UBS Asset Management

Why dividends matter

Finding yield in a low interest rate environment

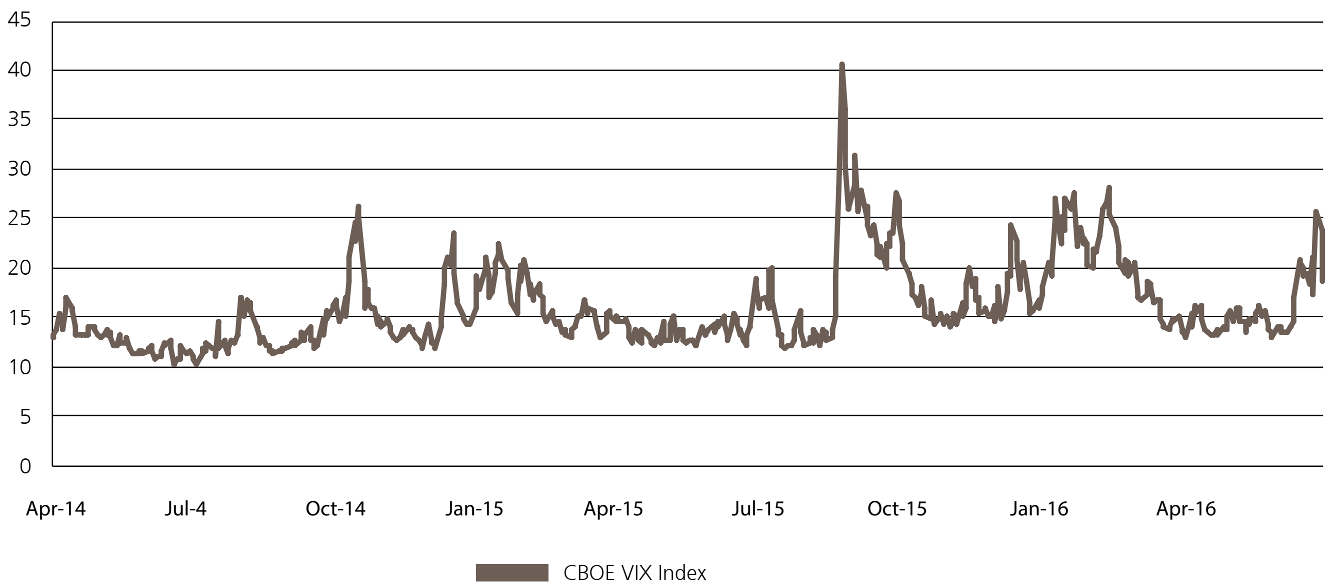
Harvesting yield

Strong free cash flow generation and healthy balance sheets underpin the case for companies to maintain or increase their cash distribution in the form of dividends. The low yield environment bodes well for high dividend yielding stocks as investors hunt for yield.

After a prolonged period of strong risk-adjusted returns for global equity markets, investors now face a challenging market environment. Market volatility spiked in autumn 2015 and the first half of 2016 as shown in chart 1. Meanwhile, low or negative real interest rates have led to compressed risk premia, and thus to lower expected returns across most asset classes. Against this market backdrop, we believe that the case for investing in high dividend stocks is compelling.

Global central banks have deployed a range of unorthodox policies and lowered policy rates to unprecedented levels. In an environment where interest rates are at historically low levels and likely to stay low for the foreseeable future, high dividend stocks look attractive for investors with respective risk tolerance as they provide a source of income as well as potential capital gains. Investors in high dividend stocks have the benefit of a potentially reliable income stream and upside participation if equity markets perform well.

Chart 1: CBOE S&P 500 Implied Volatility Index (VIX)



Source: Bloomberg, UBS Asset Management. Data as of 28 June 2016.

