastream, Allianz GI Capital Markets & Thematic Research, as of 02.12.2015

Chart 2: Dividend Yields Are Attractive Around the Globe

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



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Source: Datastream, Allianz GI Capital Markets & Thematic Research, as of 30.11.2015

Dividends – a key driver of performance when real interest rates are low

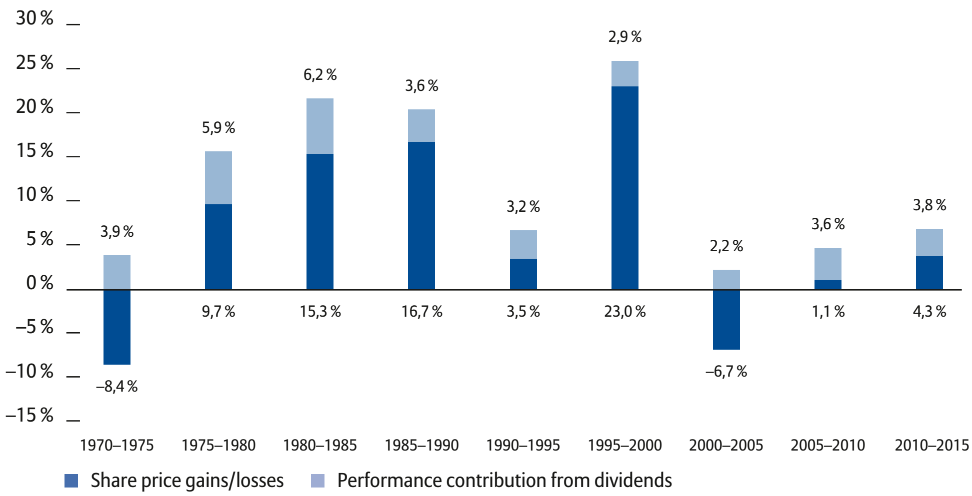
By international comparison, European companies in particular pay high dividends, as demonstrated by an average dividend yield across the market of 3.3 % at the end of 2015 (based on MSCI Europe). Expected dividend yields in a portfolio could be further increased by focusing on securities that pay out particularly high dividends. Outside of Europe, other regions also offer dividend yields that are higher – in some cases considerably higher – than the returns on 10-year government bonds (see Chart 2). Companies in Australia, New Zealand or Norway in particular have shown themselves to be generous with their dividend payouts.

At the same time, dividends have proven their ability to enhance the stability and

real performance of a portfolio. In the past, investors in European equities in particular have enjoyed substantial dividend payouts. Dividends have made a consistently positive contribution to MSCI Europe performance since 1970 (see Chart 3), enabling them to partially offset or at least mitigate (1970–1975, 2000–2005) the effects of share price losses. Dividends accounted for about 39 % of the total annualized return of equity investments for the MSCI Europe over the entire period. Dividends also contributed more than one-third to total performance in other regions, such as North America (MSCI North America) or Asia-Pacific (MSCI Pacific), although the dividend yields themselves were lower in absolute terms (see Chart 3b, 3c).

Chart 3a: Dividends – A Stabilising Factor for Investors

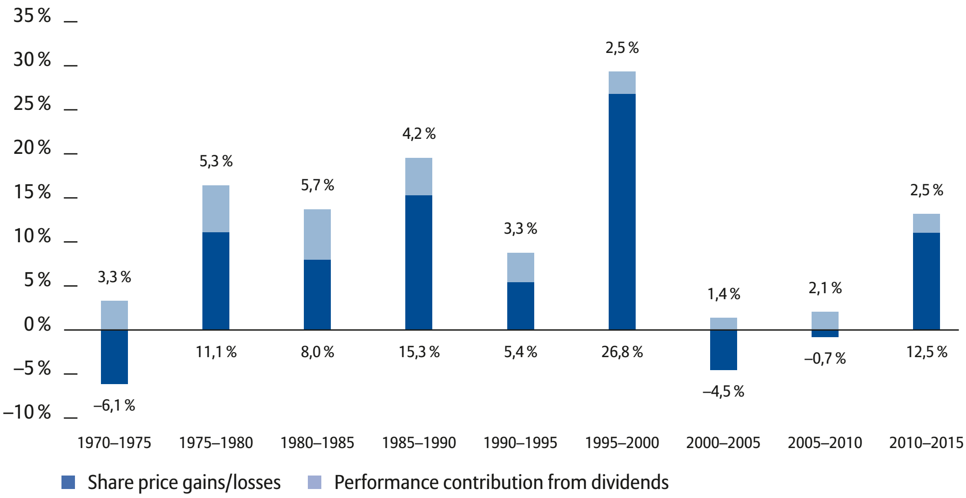
Performance contribution from dividends and MSCI Europe share prices since 1970 in five-year periods (% p. a.)



