HEALTH WEALTH CAREER

DIVIDEND INVESTING

A GLOBAL EQUITY PERSPECTIVE

MAKE TOMORROW, TODAY

MERCER

WHY DIVIDEND INVESTING?

Dividend investing, or equity income, has always been featured in the investment landscape. Increasingly, we find it has a role to play in client portfolios, driven by certain demographic and social (rather than investment) trends. With an aging population and the declining use of traditional postretirement income solutions (such as annuities) in many regions around the globe, the focus on the income generated from postretirement investments is increasing.

In this paper, we discuss why investors may want to consider an allocation to dividend-focused strategies, along with the associated pros and cons.

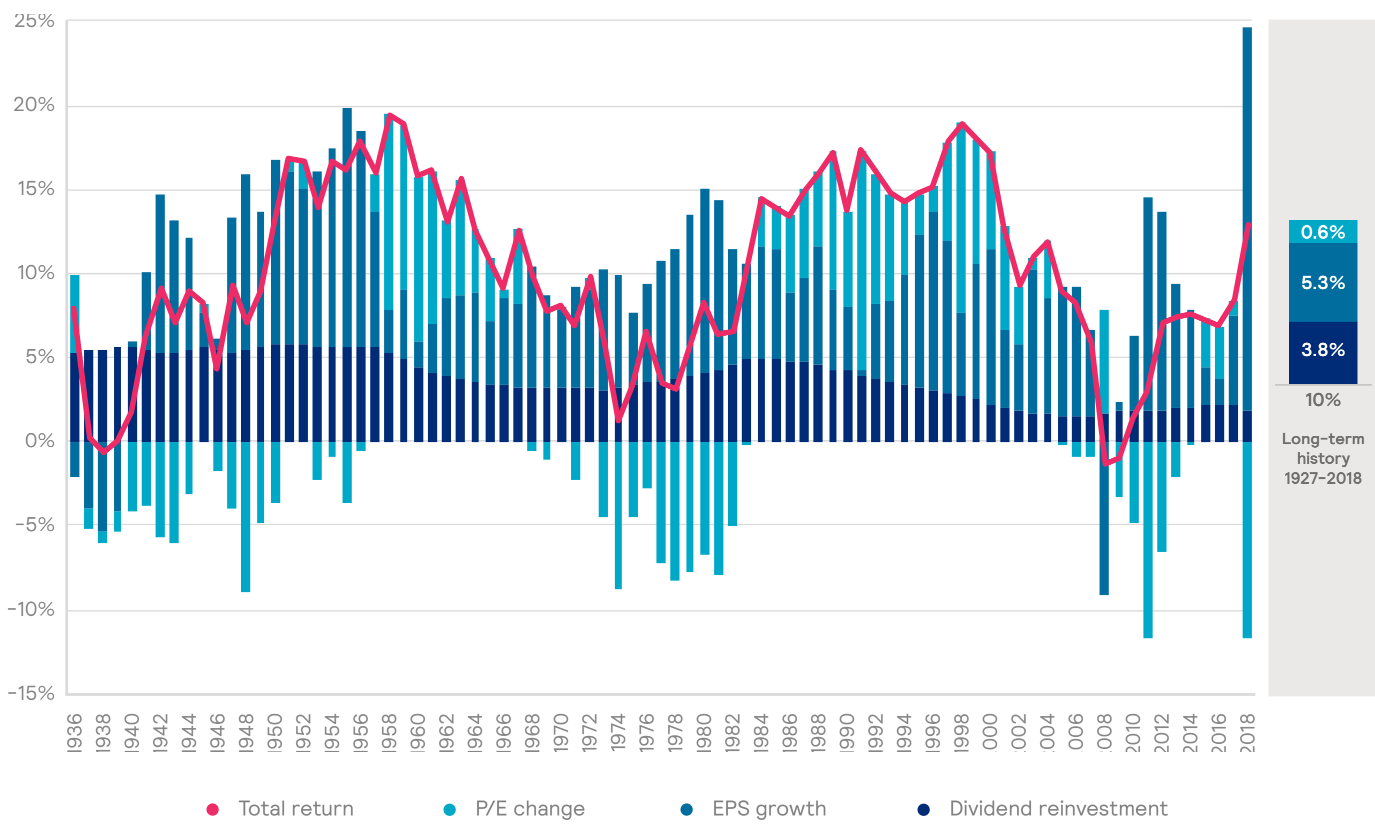
We also address the characteristics associated with investing in a higher-yielding equity portfolio and some of the different approaches available to investors seeking yield-oriented exposure within the equity portions of their portfolios.[1] Mercer believes dividend strategies are appropriate for investors targeting income — either within a well-balanced lineup of equity managers or as part of a multi-asset income solution. However, not all equity income approaches are the same. Care is needed to properly understand the characteristics of any given strategy and ensure they align with the investor's objectives.

