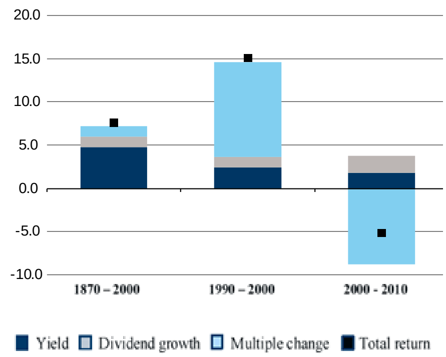
# High dividend yield Blue Chips -- yield deprivation relief over time

Over a 130-year period to 2000, 66% of total nominal US stock market return from dividend yield

**August 2013**

Decomposition of average annual nominal returns in percentage terms (%) in the US over various time periods ➲

Source: SG Equity Research




**The challenge:**
"The crisis of the 21st century will be the shortage of income." Author: 89-year old Richard Russell.

Quantitative easing (QE)-engineered yield deprivation, lacking net present value (NPV)-based governmental recognition of public pension promises, and sustained, politically-motivated expansion of pension benefits for governmental workers has put investors and taxpayers into a tough spot with potentially large negative implications as regards:

- Mounting governmental -- international, federal, state, and local -- solvency risks (http://news.investors.com/economy/080613-666582-chicago-pension-deeply-underfunded.htm?p=full).
- Monetary inflation risks related to sustained QE.
- Large potential capital loss risks on long-dated bonds, such as 10-year Treasuries, should "market-based" interest rates continue to reassert themselves. For example: a newly issued 10-year Treasury with a 2.9% coupon would fall 15.7% to 84.3% of the issue price if 10-year interest rates rose to 4.9% rather quickly.
- Higher tax rates related to financing deficits and refinancing debt at higher interest rates.
- Potentially outsized long-duration (growth stock) equity valuation compressions as triggered, disproportionately relative to their shorter-duration value stock brethren," through rising discount rates.
- (Duration is the weighted average of all payments an investor will receive over time, discounted to NPV)

**The opportunity:**
How do high dividend yield Blue Chips figure into this yield starvation dilemma? Global QE has left savers with no yields at the short end of maturity spectrum and with lacking real yields on 10-year government bonds. Meanwhile, investors can currently purchase investment-grade equities with earnings yields of 5 - 6% offering a dividend yield (on the S&P 500) of 2.1%, not too far below the current 2.8% 10-year Treasury yield. And this is prior to considering "locked in" dividend increase potential, which tends to reflect EPS growth over time. In addition, vastly superior, to nominal government bonds, equity-based inflation return protection is on offer, because companies can at least partially pass on rising costs.

If investors focus their equity exposure in the higher dividend yield spectrum of the S&P 500 and in similar non-American Blue Chips versus in a S&P 500 or a MSCI All-Country World stock basket (current dividend yield, 3.1%), odds are favorable that they will achieve "better than index" strategic returns.

As regards foreign stocks, in general they deliver notably higher dividend yields than their US brethren because foreign boards have a more traditional approach wherein earnings/earnings growth is returned more fully to stockholders as rising dividend payments.

Concretely, let's consider a hypothetical, equally-weighted, global, high dividend yield Blue Chip portfolio consisting of nine US stocks and nine European/Swiss shares -- i.e., the ADRs thereof. The stocks were chosen based on the achievement of a favorable composite score and/or conviction in the following realms:

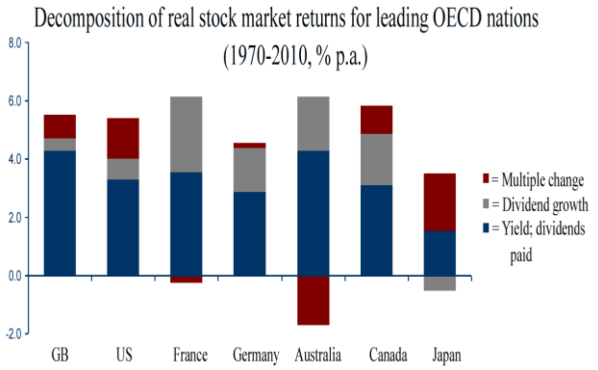
- P/Es (based on historical earnings and normalized earnings, assuming stable core business portfolio)
- Dividend payout ratio
- Dividend yield per share
- Growth in dividends paid per share
- Normalized free cash flow per share (five year history, assuming stable core business portfolio)
- Debt/equity per share
- Constructive balance sheet when "corrected" for de facto long-lived,"off-balance sheet" obligations
- Earmarks of perceived sustainable enterprise differentiation (the "franchise")

