



Dividend Investing: A Value Tilt in Disguise?

In today's near-zero interest rate environment, dividend investing is back in fashion. The popularity of stocks that offer investors generous dividend distributions has only been heightened by their recent performance. From January 1, 2011 to September 30, 2012 the FTSE High Dividend Yield Index of US stocks returned 26% compared to just 19% for the S&P 500 Index. But what is really contributing to this higher return?

Abstract

To better understand the performance of high-dividend-yielding stocks relative to the broader equity market, we dissected their return patterns and examined them over a period of more than 30 years through the lens of risk factors. Our research revealed that it was not actually the dividend yield factor that was responsible for this outperformance – rather, it was the *value* factor inherent in most high-dividend yielding stocks that enhanced returns. Perhaps even more surprising, we discovered that the dividend yield factor was actually a negative contributor to performance over the period we studied.

This paper also takes up the subject of taxes as it relates to dividend investing. Most investors are cognizant of the fact that they could see a steep increase in the tax rate applied to dividend payments in 2013, potentially from 15% to as high as 43.4%. Exactly how the returns of dividend-paying stocks will be affected by this change can't be predicted with certainty, but we thought it would be instructive to use the same multi-factor analysis to examine periods in the past that were also characterized by changes in tax laws to see if any patterns emerged. What we found was that prominent spikes in the yield factor's contribution to (or deduction from) return tended to occur on a short-term basis in the time frame around the news of tax changes, but over the longer term, in each case the factor's contribution reverted to normal.

Part 1: The Dividend Yield Factor Examined Methodology

We analyzed the sources of stock returns over the 33-year period from August 1, 1979 to July 31, 2012, separating out risk factors such as value, growth, momentum and company size. We divided the Russell 3000 Index into 10

deciles and honed in on two portfolios: one representing the entire market (referred to as "Market Portfolio" in this paper) that essentially served as a benchmark and the other being just the decile comprised of the highest-yielding stocks – or the 10% of stocks with maximum exposure to the dividend yield factor (referred to as "High Dividend Yield Portfolio"). We updated the portfolios monthly (quarterly prior to 1987, prior to which monthly data was unavailable).

Results

The High Dividend Yield Portfolio's annualized return was 1.27 percentage points greater than that of the Total Market portfolio (12.42% vs. 11.15%), which was enough to compound wealth 48-fold over the 33 years, compared to 33-fold for the Market Portfolio. But when we decomposed the factors explaining the returns, we found that, interestingly, the dividend yield factor actually contributed *negative* 1.02% annualized to the excess return – in other words, it actually detracted from performance.

With a multi-factor approach the total returns can be broken down into contribution from several risk factors like industries, asset selection, etc. The total contribution explained by the risk factors for the high dividend yield portfolio was 3.16 percentage points higher than that of the market portfolio. The return from risk factors can be further broken down into individual risk factors like value, size, earnings yield, dividend yield, etc. Analyzing these individual risk factors helped us gain insight into what actually happens when we invest in a high-dividend yield portfolio.

Exhibit 1 shows the exposure and annual contribution of the individual risk factors of the High Dividend Yield Portfolio.

Exhibit 1: Active Exposure and Annualized Contribution of the Risk Factors of the High Dividend Yield Portfolio as Compared to the Market Portfolio

Source of Return	Average Active Exposure	Total Contribution
Yield	1.60	-1.02
Leverage	0.42	-0.32
Momentum	-0.22	-0.21
Currency Sensitivity	-0.02	-0.01
Size Non-Linearity	0.02	0.01
Non-Est Universe	0.01	0.01
Earnings Variation	-0.07	0.02
Trading Activity	-0.32	0.11
Size	0.02	0.28
Growth	-0.41	0.40
Value	0.53	0.41
Volatility	-0.37	1.22
Earnings Yield	0.47	2.28
Total		3.16

Source: GF Research, MSCI, Russell Investment Group

Let's take a closer look at some of the line items in Exhibit 1:

