CLEARPOINT

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A HISTORICAL REBALANCING—DIVIDEND INCOME SET TO RE-EMERGE AS A KEY DRIVER OF EQUITY RETURNS

BY DANIEL MEGES, MANAGING DIRECTOR, RESEARCH

The US market and economy appears to be in the early years of transition from a three-decade disinflationary environment—one where inflation rates were gradually falling—to a period of more stable inflation—one in which inflation rates move back towards long-term historical norms. This transition is likely to have important implications for drivers of investors' future equity returns.

Investors' total return from their investments in equities can be thought of as being driven by three components: dividends, capital gains (stock price appreciation) and changes in the price/earnings ratio (how much the average investor is willing to pay for $1.00 of future earnings). A seminal study by the US Federal Reserve ("the Fed") and the German Bundesbank examined stock returns globally from 1870 to 2015 and concluded that US equities over the full period returned 11.1% annualized and that dividend income accounted for 40% of this annualized return, while capital gains accounted for about 60% of the return.[1] Earnings per share growth is widely accepted—both in theory and by empirical studies—to be the primary driver of capital gains (stock or index price appreciation).[2] Therefore, about 60% of returns can be attributed to earnings growth of corporate America during this period. Furthermore, this and other

CLEARSTEAD CONTINUES TO BOLSTER TEAM WITH NEW TALENT

We are pleased to announce that we have added talent to the Private Client team with Gina Gurganus and Luke Sommer.

Gina comes to Clearstead from PNC where she has worked in their Asset Management Group Rotational program spending time as a Banking Analyst in Private Wealth, Wealth Strategy Analyst at Hawthorn (PNC Family Wealth), Investment Analyst, and as a Business Development Officer in the Institutional Asset Management group.

Luke has joined Clearstead as a Client Service Associate, PCG. Luke comes to us from Bankers Life Securities where he spent time as an Investment Advisor Representative.

These changes underscore the firm's commitment to building its investment consulting practice, promoting the next generation of leadership, and maintaining a rigorous investment process.

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studies show that, while changes in the price/earnings ratio can be volatile in the short-run, over long periods of time they have historically averaged close to zero and thus have minimal impact on long-run returns.*[3] Moreover, the central role of dividend income to long-run equity returns has been consistent across global markets over the past century (see table below).[4]

NOMINAL RATES OF RETURN ON EQUITY MARKETS

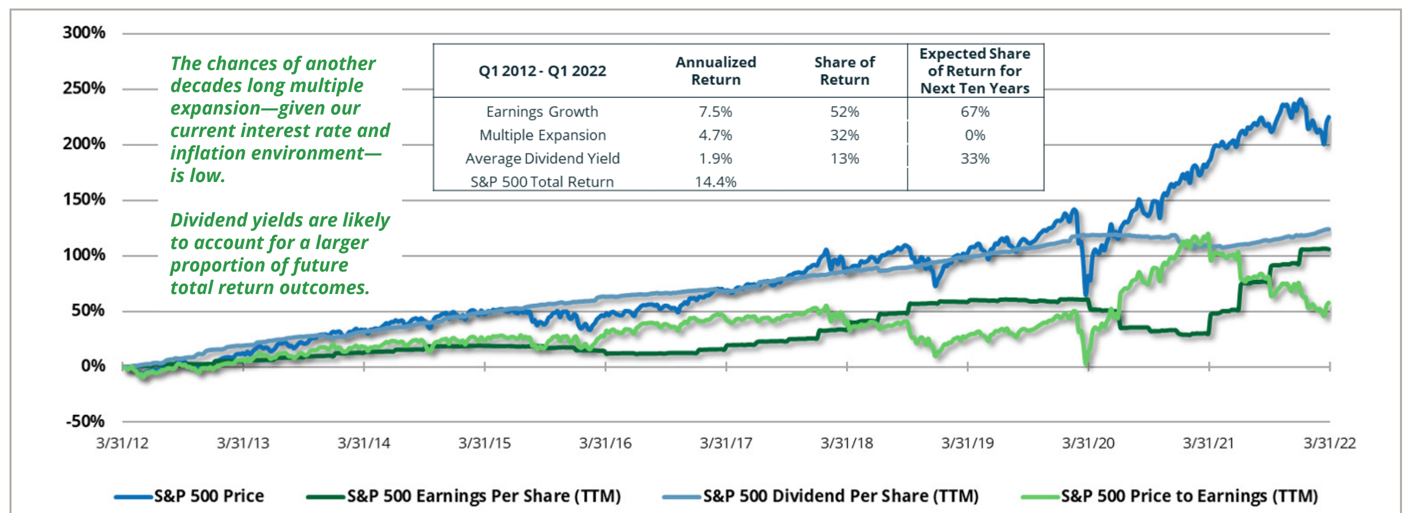
	Capital Gain (Price Appreciation)	Dividend Income	Total Return	Dividend Share of Total Return	Period Analyzed
USA	6.70%	4.38%	11.1%	40%	1872-2015
UK	6.20%	4.53%	10.7%	42%	1820-2015
Switzerland	5.76%	3.20%	8.9%	36%	1900-2015
Australia	6.92%	4.90%	11.8%	41%	1882-2015

