



Dividend strategies

Dividend strategies in times of financial repression

Dividends are still important performance drivers. They accounted for 40% of the total return on equity investments in the last 40 years.

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Imprint

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Dividend strategies in times of financial repression

Historically low interest rates, temporary surges in volatility on the capital markets and a phase in which the developed world must cut back its debt. A good environment for taking advantage of the benefits offered by dividend strategies.

We are witnessing a turning point where the huge debts of industrial countries and global imbalances have to be eliminated in order to restore confidence in the markets. The return to balance will very likely be accompanied by a phase of financial repression where investors should be faced with a longer period of low or even negative real interest in the developed world.

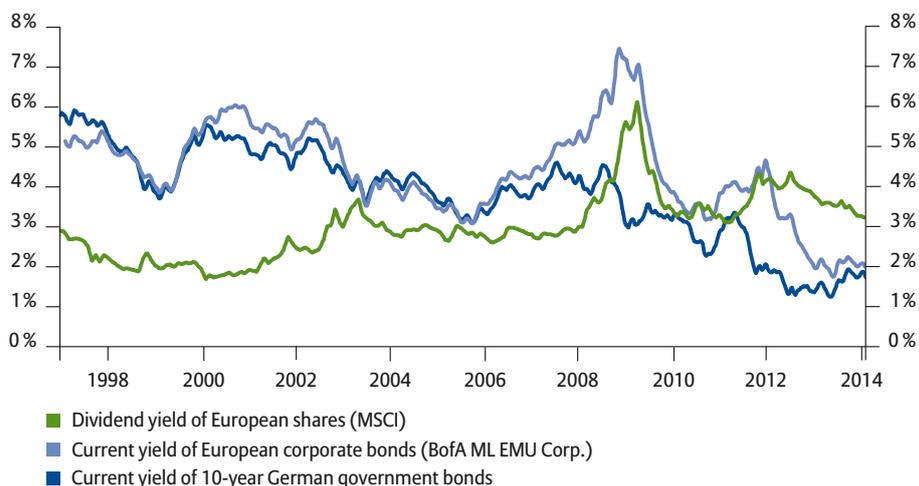
Investors seem to be focusing on two issues, in particular, in respect of statements about the future success of dividend strategies: How sustainable are the relatively high dividend yields in the present market environment? And what benefits do dividend strategies offer investors with a long-term horizon?

Compared with other asset classes, the risk-return profile offered by dividend strategies would seem to be much more interesting. These strategies combine the benefits of currently high dividend yields while at the same time working to protect against inflation. At least as far as European companies are concerned, the gap between dividend yields and the yields on government and corporate bonds has historically rarely been so wide (see Chart 1).

- Dividend strategies are generally characterised by companies who
1. have above-average dividend yield within their respective market index,
 2. have a payout ratio of less than 70%,
 3. have the potential for future dividend increases and additionally
 4. have had a reliable dividend policy and history.

Chart 1: European Shares Offer Attractive Dividend Yields

Dividend yields (MSCI Europe) versus yields of German government (10 year) and European corporate bonds.



Past performance is not an indication of future results. Source: Datastream, Allianz GI Capital Markets & Thematic Research, as of 17.2.2014

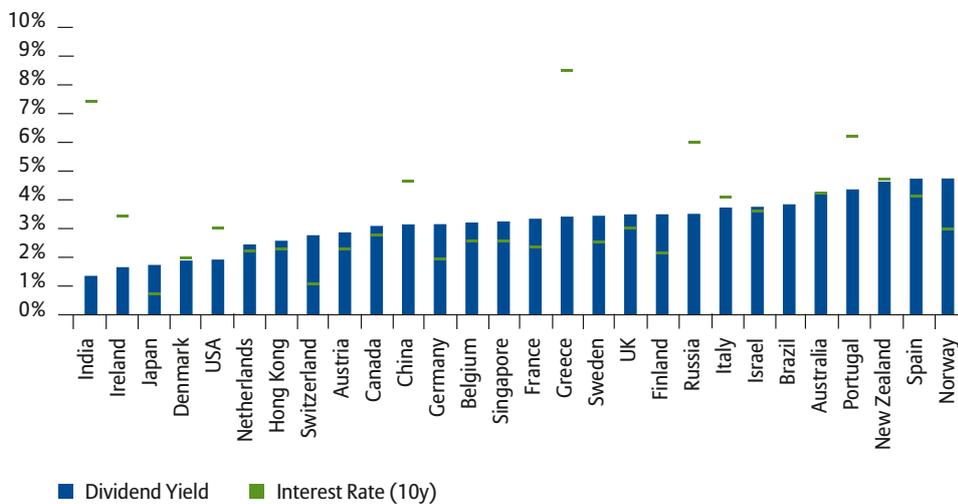
Dividends – a key driver of performance when real interest is low