[1] For a summary of our thoughts on building broader income strategies, see a recent Q&A on the topic featured in *Research Perspectives*.

WHAT IS DIVIDEND INVESTING/ EQUITY INCOME?

Returns from equities, ignoring shifting sentiment (shown as P/E change in Figure 1, below), are derived from the cash flow produced by the underlying business. They can either be reinvested to fund future growth or distributed to shareholders in the form of dividends (or share and debt buybacks). A simple market analysis bears this out, as seen in the chart below.[2] Although specific objectives and approaches will vary from strategy to strategy, the emphasis placed on income is what ultimately distinguishes dividend strategies from others and unifies them under the same broad umbrella.

Figure 1: Earnings, Dividends and Valuation: Return Contributions for Rolling 10-Year Periods
S&P 500 Index 1927–2018



Sources: Epoch Investment Partners, Inc., Standard & Poor's
Note: We use US historical data as a proxy for global markets because similarly detailed data is not available for non-US markets.

[2] Some very-long-term studies show that dividends can make up more than 50% of a stock market's total return (Dimson, Staunton and Marsh's *Triumph of the Optimists* shows that between 1900 and 2010, the US equity market generated a capital return of 5.0% and a total return of 9.8%; that is, dividends accounting for almost half of the return).

THE BENEFITS AND DRAWBACKS OF DIVIDEND INVESTING

Finance theory states that investors should not differentiate between a company with a *high current dividend* but low future growth and one with a *low current dividend* and high future growth (provided investors are compensated for the risks to that future growth). Total return approaches tend to take this view. However, for some investors, it does matter.

The requirement for a strategy to deliver a specific level of dividends creates a constraint in the opportunity set for the portfolio manager. If an investor is agnostic about receiving returns through capital growth or dividend, then having a dividend requirement arguably introduces an unnecessary constraint. In general, Mercer believes the fewer constraints put on a portfolio manager at a mandate level, the better. We recognize that most approaches create some constraints to narrow the focus of the investment universe. However, in the case of dividend strategies, the constraint often stems from external factors, such as marketing-led initiatives, rather than strong investment beliefs. As such, many yield-oriented equity strategies fail to pass Mercer's test of best-in-class investment strategies.

Nevertheless, equity income solutions are relatively easy for investors to understand, providing both growth and income in a transparent way. In our view, dividend-led approaches — in which constraints are minimal, high-yielding securities are central to the investment philosophy or generating a high yield is achieved as a byproduct of the process (rather than being explicitly targeted) — have more appeal. In addition, the characteristics typically associated with dividend investing, such as value,[3] strong capital discipline and low volatility,[4] are all factors that have been shown to reward investors over the long term.

[3] Bauman WS, Conover CM and Miller RE. "Growth Versus Value and Large-Cap Versus Small-Cap Stocks in International Markets," *Financial Analysts Journal*, Volume 54, Issue 2 (1998), pp. 75–89.
[4] Haugen RA and Heins AJ. "Risk and the Rate of Return on Financial Assets: Some Old Wine in New Bottles," *Journal of Financial and Quantitative Analysis*, Volume 10, Issue 5 (1975), pp. 775–784.

THE CHARACTERISTICS OF DIVIDEND INVESTING

Dividend or income strategies vary greatly depending on the approach. However, they typically come with certain characteristics that may be of benefit to investors. The most obvious characteristic of dividend investing is **a portfolio-level dividend yield in excess of the market**[5] (that is, the relevant benchmark). The degree and stability of the yield does, however, vary by market and investment strategy.

Below, we highlight three other common characteristics of high-yielding equity strategies that may both benefit and appeal to investors but, critically, vary greatly depending on the approach.