Source: "The Rate of Return on Everything, 1870–2015" San Francisco US Federal Reserve/Deutsche Bundesbank.

In more recent decades, the share of total returns accounted for by dividends has declined as tax policy—which favored share buy-backs versus cash dividends—and the digital revolution and globalization that spurred periods of higher capital reinvestments in IT resources and global supply chains. These trends have pushed the share of total returns accounted for by capital gains (price appreciation) higher and dividend's share lower.[5] Clearstead's analysis of US equity nominal returns since 1946 shows that dividends have accounted for about 1/3 of the S&P 500's annualized returns, which were about 11% annualized (on par with the pre-WWII era). The remainder of returns were accounted for by capital gains, while the changes in the price/earnings ratio were close to zero.[6]

However, the past disinflationary decade saw the normal attributes of these long-run return drivers upended. Between Q1-2012 and Q1-2022 the S&P 500 returned 14.4%—about 30% higher than its long-run post-WWII average—and the typical drivers of equity returns (capital gains and dividends) accounted for only about 2/3 of the total return. The change in the price/earnings ratio (multiple expansion) accounted for nearly 1/3 of the total return over the past decade (see graph below).

PAST DECADE OF S&P RETURNS - DRIVEN BY MULTIPLE EXPANSION



Source: Clearstead, Bloomberg LP, as of 31-March-2022, Weekly data, SS&P Total return = (1+Change Earnings Growth) X (1+Change in Multiple) X (1+Average Dividend Yield). "Share of Return" defined as percent of total return attributable to earnings growth, P/E multiple expansion, and average dividend yield. "Expected Share of Return for Next Ten Years" based on a reversion of long run trends. "Multiple Expansion" = change in Price to earnings ratio. Past performance is not an indictor of future results.

*Several studies examining solely US stock returns, particularly after WWII, have found that changes in the price/earnings ratio (multiple expansion) do contribute positive to long-run annualized returns but that this impact is typically estimated to be minimal and range between +20 to +50 basis points of long-run annualized returns. Bear in mind, there is no theoretical or practical basis for why an investor would be increasingly inclined to pay more for a $1 worth of future earnings over time (ceteris paribus).