Compared with their peers at international level, European companies seem to be particularly forthcoming where dividends are concerned, as demonstrated by an average dividend yield as of end February 2013 of about 3.2% across the market (based on MSCI Europe). Expected dividend yields could, moreover, be significantly increased by focusing on securities that pay out particularly high dividends. After all, as of end February 2014 –

despite the good equity performance in the last year – the dividend yield of some 60 companies in the MSCI Europe Index (of a total of 461) exceeded 4%. Accordingly, European dividend strategies have the potential to generate attractive dividend yields. But it is not only Europe; other regions also offer dividend yields that are – in some cases substantially – higher than the yields on 10-year government bonds (see Chart 2). Companies in New Zealand, Australia, Norway or Brazil have been particularly investor-friendly when it comes to paying dividends.

Chart 2: Dividend Yields Are Attractive Around the Globe

Dividend yield (MSCI Indices) and interest rate of 10 year government bonds in comparison

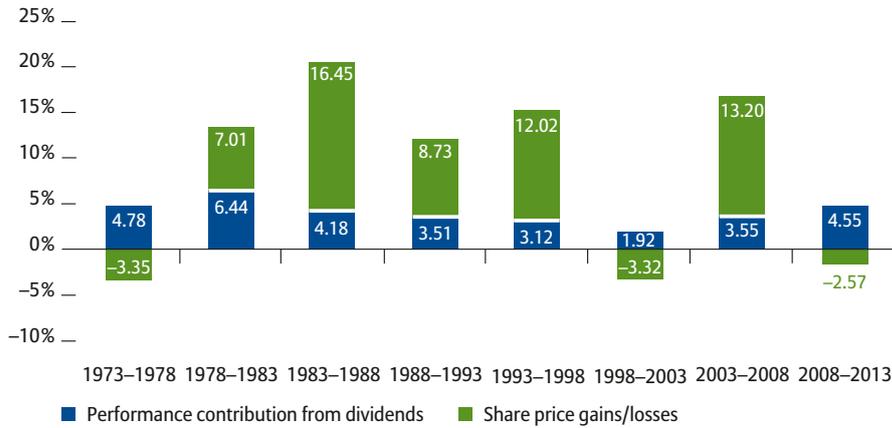


Past performance is not an indication of future results.

Source: Datastream, Allianz GI Capital Markets & Thematic Research, as of 31.12.2013

Chart 3: Dividends – A Stabilising Factor for Investors

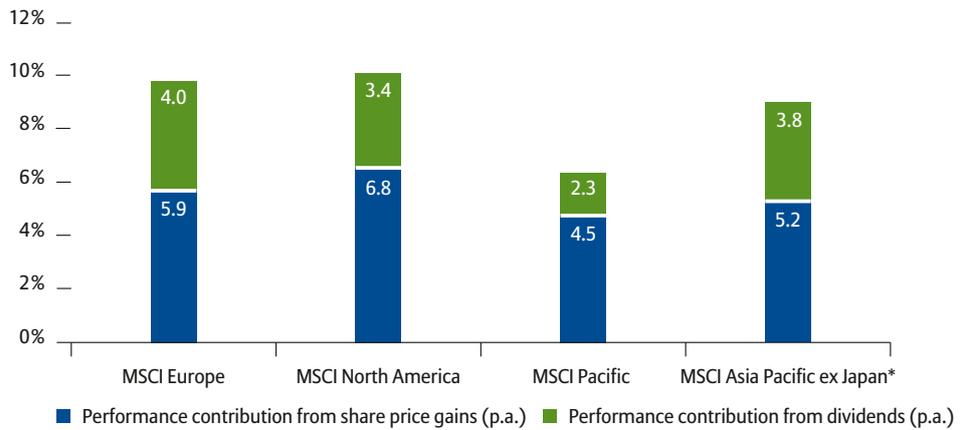
Performance contribution from dividends and MSCI Europe share prices since 1973 in five-year periods (% p.a.)