Value: Dividend yield is one of the common valuation metrics used by investors to both identify low-priced stocks and access the "value premium," as such strategies with a high dividend yield typically display broader value characteristics. (For example, low price-to-earnings or price-to-book, two accounting ratios often used to assess whether a company is high-priced or low-priced.) However, this is not always the case, particularly if a high yield is explicitly targeted.

Strong capital discipline (management quality): The management of a business has limited options for its cash flows, and if it's paying out higher dividends, then perhaps it isn't finding new opportunities to reinvest the cash to help the business grow. Although this seems a sensible conclusion, evidence[6] suggests that management teams committed to paying dividends to shareholders will weigh reinvestment opportunities more carefully and are less likely to invest the cash flow of the business into ventures that are not truly value-adding for shareholders.

Lower Volatility: Some evidence suggests that high-dividend-paying businesses are less volatile than their lower-paying peers.[7] There may be a number of reasons for this, including:

- Higher-dividend-paying companies display **stronger capital discipline** (as discussed above).
- Higher-dividend-paying companies tend to be **more mature** and less growth-focused in their strategies. As such, the businesses tend to be less volatile. They are also typically larger businesses.
- Given that the nature of the underlying businesses tends to be more stable, there is a **lower level of "forecast risk,"** as analysts modeling these businesses have more-predictable earnings streams to work with. This reduces the risk of overly aggressive growth being baked into valuation models.

These characteristics can be seen when we analyze a naïve high-dividend-yield index as shown below.

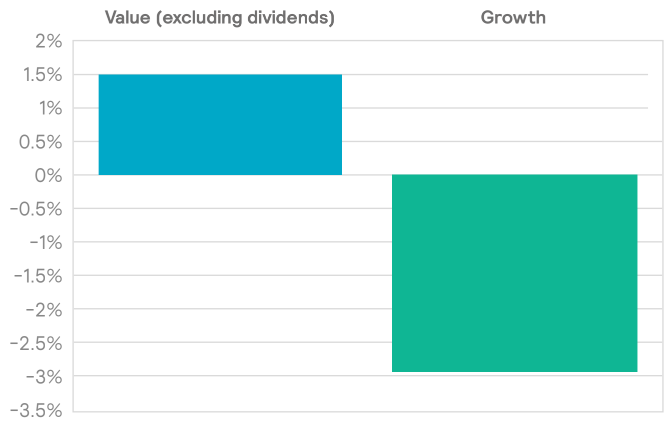
[5] The global equity market has delivered a yield over the long term of around 3% (although this has fallen a little over the past decade). The yield pickup from a specific yield strategy has ranged from as low as 50 basis points (bps) to 300 bps, with, on average, an increase of around 100–150 bps (that is, a total dividend yield of approximately 3.5%–4.0%).

[6] Arnott RD and Asness CS. "Surprise! Higher Dividends = Higher Earnings Growth," *Financial Analysts Journal*, Volume 59, Issue 1 (2003), pp. 70–87. Zhou P and Ruland W. "Dividend Payout and Future Earnings Growth," *Financial Analysts Journal*, Volume 62, Issue 3 (2006), pp. 58–69.

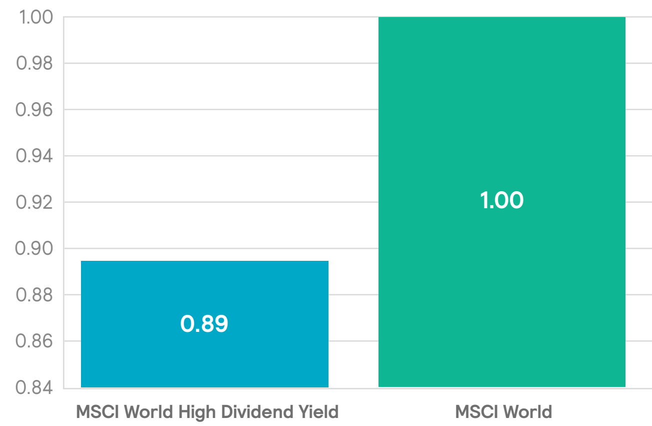
[7] Dimensional. *Global Dividend-Paying Stocks: A Recent History*, 2013.