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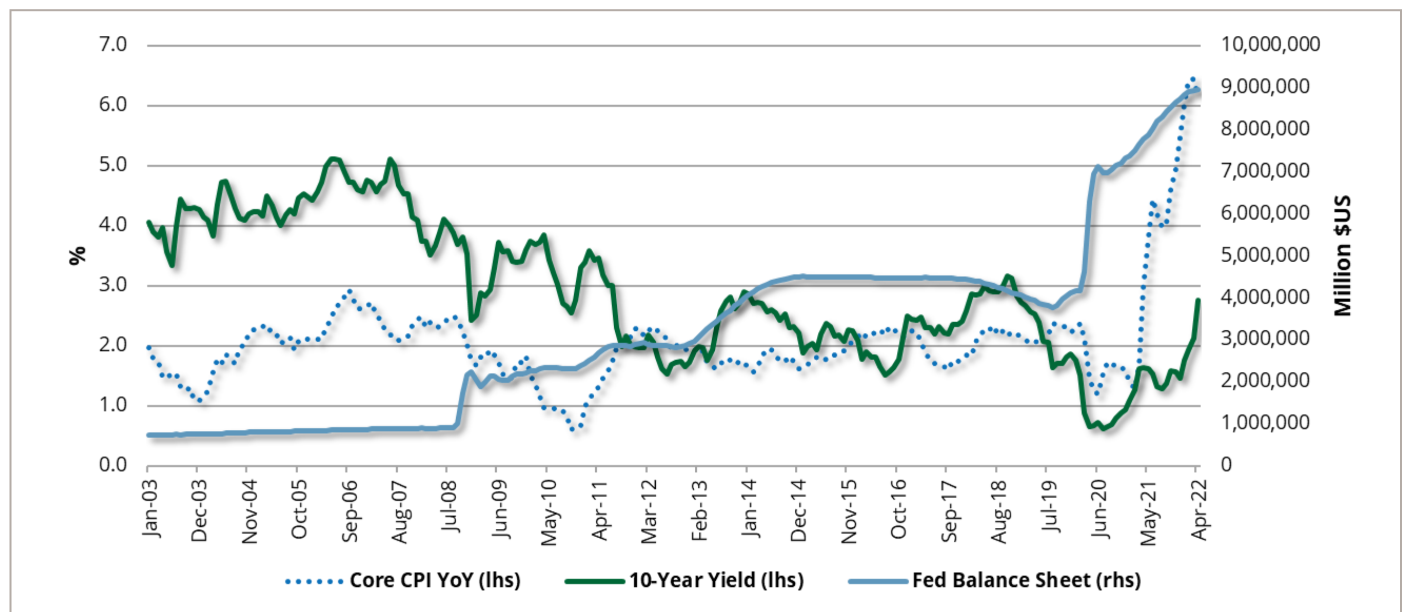
This is not wholly unprecedented as the twenty years from the 1980s to the end of the 1990s also saw S&P 500 returns boosted by multiple expansion: the S&P started early 1980s priced at 6.9x earnings and ended the 1999 priced at 27.7x earnings.[7] But these periods of higher-than-average annualized returns spurred by multiple expansion typically unwind and the price/earnings ratio contracts and the long-run drivers of returns (earnings growth and dividends) re-assert themselves.

So, what caused the return drivers of the past decade to deviate from historic norms? In short, it was close to 15 years of accommodative monetary policy coupled with global structural trends that reinforced disinflationary forces. Starting with the fallout from the Great Financial Crisis (GFC), the Fed slashed interest rates to zero and expanded its balance sheet—so called quantitative easing—by purchasing US Treasuries and mortgage-backed securities. This was to stabilize the US banking sector as well as the broader economy after the GFC-induced recession of 2007-2009. After the outbreak of the COVID-19 pandemic, the Fed rebooted is quantitative easing efforts and included select corporate bonds in its quantitative easing programs. On top of these Fed actions, globalization ushered more than 600 million low-wage Chinese workers into the global labor force, lowering the costs for a myriad of goods; aging populations in Japan, Europe, and the US changed consumption patterns and the slower growth in the prime-working age cohorts (ages 25-54) broadly reduced aggregate demand; and technology enabled unparalleled price transparency that increased competition and boosted the reach of low-cost producers.[8] The net impact of these phenomena was a decades-long disinflationary environment and the willingness—at least until Q1-2022—for investors to pay an ever higher multiple for same $1 worth of future earnings.

MORE THAN A DECADE OF DISINFLATION AND QE



Source: Clearstead, St. Louis Federal Reserve 1/1/2003 - 4/29/2022.

Unfortunately, many of the global trends that coalesced over the past 15 years to cause this prolonged multiple expansion and boost the last decade of S&P 500 returns above their historical average are no longer likely to have the same impact. The Fed is rapidly—at least by Fed standards—trying to raise rates and shrink its balance sheet to return to a more normal monetary policy. Supply chain disruptions related to COVID-19 and the war in Ukraine are pushing up prices of basic commodities and food inputs worldwide, which means that higher inflation is likely to persist even as tighter monetary policy curbs aggregate demand. Lastly, globalization, while not reversed, appears to be no longer expanding. China is no longer a low-cost producer but an increasingly middle-class economy, and other lower-wage countries such as Vietnam or Thailand are simply too small to take China's place as the manufacturing center of the world. This means China's key role in exporting disinflation via lower-priced goods across the world is likely to be played out. Moreover, as companies increasingly near-shore operations or build more resiliency in their supply chains, the cost of doing business is likely to rise rather than fall.