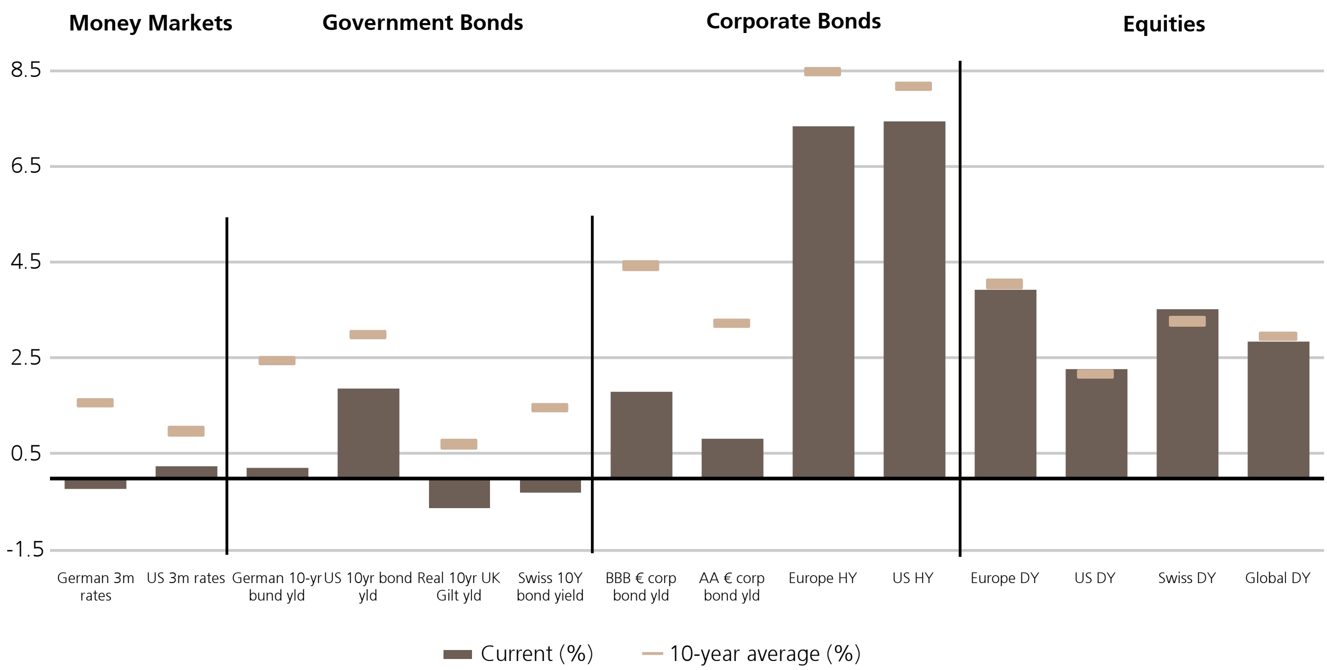
Although distinctly different risk and return profiles do not allow for an apple-to-apple comparison across asset classes, global equities currently offer dividend yields in line with the 10 year average, while the yields on money market and government bonds as well as many segments of corporate bonds are well below their historical averages, as shown in chart 2. This is, amongst other factors, a result of central banks having aggressively cut interest rates after the financial crisis to stimulate a quick economic recovery. For several developed countries, the government bond yields have even turned negative. High yield bonds still offer higher yield pick-up compared to global equities, however their potential for capital gain is lower, particularly given the recent spread contraction in the past three months or so.

In the current low interest rate environment, high dividend yielding stocks look compelling.

Healthy balance sheets support dividends

As a result of the global financial crisis, companies have deleveraged and their balance sheets now look healthier than in 2008. Companies are generating more cash on the back of the US and European economic recovery and accommodative monetary policies. Profit margins as measured by EBITDA[1] at the global level have remained stable at around 16% over the last three years[2]. In addition, corporate free cash flow globally is at a 20-year historical high after an increase of 11.1% yoy in Q1 2016[3], thanks

Chart 2: Bond yields (%) significantly below historical averages



Source: UBS Asset Management, UBS Investment Banking, Equity Strategy. Note: DY stands for dividend yield. Data as of 20 May 2016.

[1] EBITDA = Earnings Before Interests, Taxes, Depreciation, and Amortization.
[2] Source UBS Investment Bank and Datastream, data as of 31 May 2016
[3] Source UBS Investment Bank, data as of 31 May 2016

partly to greater capital expenditure discipline. This solid cash flow generation is expected to continue in 2016. Cash on balance sheet for the companies in the MSCI All Country World index[4] is at a 16-year high (chart 3). The strong cash flows have in part been used to reduce debt. While net debt to equity ratios have gone up recently, perhaps partially due to adverse stock market movements, the average has fallen significantly, to roughly 50% over the last couple of years, from the 70% levels witnessed during the tech bubble (chart 4). Given strong cash flow generation and healthy balance sheets, corporates are likely to continue distributing a portion of their cash in the form of dividends.