Figure 2. Characteristics Using the MSCI World High Dividend Yield Index Against the MSCI World Index as of December 31, 2018

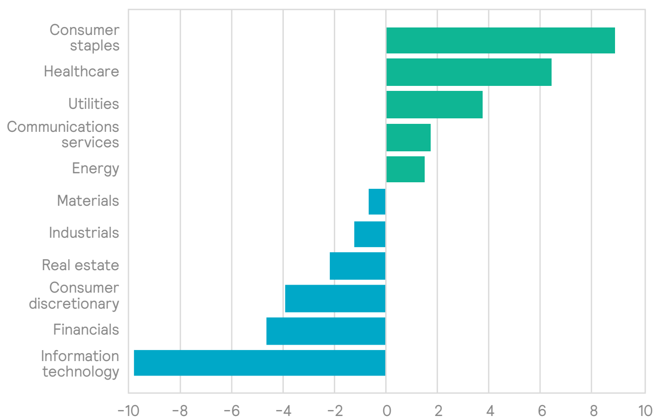
A value bias with an anti-growth tilt



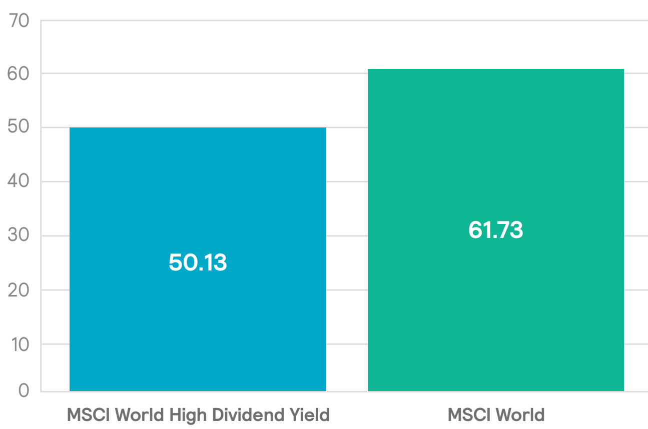
Low market beta



A bias in certain sectors: healthcare, consumer staples and utilities, and underweights to info tech, financials and industrials in particular



An underweight to the US that may be structural, given the different tax treatment for corporates paying dividends



Sources: MSCI, Style Research

THE DIFFERENT APPROACHES

There are a number of different approaches to generating an above-average dividend yield. Each approach has different characteristics and is suitable for different types of investors. Although strategies do not fall neatly into clearly defined buckets, we summarize the key investment approaches below and categorize them in terms of their yield focus and complexity in Figure 3.

Systematic yield approaches: Systematic or purely quantitative approaches can either be passively managed to a recognized high-dividend index or use simplistic quantitative screens focusing on yield. Although other fundamental approaches will also use some form of screen, in general, the approaches that only rely on screening are overly simplistic and aren't suitable for most investors unless yield is key, fees are a consideration and other options are not suitable. In these instances, we would emphasize systematic strategies with some degree of focus on the sustainability of the dividend and some flexibility in the portfolio construction.

Value approaches: Some value strategies may use dividends as their focus and deliver sustainably higher dividend yields than the index. Typically, yield is used at the idea-generation stage, but the yield increase is often modest, performance tends to be more closely aligned to the value premium than dividend investing and they are less likely to exhibit defensive characteristics. Such strategies are commonly used by long-term investors in well-diversified portfolios but are less suitable when income is the core objective.

Capital discipline or dividend growth: For certain quality-oriented strategies, a high-dividend exposure can result from a focus on corporate management teams with strong capital discipline (as already discussed). These strategies typically have more of a growth bias with low turnover and a consideration of the sustainability of the business, and they tend to provide greater levels of defensiveness. Such approaches can be useful for both long-term investors and income-seeking investors.

Income maximizers: Other strategies may use derivatives to maximize income or provide the client with income through a multi-asset approach. Equity-centric income strategies are simpler, more transparent, likely to provide higher long-term growth and can manage risk by investing in more defensive yield/quality strategies. There is also a wider universe. However, there may be better risk-adjusted returns available in a multi-asset solution.