Past performance is not an indication of future results.
 Source: Datastream, Allianz GI Capital Markets & Thematic Research, as of 31.12.2013

Chart 4: Shareholder-Friendly Dividend Policies, Especially in Europe

Global comparison of how dividends and share price gains contributed to performance between 1970 and the beginning of 2014 (annualised)



* Data for MSCI Asia Pacific ex Japan available from 01.01.1989
 Past performance is not an indication of future results.
 Source: Datastream, Allianz GI Capital Markets & Thematic Research, as of 3.2.2014

An interesting by-product of dividends is that they have helped to enhance the stability and the real performance of equities. In the past, investors in European equities, in particular, have enjoyed substantial dividend payouts. On a 5-year rolling basis, dividends have made a consistently positive contribution to MSCI Europe performance since 1973 (see Chart 3), and have been able at least to mitigate (1973 – 1978; 1998–2003; 2008 – 2013)

the effects of share price losses. Dividends accounted for about 42% of the total annualised return of equity investments for the MSCI Europe over the entire period. Dividends also contributed more than one-third to total performance in other regions as well, such as North America (MSCI North America) or Pacific (MSCI Pacific), although the dividend yields themselves were lower in absolute terms (see Chart 4).



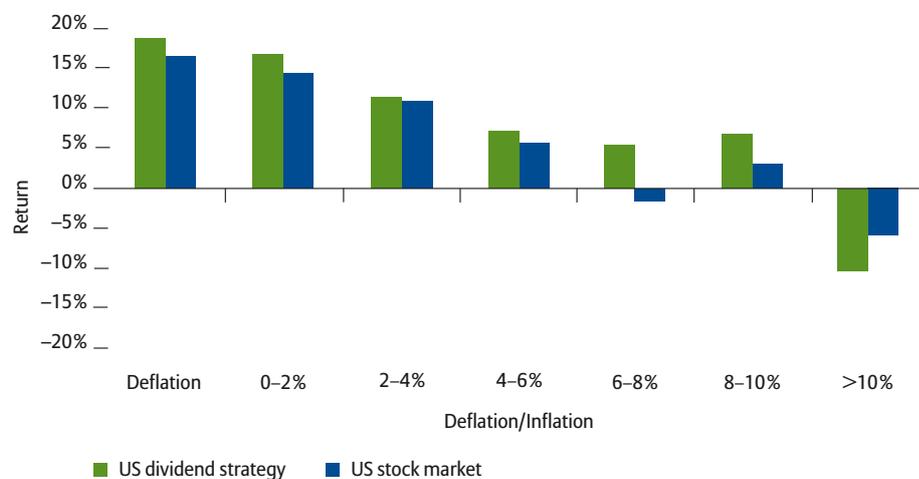
A look at the US since 1950 shows that, here too, dividend strategies have outperformed the wider market in times of both rising inflation (up to 10%) and deflation (see Chart 5). This is really quite interesting since inflating the economy as part of a financial repression regime can be one effective means of reducing the huge debt in the industrialised world,

in addition to consolidating national budgets and growth.

If the companies continue to pursue their dividend policies and share prices do not depreciate, equities allow investors to earn a nice “coupon”. The key issue is, however: Just how sustainable is it?

