What if the Market is Revaluing Dividends?

As nominal bond yields have fallen to 50-year lows, earnings yields have been increasing for the past decade, implying that equity risk premiums have moved to 30-year highs. Equity investors' recent experiences largely explain this. From 2000 to 2009, investors suffered through two of the most severe bear markets and the largest drops in S&P 500 earnings in 80 years. These experiences have led to an investor behavioral bias around the perceived risk of stocks relative to bonds. With higher risk premiums embedded into stock prices and lower risk premiums embedded into bond prices, historical valuation parameters between the two asset classes have also diverged.

Investors seeking current income have been forced to move out the risk spectrum within the fixed income universe, pushing nominal yields of nearly all instruments close to 50-year lows. The parallel to this behavior within the equity universe appears to be causing a phase change in terms of desired equity characteristics. Investors are increasingly favoring companies with high current yields and payout ratios. To explain this paradigm shift, we will present a unified valuation framework for both dividends and undistributed earnings which attempts to reconcile these phenomena.

What finance theory tells us to expect

In traditional finance theory, a variety of factors influence equity valuations, including interest rates, inflation expectations, earnings growth rates, and investor risk tolerances. The empirical research describing the relationships between these factors and equity valuations has largely reflected a set of inflation assumptions and a range of nominal interest rates from 4% to 10%. Much of the literature has examined how inflation affects equity prices. Over 80 years ago, money illusion was defined as “the failure to perceive that the dollar, or any other unit of money, expands or shrinks in value.” Accordingly, equities can be underpriced when inflation is rising because investors tend to discount real cash flows using nominal rather than real rates. In addition, real growth of the economy is hindered at higher levels of inflation. When investors recognize that slower economic activity will impair future corporate earnings, equity prices can decline.

A simple form of the “Fed model” suggests that stocks are undervalued when the yield on equity earnings exceeds the yield on long-term Treasury bonds, overvalued when the Treasury yield is higher, and fairly valued when the yields are equal. But critics have argued that the model confuses the real yield on the stock market’s earnings with the nominal yield on long-term government bonds. The model has also been found to work better as a behavioral description than a rational explanation of how stock prices are set. Alternatively, investors’ changing perceptions of risk have been shown to influence the relationship between bond and equity yields. It has also been demonstrated that recurring bouts of stagflation explain why yields on fixed income and equity earnings move together.

Much less theoretical and empirical research covers the current situation, with significantly lower nominal rates in the 0% to 3% range. It is this environment that motivated us to develop a new explanatory framework for valuing equity with both distributed and undistributed earnings.
Historical Nominal Yields

EXHIBIT 1: Earnings yields trended down with nominal bond yields through 2001, but have diverged since then.

Equity Risk Premium

EXHIBIT 2: The equity risk premium has risen along with the perceived risk of equities.

What we see now

The earnings yield—or earnings/price ratio—is the inverse of the price/earnings ratio (P/E). This is a useful construct for direct comparison of stocks to bonds or other yield-oriented investments. From 1980 to 2001, the S&P 500 earnings yield fell in tandem with nominal bond yields (see Exhibit 1, above). This pattern is consistent with traditional expectations of a positive correlation between the two yields. Since 2002, however, the S&P 500 earnings yield has increased even as nominal bond yields have continued to decline.

A bond represents a contractual obligation from the issuer, and bonds that are held until maturity will return principal in full under normal conditions. Stocks are thus considered risk assets relative to bonds under most circumstances, and the equity risk premium compensates investors for bearing this additional risk. In theory, as nominal bond yields reach some critical low level, investors’ focus shifts from excitement about lower discount rates to concerns about future nominal growth. Such a shift generally sends equity risk premiums higher, typically causing equity earnings yields to increase.9

Stock volatility can also influence the equity risk premium. When bond yields are higher, and perceived stock market volatility is higher than bond market volatility, then stock yields must be higher.10 From 1980 to 2000, while nominal yields on 10-year Treasury bonds declined from 14% to 5%, the implied equity risk premium ranged from 200 to 450 basis points (bps) (see Exhibit 2, above right). Since 2000, investors have experienced two extremely deep drawdowns in 2000–2002 and 2008–2009. Combined with growing concern about deflation, such recent significant stock corrections have caused the equity risk premium to move materially out of its long-term range to 20-year highs above 800 bps as 10-year Treasury yields have fallen below 5% to the current 2%.