Figure 3: Key Investment Categories

CONCLUSION

We believe equity income strategies have a role to play within an investor's portfolio. They can provide access to some appealing characteristics: biases to value, low volatility/beta, low gearing and strong capital discipline. They offer a transparent and straightforward way to generate income while maintaining some capital growth. However, not all equity income strategies are the same, and the different approaches can lead to very different results — clients should be aware of the likely outcomes.

For those clients **seeking income**, equity income strategies should be a part of a multi-asset solution, delivering relatively stable income with stronger capital growth than many other income-generating assets while also providing diversification through the equity component.

Similarly, **long-term investors** shouldn't ignore income strategies, because they have attractive characteristics that can form part of a well-balanced lineup. However, a clear focus on avoiding strategies that incorporate unnecessary constraints and an understanding of the characteristics of any strategy are crucial for such an investor.

Income maximizers or multi-asset approaches may be particularly appropriate for **retirees**, for whom the higher level of risk management and shallower drawdowns may be preferable. It should also be noted that equity income strategies may well be incorporated into multi-asset strategies. In the case of income maximizer strategies, the extent of other (noninvestment) risks introduced by the use of derivatives versus their efficacy in boosting the income will need to be explored.

We recommend a considered approach to selecting an equity income solution with the characteristics that clearly meet the objectives of each investor's requirements.

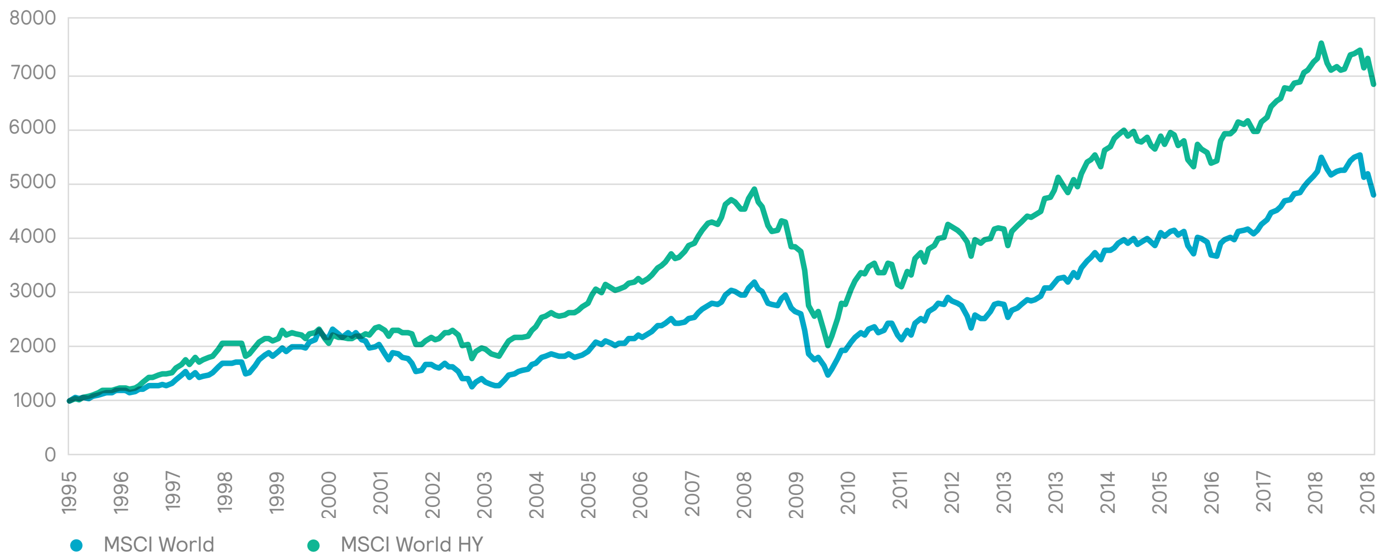
APPENDIX

HISTORIC PERFORMANCE AND THE CURRENT ENVIRONMENT

From a performance perspective, the MSCI World High Dividend Yield Index has outperformed the MSCI World Index over the past 30 years and has done so with less volatility. We do note, however, that the volatility is not consistently lower than the broader benchmark. In particular, volatility spiked from 2008 through 2011 — the result of banks, especially, dominating the index before the financial crisis and retrenching during 2008 and 2009.