That globally diversified portfolio would consist of the following names: Philip Morris, Emerson Electric, Archer Daniel Midlands, Johnson & Johnson, ExxonMobil, Chevron, Proctor & Gamble, Consolidated Edison, Apple, Vivendi, Deutsche Post, Axa SA, Royal Dutch/Shell, BAT, GDF Suez, Nestle, Swisscom, and Roche. The current dividend yield of the aforesaid portfolio: 3.8% or 1 percentage point (100 basis points) higher than what the 10-year Treasury currently yields. Moreover, let us assume a conservative 5% annual increase in this portfolio's dividend payment -- a surrogate for pedestrian earnings growth of the same magnitude. After five years, that portfolio would yield 4.8%; after ten years, 6.1%. The newly issued 10-year Treasury's yield would remain unchanged at 2.9%, if purchased at the time of this writing. (Sources: Form 10Ks, annual reports, Bloomberg, Yahoo Finance, Morningstar.)

**The rationale:**

The historical and prospective reasons an investment-grade high dividend allocation should produce favorable relative returns and solid long-term absolute returns are as follows:

- *The vast majority of long-term equity returns are from dividends paid (the yield)*; this shouldn't be a surprise, given that dividends are paid-out earnings. For a real return decomposition of stock market returns over a 40-year period across OECD nations, please see below:

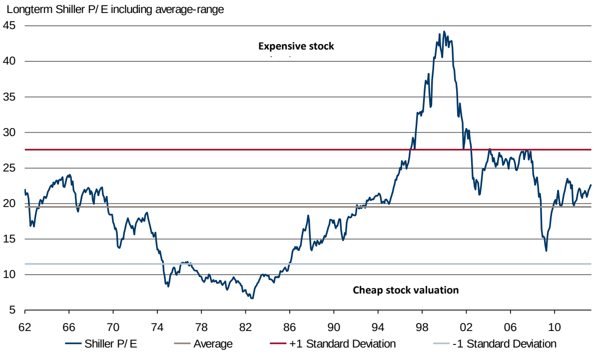



Since 1970, dividends paid accounted for approximately 66% of the total return of the leading developed world stock markets

Sources: Société Générale, Credit Suisse

- *Multiple (P/E) expansion-based stock market returns are unlikely going forward.* This is thanks to the currently still equity valuations (please see the long-term Shiller P/E chart below) on the one hand, and on the swelling likelihood of a sustained rise in long-bond interest rates after a 32-year secular bond bull market on the other hand (http://finance.yahoo.com/echarts?s=%5ETYX+Interactive#symbol=^tyx;range=my;compare=;indicator=volume;charttype=area;crosshair=on;ohlcvalues=0;logscale=off;source=undefined;).

  In fact, we could well be facing an indefinite period of multiple compression(s). And this for a host of reasons, including expanding solvency, aging, and inflation risks -- examined overleaf -- as well as an eventual/related return to "market-based" interest rates.




Sources: Robert J. Shiller, Credit Suisse

Also noteworthy: during the past 108 years in the US, secular stock bull markets (expanding P/Es) have commenced after P/Es bottomed out in the 7.5 to 10 range, levels over 50% below the current multiple of normalized, historical GAAP earnings depicted above.

