



Wolves in Sheep's Clothing: Hidden Risks in Dividend Portfolios

By John C. Bailer, CFA
Senior Portfolio Manager

S. Joel Mittelman, CFA, CPA
Portfolio Strategist

Brock Campbell, CFA
Research Analyst

The Boston Company Asset
Management, LLC

In the past five years, we have witnessed a resurgence of interest in US dividend-paying stocks.

EXECUTIVE SUMMARY

In the past five years, we have witnessed a resurgence of interest in US dividend-paying stocks. This is due to investors seeking income generation in a zero-interest-rate environment, and a defensive way to increase their US equity exposure as well as concerns about bonds in a rising interest rate environment. We contend that investment managers have chased this bond-proxy trade with a myopic view of the potential rewards without fully considering the associated risks.

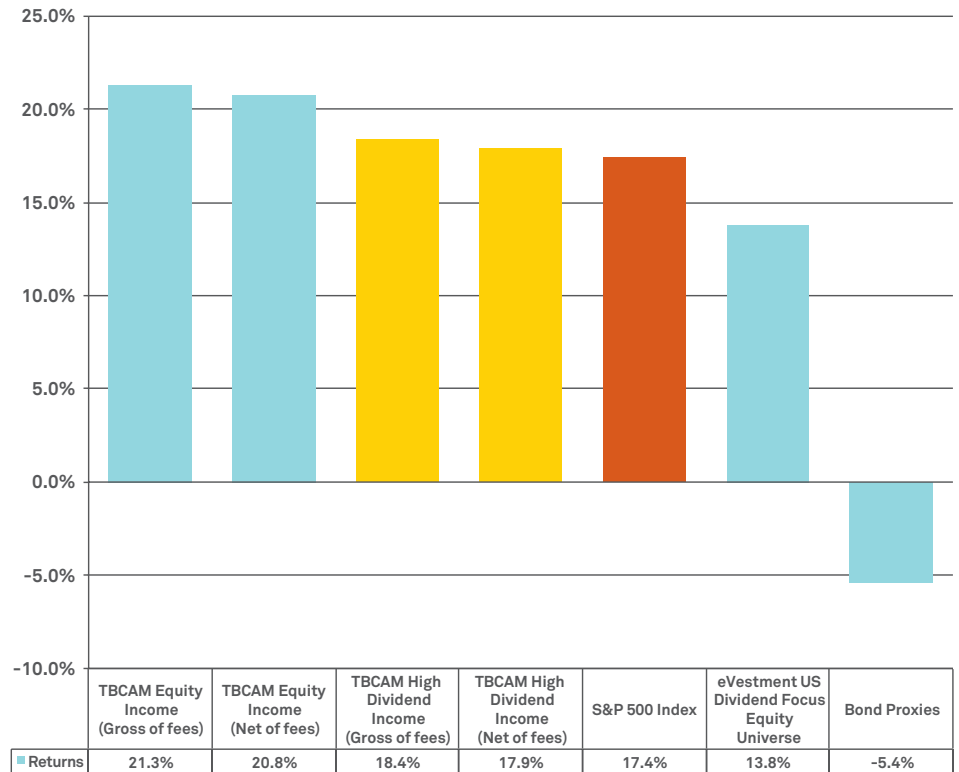
Historically, investors have pursued stocks that yield high dividends for their superior downside protection and significant contribution to total market return. In today's environment, however, chasing these yield-producing stocks without regard to entry points can be risky. In some cases, the risks may potentially even outweigh the benefits of dividend investing. Thus, investors interested in dividend-paying stocks need to consider the potential effects of currently prevailing market conditions, particularly the three which we address in this piece:

- The risks of a rising interest-rate environment
- The downside of valuation indifference
- The effect of a changing fundamental landscape

While these headwinds affect many investors, they are not insurmountable. Figure 1 shows that during a recent period when all of these risks coexisted, dividend investing using a fundamental, forward-looking and valuation-sensitive approach yielded results that compared favorably with other approaches.

Investors have often sought these stocks in an effort to preserve legacy fixed-income capital for a time when interest rates inevitably rise.