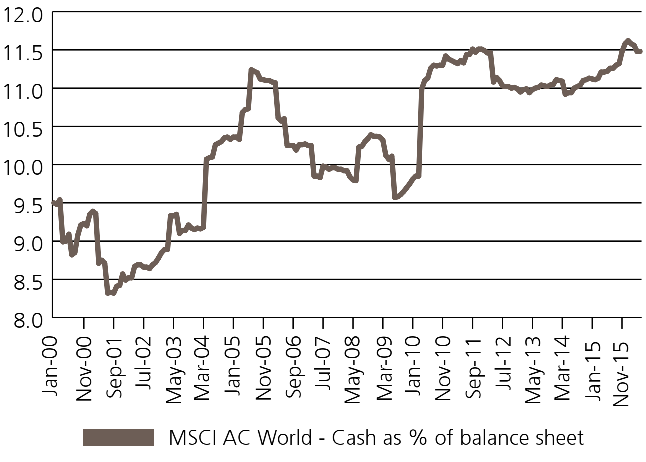
Adding value by combining dividend and quality factors

The dividend factor has long been a focus of academic as well as practitioners' research in their search for ways to explain returns or generate outperformance. For instance, Fama and French in 1988 analyzed whether or not dividend yields have the power to forecast stock returns.[5] They found that, while dividend yields typically explained very little of monthly or quarterly returns, their predictive power grew over longer return periods and often explained more than 25% of the variances of two- to four-year returns. For this reason, many money managers believe that the dividend yield is a value adding factor.

Corporate balance sheets are in good shape, with high levels of free cash flow. This bodes well for dividend payments.

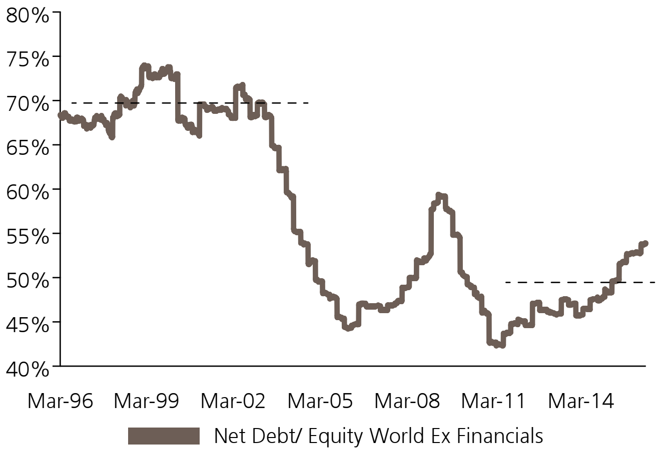
However, we believe that picking stocks solely on the basis of their current dividend yield is not advisable. A stock with a high yield may be a genuinely attractive investment opportunity or it may have experienced a sharp drop in price which would inflate the dividend yield. In case of the

Chart 3: Cash positions (as % of balance sheet) are at a 16-year high



Source: UBS Asset Management, UBS Investment Banking, Datastream, as of 31 May 2016

Chart 4: Net debt to equity at mid-term average of around 50%



Source: UBS Asset Management, UBS Investment Banking, Datastream, as of 31 May 2016

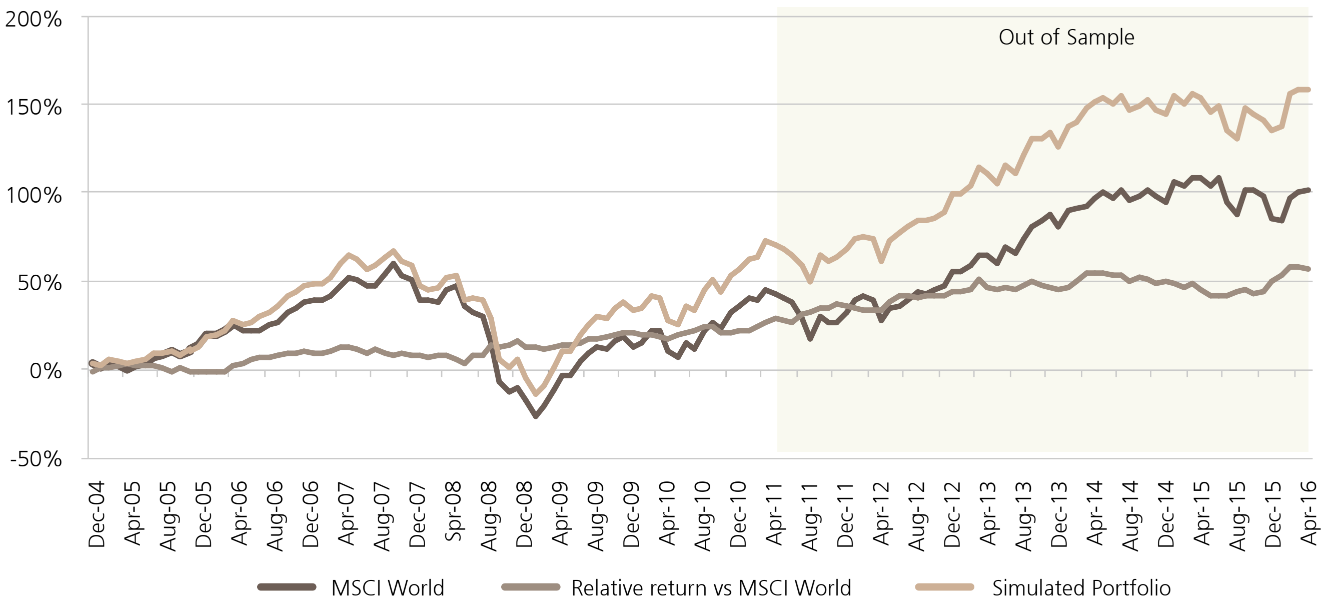
[4] The MSCI World index captures large and mid cap representation across 23 developed and 23 emerging market countries and as of end May 2016 consists of 2476 constituents.
[5] Eugene F. Fama and Kenneth R. French, Dividend Yields and Expected Stock Returns, Journal of Financial Economics 22 (1988) 3-25

