Equity-income investing: debunking the myths

MARCH 2021
## Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Background</td>
<td>3</td>
</tr>
<tr>
<td>The backdrop to equity-income investing</td>
<td>5</td>
</tr>
<tr>
<td>The research</td>
<td>8</td>
</tr>
<tr>
<td>Key findings</td>
<td>9</td>
</tr>
<tr>
<td>Conclusion</td>
<td>13</td>
</tr>
</tbody>
</table>
Background

In recent years, income-paying equities have been largely out of favour, and the preference for growth-orientated stocks, already evident before the events of 2020, has been exacerbated this year by the broad-based dividend cuts and suspensions which have been made amid the fallout from the Covid-19 pandemic.

Three key objections have been levelled at equity-income investing:

1. That better returns can be harnessed elsewhere in markets
2. That an income-focused approach entails missing out on growth opportunities
3. That share buybacks provide a viable alternative to dividend payments by companies.

Given these objections, and our conviction that they are largely unfounded, we are delighted to have supported the Centre for Endowment Asset Management at Cambridge Judge Business School, with which we have had a long-standing relationship, in its undertaking of research to enhance the understanding of equity-income investing.

The research addresses the three key objections set out above by asking the following questions:

- Do dividends drive returns?
- Does pursuing an income-focused approach necessitate a sacrificing of growth?
- Are dividends and buybacks equally suitable ways to return income to investors?

The research was undertaken independently by Dr David Chambers, Reader in Finance at the University of Cambridge Judge Business School, Elias Ohneberg, a PhD student at the University of Cambridge and Dr Adam Reed, Professor of Finance at UNC Kenan-Flagler Business School at the University of North Carolina and Research Fellow at Cambridge Judge Business School.

In this article, we explain the backdrop to equity-income investing, and we summarise the findings of the research, a full version of which is available at:

www.newtonim.com/incomeresearch
Newton is proud to be a long-term supporter of the Centre for Endowment Asset Management, which is based within the University of Cambridge’s Judge Business School.

The Centre’s work is dedicated to high-quality research which furthers academic knowledge and practitioner understanding of long-horizon investing.

Among its areas of focus are historical perspectives on current investment issues, one of which is equity-income investing.
The backdrop to equity-income investing

It was Oscar Wilde who more than 100 years ago said:

“\[quote\]
It is better to have a permanent income than to be fascinating.\[quote\]”

Looking at the performance of stock markets over the last five years, however, investors appear to have believed the contrary. There seems to have been a fascination with growth – especially the technology stocks which have driven indices higher, but which pay no (or very low) dividends and prefer to return money to shareholders via share buybacks.

Meanwhile, income stocks have been generally shunned, notwithstanding all-time-low yields on other asset classes, and despite no real prospect of those yields rising; and, in 2020, the phenomenon has actually become more extreme. By way of example, as exhibit 1 shows, the market capitalisation of the (technology-weighted) Nasdaq Composite index has been larger than that of the MSCI World ex-US index since the beginning of the second quarter of 2020.

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**EXHIBIT 1: MARKET CAPITALISATION OF NASDAQ COMPOSITE VERSUS MSCI WORLD EX-US**

Source: FactSet, 30 November 2020.

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1 The Modern Millionaire, 1912.
While secular tailwinds (which we capture in our net effects and smart revolution themes) are benefiting technology stocks, income stocks have faced the headwind of the broad-based dividend cuts and suspensions which have been made amid the fallout from the Covid-19 pandemic. Companies across the world have gone through the largest round of dividend cuts and suspensions since the global financial crisis. As exhibit 2 shows, global dividends are down -15.3%, and companies with dividend yields above 4% face cuts of around 24.3%.

**EXHIBIT 2: OUTLOOK FOR DIVIDENDS**

Change in consensus dividend forecasts (by sector)
Year-to-date % change in year-1 dividend per share