Chart 5: Inflation – Real Increase in Value Through Dividend Strategy

Dividend strategy compared with overall market in periods of inflation and deflation in the US between 1950 and 2014

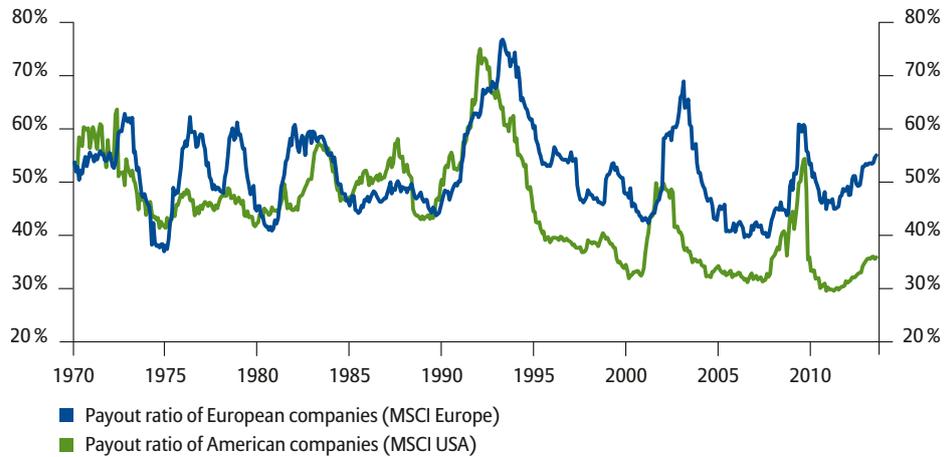


Past performance is not a reliable indicator of future results.

Source: K. French, http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html, period 1950–2012, Datastream, Allianz GI Capital Markets & Thematic Research

Chart 6: Low Distribution Ratios Offer Potential for Further Dividend Increases

Dividend payout ratios (dividends earnings) of European and American companies from 1970 till February 2014



Source: Datastream; Allianz Global Investors Capital Markets & Thematic Research 17.02.2014

How sustainable are dividends?

Three factors that favour stable dividend yields in the present market environment are:

1. We believe that the basis for dividend payments – company profits – will continue to grow moderately in 2014. Overall the

framework of monetary policy should continue to support global growth—monetary policy therefore represents the safety net for the global economy. The inventory build-up should benefit the developed economies additionally. Accelerating investment activity boosts economic growth further. However, the long-term



growth rates of developed countries will most likely fall short of the rates before the financial crisis, as the continued reduction of deficits in the private and public sectors will probably slow down the economy.

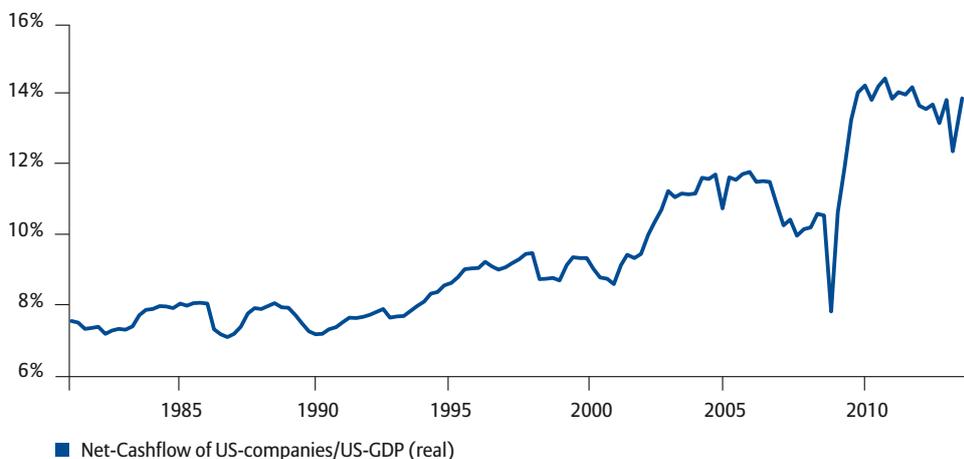
2. As earnings blossomed following the 2008/2009 financial crisis, the distribution ratios of companies have declined considerably. In Europe, the ratio of paid dividends to earnings per share is currently around 55%, which is moderate by historical comparison. In the US, it is close to its lowest levels ever, at about 35% (see Chart 6). There is thus scope for dividend hikes.
3. At present, companies are sitting on a lot of cash. The net cash flow of US companies, for example, is nearly 14% relative to US gross domestic product and close to its former record high (see Chart 7). Companies have already made good progress with the deleveraging phase that followed the financial crisis to strengthen the equity base and reduce borrowings. In 2014, these companies can carry on focusing on shareholder value.