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Dividend income also has the advantage of historically being a relatively sure way to compound returns over long periods of time. While generally not as reliable as a bond coupon, dividend payments have increasing appeal as the level of market uncertainty rises vis-à-vis recession risks, geo-political headwinds to corporate margins, or the path of rising interest rates. Dividends are paid in hard cash from companies generating ample cash flow. They represent a highly visible public declaration by company management that their business has strong fundamentals, solid business plans, a commitment to prudent capital allocation, and a leadership team oriented towards shareholder value. Companies that pay dividends are loathe to cut them and typically work to grow their dividends steadily overtime, because cutting dividends could be damaging to share prices and largely viewed as an admission of failure by senior management to execute on their business strategy. Furthermore, the reinvestment of dividend income back into portfolios unlocks the power of compounding returns and boost long-run wealth accumulation that once prompted Albert Einstein to term financial compounding "the eighth wonder of the world."

Clearstead has discussed the impact of these trends on the structure and performance of a traditional 60/40 portfolio (see our May *ClearPoint*), but what does this mean for our client's portfolios? We believe that, over the next decade, multiple expansion is unlikely to contribute meaningfully to the total return of the S&P 500—in fact the change in the price/earnings ratio is likely to be detrimental to 2022 returns and potentially next year as well. Clearstead is actively working with our clients to increase the dividend and yield income components of their portfolios. This can involve increasing exposure to corporate lending strategies that feature high, floating-rate yields, or working to ensure that portions of US equity exposure is oriented to dividend-paying stocks. Equally, we continue to advocate for exposure to real-assets—private if possible, or public if not—that have high-dividend yields, the explicit ability to pass along rising inflationary dynamics to investors, and feature stable, recession-resilient cash-flows. Clearstead stands as a ready partner to proactively work with clients to position their portfolios in light of current market challenges and the ongoing transition to a new inflationary environment, where we believe historical market drivers remain the most tried and true.

Sources:

(1) Federal Reserve Bank of San Francisco "The Rate of Return on Everything, 1870–2015" O. Jorda, et al, Dec-2017.
(2) European Journal of Business & Management "How Earning Per Share (EPS) Affects Share Price and Firm Value" Nov-2014.
(3) CFA Institute "Expected Returns on Major Asset Classes" Antti Ilmanen June-2012.
(4) London Business School "The Worldwide Equity Premium: A Smaller Puzzle" Dimson, Marsh, & Staunton, Apr-2006.
(5) Janus Henderson "The Importance of Dividends to Total Returns" 2020.
(6) Clearstead Investment Office "Capital Market Assumptions" June–2021 & Dece-2021.
(7) Morningstar Research "The Importance of Dividend Yields and Earnings Growth to Stock Returns, M. Coffina, Aug-2013.
(8) Society of Actuaries "Investigating the Link Between Population Aging and Deflation" Feb 2016.

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Performance data shown represents past performance. Past performance is not an indicator of future results. Current performance data may be lower or higher than the performance data presented.

MARKET BENCHMARK RETURNS

May 31, 2022		1M	3M	12M	YTD
US Large Cap	S&P 500	0.2%	-5.2%	-0.3%	-12.8%
US Small Cap	Russell 2000	0.2%	-8.7%	-16.9%	-16.6%
Developed Intl	MSCI EAFE	0.7%	-5.2%	-10.4%	-11.3%
Emerging Intl	MSCI Em Mkt	0.4%	-7.3%	-19.8%	-11.8%
Real Estate	NAREIT	-4.3%	-1.9%	3.2%	-13.0%
Core Fixed	BarCap Agg	0.6%	-5.9%	-8.2%	-8.9%
Short Fixed	BarCap 1-3Yr	0.6%	-1.3%	-3.0%	-2.4%
Long Fixed	BarCap LT G/C	-0.3%	-13.1%	-14.8%	-19.5%
Corp Debt	BarCap Corp	0.9%	-6.8%	-10.0%	-11.5%

Source: Bloomberg

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