Past performance is not an indication of future results.
Source: Datastream, Allianz GI Capital Markets & Thematic Research, as of 30.11.2015

Chart 3b: Dividends – A Stabilising Factor for Investors

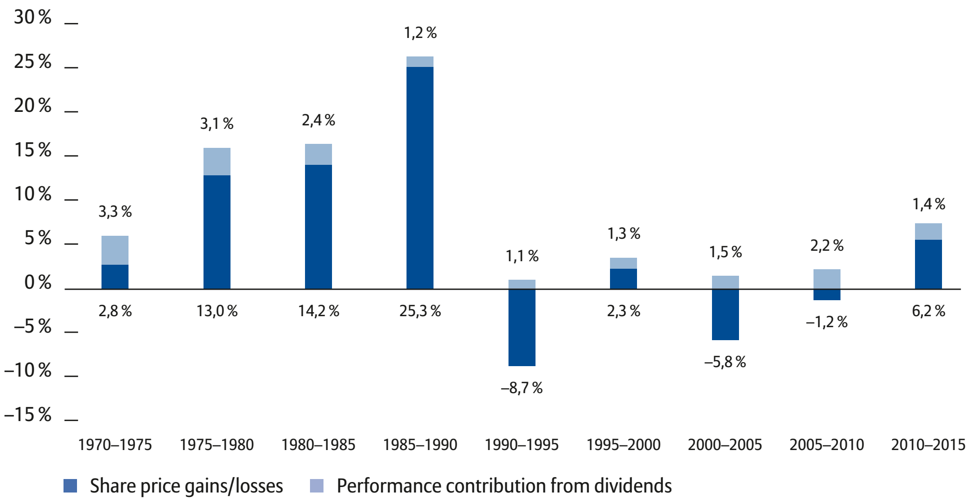
Performance contribution from dividends and MSCI North America share prices since 1970 in five-year periods (% p. a.)



Past performance is not an indication of future results.
Source: Datastream, Allianz GI Capital Markets & Thematic Research, as of 30.11.2015

Chart 3c: Dividends – A Stabilising Factor for Investors

Performance contribution from dividends and MSCI AC Asia ex Japan share prices since 1970 in five-year periods (% p. a.)



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Source: Datastream, Allianz GI Capital Markets & Thematic Research, as of 30.11.2015

A look at the USA since 1950 shows that dividend strategies have outperformed the wider market in times of both rising inflation (up to 10%) and deflation (see Chart 5). This is very interesting since inflating the economy as part of a financial repression programme can be an effective means of reducing the huge debt in the industrialized world, in addition to consolidating national budgets and growth.

If companies continue to pursue their dividend policies and stock prices do not change, equities allow investors to earn a "nice coupon". The key issue is, however: just how sustainable is this "coupon"?

How sustainable are dividends?

Two factors that favour stable dividend yields in the present market environment are:

1. In Europe, the ratio of dividends paid to earnings per share is currently around 60 %, back at its pre-crisis level, whereas it is around 43 % in the US and 42 % in Asia, which is moderate by historical comparison (see Chart 6). Thus, companies in these markets still have ample room for future dividend increases.

2. Companies are sitting on a lot of cash at present. US corporate net cash flows, for example, total around US$1,960 billion net, which is equivalent to more than 12 % of US gross domestic product (GDP) and close to its peak since 1980 (see Chart 7).