<table>
<thead>
<tr>
<th>Sector</th>
<th>Year-to-date % change in year-1 dividend per share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Automobiles and parts</td>
<td>-51.9</td>
</tr>
<tr>
<td>Travel and leisure</td>
<td>-47.2</td>
</tr>
<tr>
<td>Banks</td>
<td>-35.9</td>
</tr>
<tr>
<td>Consumer products and systems</td>
<td>-31.2</td>
</tr>
<tr>
<td>Media</td>
<td>-24.2</td>
</tr>
<tr>
<td>Construction and materials</td>
<td>-21.0</td>
</tr>
<tr>
<td>Retailers</td>
<td>-20.9</td>
</tr>
<tr>
<td>Industrial goods and services</td>
<td>-19.7</td>
</tr>
<tr>
<td><strong>Market average</strong></td>
<td><strong>-15.3</strong></td>
</tr>
<tr>
<td>Energy</td>
<td>-15.3</td>
</tr>
<tr>
<td>Basic resources</td>
<td>-11.2</td>
</tr>
<tr>
<td>Financial services</td>
<td>-7.9</td>
</tr>
<tr>
<td>Utilities</td>
<td>-6.5</td>
</tr>
<tr>
<td>Food, beverages and tobacco</td>
<td>-6.4</td>
</tr>
<tr>
<td>Technology</td>
<td>-4.1</td>
</tr>
<tr>
<td>Drug and grocery stores</td>
<td>-3.9</td>
</tr>
<tr>
<td><strong>Energy</strong></td>
<td><strong>11.2</strong></td>
</tr>
<tr>
<td><strong>Change in consensus dividend</strong></td>
<td><strong>-32.6</strong></td>
</tr>
<tr>
<td><strong>forecasts (by region)</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Global universe</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Year-to-date % change in year-1</strong></td>
<td><strong>-15.3</strong></td>
</tr>
<tr>
<td><strong>Global US</strong></td>
<td><strong>-6.6</strong></td>
</tr>
<tr>
<td><strong>Europe ex-UK</strong></td>
<td><strong>-12.4</strong></td>
</tr>
<tr>
<td><strong>Asia</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Japan ex-Japan</strong></td>
<td><strong>-22.0</strong></td>
</tr>
<tr>
<td><strong>UK</strong></td>
<td><strong>-32.6</strong></td>
</tr>
</tbody>
</table>


Our smart revolution theme reflects how a range of technologies are making networks, systems, processes and products of all kinds increasingly responsive and intelligent. The revolution in connectivity is leading to profound changes to business models for many companies across the world and in many sectors. These technological advances are likely to lead to increased productivity.
Since the late 1990s, share buybacks have gained increasing popularity, with their volume surpassing that of dividends since 1997. They can offer companies more flexibility, may be considered a way of signalling to investors that a company is undervalued, and are preferred by retail investors in some regions for tax reasons. The latest boost to share buybacks was triggered by President Trump’s tax cuts, and the popularity of share buybacks in the US has even led to an increasing trend of companies borrowing to buy back shares.

EXHIBIT 3: BUYBACKS AND DIVIDENDS

While the current crisis has led to cuts and suspensions in dividends, share buybacks have actually fallen more sharply. Dividends in the US came down by 1.1% in the six months to 30 September 2020, but net US share buybacks fell by 27.6% over the period. While the tailwinds technology companies enjoy will not disappear, and have even led to a sharp increase in productivity gains for the broader economy, the cuts in share buybacks have been more severe than the cuts in dividends, especially as a proportion of operating profits, and have proven once again to be more volatile than dividends and very ‘pro-cyclical’ because of their positive correlation with financial-market strength.

We believe it is time to take a step back, especially with valuations of income stocks versus the market having become low. We think there is a strong case to reconsider whether active investing in high-quality global income stocks provides investors not only with the best way to secure income, but also with attractive and lower-volatility returns.

"We think there is a strong case to reconsider whether active investing in high-quality global income stocks provides investors not only with the best way to secure income, but also with attractive and lower-volatility returns."

"While the current crisis has led to cuts and suspensions in dividends, share buybacks have actually fallen more sharply."

2 Source: SG Cross Asset Research/Equity Quant, FactSet; based on constituents of the S&P 500 index.
The research

The research carried out by the Centre for Endowment Asset Management compares the performance of low, medium and high-yielding portfolios in the US equity market – both among themselves and versus zero-paying stocks. It focuses on the US equity market because the US still has the best data for running long-term empirical analyses.

Most other academic studies go back to around the 1960s at the earliest and end in the mid-2000s, while studies containing samples on earnings growth and dividends usually start in the 1970s and end in the mid-2000s. There is considerable benefit in having a data set which not only goes back further in history than other studies, but also covers the global financial crisis and a whole decade after it.

Given the growing popularity of returning money to shareholders through share buybacks, the study further investigates whether a total-payout approach (explicitly harnessing share buybacks and dividend income) outperforms a dividend-only approach, and its implications for volatility and portfolio turnover.

