Cadence Capital Management
265 Franklin Street, 4th Floor
Boston, MA 02110
617-624-3500
**cadencecapital.com**

# When Looking for Equity Income, Don't Overreach for Ultra-High Yielders

By Austin Kairnes, Portfolio Manager

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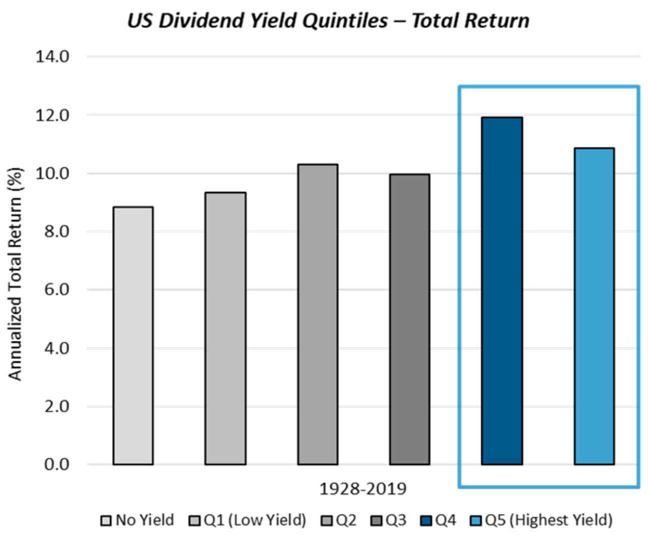
With interest rates and bond yields falling, investors looking for income might consider looking to dividend-paying stocks as an option. History has shown that investing in high-yielding stocks has been an attractive investment strategy both in terms of total return and income generation. However, if investors are looking for yield in stocks, historically, it has not been wise to simply reach for the highest yields possible. The ultra-high-yielding stocks have tended not to perform as well as other stocks with above-average yields. We explore this topic in this paper.

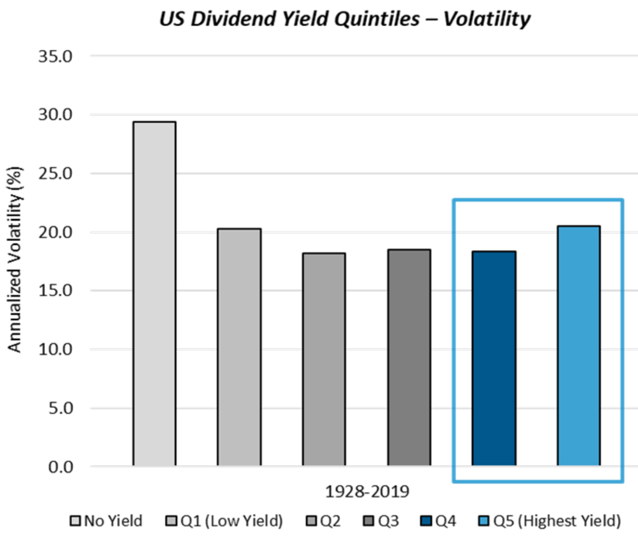
## HISTORY

Investors have long been attracted to investing in firms which pay dividends and have attractive yields - and with good reason - as these types of firms have tended to experience above-average stock returns with lower levels of risk over the long term.

The following two charts demonstrate this using data from Fama and French based on the Center for Research in Security Prices (CRSP) dataset which includes all equity securities listed on NYSE, Amex, NASDAQ and NYSE Arca during the time period. The charts show the annualized value-weighted total returns and risk of U.S. stocks for five portfolios of dividend paying stocks and for a "no yield" group of stocks dating back to 1928. The five dividend paying portfolios are constructed using quintiles of the dividend-to-price ratio (dividend yield). Quintile 1 represents the lowest yielding dividend payers and quintile 5 represents the highest. Portfolios were formed and rebalanced annually.

In the chart on the left, we see that stocks which fall into the top two highest yielding quintiles have performed better over time. The chart on the right shows the performance volatility, measured by annualized standard deviation, of these different groups of stocks. Here, we see that the top two quintiles of dividend yield stocks also tend to have low volatility, especially compared to non-yielding stocks.