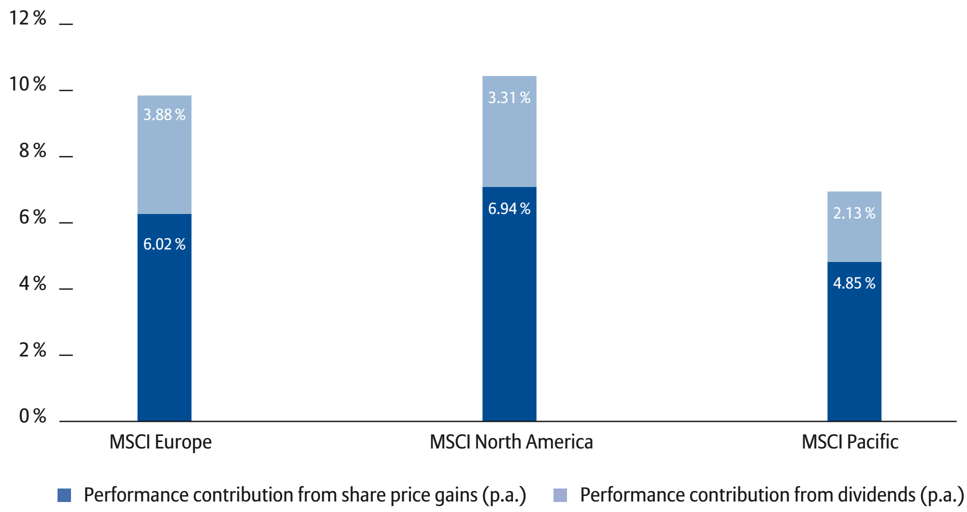
Companies have already come a long way in the deleveraging phase following the financial crisis, i. e. strengthening their equity base and reducing borrowings.

Dividend securities enhance portfolio stability

Promising equities that pay out high dividends do not just offer higher returns though, they also bring more stability to a portfolio. Longer time series are available for the USA. They show that the volatility (measured against the 36-month rolling standard deviation) of US equities has been tangibly lower since 1972 among companies who paid dividends compared to stock corporations who did not distribute profits (see Chart 8). The same trend is visible among European dividend securities since the 1990s.

Chart 4: Shareholder-Friendly Dividend Policies, Especially in Europe

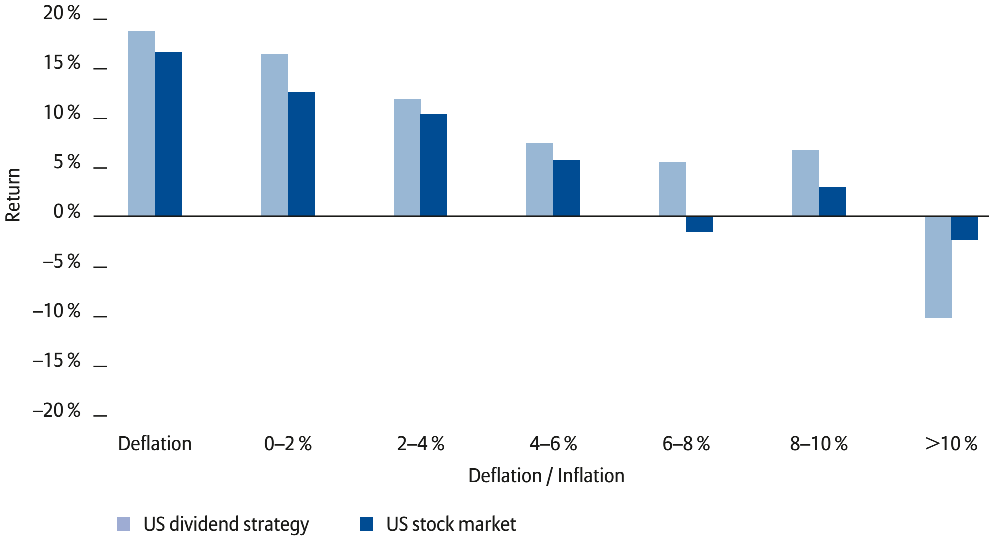
Global comparison of how dividends and share price gains contributed to performance between 1970 and the beginning of 2015 (annualised)



Past performance is not an indication of future results.
Source: Datastream, Allianz GI Capital Markets & Thematic Research, as of 30.11.2015

Chart 5: Inflation – Real Increase in Value Through Dividend Strategy

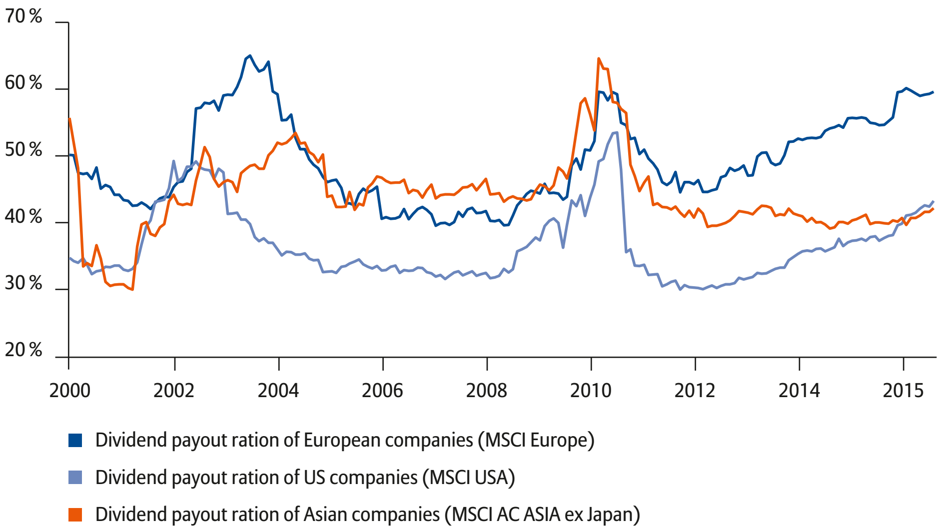
Dividend strategy compared with overall market in periods of inflation and deflation in the US between 1950 and 2015



