Beware the Downside of Dividend Income

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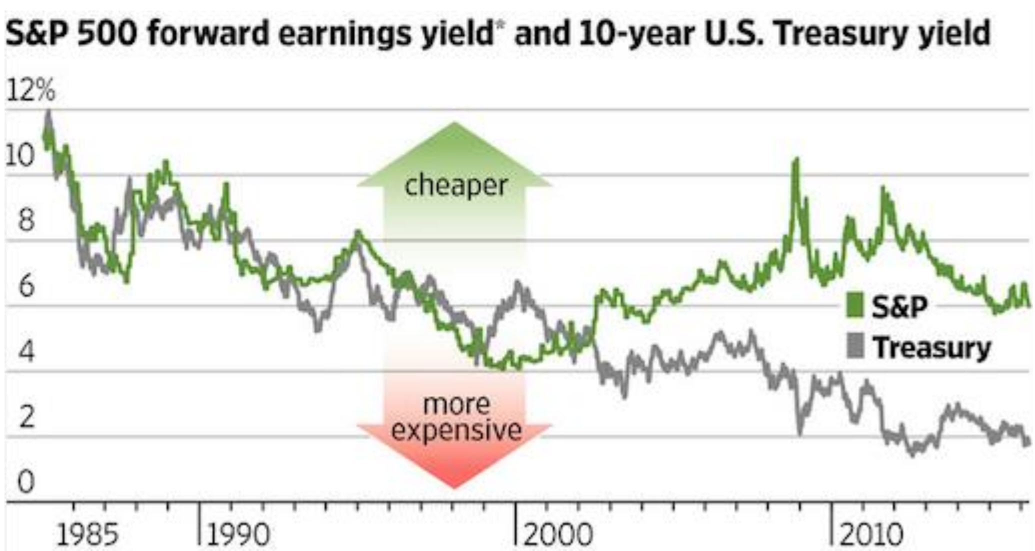
The Wall Street Journal recently showed a chart comparing the forward earnings yield of the S&P 500 to that of the 10-year U.S. Treasury yield over the past 30 years. Around 2002-2003, the two yields were almost identical at 5%; today, the proxy yield for stocks is three-times that of U.S. 10-year treasuries suggesting, at least by this valuation metric, that stocks are currently cheaper than bonds.



*Estimated earning/price, inverse of PE ratio
Note: PE ratio not available for consumer-staples sector before January 1995
Sources: Thomson Reuters Datastream (12-month forward PE ratio, yields): Pro Robert Shiller (S&P Composite PE ratio)
THE WALL STREET JOURNAL

It's precisely this argument that has financial advisors recommending a steady diet of dividend-paying stocks for all but their most risk-averse clients ignoring one of the most fundamental of asset allocation principles: a reasonable mix of stocks, bonds, and cash. Dividends, after all, tend to grow from year-to-year — think, the S&P 500 Dividend Aristocrats, those special companies who've increased ordinary dividends for at least the last 25 consecutive years, or the Canadian Dividend Aristocrats who've done so over the past five — protecting one's capital from the ravages of inflation, while bonds don't, instead paying a fixed rate of interest until maturity.

At least that's the theory.

There are, however, two counter-arguments to this idea that fixed income investments can't compare to their income-producing equity brethren: The first being that while dividends often increase, they also get cut.

According to the S&P Dow Jones Indices' quarterly review of dividend activity on the 10,000 or so stocks traded in the U.S., the first quarter of 2016 saw 252 companies decrease their dividend payout compared to 172 in the same quarter a year earlier. Over the past year, a total of 584 companies cut their dividend payout, a 62% increase year-over-year.

While you can make the argument that the increase in dividend cuts in recent quarters is directly related to the troubles in the oil patch, it's incumbent upon financial advisors of all stripes to at least recognize that income derived from dividends can decline and if that income is needed for a client's relatively fixed overhead, you've potentially exposed them to greater harm than good.

If someone tells you dividends are a sure thing, they haven't lived long enough — a not dissimilar situation to residential real estate in Toronto and Vancouver where some people believe prices only go up.

The second argument has as much to do with advisors looking as though they themselves are growing the businesses that pay the increased dividends as it is about doing what's right for the client. Bonds are boring; there's not much to do except collect the interest. Dividends, on the other hand, utilize the magic of compounding to make a great sales pitch.

Unfortunately, that pitch always fails to mention the dividend cut. It also fails to mention that dividends are discretionary in nature while bonds are legally binding and enforceable contracts.

In fact, in a recent interview, guru investor Jeffrey Gundlach, CEO of Doubleline, went so far as to say "In the United States stocks are very expensive, particularly low volatility stocks. One of the most popular categories in US investing is low volatility stock funds. But there is no such thing! If you think that a stock like Johnson & Johnson can't go down, you're wrong. And if people own funds that invest in stocks which they think are immune from decline and they start to decline, all hell breaks loose."[i]

Scary stuff.

The Canadian Couch Potato ran a series of six articles in 2011 debunking the biggest myths surrounding dividend investing. While all of them are worth reading, it's Dan Bortolotti's third article[ii] that really hits home why dividend-paying stocks are not a substitute for bonds in income-oriented portfolios.

Bortolotti uses research from California financial planner William Bengen that originally appeared in the October 1994 issue of the Journal of Financial planning[iii].

Ground-breaking at the time, Bengen's findings showed that a retirement portfolio 50% invested in stocks and 50% in intermediate-term treasury notes could withstand 30 years or more of inflation-adjusted annual withdrawals [starting at 4%] without exhausting savings.

It successfully demonstrated using various interest-rate environments — both high and low — that retirement portfolios need not be invested 100% in dividend-paying stocks in order to provide sufficient cash flow to keep up with inflation.

The 50/50 asset mix between stocks and bonds might seem antiquated to many financial professionals today but the evidence suggests this old-fashioned approach to income generation both nearing and into retirement works in good times and bad; the same can't be said for a portfolio comprised entirely of dividend-paying stocks.

Lawrence Park Asset Management takes investment grade bonds and turns them into high-yield instruments without ratcheting up the risk.

How do we do this?

By altering the risk profile of the portfolio we're able to mitigate the four risks commonly associated with fixed-income investing: interest rates, foreign exchange, default, and credit.

There's more to it, of course, much more, so feel free to contact us. We'd be glad to show you how.

Thank you to Will Ashworth for his assistance in the creation of this article.

Andrew Torres is the Founder and Chief Executive Officer of Lawrence Park Asset Management, an alternative fixed income manager based in Toronto. Andrew is a 25 year veteran of Canadian and international bond markets, and was a former Vice Chair at TD Securities in charge of global credit trading.

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[i] Interview with Jeffrey Gundlach - http://www.fuw.ch/article/negative-interest-rates-are-the-dumbest-idea-ever/

[ii] Dan Bortolotti's article - http://canadiancouchpotato.com/2011/01/24/debunking-dividend-myths-part-3/

[iii] William Bengen's article - http://www.bobneiman.com/NWM_Pages/Determining%20Withdrawal%20Rates%20-%20William%20Bengen.pdf