Figure 1: 10-Year US Treasury Interest Rate May 2013–December 2013



Source: FactSet, eVestment. Note: Bond Proxies are represented by the Telecommunications and Utilities sectors of the S&P 500 index. Please refer to the back page for other important disclosures. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.

THE RISKS OF A RISING INTEREST-RATE ENVIRONMENT

Recently, underwhelming fixed-income yields have driven investors into a select group of high-yielding equities that have become known as bond proxies.¹ These stocks traditionally offer many of the same characteristics investors seek in bonds, namely income and downside protection. Investors have also often sought these stocks in an effort to preserve legacy fixed-income capital for a time when interest rates inevitably rise.

¹ Bond proxies can include select names within Utilities, Telecommunications Services, Consumer Staples and real estate investment trusts, as well as other industries. For illustrative purposes in this paper, we use “bond proxies” to refer primarily to the Utilities and Telecommunication Services sectors.

Many investors, however, were surprised by the magnitude of the underperformance by (and, in some cases, outright capital loss from) these bond proxies during the interest-rate spike caused by former Federal Reserve Chairman Ben Bernanke's tapering talk in May 2013. (See Figure 2.) While interest rates have reversed course in 2014, we still believe the most likely path for rates is higher over the long term.

Figure 2: Periods of Rising Interest Rates and Related Performance

	Oct. 1993 – Nov. 1994	Oct. 1998 – Jan. 2000	Jun. 2003 – Jun. 2006	Dec. 2008 – Apr. 2010	May 2013 – Dec. 2013	Average
10 Year UST Change (bps)	281	263	207	189	140	219
S&P 500 Return	2.5%	48.8%	32.0%	39.9%	17.4%	30.6%
Telecom Sector Return	-1.1%	40.9%	29.6%	6.9%	-4.8%	20.0%
Utilities Sector Return	-1.2%	-3.3%	39.6%	9.9%	-6.0%	16.7%

Source: Bloomberg, FactSet.

Equities tend to appreciate meaningfully during periods of rising rates, but as Figure 2 shows, not all stocks and sectors benefit equally. In the most recent periods of materially higher rates, the Utilities and Telecommunication Services sectors consistently and significantly underperformed. The only two exceptions were utilities in 2003 and telecoms in 1998, when the sector yields were not materially different from the market (i.e., they were not functioning as bond proxies). Moreover, in half of the observations, the sectors' performance was negative on an absolute basis and capital was not preserved.

When seeking protection against interest-rate risk, investors may consider companies that are sensitive to the health of the economy and that enjoy high yields and/or superior dividend growth prospects. For example, Information Technology and Financials are two economically sensitive sectors that have seen dividend growth rates of roughly 30 percent during the past three years. Although investors may give up a modest amount of yield (albeit while still maintaining a premium to the market), they can benefit from better upside performance and downside protection.

Equities tend to appreciate meaningfully during periods of rising rates, but not all stocks and sectors benefit equally.

Successful dividend investing should include a focus on underlying business fundamentals.

THE DOWNSIDE OF VALUATION INDIFFERENCE

The highest-yielding bond proxies have historically traded at a 10 to 20 percent discount to the overall market, due to their limited growth prospects. However, this relative discount has broken down over the past five years as investors have aggressively pursued high-yielding stocks without much regard for price. Paying too much for a desired benefit—in this case, a superior yield—can significantly undermine its overall value. (See Figure 3.)

Figure 3: Percent Excess Return

		Valuation as Measured by P/E	
		Attractive	Unattractive
Dividend Yield	High	1.5%	-0.4%
	Low	0.4%	-0.5%

Source: Wolfe Trahan Accounting & Tax Policy Research, Company filings, Bloomberg, Standard & Poor's, FactSet. Note: Dividend Yield - 500 largest companies ex-REITs; 1990-2/6/13. Dividend yield is not sector neutral. P/E is sector neutral.