There are, however, particular factors that may preclude an increase in dividend yields across the board:

1. Historical experience has shown that, following financial market crises, recovery tends to be fairly weak, and a self-sustaining upswing is slow to emerge. This nourishes expectations of persistent weak economic growth.
2. Earnings of many companies are still volatile. Banks, for example, are scarcely able to guarantee dividend continuity when faced with massive refinancing needs and increasing regulation. These companies, however, are generally not the main focus of dividend strategies.
3. Instead of distributing their free cash flow, companies may search for investment opportunities, possibly resuming their merger and acquisition activities, for example. Past studies on acquisitions, however, have shown that the vast majority of acquisitions have never generated the promised returns.

Chart 7: US Companies Holding Substantial Cash

Net cash flows of US companies relative to US gross domestic product



Source: Datastream; Allianz GI Capital Markets & Thematic Research, as of February 2014

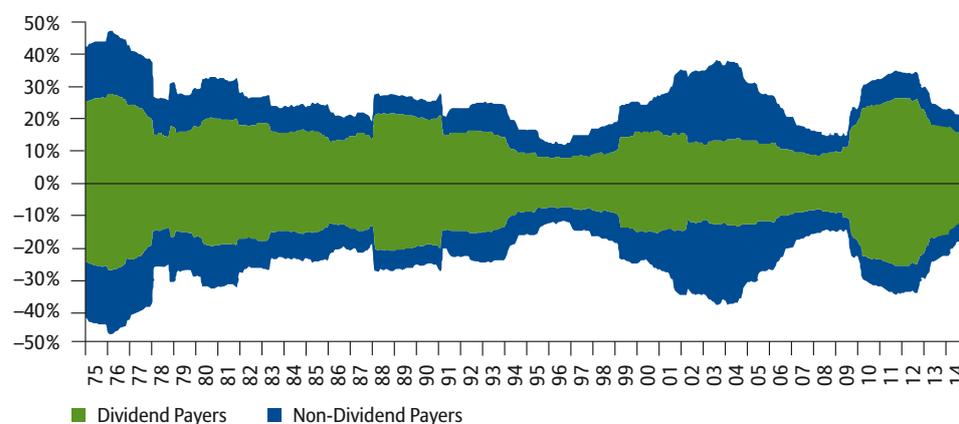
Dividend securities may enhance portfolio stability

Equities that pay out high dividends not only may offer higher returns, however: they could also bring more stability to a portfolio. A look at the US, where longer time lines are available, shows that the volatility

(measured against the 36-month rolling standard deviation) of US equities has been tangibly lower since 1972 among companies that paid dividends compared to stock corporations that did not distribute profits (see Chart 8). The same trend is visible among European dividend securities since the 1990s.

Chart 8: Share Prices of Dividend Securities Tend to Be Less Volatile

36-month rolling standard deviation of S&P 500 companies that did and did not pay dividends (Jan. 1972 – Jan 2014)



Past performance is not an indication of future results.
Source: Datastream, NFI Research, Allianz Global Investors, as of 31.1.2014

Moreover, over the course of various economic cycles in the US since 1990, dividends have proven to be a reliable factor for investors. In years of recession or weak growth, when gross domestic product (GDP) in the US increased by less than 1%, the performance of company profits and the S&P 500 Index was significantly negative on average, whereas the dividends paid by S&P 500 companies remained largely constant (see Chart 9). The result: consistently high dividend yields on average in virtually all economic cycles.