To see how equity valuations have changed, consider the forward P/E multiple that the market has paid for stocks with expected earnings growth of 10%, comparing those that paid a significant dividend—payout ratio greater than 30%—with those that paid no dividend at all (see Exhibit 3, page 3). Historically, there has been a discount for dividend payers versus non-payers. The best explanation for the historical discount relates to the perception that long-term growth may be impaired by the return of capital to shareholders via the dividend. Yet this discount has been narrowing for the past 10 years, and dividend payers now trade at a slight premium to non-payers, causing them to appear expensive based on most relative valuation metrics.

Why would the market revalue dividend-paying stocks?

We believe the relative multiple expansion for stocks with high payout ratios is occurring because the market is increasingly taking a bifurcated view on company earnings, treating distributed earnings—or dividends—and undistributed earnings very differently. Collapsing nominal bond yields and increasing concerns about long-term growth rates have set the stage for this revaluation.

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To demonstrate why, we present the following framework for valuing both distributed and undistributed earnings over a range of theoretical risk-free rates (see Exhibit 4, right). In a market with extraordinarily low nominal yields, the relationship supporting the risk premium between equity and fixed income is challenged, and stable high quality dividends can be viewed similarly to a bond coupon. Thus it would be logical for the market to value dividends within the prevailing yield structure of the fixed income market:

\[
\frac{\text{Price}}{\text{Dividend}} = f(\text{Interest Rates})
\]

When nominal rates are at 50-year lows, there is a practical need to source current income from non-bond investments. This causes an increase in the value of dividends on a stand-alone basis, apart from their role in equity valuations.

Undistributed earnings, however, are still viewed as subject to the uncertainties associated with equity investing. Factors such as increased stock volatility after two bear markets in 10 years, P/E multiple compression over the past 12 years, and declining confidence in firms’ ability to allocate capital at attractive returns have together contributed to an elevated equity risk premium:

\[
\frac{\text{Price}}{\text{Earnings}} = f(\text{Equity Risk Premium})
\]
In theory, nominal interest rates reach a sweet spot for the equity risk premium in which companies can maximize real earnings growth at a reasonable level of inflation, and investors are not concerned about either deflation or excess inflation. In this range, implied equity valuations are maximized.

On either side of this ideal zone, equities begin to suffer valuation headwinds due to investors’ concern about inflation—or deflation—and lack of confidence in companies’ ability to maintain real growth rates in more extreme nominal growth environments.

Across a wide range of typical interest rate, inflation, and growth environments, traditional relationships between interest rates and equity valuation and growth measures hold. At the extremes, however, there is potential for a phase change within the equity market, affecting both stock valuation characteristics and the level of the market overall. In the current environment, we have seen both multiple compression for non-dividend-paying stocks—due to increasing equity risk premiums—and expanding multiples for dividend-paying stocks—due to extremely low nominal rates.

Observed market behavior under various risk-free rate environments seems to corroborate our view on the shift in the preference for dividends. Historically, dividend-paying stocks traded at a discount to non-payers because of the perception of slower growth. This was especially apparent as nominal yields on the 10-year U.S. Treasury bond remained in the sweet spot of 5%–7% during the technology bubble of the late 1990s.

With the dividend yield on the S&P 500 broad equity market now exceeding the roughly 2% yield on the 10-year Treasury, we have seen convergence in multiples. At this point of phase change with respect to dividend-paying stocks, investors show a willingness to pay a premium for dividend yield.

The current relative valuation framework highlights this phenomenon: Companies with the highest payout ratios trade at premium valuations—even relative to other dividend-paying stocks—despite lower growth expectations. This is because more of their earnings are distributed and thus valued inside the dividend valuation framework described above.

What are the investment implications?