The study is based on a data set ranging from July 1927 to June 2019, which combines CRSP return data with Compustat financial data for the largest 3,000 firms whose common stock is listed on the Nasdaq, AMEX (now NYSE American) and NYSE in any given year from 1926 to 2019. Exhibit 4, which incorporates a chart taken from the research, shows the sample size and average number of years in the sample over time.

EXHIBIT 4: DATA SET IN THE RESEARCH

Research paper figure 1: Sample size and average number of years in the sample over time

An individual equity security enters the sample when data on prices, dividends and repurchases are available and it is one of the 3,000 largest firms by market capitalisation. The number of firms in the sample is depicted by bars. The orange line shows the average number of years a firm stays in the sample.


“We believe it is unique to have a data set which not only goes back further in history than other studies, but also covers the global financial crisis and a whole decade after it.”

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3 See page 17 of the paper: www.newtonim.com/incomeresearch.
Key findings

The research has three key findings:

**KEY FINDING 1**
High-dividend yield portfolios outperform low and zero-yield portfolios on a value-weighted basis. In other words, investing in higher-yielding portfolios offers superior returns to investors. Higher dividend stocks also experience higher future returns.

**KEY FINDING 2**
Buybacks represent a less stable commitment to return cash to investors than dividends do.

**KEY FINDING 3**
A high total-payout yield (buybacks and dividends combined) portfolio exhibits a statistically significant higher turnover rate than a high-dividend yield portfolio does for a value-weighted strategy (higher by 9.1%), as well as for an equal-weighted strategy (higher by 17.1%) without offering a statistically significant larger arithmetic mean return than a high-dividend yield portfolio.
KEY FINDING 1

High-dividend yield portfolios outperform low and zero-yield portfolios on a value-weighted basis. In other words, investing in higher-yielding portfolios offers superior returns to investors. Higher dividend stocks also experience higher future returns.4

Over the period from July 1928 to June 2019, high-dividend yield portfolios outperformed both low and zero-dividend yield portfolios on a value-weighted basis: 199 bps for the low-yield portfolios, and 330 bps for the zero-yield portfolios. See exhibit 5.

EXHIBIT 5: PORTFOLIO RETURNS
Research paper figure 2
High, medium, low and zero-dividend yield (value-weighted) portfolios: cumulative wealth July 1928 – June 20196

At the start of each year, we rank by dividend yield the largest 3,000 US stocks that paid a dividend over the trailing twelve months and partition the sample into terciles to form high, medium, and low-dividend yield portfolios. Following Conover et al. (2016), the top 5% of dividend payers are excluded from the high-dividend yield portfolio. The zero-dividend yield portfolio consists of all firms with a dividend yield of zero. The ‘All’ portfolio is the all-firm benchmark. We graph on a logarithmic scale the value-weighted cumulative wealth of US$1 invested in July 1928. We report the annualised returns for each portfolio in the legend. All years end in June.


4 See pages 8-9 of the paper: www.newtonim.com/incomeresearch.
5 See page 20 of the paper: www.newtonim.com/incomeresearch.
Buybacks represent a less stable commitment to return cash to investors than dividends do.⁶

The study confirms the pro-cyclical (positively correlated with financial-market strength) nature of share buybacks — see exhibit 6. The advantage of dividends is that they provide a relatively reliable source of income, assuming the investor is able to select the sustainable dividend payers, particularly in downturns when investors might need a steady income stream most.

**EXHIBIT 6: PORTFOLIO RETURNS**

*Research paper figure*⁴

**Stability of dividends and repurchases July 1982 – June 2018⁷**

*Dividend (repurchase) contribution is defined as the amount paid out in dividends (repurchases) in a given year as a percentage of the total amount paid out in both dividends and repurchases over the life of a firm. For each year ended June, we estimate the average contribution across all firms and graph the two time series. The grey bars depict recession periods. We include all firms in our sample in 4(a) and include only those firms surviving the whole period 1982-2018 in 4(b).*

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⁶ See page 12 of the paper: www.newtonim.com/incomeresearch.

⁷ See page 28 of the paper: www.newtonim.com/incomeresearch.
A high total-payout yield (buybacks and dividends combined) portfolio exhibits a statistically significant higher turnover rate than a high-dividend yield portfolio does for a value-weighted strategy (higher by 9.1%), as well as for an equal-weighted strategy (higher by 17.9%) without offering a statistically significant larger arithmetic mean return than the high-dividend yield portfolio.\(^8,9\)

We believe that the higher turnover rate in a high total-payout yield portfolio is attributable to the more volatile nature of share buybacks. Even in the idealised world of a theoretical portfolio (where turnover comes at zero cost), a total-payout portfolio does not generate statistically significant larger average returns for investors.