Some of the reasons why dividend securities have demonstrated value and share price stability include:

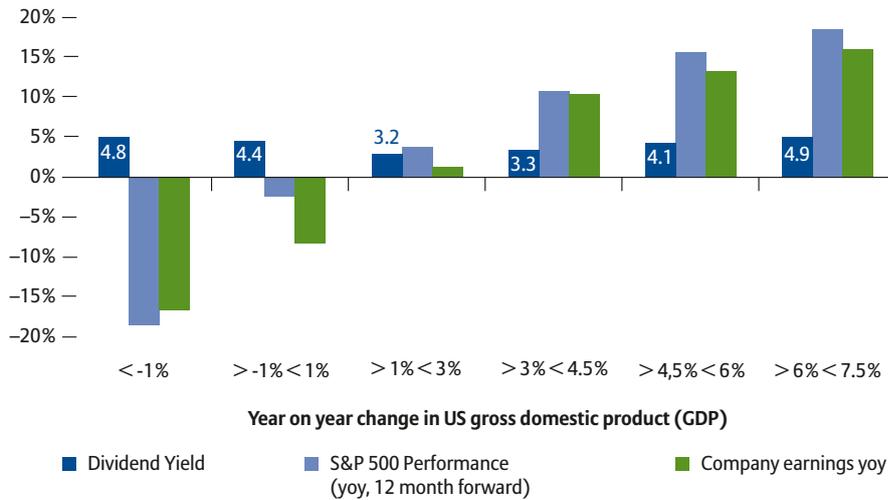
- Dividend policy frequently forms an active component of a company's strategy. Usually dividends have an extraordinarily strong signal effect. The market often takes a very negative stance when dividends are

cut or waived, as this raises doubts about the future sustainability of the enterprise. Companies therefore strive to secure consistent dividend payouts. A comparison of dividends and profits among the members of the S&P 500 Index since 1900 shows that company profits were subject to much greater volatility. Over the past 12 years, especially, earnings fluctuated by 34% on an annualised basis, which was much higher than the 3% volatility witnessed by dividends each year (see Chart 10).

- High distributions, and the commitment to paying them consistently in view of the signal effect, have tended to produce more disciplined companies. They need to budget their financial resources carefully and use them efficiently. By contrast, share buyback programmes neither produce a similar signal effect nor do they exert the same disciplinary constraints on a company due to their discretionary nature.

Chart 9: A Consistent Contributor to Performance

Dividend yields, company earnings and share price trends of the S&P 500 in economic growth cycles from 1900 till end of 2013(in %)



Past performance is not an indication of future results.

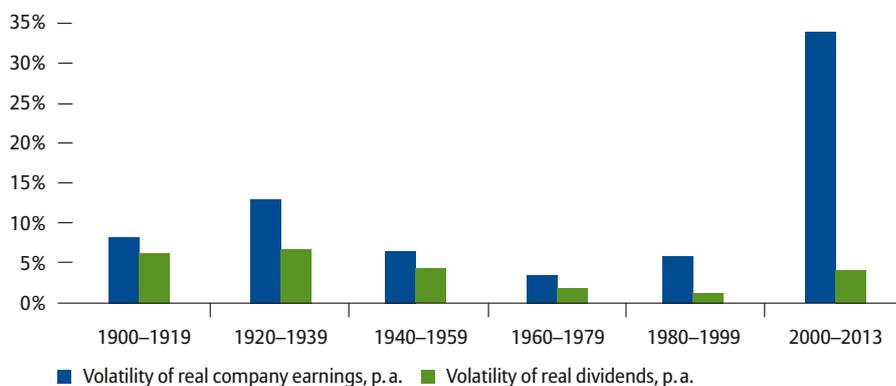
Source: Shiller, R., "U.S. Stock Price Data since 1871"; Allianz GI Capital Markets & Thematic Research as of 31. 12.2013

- Companies with high dividend yields generally have healthy balance sheet ratios with a relatively large equity base and stable cash flows.
- Equally, investors are usually less quick to sell off a stock that pays high dividends and produces earnings that have been more reliable, even in negative or stagnating market conditions.

Focusing on high dividend payments alone, however, can be misleading. Rather, it is the business model of a company, above all, that should shape expectations for sustainable earnings, in addition to a shareholder-friendly corporate policy. Factors such as market share, entry hurdles or the power to set prices all play an important role in this respect. If its business model works, a company can also offset the effects of inflation by raising its prices, which has the potential effect of increasing profits and ultimately its dividends.