latter, the probability that the high dividend can be sustained is low. We believe that a focus on companies that exhibit both high dividends as well as strong balance sheets, healthy levels of profitability, good cash flow generation and lower risk characteristics should lead to better results. Quality factors tend to be value adding, i.e. conducive to better risk-adjusted returns. On the other hand, companies with high quality characteristics should exhibit a higher probability of being able to maintain or increase their dividend payments.

Our simulated portfolio combining high dividend and high quality stocks outperformed the broader equity market index.

To verify our assumption, we performed simulations by applying pre-determined dividend yield and quality criteria to the constituents of the MSCI World index[6]. The criteria applied included a number of factors: historical price volatility, stability of historical dividend payments, balance sheet quality measured through a number of balance sheet ratios, company size and profitability metrics. We found that over the period of December 2004 to May 2016 a hypothetical portfolio of high dividend and high quality stocks outperformed the MSCI World index by 2.3% annually before costs and gross of fees. After factoring in estimated transaction costs of 0.8%, the outperformance of the simulated portfolio versus the MSCI World index is 1.5% per annum. As the cumulative active return in the following chart shows, the outperformance was achieved with rather high consistency. From April 2011 onwards, the simulation is based on out-of-sample[7] results which should give the study further credibility.

Chart 5: Simulated portfolio combining dividend and quality criteria for stock selection added value (cumulative returns in USD, indexed)



Source: UBS Asset Management. Simulation is based on a subset of equity constituents in the MSCI World index, in USD, gross of fees and transaction costs. Simulated portfolio was rebalanced monthly. The dividend criteria used for stock selection is net of non-reclaimable withholding tax dividend yields from a Luxembourg domicile's perspective, but returns are based on total returns. Simulation is hypothetical and does not represent a live track record or actual returns realized by any investor. Past performance, whether simulated or actual, is not a guarantee for future performance. See disclosures for additional information.

[6] The MSCI World index captures large and mid cap representation across 23 developed markets and as of end May 2016 consists of 1639 constituents.
[7] As opposed to in-sample which refers to data points used to build the model, out-of-sample refers to new data points and is a way to test the likely accuracy of a forecasting model.

Conclusion

The current environment of low interest rates is likely to remain for the foreseeable future; at least, that's one of the key takeaways from the major central banks meetings. The ECB unleashed an aggressive set of measures aimed at stimulating lending without hurting the profitability of banks, and slashed interest rates to zero for the refinancing rate, or further into negative territory for deposit rates. In June 2016, the dot plot showed that FOMC members lowered their expectations for the appropriate level of interest rates at the end of 2016 to two rate hikes from four back in December 2015. Therefore, we believe that investors with the risk tolerance for equity investing and aiming to achieve a high yield should consider high dividend yielding stocks, in particular considering the low (or negative) yields from government bonds. Combining dividend with quality criteria such as profitability and low financial leverage helps improve the likelihood of stable or even growing dividend income. Although equity share prices are typically more volatile than bonds, high dividend yielding stocks offer the benefit of a potential attractive income stream, and possible capital gains.

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