In the real world, portfolio turnover comes at a cost in the form of trading costs and potential market impact costs. The latter are caused by the fact that, depending on the size of a transaction and the liquidity of a stock, the price moves beyond its starting bid or ask price when a portfolio buys or sells a stock/position. This certainly implies higher trading costs for a total shareholder return portfolio than for a dividend-focused portfolio, and we believe the finding underpins the attractiveness of a high-dividend yield approach.

**EXHIBIT 7: PORTFOLIO TURNOVER**

*Research paper table 9*

Portfolios turnover comparison July 1982 – June 2019\(^{10}\)

The high-dividend yield (DY) portfolio and high total-payout yield (TPY) portfolio are defined in figures 2 and 3, respectively. We construct the DY and TPY portfolios on both a value-weighted and equal-weighted basis. Portfolio turnover is the minimum of sales and purchases in a given year divided by the average of the starting and ending portfolio values. We report average portfolio turnover across each decade and for the whole sample period.

<table>
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<tr>
<th></th>
<th>Value-weighted</th>
<th>Equal-weighted</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>High DY portfolio</td>
<td>%</td>
</tr>
<tr>
<td>1983-89</td>
<td>28.5</td>
<td>33.4</td>
</tr>
<tr>
<td>1990-89</td>
<td>20.5</td>
<td>36.3</td>
</tr>
<tr>
<td>2000-09</td>
<td>42.0</td>
<td>48.4</td>
</tr>
<tr>
<td>2010-19</td>
<td>30.1</td>
<td>37.8</td>
</tr>
<tr>
<td>1983-2019</td>
<td>30.4</td>
<td>39.5</td>
</tr>
</tbody>
</table>


“Even in the idealised world of a theoretical portfolio (where turnover comes at zero cost), a total-payout portfolio does not generate statistically significant larger average returns for investors.”
Conclusion

We believe the research carried out by the Centre for Endowment Asset Management underscores the relevance of equity-income investing, and its ability to deliver attractive long-term returns with lower volatility than low-yield or no-yield portfolios. We hope you enjoy reading the full study [www.newtonim.com/incomeresearch](http://www.newtonim.com/incomeresearch).

While the income-based portfolios in the study were constructed mechanically (by splitting the US equity market into thirds to create low, medium and high-yielding portfolios), we aim in our Global Equity Income strategy to select stocks with a sustainable dividend yield – bought at a yield higher than that of the market and sold when the yield drops to the market yield.

We believe we can add value with our active equity income investment approach, which seeks to harness the key structural trends that shape investment opportunities and risks. We work with our 32-strong research team to identify high-quality dividend-paying companies trading at a reasonable price based on yield considerations, and we believe our full integration of environmental, social and governance considerations, as well as thematic considerations that help us to focus on key structural tailwinds and headwinds in our analysis, are also key in seeking to ensure the sustainability of dividends.

Our strategy takes a disciplined and time-tested approach, and we believe it is as relevant today as it has ever been.
The value of investments can fall. Investors may not get back the amount invested. Income from investments may vary and is not guaranteed.

RISKS

Objective/Performance Risk: There is no guarantee that the strategy will achieve its objectives.

Currency Risk: This strategy invests in international markets which means it is exposed to changes in currency rates which could affect the value of the strategy.

Derivatives Risk: Derivatives are highly sensitive to changes in the value of the asset from which their value is derived. A small movement in the value of the underlying asset can cause a large movement in the value of the derivative. This can increase the sizes of losses and gains, causing the value of your investment to fluctuate. When using derivatives, the strategy can lose significantly more than the amount it has invested in derivatives.

Emerging Markets Risk: Emerging Markets have additional risks due to less-developed market practices.

Concentration Risk: A fall in the value of a single investment may have a significant impact on the value of the strategy because it typically invests in a limited number of investments.

Liquidity Risk: The strategy may not always find another party willing to purchase an asset that the strategy wants to sell which could impact the strategy’s ability to sell the asset or to sell the asset at its current value.

High Yield Companies Risk: Companies with high-dividend rates are at a greater risk of being able to meet these payments and are more sensitive to interest rate risk.

Counterparty Risk: The insolvency of any institutions providing services such as custody of assets or acting as a counterparty to derivatives or other contractual arrangements, may expose the strategy to financial loss.

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This is a financial promotion and is not investment advice.

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