KBI Global Investors

THOUGHTPIECES

Surprise : dividends become more important as interest rates rise

Good news for diversified equity managers, bad news for concentrated ones

Surprise: dividends become more important as interest rates rise

Global interest rates and bond yields are at multi-year lows. The debate about when they might rise from these extraordinary levels is likely to remain loud, particularly in the US. While predictions about the timing of such a rise are futile, few argue with the view that rise they must at some point in the future. We feel therefore that it's important to devote some thought to the likely impact of a rising interest rate environment on equity investors regardless of when it may come about.

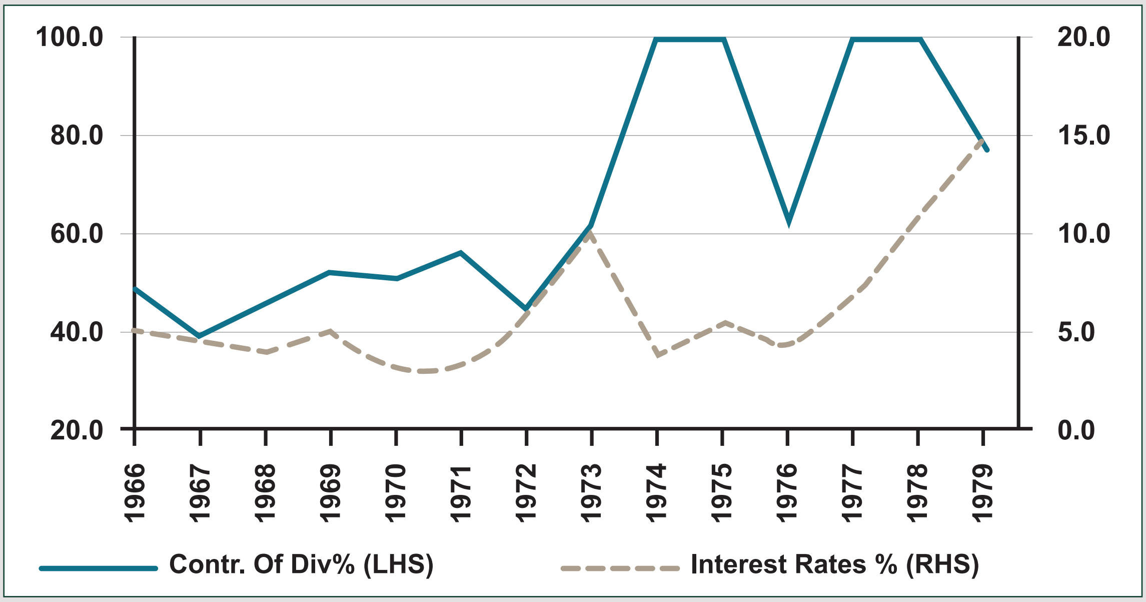
The commonly held rule of thumb is that dividends become less important as a source of return as interest rates rise. In part this view is formed because investors think of dividends narrowly as just income or yield and compare their effectiveness to that of bond coupons. They forget that dividends and earnings are intrinsically connected over time, that there can be a growth element to dividends and that this growth element can be very responsive to interest rate changes.* When you combine dividend yield and dividend growth together to get the total contribution from dividends we find the dividend component of return is actually positively correlated to interest rate changes.

Also investors focus so much on second guessing earnings over short time periods, they tend to assume that the valuation multiples of those earnings (as well dividends they generate) are relatively static, and don't change enough to impact on performance.

Rising interest rates means the discount rate used when calculating the present value of future earnings also increases and this has a negative impact on valuation multiples. This means that price changes tend to be negatively correlated to interest rates. From a total return perspective the damage that rising rates does to the multiple (prices) has tended to have the greatest impact historically. In extreme cases this can mean that dividends sometimes become the only source of return from equities.