In our view, there are three implications of the paradigm shift in the preference for dividends in the current environment:

1. Dividend-paying stocks may offer an attractive entry point into the equity asset class for yield seeking investors. Note that the yield curves across fixed income and equity risk spectrums have distinct shapes. While yield tends to increase with risk for fixed income instruments, the inverse is arguably true for equities, because larger, more stable companies are generally more likely to pay dividends. This creates an opportunity for investors to replace declining income from bonds, while swapping interest-rate risk for equity risk inside the equity-income space at attractive relative valuations.

EXHIBIT 8: Stocks with high dividend payout ratios have higher P/E multiples.

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EXHIBIT 7: Forward P/E multiple spreads between stocks with high payout and non-payers have converged since 2000.

- **Forward Multiple Spread & 10-Year Yield**
  - **Tech Bubble**
  - **Convergence**

Difference between next 12-month earnings of stocks with 0% and +30% payout. Yield on 10-year Treasury bond. Source: FAM.

- **Forward P/E & EPS Growth**
  - EPS Growth Expectations
  - Forward Mean P/E

Average forward P/E ratios and EPS growth expectations for stocks with varying payout ratios. Source: FAM.
Looking for above-average yield with low payout has proved to be a successful equity-income strategy over time (see Exhibit 10, below). If the current low growth/low rate paradigm persists, this strategy offers opportunity as companies that can shift from undistributed earnings to dividends experience multiple expansion.

Dividend-oriented equities—unlike fixed coupon-paying bonds—can play an important role in nominal income protection as earnings and dividends move higher with nominal economic activity. Given fears that current monetary policy may end up swinging the economy from deflationary concerns straight into inflationary pressures, investors may find this attribute particularly useful. In markets—such as Japan—where deflationary pressures have instead persisted over long periods, high-yielding stocks have also provided relatively stronger performance than their lower-yielding counterparts (see Exhibit 11, above).

EXHIBIT 10: Companies with higher dividend yields and lower payouts—thus greater ability to continue growing dividends—tend to outperform in the long term.

EXHIBIT 11: The highest yielding cohort of Japanese stocks has also been the highest returning during the past 10 years.

Investing in dividend-paying diversified equities

Investing for income from equities should emphasize identifying companies that are able to maintain or grow their current dividends. A focus on firms with stable business models is important to help manage downside price risk and increase the probability of steady income generation.

A thorough equity-income research process should include traditional analysis, focused on fundamentals and valuation metrics, as well as credit analysis to assess the balance sheet and dividend-paying capacity of potential investments. An emphasis on future free cash flow generation can help evaluate the safety of current dividends as well as the potential to grow future dividends.

Focusing on firms with attractive current yields and low current payout ratios can be an effective way to build an equity-income portfolio. A low payout ratio indicates dividend growth potential, while a high payout ratio indicates less cash to increase dividends. Companies with high dividend yields and low payout ratios have outperformed historically.

Seeking yield across the entire portfolio also makes sense, rather than pursuing a barbell approach that buys a combination of very high-yielding and zero-yielding stocks. The highest-yielding equities in the market typically carry additional risks that may reflect an elevated likelihood of capital loss, which could more than offset current income. Although diversification does not ensure a profit or guarantee against loss, by building a portfolio of equities with above-average yields in all sectors and across all risk exposures, an investor can help ensure that this high-yielding equity portfolio is properly diversified.

Before investing, consider the funds’ investment objectives, risks, charges, and expenses. Contact Fidelity for a prospectus or, if available, a summary prospectus containing this information. Read it carefully.

Past performance is no guarantee of future results.

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Diversification does not ensure a profit or guarantee against loss.

In general the bond market is volatile, and fixed-income securities carry interest rate risk. As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities. Fixed-income securities also carry inflation, credit, and default risks for both issuers and counterparties.

Stock markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments.

It is not possible to invest directly in an index. All indices are unmanaged.

References

Endnotes
1 See Fisher (1928).
3 See Fama (1981).
4 See Wilcox (2012).
7 See Asness (2000).
8 See Bekaert–Engstrom (2010).
9 See Asness (2003).
10 See Asness (2000).

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