- 1) **Yield:** This represents the dividend yield factor. As expected, it has the highest exposure among other risk factors as we have deliberately tilted our portfolio towards high-dividend yield stocks. The contribution of the yield factor, however is a negative 1.02 percentage points, which indicates that the higher return of the high dividend yield portfolio is not due to the yield factor. Rather, it acts as a negative contributor.
- 2) **Value and Earnings Yield:** Value, defined as the book value to price ratio, has a positive exposure of 0.53 and positive contribution of 0.41 percentage points, the third-highest contributor to the total returns. Earnings yield, defined as stock earnings per share divided by price per share, also has a positive exposure of 0.47 and is the highest contributor to total returns, adding 2.28%. This indicates that our portfolio of high dividend yield stocks is also tilted towards value and earnings yield, and these factors are contributing meaningfully to the portfolio's high returns.
- 3) **Volatility:** The High Dividend Yield Portfolio is less volatile as compared to the market by a factor of -0.37. Volatility has a positive contribution of 1.22.

- 4) **Size:** Given that dividend-paying stocks typically are large capitalization companies, it would have been reasonable to expect the portfolio's size factor to have been higher than it was. In fact it was fairly neutral, with an exposure of 0.02. To understand this result, we separated the dividend-paying stocks from the Russell 3000 and compared these to the Market Portfolio as of July 31, 2012. The exposure of the size factor of this portfolio was 0.24, which proves the fact that if we take the entire lot of dividend-paying stocks (all 1,382 of them) we *would* in fact end up with a portfolio containing more large cap companies as compared to the Market. But since we are only considering the top 10% of these stocks – for which, as of July 31, 2012 the exposure was -0.05 – we see that the average size of the companies in this top 10% portfolio is fairly similar to that of the market portfolio.

So what, in aggregate, are these risk factors telling us? First, by focusing on high-dividend-yielding stocks, investors unwittingly tilted their portfolios to value stocks: the dividend yield factor is subsumed in the value and earnings yield factors. Second, the value factor, not the yield factor, was responsible for the excess performance over the period studied. And finally, the dividend yield factor tilt also brought with it a high exposure to the earnings yield factor, which is a commonly used method for identifying value stocks, and a strong contributor to positive returns.

To illustrate the benefit of a value tilt within a portfolio, we back-tested two versions of our Market Portfolio. In the first, we fixed the portfolio's dividend yield factor exposure at 0.50. In the second, we set an exposure of 0.50 for both the value factor and the earnings yield factor. We back-tested both portfolios over the same time period (August 1, 1979-July 31, 2012). The portfolio with the value and earnings yield tilts realized a total annualized return of 14.12% as compared to 11.40% for the portfolio with the dividend yield factor exposure. Analyzing these returns from the multi-factor model and segregating the portion explained by the risk factors, we also observe that the exposure of 0.50 towards dividend yield is still a negative contributor, and that the most positive contribution comes from the earnings yield factor. The complete analysis of the returns explained by risk factors is shown in Exhibit 2.

Exhibit 2: Return Contribution Breakdown: Dividend Yield Tilt Portfolio vs. Value/Earnings Yield Tilt Portfolio

Aug. 1, 1979-Jul. 31, 2012

Source of Return	Portfolio with Yield Exposure of 0.5		Portfolio with Value and Earnings Yield Exposures of 0.5	
	Average Active Exposure	Total Annualized Contribution	Average Active Exposure	Total Annualized Contribution
Currency Sensitivity	0.02	-0.02	0.01	0.00
Earnings Variation	0.00	0.00	0.01	-0.03
Earnings Yield	0.06	0.33	0.50	2.29
Growth	-0.03	0.01	0.01	-0.03
Leverage	0.04	-0.02	0.00	0.03
Momentum	0.01	0.03	-0.01	0.06
Non-Est Universe	0.01	-0.01	0.01	0.00
Size	-0.05	0.16	-0.10	0.37
Size Non-Linearity	-0.03	-0.02	-0.12	-0.15
Trading Activity	0.03	0.02	0.03	0.02
Value	0.03	0.05	0.50	0.28
Volatility	-0.01	0.03	0.00	0.08
Yield	0.50	-0.45	0.07	-0.05
Total		0.11		2.89