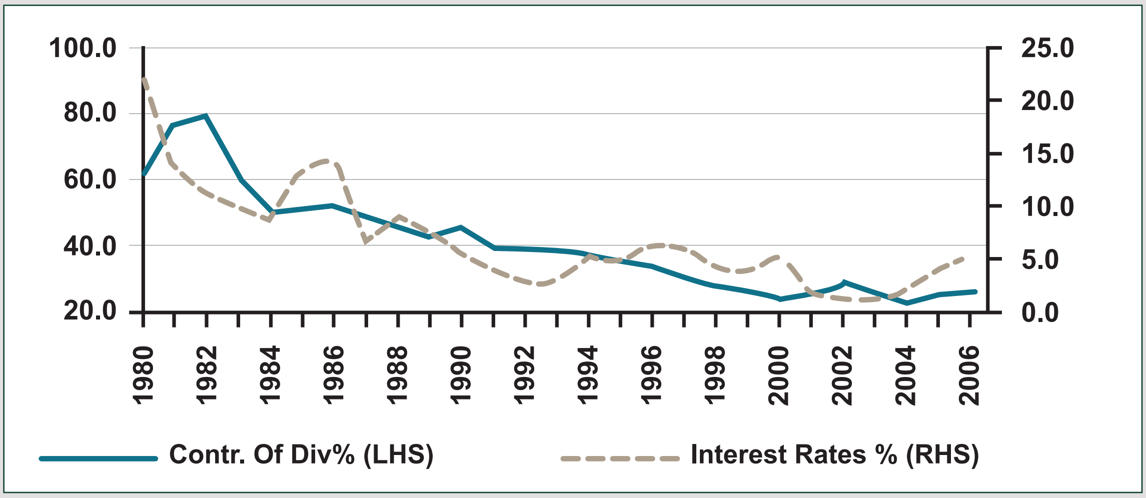
We have analysed equity returns since the mid 1950's, decomposing the price and dividend elements of return and mapping them against changing interest rates. The data is summarised in the charts below. The broken line in the charts track interest rates (fed funds) on a quarterly basis since 1956. The solid blue line tracks the percentage of equity returns that can be attributed to dividends (both yield and growth) on a rolling ten year basis over the same time period (The difference between the price return and the total return). The points in the chart when the solid blue line breaks 100% are periods when 10 year equity returns were negative.

% contribution of dividends to total equity returns when interest rates rise (1966-79)



Source: Barclays Capital and Datastream. S&P 500 and Fed Funds rate

% contribution of dividends to total equity returns when interest rates fall (1979-2006)



Source: Barclays Capital and Datastream. S&P 500 and Fed Funds rate

Contrary to the conventional wisdom we find that historically dividends have made the highest contribution to equity returns when interest rates are on the rise. More generally we can see when dividend growth is taken into account the total contribution that dividends make to equity return tends to move in the same direction as interest rates, while prices (valuations) tend to move in the opposite direction.

In terms of current portfolio positioning, because dividend growth is very successful at delivering excess return when interest rates (or inflation) are on the rise, we are placing a greater emphasis on this factor in those regions of the world where these monetary outcomes are becoming increasingly likely (US and Japan). We are also ensuring that valuations and exposure to external debt are relatively low as these being overweight to these factors can hurt if rates rise. Europe by contrast is still under deflationary pressure, where well covered yield is likely to perform best.

*Dividend Growth: The key to “real” investment success – KBI Global Investors 2011

Good news for diversified equity managers, bad news for concentrated ones

Unconstrained, concentrated, high tracking error managers have been popular since the financial crisis. The thinking being that in highly correlated equity markets dominated by macro events that stock dispersions would be low and the ability to "go anywhere" would increase the probability to add value. Highly diversified approaches like ours were seen by some to be too "tame" to compete.

The logic behind this interpretation also works in reverse, and highly concentrated approaches usually underperform other active approaches when dispersions are high. Rising dispersions have been an increasing trend over the last two years and reports of disappointing returns from more "aggressive" investment approaches have been increasing. Why? Because active management is not just about what you own, it's also about what you don't own. **This is particularly true in the context of global mandates where the number of stocks in the universe is much higher.** When the underlying movement of thousands of stocks goes up, the idiosyncratic (or sometimes even random) nature of this movement can make it very hard to manage with a small number of holdings. When dispersions are high there are simply too many moving parts moving too dramatically to defend yourself with so few positions. You get outnumbered.