Chart 10: Exhibited Low Volatility of Dividend Payments

Volatility of company earnings and dividends, S&P 500, from 1900 till end of 2013 (% p.a.)



Past performance is not an indication of future results.

Source: Shiller, R., "U.S. Stock Price Data since 1871"; Allianz GI Capital Markets & Thematic Research, as of 31.12.2013

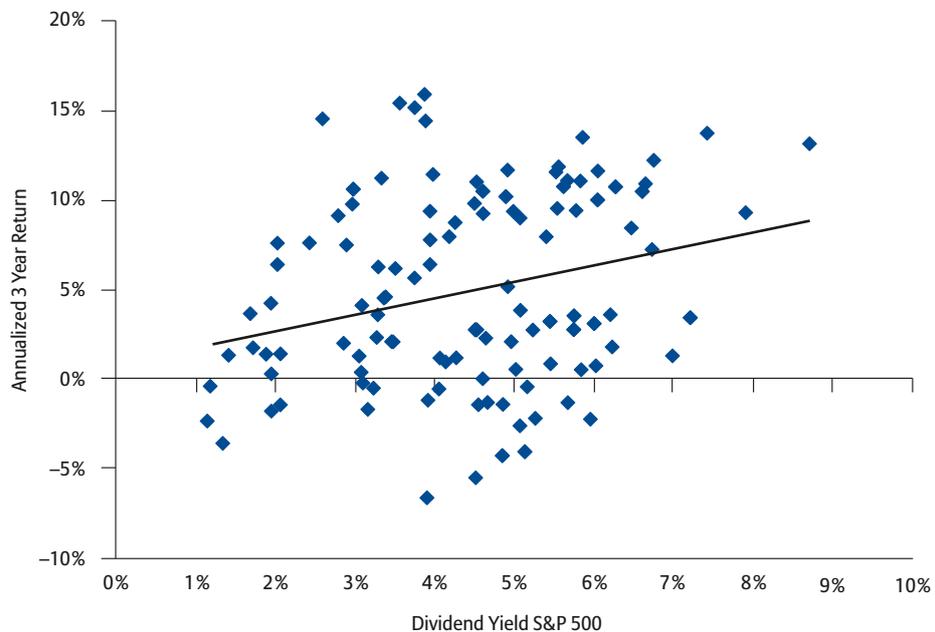
Dividend yields send signals to the markets

Sustainably high dividend yields could be indicative of the attractiveness of a stock not only at individual security level. At the market level, they often indicate that investor pessimism about earnings trends is already widespread or that the risks have already been priced in for the most part. Alongside other valuation benchmarks, the absolute dividend yield can therefore act as one indicator for assessing attractiveness. Statistics from the US since 1900 reveal a trend of positive correlation between dividend yields and S&P 500 performance over the next three years (see Chart 11).

Even as recently as last year and the year before, the beginning of 2013 and 2012, for example, the average dividend yield on the global stock market sent a successful buy signal, unlike other asset classes. If the dividend yield seems secure from a fundamental perspective, the market seems to send a positive signal. From a dividend yield perspective, this signal to buy shares is still present. At the beginning of 2014 equities offered attractive returns when compared with various bond classes. The relatively conservative risk profile of a dividend strategy may act as a further incentive to respond to the buy signal.

Chart 11: Dividend Yields Send Signals to the Markets

Dividend yields and 3-year S&P 500 performance from 1900 till end of 2013 (% p.a.)



Past performance is not an indication of future results.

Source: Shiller, R., "U.S. Stock Price Data since 1871"; Allianz GI Capital Markets & Thematic Research, as of 31.12.2013



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Over the long term, dividend securities can add value to a portfolio – and not just through the additional income stream from earnings distributions. Substantial dividend yields can be earned using a fundamental dividend strategy despite the equity price gains of last year, provided, however, that security selection focuses on future dividend expectations rather than on recent distributions. Especially in times of financial repression, when interest rates are kept artificially low, this strategy would seem to offer a very promising complement for an equity portfolio.

Dennis Nacken

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