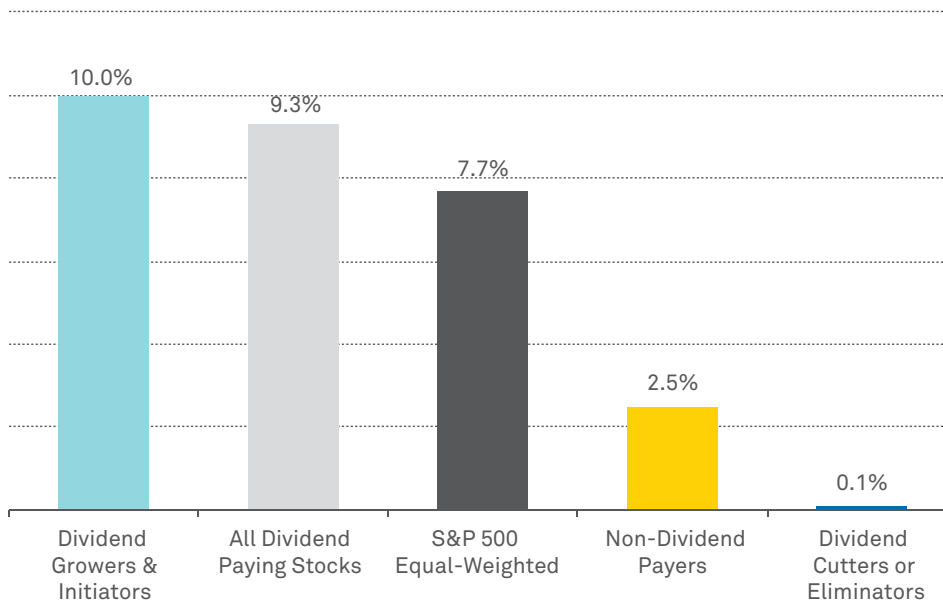
Figure 3 shows excess returns for four groups of stocks based on the attraction of dividend yield and valuation. The high-dividend-yielding stocks provide higher returns than the low-dividend-yielding stocks for a given level of valuation, which underscores a primary appeal of dividend investing. Regardless of the level of their dividend yield, richly valued stocks (measured by a high price-to-earnings ratio in this case) underperformed. Stocks that offer high yields at attractive valuations are the attributes that serve as cornerstones of The Boston Company's investment approach.

THE EFFECT OF A CHANGING FUNDAMENTAL LANDSCAPE

Successful dividend investing should also include a focus on underlying business fundamentals. For example, the traditional business models of high-yielding utility companies are likely to undergo profound change as the industry finds itself subject to disruptive pressures such as rooftop solar and home automation. We see these changes putting downward pressure on the amount of electricity which utilities will sell to consumers and lead them to try to charge higher rates to cover their large fixed bases. These rate increases, however, will likely face considerable political pushback from public utility commissions, as many lower-income consumers are unable to afford rooftop solar systems and would bear the brunt of higher electricity costs. Thus, with volumes declining and rate inflation challenged, the financial position of some utilities will deteriorate over time.

Some companies and management teams will react far better than others to this evolution, and the returns of their companies' stocks are likely to diverge accordingly. Those who are unable to manage this transition effectively may also have to cut their dividends, a move which is almost always draws scorn from investors and subsequent selloffs. Fortunately, forward-looking active investment managers, who are skilled at identifying management's ability and willingness to continue to pay and grow their dividends, are capable of identifying these winners and losers and positioning their portfolios accordingly. (See Figure 4.)

Figure 4: Average Annualized Returns of S&P 500 Stocks by Dividend Cohort (1972 – 2014)



Source: Ned Davis Research. Monthly data 1/31/72 – 7/31/14.

Utility companies are using financial re-engineering to unlock shareholder value.

Utility companies are using financial re-engineering to unlock shareholder value. In the past year alone, at least five utility companies have spun out their fixed assets into “yield cos.” These fast-dividend-growing, tax-advantaged companies have enjoyed tremendous early outperformance. (See Figure 5.) Few passive and/or quantitative managers have exposure to these types of securities despite their powerful combination of high dividend growth and robust performance because of their limited float and/or liquidity and lack of historical data. We believe that a forward-looking fundamental manager can overcome these challenges.