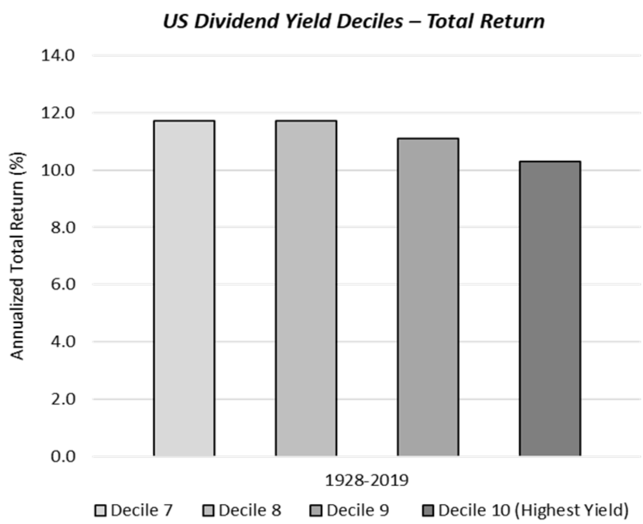



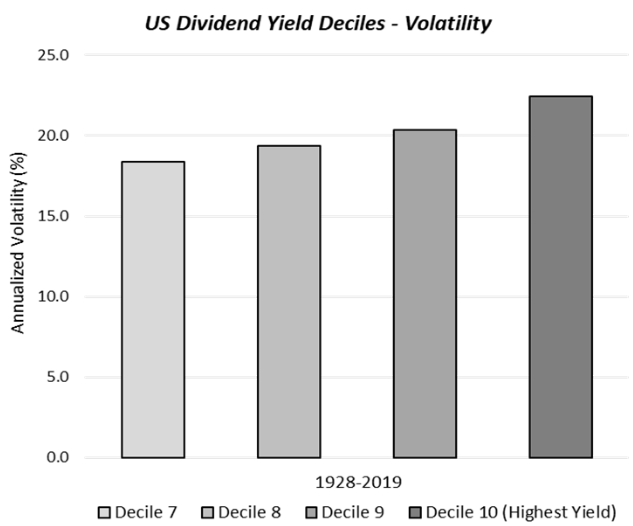

Source: Cadence; Kenneth R. French "Portfolios Formed on Dividend Yield" and CRSP data, 1/1/1928 to 12/31/2019. Performance results are annualized value-weighted returns which reflect the reinvestment of dividends. Charts are for illustrative purposes and do not reflect Cadence's client returns. Past performance is no guarantee of future results

Today, the income opportunity in equities remains attractive and stocks with dividend yields appear to have several tailwinds, which may help lead to attractive future returns for these stocks. In the short term, with interest rates having fallen, many traditional sources of income offer lower yields compared to dividend-paying equities. Longer-term, shifting demographics and an older population may lead to a shift in income demands, creating increased demand for income-paying equities in the future. Additionally, in periods of lower equity returns, having the income from dividend-paying securities making up a larger percentage of the total equity return could be advantageous.

## BUT BEWARE OF ULTRA HIGH YIELDERS

As we have seen, historically, stocks with high dividend yields (quintiles 4 and 5 in the above charts) have generated attractive returns compared to lower-yielding and non-yielding stocks. However, in the charts above, notice in the chart on the left, that the quintile 5 bar is not quite as high as the quintile 4 bar. Let us explore this by examining the data in a more granular fashion using decile groupings instead of quintiles. Again, using data from Fama and French, ten dividend paying portfolios are constructed using deciles of dividend yield. Decile 1 represents the lowest yielding dividend payers and decile 10 represents the highest. Further, let us focus on deciles 7, 8, 9, and 10 which comprise quintiles 4 and 5 from the above chart. We see that decile 10, the ultra-high yielding stocks, performed less well with more volatility than deciles 7, 8, and 9.

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## WHY DO ULTRA-HIGH YIELDERS PERFORM WORSE?

A natural question that arises from examining this data is "Why do the ultra-high-yielding stocks tend to perform worse than other high-yielding stocks?" One possible reason is that the stocks in decile 10 appear to be less attractive from a fundamental perspective than stocks in deciles 7, 8, and 9. As we see from the tables below, the decile 10 stocks have tended to have higher earnings variation and more leverage than their decile 7, 8, and 9 counterparts.

**Average Barra US Risk Model Exposures 12/31/1998 – 02/29/2020**

| | Decile 7 | Decile 8 | Decile 9 | Decile 10 |
|---|---|---|---|---|
| Earnings Variation | 0.01 | 0.04 | 0.09 | 0.33 |
| Leverage | 0.21 | 0.32 | 0.59 | 1.07 |

NOTE: To calculate these numbers we used the Russell 1000 universe of stocks, and calculated equal-weighted average Barra risk model exposures (using the Barra US Long-Term Model, USE3L) each month from 12/31/1998-02/29/2020 and averaged these monthly numbers through time. Past performance is no guarantee of future results. Data: Factset, Russell, Barra, Cadence

It also appears to be the case that with the ultra-high-yielding stocks, investors may not reward them because they may not believe that the current dividend will persist. That is, investors may believe that the dividends of these ultra-high-yielders might get cut in the future. And indeed, we see that the forward dividend growth rate of these decile 10 ultra-high-yielding stocks is lower (and in fact negative) than it is for the decile 7, 8, and 9 stocks.

**Average Barra US Risk Model Exposures 12/31/1998 – 02/29/2020**

| | Decile 7 | Decile 8 | Decile 9 | Decile 10 |
|---|---|---|---|---|
| Dividend Growth (%) | 8.94 | 6.39 | 3.70 | -1.28 |

NOTE: To calculate these numbers we used the Russell 1000 universe of stocks, and calculated equal-weighted average dividend growth each month from 12/31/1998-02/29/2020 and averaged these monthly numbers through time. Dividend growth is defined as: the (forward 1 quarter dividend – dividend from same quarter one year ago) / dividend from same quarter one year ago. Past performance is no guarantee of future results. Data: Factset, Russell, Cadence

## CONCLUSION

As we have seen, in a world of falling interest rates and yields, investors might be well-served to consider investments in high-yielding dividend paying stocks. However, investors, searching for yield and income, should take care when choosing which high yielding stocks to invest in - simply reaching for the stocks with the highest yields might not be the best approach. The ultra-high-yielding stocks have tended to not perform as well as other above-average-yielding stocks and have had less favorable fundamentals: such as more earnings volatility, more leverage, and lower dividend growth rates.

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Please contact Paige Butters at (617) 624-3500 or info@cadencecapital.com