Source: GF Research, MSCI, Russell Investment Group

When we analyzed the return streams on a monthly basis, we found that the dividend yield factor had a negative contribution to return in 231 months and a positive contribution in 170 months. And not only was the dividend yield factor's contribution to return negative more often than it was positive, but the average downside was larger than the average upside: the monthly average for negative months was -0.40% compared to a monthly average of 0.35% for the positive months. As a result, the overall contribution of the dividend yield factor has been negative.

But the question that still remains unanswered is, *why* is the return of the dividend yield factor negative? One possible explanation for this could be a combination of delayed reaction by management and price momentum, as described below:

- **Delayed Reaction by Management:** Markets do a reasonably good job of pricing risk. Based on the fundamentals of a company, the market adjusts the price of its stock. Company management and boards of

directors, however, tend to take longer to adjust dividend policy. Assuming dividends remain unchanged, an increase in stock price results in a decrease of the dividend yield, and a *decrease* in the price results in an *increase* in the dividend yield. The net effect is that a stock that declined in price would now have a higher dividend yield and the stock that increased in price would have a lower dividend yield. This is where the next dynamic, price momentum, comes into play.

- **Price Momentum:** Price momentum is the tendency of recent outperforming stocks to keep outperforming and underperforming stocks to continue on a downward trajectory. As it relates to the above example, the theory of price momentum suggests that the stock that decreased in price will tend to keep decreasing in price and the stock that increased in price will tend to keep increasing in price. Said another way, the stock that now has a higher dividend yield will tend to decrease in price; i.e., have a negative return, and the stock that now has a lower dividend yield will tend to increase in price; i.e., have a positive return.

To conclude this section of our paper, investors who tilted their portfolios toward high-dividend-yielding stocks took on an inherent value tilt, and it is really the value and earnings yield factors that contributed to the portfolio's strong returns relative to the broader market. The dividend yield factor has been shown to actually detract from portfolio performance.

Nonetheless, high-dividend-yielding stocks have their place in a diversified portfolio, particularly if investors value their income characteristics. Yet if it is long-term outperformance over the broader market that investors are seeking, we believe a more direct approach would be to employ a portfolio tilt toward value and high-earnings-yield stocks.

Part 2: Taxes and Dividends

Unless current law is amended before the end of 2012, starting in January 2013 investors will face the single steepest increase in dividend taxation in history. For taxpayers in the highest income brackets, if the sun sets on the current 15% qualified dividend tax and instead dividends are taxed as ordinary income, they could be paying as much as 43.4%. This uncertainty is weighing on the minds of dividend investors and investors more generally who wonder about the implications of such a change for the equity markets. While these outcomes are not knowable in advance, we thought it would be instructive to look at some past tax regime changes to see if any patterns emerged.

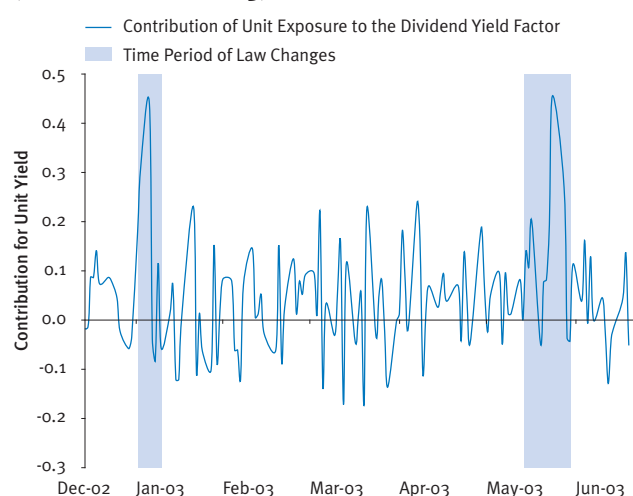
Methodology

Using a multi-factor approach to analyze the returns, we isolated the monthly contribution of the dividend yield factor of our High Dividend Yield Portfolio from Part 1 during periods of past tax law changes.