Dispersion of Returns (MSCI World)

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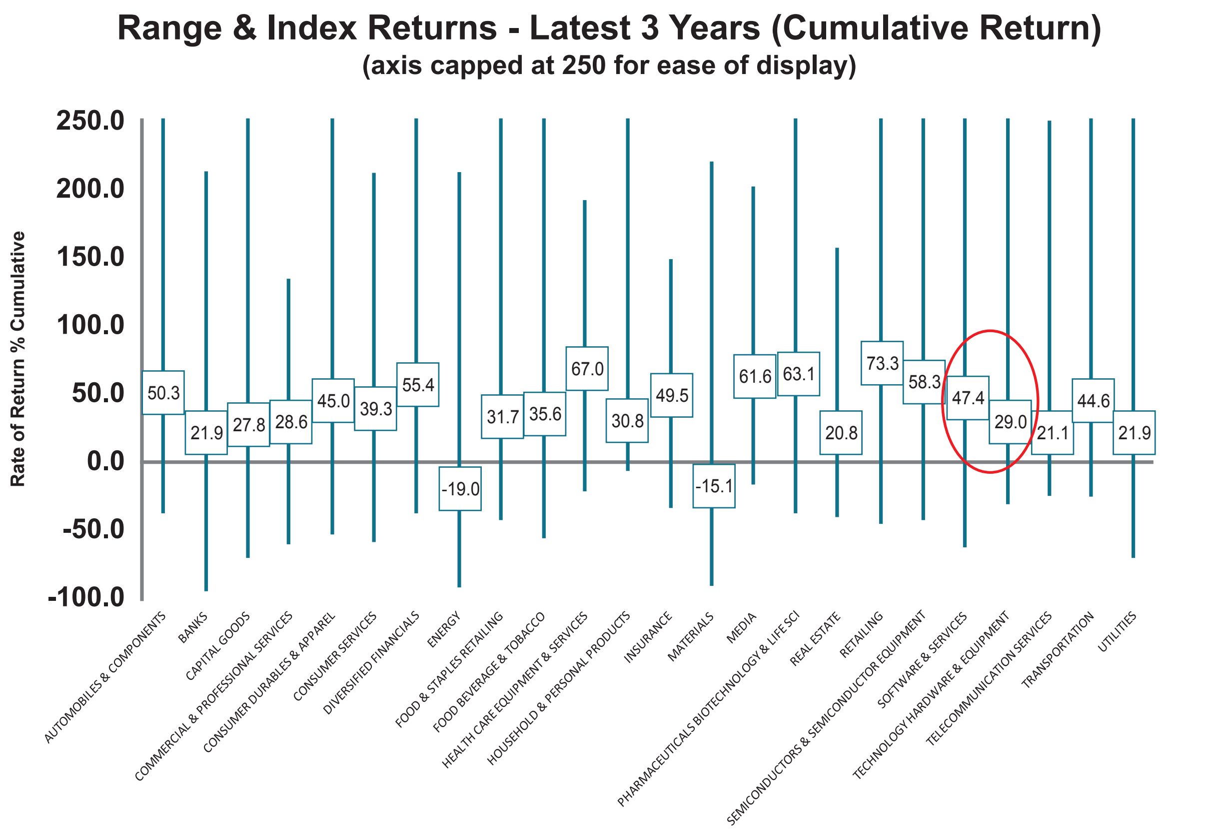

Source: Thomson Reuters Datastream, KBI Global Investors, as at 30th September 2015 (USD, MSCI World).

There is also a direct connection between the level of stock dispersions and the relevance of industry/regional effects. Higher stock dispersions mean that industry/regional effects are lower and become much less relevant in explaining returns. This is because stocks are not behaving similarly to their industry average anymore, the bandwidth has gone up. The two are flip sides to the same coin.

Yet the industry rarely grasps this fluidity, assuming instead that industry/regional effects are somehow stable or fixed over time. The reality is that they are not.

Further still we would argue that they are a lot less significant than investors think. The chart on page 4 shows the extent of individual stock movements over the last three years and compares them to industry movements. (you can do the same exercise using regions – you get the same results) The boxes represent the conventional way of breaking down equity returns. They are index returns, or market weighted averages, the biggest stocks having the biggest influence, the smaller ones having hardly any impact at all. But there is no compulsion on Fund Managers to carry higher weights in bigger stocks, they are free to invest according to their convictions. The blue lines represent the range of stock returns in each industry, regardless of size. We have capped the upside of these lines at +250% to make the charts easier to read. While this cuts out a significant part of the return set (not just the outliers) and makes the bandwidth of alpha potential look smaller, it helps to focus the eye on a much more crucial observation – frequency. Look at the regularity with which the intra industry stock dispersions move dramatically and dwarf the aggregated industry return, regardless of which industry you pick.

Looking at the world in this way we would argue that dispersions were never as low as everyone thought (would you believe us if we told you that some of the best performing stocks during the financial crisis were European banks?) and the need to cut across industries and regions to add bandwidth to alpha is just a red herring.

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ALL MARKETS

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