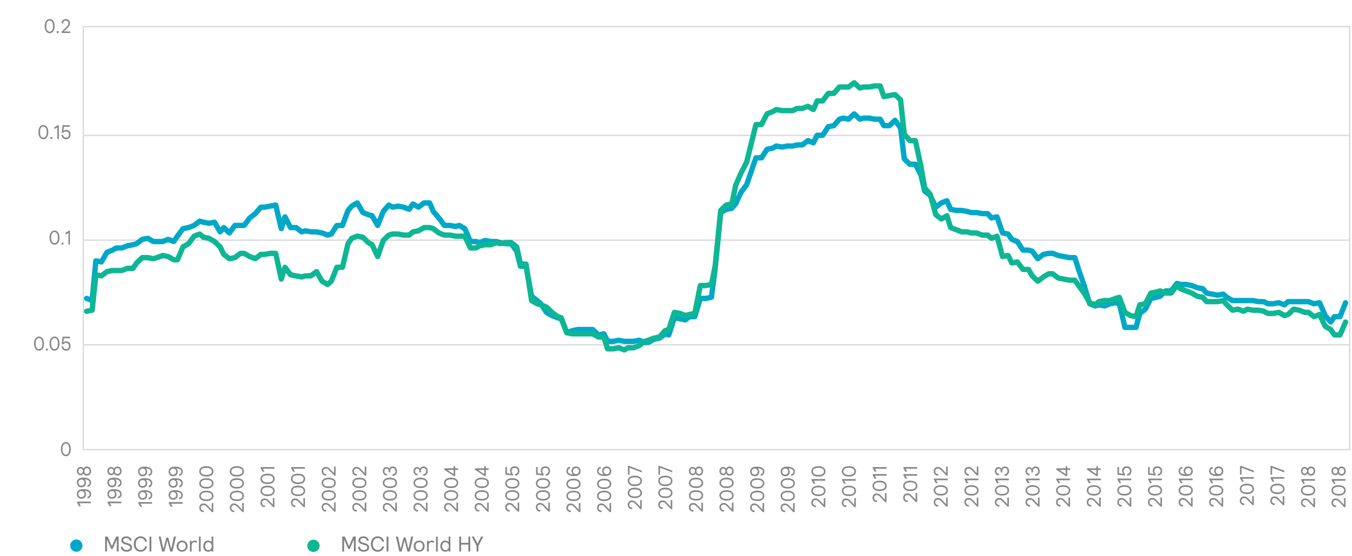
Figure A1: MSCI World High Dividend Yield Index Versus MSCI World Index