CONCLUSION

Many investors have been increasing exposure to dividend-paying stocks of late, but have done so with a narrow focus on high yields alone. Unfortunately, this has introduced unintended risks into their portfolios, stemming from a rising interest-rate environment, valuation indifference and/or a changing fundamental landscape.

Fortunately, we believe these risks can be effectively mitigated to allow investors to realize the tried- and-true benefits of dividend investing. But to do so, investors need to broaden their investment criteria beyond high yield alone and include dividend growth prospects, economic sensitivity, fundamental position and valuation attractiveness.

[THIS PAGE INTENTIONALLY LEFT BLANK]

BNY Mellon Investment Management is one of the world's leading investment management organizations and one of the top U.S. wealth managers, encompassing BNY Mellon's affiliated investment management firms, wealth management organization and global distribution companies. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation and may also be used as a generic term to reference the Corporation as a whole or its various subsidiaries generally.

The information in this document is not intended to be investment advice, and it may be deemed a financial promotion in non-U.S. jurisdictions. Accordingly, where this document is used or distributed in any non-U.S. jurisdiction, the information provided is for Professional Clients only. This material is not for onward distribution to, or to be relied upon by, retail investors.

Any statements and opinions expressed in this document are as of the date of the article, are subject to change as economic and market conditions dictate, and do not necessarily represent the views of BNY Mellon or any of its affiliates. The information contained in this document has been provided as a general market commentary only and does not constitute legal, tax, accounting, other professional counsel or investment advice, is not predictive of future performance, and should not be construed as an offer to sell or a solicitation to buy any security or make an offer where otherwise unlawful. The information has been provided without taking into account the investment objective, financial situation or needs of any particular person. BNY Mellon and its affiliates are not responsible for any subsequent investment advice given based on the information supplied. This document is not investment research or a research recommendation for regulatory purposes as it does not constitute substantive research or analysis. To the extent that these materials contain statements about future performance, such statements are forward looking and are subject to a number of risks and uncertainties. Information and opinions presented in this material have been obtained or derived from sources which BNY Mellon believed to be reliable, but BNY Mellon makes no representation to its accuracy and completeness. BNY Mellon accepts no liability for loss arising from use of this material. If nothing is indicated to the contrary, all figures are unaudited.

Any indication of past performance is not a guide to future performance. The value of investments can fall as well as rise, so you may get back less than you originally invested.

This document is not intended for distribution to, or use by, any person or entity in any jurisdiction or country in which such distribution or use would be contrary to local law or regulation. This document may not be distributed or used for the purpose of offers or solicitations in any jurisdiction or in any circumstances in which such offers or solicitations are unlawful or not authorized, or where there would be, by virtue of such distribution, new or additional registration requirements. Persons into whose possession this document comes are required to inform themselves about and to observe any restrictions that apply to the distribution of this document in their jurisdiction. **The investment products and services mentioned here are not insured by the FDIC (or any other state or federal agency), are not deposits of or guaranteed by any bank, and may lose value.**

This document should not be published in hard copy, electronic form, via the web or in any other medium accessible to the public, unless authorized by BNY Mellon Investment Management.