Results

Exhibit 3 represents the 2003 tax law changes (in this instance, tax *cuts*) under President George W. Bush.

Exhibit 3: Contribution/Exposure – Dividend Yield Factor (Bush Tax Cuts – 2003)

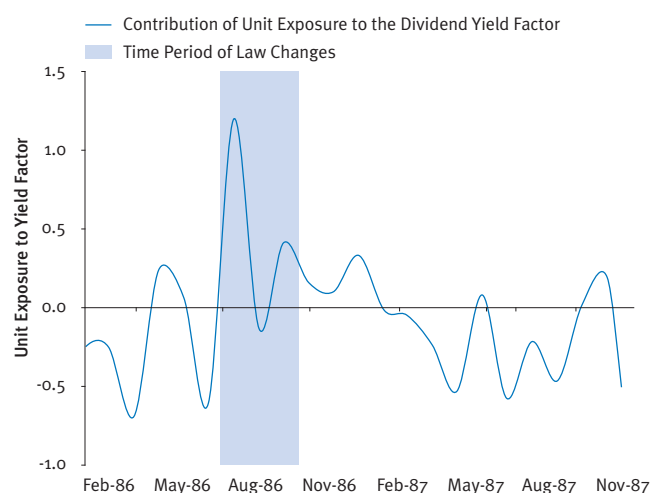


Source: GF Research, MSCI, Russell Investment Group

The shaded area represents two time periods January 3rd to January 9th representing the announcement period for the tax cut plans and May 14th to May 28th representing the acceptance period of the plan.

As is clearly visible, there is a sharp increase in the contribution of the dividend yield factor for every unit of exposure. But this sharp increase only lasts for a short period of time. Over a longer period, these contributions return to the norm. The same can also be observed in Exhibit 4, which looks at the period surrounding the Tax Reform Act of 1986, also referred to as the Reagan Tax Cuts:

Exhibit 4: Contribution/Exposure – Dividend Yield Factor (Reagan Tax Cuts – 1986)



Source: GF Research, MSCI, Russell Investment Group, Library of Congress

The shaded area represents the time period of the tax law change. Again the spike is a short-term aberration. Other tax law changes such as the Omnibus Budget Reconciliation Act of 1993 by President Bill Clinton (which *increased* taxes and saw the dividend yield factor decline for a short period following its passage) and the Economic Recovery Tax Act of 1981 by President Ronald Reagan showed us a similar pattern of short-term or no substantial change in the returns of the dividend yield factor.

These short-term spikes could be attributed to the fact that the total number of investors who are affected by an increase in tax law changes is small as compared to the total number of investors in the market overall. For example, a substantial amount of investment is made from tax-deferred and tax-exempt accounts, which are unaffected by tax law changes.

Another important effect of tax law changes for the dividends paid is the policy of corporations. Our research shows that during the 2003 tax deductions, the total number of companies paying dividends had a substantial increase after the tax cut was announced. In the Market Portfolio we considered in Part 1 of this paper, 41.5% of the companies paid dividends as of the end of the first quarter of 2003. In the next four quarters following the May 2003 announcement of the tax law cuts, the number of companies paying dividends rose to about 46%.

Conclusion

Dividend investors concerned about impending tax increases should bear in mind that while the dividend yield factor historically has been affected by changes in tax law, this has typically been a short-term phenomenon around the time that changes are a) announced and/or b) implemented, and over the longer term returns do not appear to be materially impacted. Going back to lessons learned from Part 1 of this paper, perhaps a bigger question in dividend investors' minds should be, are high-dividend-yielding stocks really the best path to meeting my near- and long-term goals? If outperformance over the broader market is a medium- to long-range objective, they might be better served tilting their portfolios to value stocks instead.