Past performance is not an indication of future results.
Source: K. French, http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html, period 1950–2015; Datastream, Allianz GI Capital Markets & Thematic Research

Chart 6: Low Moderate Distribution Ratios Offer Potential for Further Dividend Increases

Dividend payout ratios (dividends/earnings) of European, American and Asian companies from 2000 till Beginning of December 2015



Source: Datastream; Allianz Global Investors Capital Markets & Thematic Research, as of 22.12.2015

Some of the reasons why dividend securities demonstrate value and share price stability include:

- Dividend policy frequently forms an active component of a company's strategy. Dividends have an extraordinarily strong signal effect. The market takes a very negative stance when dividends are cut or waived, as this raises doubts about the future sustainability of the enterprise. Companies therefore strive to secure consistent dividend payouts. A comparison of dividends and profits among the members of the S&P 500 index since 1900 shows that company profits have been subject to much greater volatility. Over the past 10 years especially, earnings volatility was almost above 56% on an annualized basis, which was much higher than the 6% volatility witnessed in dividends each year (see Chart 9).

- High distributions and the commitment to paying them consistently in view of the signal effect tend to produce more disciplined companies. They need to budget their financial resources carefully and use them efficiently. By contrast, share buyback programmes neither produce a similar signal effect nor do they exert the same disciplinary constraints on a company due to their discretionary nature.

- Companies with high dividend yields generally have healthy balance sheet ratios with a relatively large equity base and stable cash flows.

- As a rule, investors are usually less quick to sell off a stock that pays high dividends and promises earnings that can be predicted relatively reliably, even in negative or stagnating market conditions.

Focusing on high dividend payments alone, however, can be misleading. Rather, it is the business model of a company that should shape expectations for sustainable earnings, in addition to a shareholder-friendly corporate policy. Factors such as market share, barriers to entry and pricing power all play an important role in this respect. The right business model can also allow such companies to cushion the effects of inflation by raising prices, which increases both profits and, ultimately, dividends.

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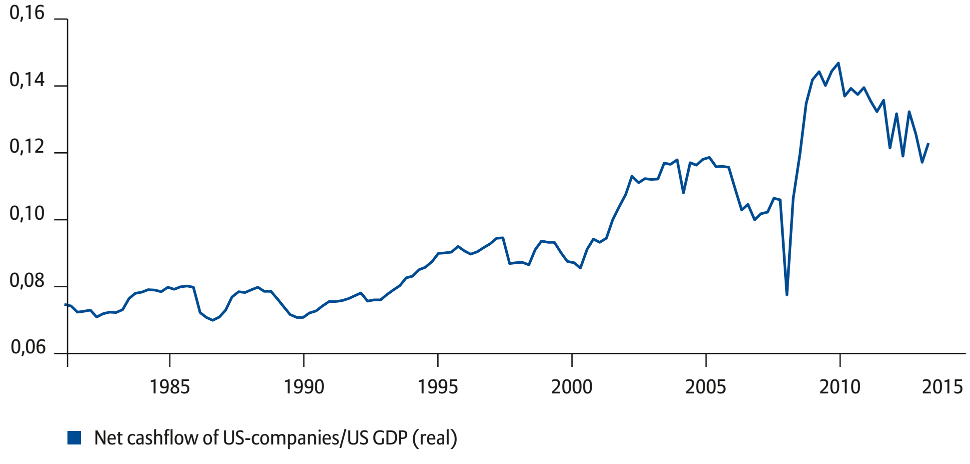
- Dividends can create added value for a portfolio in the long run – and not just in terms of additional income from profit distributions.

