The Tortoise and the hare

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The DNA of Dividend Strategies

Author:
Helge Kostka
Chief Investment Officer

As the beautiful Christmas period is approaching very fast now, relatives are starting to ask about presents for the little ones. Spending in December will jump versus November and some households might take a bit of time towards the end of the month to plan the new year including holidays or other bigger commitments and goals. I personally like to look back at both the financial assets and income side in a bit more detail than usual.

Income from financial assets has been very low for most risk averse investors, as government bond yields in many developed countries are still at or near record lows. 2017 seems to promise little or no change. Looking at much riskier assets to deliver higher yields was and is likely to continue to be a very popular theme. High yield bonds and emerging market bonds as well as high dividend yielding equity strategies attract a lot of fresh money. Total returns have two components, the bond coupon or the dividend as well as the price change. Given the abovementioned bond asset classes have 2-3 times the level of risk than government bonds, and equity strategies require an even higher risk tolerance, these investors expose themselves to much greater price swings. If they cannot cope with a proper down market, there is a high likelihood they will make the costliest investment mistake of all: Selling at the bottom motivated only by fear!

High dividend yields are a result of either or both a high dividend and a low price. Most companies try to keep their dividend payments relatively steady, so on average it is a low price that causes relatively attractive yields. But could a high dividend yielding strategy be picking up one of more stocks that turn out to be value traps, e.g. prices drop even further? Maybe one company even goes out of business? Dividend investors are advised to make this question part of their standard due diligence.

One possible answer is the quality factor I described in my previous letter. While it might not deliver a premium on its own, it can be really useful, if combined with the value factor. A dividend strategy is also a value strategy because it selects stocks by the ratios of company specific fundamental information to the price of its stock. Price-to-book value(P/B), price-to-earnings (P/E) or price-to-dividend (the inverse of dividend yield) are all siblings from the same family. A value strategy attempts to find cheap securities; a quality strategy attempts to avoid bad quality. It would be great to hold securities that meet both criteria at the same time. In the case of a dividend strategy, the benefit to investors would not only be higher dividend pay-outs, but possibly also positive price effects on their total return.

Let's make an example. If anyone ranks 1000 stocks by its dividend yield and decides to invest into the 250 with the highest yield, that strategy has an attractive dividend yield. If I assign an equal weight to the before mentioned 250 high dividend yielders, each stock will receive a 0.4% allocation. So if one company goes bust, the portfolio suffers a 0.4% capital loss. But the total number of stocks is a critical variable. Imagine I would change only that parameter and do what the majority of existing dividend index strategies do to produce an even higher dividend promise - I select only the top 25 dividend yielding stocks. Keeping my weighting approach, every stock will now receive a 4% weight in my portfolio. And suddenly, if the same one company goes bankrupt, my loss of capital is 4%, ten times higher! A successful quality assessment in this scenario could prove to be a lot more effective.

So, in a nutshell:

» Dividend strategies are also value strategies.
» Applying quality in combination with value can be very useful the more concentrated a portfolio is.
» Passive dividend strategies need to be judged by their index construction methodology first and foremost, not only based on dividend yield and fees.

I wish every reader a wonderful Christmas period!

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Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

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