Growth of $1,000



Source: Thomson Reuters Datastream

Rolling 3-year volatility



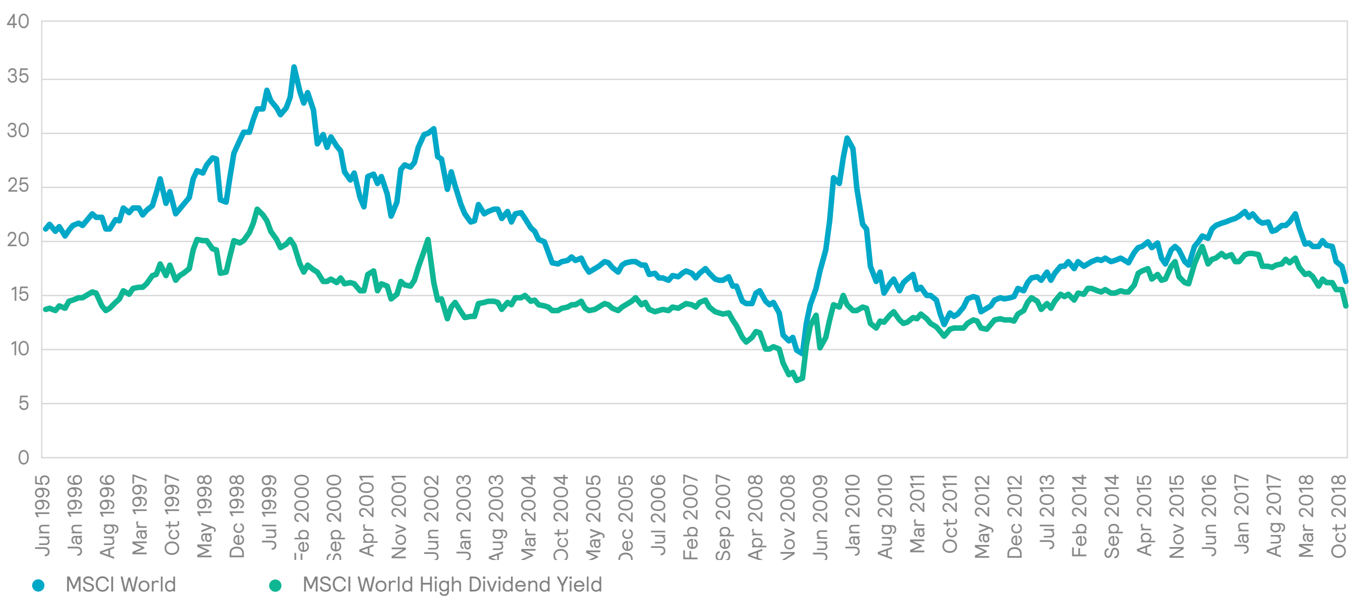
Source: Thomson Reuters Datastream

Interestingly, since the financial crisis, despite the lower yield from fixed income and the expectation that high-dividend-yielding stocks would outperform, the MSCI World High Dividend Yield Index has not delivered returns significantly ahead of the broader index, as seen in Figure A2, below. This may be due in part to the underperformance of value as a style — the MSCI World High Dividend Yield Index falls largely into this camp based on its persistently lower price-to-earnings ratio (P/E) than the broader market, shown in Figure A3, below.

Figure A2: MSCI World High Dividend Yield Index Rolling Three-Year Relative Returns

Source: Thomson Reuters Datastream

Figure A3: P/E Ratios



Source: Thomson Reuters Datastream

A NOTE ON LOW VOLATILITY

One of the more common reasons for investing in dividend strategies is their defensive characteristics. But are dividends the best way to introduce a defensive bias? It may have been true in the past that dividends were a reasonable proxy for low volatility or defensiveness, but over the past decade, we have seen a marked development in the industry in terms of the availability of options for the client wishing to access such an investment approach. The table below shows the average rolling five-year returns of various indices that represent different approaches to generating a defensive portfolio over the past 15 years to September 30, 2018. It also shows the average rolling five-year standard deviation of returns over the same period and the unit of return per unit of volatility. This indicates that other approaches more explicitly focused on sustainable cash flow or return on equity (profitability strategies) and systematic strategies that explicitly target volatility reduction have historically provided better risk-adjusted returns than a naïve dividend approach.

Comparative Statistics of Quality, Income and Minimum Variance Indices Over Five Years to December 31, 2018 (USD)

Name	Return (% pa)	Standard deviation (% pa)	Return/risk
MSCI World	5.14	9.81	0.52
MSCI AC World	4.82	9.89	0.49
MSCI World High Dividend Yield	4.33	8.22	0.53
MSCI World Quality	7.51	9.90	0.76
MSCI World Minimum Volatility	8.34	7.46	1.12

Source: MercerInsight

ABOUT MERCER

At Mercer, we make a difference in the lives of more than 115 million people every day by advancing their health, wealth, and careers. We're in the business of creating more secure and rewarding futures for our clients and their employees — whether we're designing affordable health plans, assuring income for retirement or aligning workers with workforce needs. Using analysis and insights as catalysts for change, we anticipate and understand the individual impact of business decisions, now and in the future. We see people's current and future needs through a lens of innovation, and our holistic view, specialized expertise, and deep analytical rigour underpin each and every idea and solution we offer. For more than 70 years, we've turned our insights into actions, enabling people around the globe to live, work, and retire well. At Mercer, we say Make Tomorrow, Today.

HOW MERCER CAN HELP

Wealth and investment require sophisticated solutions. We offer research and advice on how to assess risk and design Wealth and investment require sophisticated solutions. We offer research and advice on how to assess risk and design investment strategies while keeping in mind the need to optimize throughout changing times. Along with more than 140 manager researcher with in-depth knowledge of the complexities and ever-changing factors that impact investment, Mercer's consultants can help you make effective decisions that align with your business needs and ensure more rewarding futures for your employees.

For further information, please visit www.mercer.ca

Join the conversation:

@MercerCanada Mercer Canada

MARSH & McLENNAN COMPANIES