Chart 7: US Companies Holding Substantial Cash

Net cash flows of US companies relative to US gross domestic product



Source: Datastream; Allianz GI Capital Markets & Thematic Research, as of 30.11.2015

- Stockpicking should not focus on recent profit distributions, which might have come from a company's equity capital, but on future expected dividends.

- A comparison of global bond and dividend yields shows that, particularly in times of financial repression, dividends can be an attractive substitute for bond coupons.

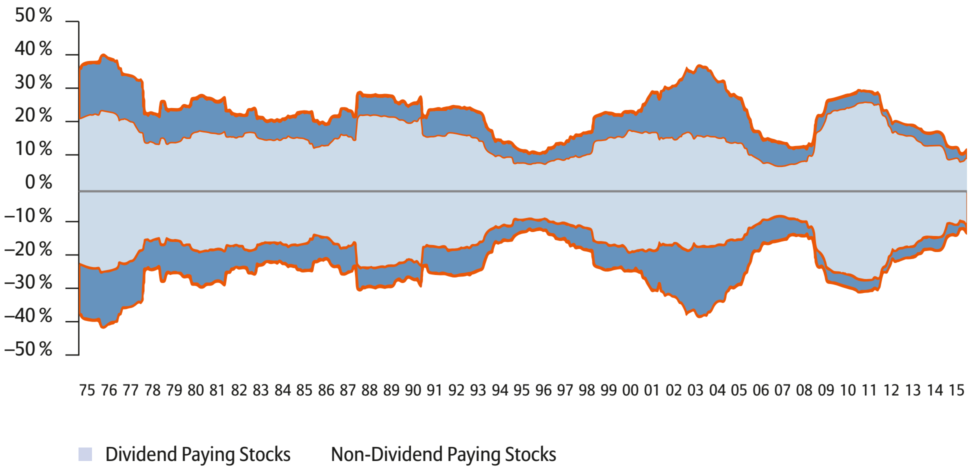
- Historically, dividends have made a significant contribution to total equity returns and have shown a steadier performance than corporate earnings. Thus, they have helped to stabilize securities portfolios.

- Stocks of dividend-paying companies have turned out to be less volatile than stocks of companies that do not pay dividends.

Dennis Nacken and Hans-Jörg Naumer

Chart 8: Share Prices of Dividend Securities Tend to Be Less Volatile

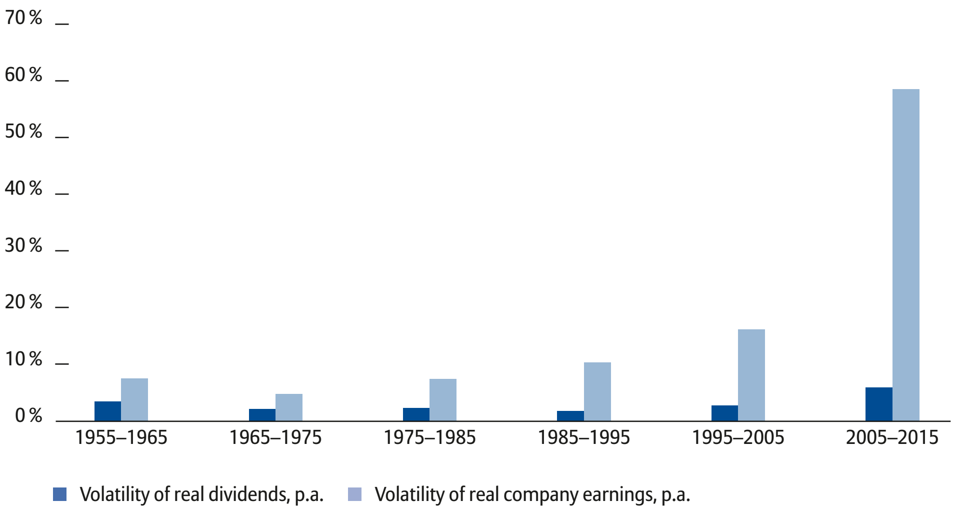
36-month rolling standard deviation of S&P 500 companies that did and did not pay dividends (Jan 1972 – End of Sept 2015)



Past performance is not an indication of future results.
Source: Datastream, NFJ Research, Allianz Global Investors, as of 30.11.2015

Chart 9: "Exhibited Low Volatility of Dividend Payments"

Volatility of company earnings and dividends, S&P 500, from 1900 till mid of 2015 (% p.a.)



Past performance is not an indication of future results.
Source: Shiller, R., "U.S. Stock Price Data since 1871"; Allianz GI Capital Markets & Thematic Research, as of 30.11.2015

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