Let's look at the multiple expansion "leg" of stockholder returns through an additional, related lens. But before we do, let's reflect upon this:

- ✓ Very long-term nominal equity returns p.a., whether in the US or other OECD nations, typically mirror average nominal GDP growth p.a. over the long pull.
- ✓ As such, S&P 500 bull markets were neither GDP growth nor earnings growth driven; rather they resulted from P/E (multiple) expansions in the '50s, '80s, and '90s, as can be seen in the table below. As regards the snorting bull markets of the '80s and '90s, it is safe to say, based on current valuations, that the resulting valuation "bubble" was not fully deflated in the '00 years, implying secular multiple moderation ahead:
  - ➢ Cumulative S&P 500 *EPS growth* from 1980 - 2000**: 339%**
  - ➢ Cumulative S&P 500 *total return* from 1980 - 2000: **2,581%**
  - ➢ Cumulative S&P 500 *EPS growth* from 1980 - 2010: **526%**
  - ➢ Cumulative S&P 500 *total return* from 1980 - 2010: **2,966%**

| Decade | Nominal Gross Domestic Product | S&P 500 EPS | Inflation (Deflation) | S&P 500 Total Return |
|---|---|---|---|---|
| 1930-1940 | -1.4% | -5.0% | -1.9% | 0.0% |
| 1940-1950 | 11.2% | 7.7% | 5.0% | 8.9% |
| 1950-1960 | 6.3% | 5.4% | 2.1% | 19.3% |
| 1960-1970 | 6.6% | 5.6% | 1.9% | 7.8% |
| 1970-1980 | 9.7% | 7.9% | 6.3% | 5.8% |
| 1980-1990 | 8.3% | 5.5% | 6.3% | 17.3% |
| 1990-2000 | 5.6% | 7.1% | 3.4% | 18.0% |
| 2000-2010 | 4.0% | 4.5% | 2.4% | 1.4% |

Sources: S&P, Bureau of Labor Statistics, Ibbotson, Crestmont Research

A multiple moderation era would suggest, ex-ante, that shorter duration, lower P/E (based on normalized earnings) value stocks as an asset class should offer good relative (compared to the stock market) performance. Moreover, such value stocks, which by definition would include high dividend yield Blue Chips, should perform exceptionally well when compared with long duration, high P/E growth stocks as an asset class.

Commensurately, let us consider the NPV impact on a "value stock" -- once again, the mid-single digit earnings growth, lower P/E type of stock that also typifies high dividend yielding Blue Chips -- of a 200 basis point rise in the discount rate from a risk-adjusted 6% to 8%. NPV calculations indicate a 20% market cap (stock price) reduction would ensue, versus a 16% decline in a newly issued 10-year Treasury yielding 2.8%, given two percentage points higher interest rates. Contrast that with the valuation compression of a 200 basis point increase in the discount rate, to 8%, on a low double-digit earnings growth, high P/E stock: here the NPV (share price) would decline by 25% (source: the author's calculations). In fact, the higher the P/E and the more distant the achievement of sizable "E" relative to "P" is, the longer the duration of a stock. In an extreme case, the duration would lengthen to approximate "30-year zero coupon bond equivalence." Upshot: such a growth stock's discount rate valuation vulnerability in a rising interest rate environment would compare with that of a 30-year zero coupon.

- *Valuations (P/Es) could be tempered by rising global government solvency risks* (below) triggering increases in interest (discount) rates associated with rising risk premiums. Allocations in shorter duration value stocks would help blunt such a "multiple compression."

**Net Present Value (NPV) of impact on fiscal deficit of credit crisis and age-related spending as a % of GDP: aging 400% of advanced G-20 GDP!**

| Country | Credit Crisis | Aging |
|---|---|---|
| Canada | 14 | 726 |
| Korea | 14 | 683 |
| Spain | 35 | 652 |
| United States | 34 | 495 |
| Australia | 26 | 482 |
| United Kingdom | 29 | 335 |
| France | 21 | 276 |
| Germany | 14 | 280 |
| Mexico | 6 | 261 |
| Turkey | 12 | 204 |
| Italy | 28 | 169 |
| Japan | 28 | 158 |
| Advanced G-20 Countries | 28 | 409 |