This document is approved for Global distribution and is issued in the following jurisdictions by the named local entities or divisions: **UK and in mainland Europe (excluding Germany):** BNYMIM EMEA, BNY Mellon Centre, 160 Queen Victoria Street, London EC4V 4LA. Registered in England No. 1118580. Authorized and regulated by the Financial Conduct Authority. • **Germany:** Meriten Investment Management GmbH which is regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht. • **Dubai, United Arab Emirates:** Dubai branch of The Bank of New York Mellon, which is regulated by the Dubai Financial Services Authority. This material is intended for Professional Clients only and no other person should act upon it. • **Singapore:** BNY Mellon Investment Management Singapore Pte. Limited Co. Reg. 201230427E. Regulated by the Monetary Authority of Singapore. • **Hong Kong:** BNY Mellon Investment Management Hong Kong Limited. Regulated by the Hong Kong Securities and Futures Commission. • **Japan:** BNY Mellon Asset Management Japan Limited. BNY Mellon Asset Management Japan Limited is a Financial Instruments Business Operator with license no 406 (Kinsho) at the Commissioner of Kanto Local Finance Bureau and is a Member of the Investment Trusts Association, Japan and Japan Securities Investment Advisers Association. • **Australia:** BNY Mellon Investment Management Australia Ltd (ABN 56 102 482 815, AFS License No. 227865). Authorized and regulated by the Australian Securities & Investments Commission. • **United States:** BNY Mellon Investment Management. • **Canada:** Securities are offered through BNY Mellon Asset Management Canada Ltd., registered as a Portfolio Manager and Exempt Market Dealer in all provinces and territories of Canada, and as an Investment Fund Manager and Commodity Trading Manager in Ontario. • **Brazil:** this document is issued by ARX Investimentos Ltda., Av. Borges de Medeiros, 633, 4th floor, Rio de Janeiro, RJ, Brazil, CEP 22430-041. Authorized and regulated by the Brazilian Securities and Exchange Commission (CVM). The issuing entities above are BNY Mellon entities ultimately owned by The Bank of New York Mellon Corporation

BNY Mellon Cash Investment Strategies is a division of The Dreyfus Corporation. • BNY Mellon Western FMC, Insight Investment Management Limited and Meriten Investment Management GmbH do not offer services in the U.S. This presentation does not constitute an offer to sell, or a solicitation of an offer to purchase, any of the firms' services or funds to any U.S. investor, or where otherwise unlawful. • BNY Mellon Western Fund Management Company Limited is a joint venture between BNY Mellon (49%) and China based Western Securities Company Ltd. (51%). The firm does not offer services outside of the People's Republic of China. • BNY Mellon owns 90% of The Boston Company Asset Management, LLC and the remainder is owned by employees of the firm. • BNY Mellon owns a 19.9% minority interest in The Hamon Investment Group Pte Limited, the parent company of Blackfriars Asset Management Limited and Hamon Asian Advisors Limited both of which offer investment services in the U.S. • The Newton Group ("Newton") is comprised of the following affiliated companies: Newton Investment Management Limited, Newton Capital Management Limited (NCM Ltd), Newton Capital Management LLC (NCM LLC), Newton International Investment Management Limited and Newton Fund Managers (C.I.) Limited. NCM LLC personnel are supervised persons of NCM Ltd and NCM LLC does not provide investment advice, all of which is conducted by NCM Ltd. Only NCM LLC and NCM Ltd offer services in the U.S. • BNY Mellon owns a 20% interest in Siguler Guff & Company, LP and certain related entities (including Siguler Guff Advisers LLC).

The Alcentra Group
ARX Investimentos Ltda
BNY Mellon Cash Investment Strategies
BNY Mellon Western Fund Management
Company Limited
The Boston Company Asset Management, LLC
CenterSquare Investment Management, Inc.
CenterSquare Investment Management Holdings, Inc.
The Dreyfus Corporation
EACM Advisors LLC
Hamon Investment Group
Insight Investment
Mellon Capital Management Corporation
Meriten Investment Management
The Newton Group
Siguler Guff & Company LP
Standish Mellon Asset Management Company LLC
Walter Scott & Partners Limited



BNY MELLON

本情報提供資料は、BNY メロン・グループ（BNY メロンを最終親会社とするグループの総称です）の資産運用会社が提供する情報について、BNY メロン・アセット・マネジメント・ジャパン株式会社が審査の上、掲載したものです。当資料は情報の提供を目的としたもので、勧誘を目的としたものではありません。当資料は信頼できると思われる情報に基づき作成されていますが、その正確性、完全性を保証するものではありません。ここに示された意見などは、作成時点での見解であり、事前の連絡無しに変更される事もあります。

BNY メロン・アセット・マネジメント・ジャパン株式会社
BNY Mellon Asset Management Japan Limited

金融商品取引業者：関東財務局長（金商）第 406 号
〔加入協会〕 一般社団法人 投資信託協会
一般社団法人 日本投資顧問業協会