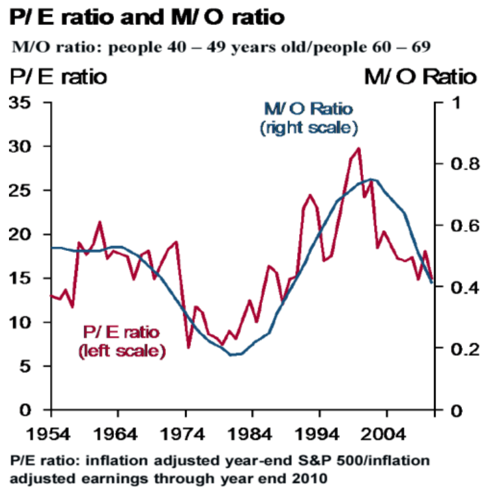
Source: IMF staff estimates. Table reports NPV of the impact on fiscal balance of crisis, and of age-related spending (primarily healthcare and pensions) liabilities. The discount rate is 1% p.a. in excess of the projected real GDP growth

Notable as regards the Advanced G-20 NPV of age-related spending:

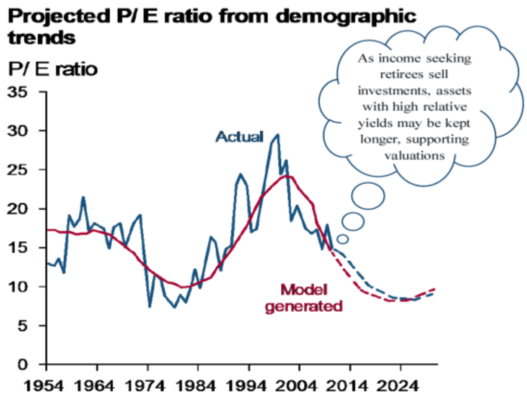
✓ Fifty five - 60 years ago, OECD life expectancy was 67 years -- a de facto "two-year pension obligation!" At that time, EM life expectancy was 41 years!

✓ Unlike corporations, government's spending commitments are "off-balance sheet" liabilities.

- *P/E contraction risks are also mounting due to "aging society" issues, which imply "disinvestment."* Better yielding, investment-grade shares will be less exposed to the intensified need to sell stocks to help meet the income needs of an aging American population, and should thus decline less in value than stocks overall:

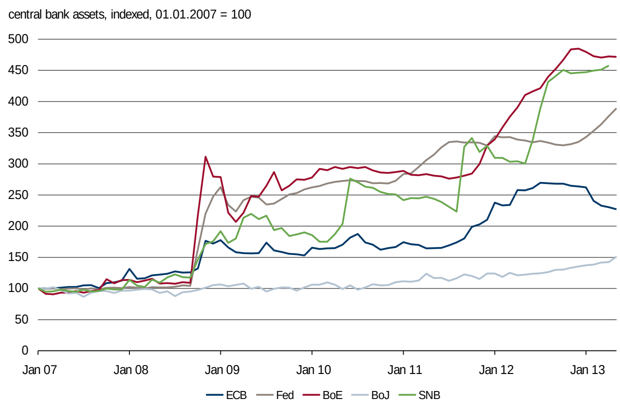



Sources: www.frbsf.org/publications/economics/letter/2011/el2011-26.html, Bloomberg, Census Bureau, Haver Analytics




Sources: www.frbsf.org/publications/economics/letter/2011/el2011-26.html, Bloomberg, Census Bureau, Haver Analytics

- *Elevated long-term monetary inflation risks*, thanks to the globally unprecedented, post WWII QE/expansion of central bank balance sheets (please see below), *eventually signify higher interest rates, again favoring value stocks with shorter durations*.




Sources: Datastream, Credit Suisse

- *Within the "value stock" asset class*, and based on the unique governmental solvency and monetary inflation risks we face, conservatively financed, "oligopolistic" *Blue Chips featuring relatively high dividend yields and relatively low (generally below 50%) dividend payout ratios should be emphasized*. The reasons:

1. The shorter durations/investor return dynamics of such equities infer lower NPV/stock price vulnerability while providing yield-starved investors with solid, mid-single digit dividend compounding prospects.
2. A global operations footprint allows Blue Chips to configure production, investment, and growth initiatives in a manner conducive to achieving the lowest consolidated effective (average) tax rate.
3. Blue Chips tend to have either pricing power and/or substantial margins ("law of large numbers") with which to pass on or to absorb, respectively, the cost-of-sales inflation they face, boding well for shareholder return protection.
4. Low dividend payout ratios provide a margin of safety for sustaining current dividend payments on the one hand, and for conservatively raising dividend payments on the other hand.
5. Blue Chips featuring normalized free cash flow generation (after dividend payments) offer another huge margin of safety in that dividend payments are internally financed.
6. Balance sheet strength (low debt/equity levels) suggests that there will be no covenant violations that could inhibit current dividend payments.
7. Upshot: over time, high dividend yield Blue Chips with well-financed dividend payments ought to outperform the S&P 500 on a total return basis.

- *Economic growth, the ultimate long-term determinant of earnings growth and thus stock valuations, continues to look subpar for developed nations* as a whole for a host of reasons, including demographic, fiscal, monetary, regulatory, the ongoing erosion of the rule of law, and taxation-related. In such an environment, Blue Chip stocks, many with "substantial government ties" and huge "compliance staffing," tend to outperform their smaller small cap contemporaries.

**Stock market and high dividend yield Blue Chip risks:**

- Sharply rising interest rates -- from near generationally low, "QE-impacted" levels -- associated with pronounced increases in either government solvency or inflation issues could offer substantial equity valuation headwind, deeply pressuring NPVs/stock prices. Caveat: the shorter durations of value stocks/high dividend yield Blue Chips confer less downside stock price vulnerability than the overall market.
- "Reversion beyond the valuation mean" (P/Es dropping below the 108-year average valuation of 16 times trailing 12-month GAAP earnings); historically, new secular bull markets have commenced from P/Es of 7 to 11 times trailing 12-month GAAP earnings, not the current 17.9 multiple! (Source: S&P.)
- Cessation of material stock repurchases would negatively impact, at least at the margin, the supply of and the demand for equities, implying lower valuations (http://www.factset.com/websitefiles/PDFs/buyback/buyback_6.19.13 http://www.forbes.com/sites/chuckjones/2013/07/01/share-buybacks-are-not-shrinking-sp-500-share-counts/).
- Reduced domestic (US) demand for equities associated with aging baby boomers increasingly selling stocks to either offset yield starvation-based income needs and/or to fund retirement may also create secular equity valuation headwinds. As alluded to earlier, investment-grade stocks offering good relative income (dividend) prospects ought to fare at least relatively well, valuation wise.
- The aging business cycle: as regards the post WWII period, we have been in an unprecedented fiscal/monetary stimulus-based economic "recovery" during the past four years. Historically speaking, at this stage of the business cycle, the likelihood that a recession will commence increases monthly, especially when considering the particularly unsustainable nature of this "recovery." Earnings, which are but "6% of top line residuals," tend to plummet (decline 30% – 50%) in a recessionary period, pressuring stock prices.
- A record high corporate profit to GDP ratio, which, historically speaking, suggests broad-based pressure on earnings power could be in the offing (http://greenbackd.com/2013/04/19/jeremy-grantham-profit-margins-are-probably-the-most-mean-reverting-series-in-finance/).
- Higher global corporate tax rates to tap record corporate cash balances in order to "reduce" government deficits, thereby pinching earnings and, by extension, possibly dividend payments.

**Conclusion:**

In all, attractive (albeit it historically lacking) relative yields, inflation protection, solid, investment-grade strategic yield deprivation relief perspectives, and relatively benign "interest rate recalibration risk" is the high dividend yield Blue Chip portfolio allocation case.

Where to invest? What kind of stocks could constitute such a portfolio? As mentioned earlier, investors would be well-advised to diversify beyond US shores, given the yield pickup on offer. As such, strategic investors should consider including, on an equally-weighted basis, the Blue Chips mentioned at the beginning of page two. Needless to say, such a portfolio would require portfolio management focused on monitoring and assessing potential dividend payment impairment risks, especially those related to a shift in the competitive landscape, a reduction in the strength of a company's "franchise," earnings power attrition, free cash flow generation erosion (e.g., greater capital intensity or reduced "turns"), and diminution of balance sheet strength.

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