Not the Same

COMMENTARY
February 2022

The world has been left bereft of "safe" yield for a decade. And over that time, savers have been required to adjust their perspectives regarding what's possible in terms of income generation from a portfolio. That thinking has led many to pursue yield from dividend stocks, rather than bonds, as a means to bolster income. That approach may not be appropriate for many, considering:

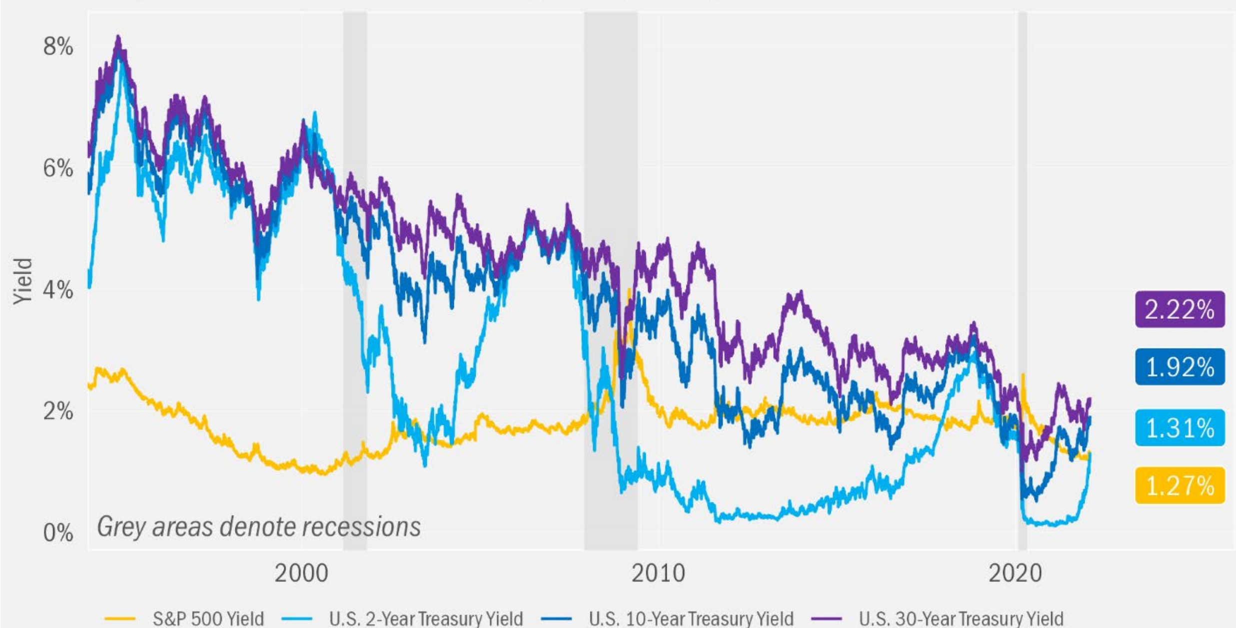
- While dividend yields from stocks were higher than those available from U.S. Treasuries through much of 2020, that spread has turned negative again (stock market yields are generally lower than high-quality bond yields)
- Dividend stocks are still stocks, which means they're generally risker than investment-grade bonds
- A focus on yield, alone, may unintentionally introduce other characteristics to the portfolio that might lead to outcomes different than had been expected

Yields Diverging

It's a chart that we've seen quite often over the past few years, one not surprisingly often tailored to pitch an investment in stocks in the place of bonds. To be fair to the suggestion, focused solely on yields, alone, one might be hard-pressed to present bonds as being as attractive now as they have been in the past from the perspective of income generation relative to stocks. But the spread of dividend yields over U.S. Treasuries returned to mostly negative over the past few months as the stock market's valuation increased (prices rose while dividend payouts remained mostly the same) and as interest rates surged on account of persistent inflation amidst still-strong macroeconomic growth. There's a bit of a mismatch in the view: the S&P 500's yield is backward-looking, while Treasuries yields look forward. But the S&P 500's "indicated" yield 1.46%, which is estimated from expected payouts over the next year, is not sufficiently different to alter the take on the data. Call it even-stevens, then, at least for income. But what about capital gain?

Figure 1: Comparative Yields: U.S. Stocks, versus U.S. Treasuries

Yields are light everywhere, but Treasuries once again are providing more income than dividends



From 12.31.93 to 02.04.22. Yield for S&P 500 Index is calculated using the trailing 12-month dividend of the SPDR S&P 500 ETF Trust (SPY), an ETF that tracks the S&P 500 Index. SOURCE: SRCM using data from Bloomberg

Missing a Point

Of course, the potential for capital gain is superior for equities. It's a point we make regularly on these pages, accepting that the more equity that we add to a portfolio, the greater the expected longer-term return. But there's a flip-side to that expectation, one that parallels the stronger rationale for having bonds in a portfolio in the first place: their generally greater stability. As we show in Figure 2, bonds are not without risk, but their declines tend to be far less oppressive than those experienced in equities, with the largest experienced to date less than a quarter the decline that stocks experienced during the Great Financial Crisis[1].

Figure 2: Top 10 Drawdowns of Stocks and Bonds

Stocks			Bonds		
Duration	Trough	Drawdown (%)	Duration	Trough	Drawdown (%)
10.10.2007–04.02.2012	03.09.2009	-55.22	08.31.1979–05.30.1980	02.28.1980	-12.74
09.05.2000–10.23.2006	10.09.2002	-47.42	07.31.1980–11.30.1981	09.30.1981	-9.00
02.20.2020–08.10.2020	03.23.2020	-33.79	01.31.1994–03.10.1995	05.09.1994	-6.56
08.26.1987–05.15.1989	10.19.1987	-32.93	03.10.2020–06.26.2020	03.19.2020	-6.30
12.01.1980–10.07.1982	08.12.1982	-20.16	09.10.2008–12.15.2008	10.31.2008	-5.08
09.22.1976–08.15.1979	03.06.1978	-19.41	03.31.1987–12.31.1987	09.30.1987	-4.90
09.21.2018–04.12.2019	12.24.2018	-19.37	02.29.1984–07.31.1984	05.31.1984	-4.88
07.17.1990–02.11.1991	10.11.1990	-19.19	05.03.2013–05.08.2014	09.05.2013	-4.87
07.20.1998–11.23.1998	08.31.1998	-19.19	06.16.2003–01.13.2004	08.14.2003	-4.65
02.14.1980–06.18.1980	03.27.1980	-16.71	03.18.2004–09.14.2004	05.13.2004	-4.56

Daily total return data for the S&P 500 Index (Stocks) from 03.31.1976 through 01.31.2022. Monthly total return data for the Bloomberg U.S. Aggregate Index (Bonds) through 12.31.88, with daily data through 01.31.2022. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. Drawdown may be measured as the maximum loss from a prior peak value or the length of time the portfolio requires to return to breakeven after a prior peak. Indexes are unmanaged. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Bloomberg

Steadier, Perhaps. Not Much

Often countering that 'stocks are risky' notion is the proposition that dividend-paying stocks are more stable than non-dividend-payers. And depending on how the specific investment is defined (e.g., individual stocks and/or funds) and how one measures stability, that can be true. We reviewed several dividend-focused ETFs for their volatility, versus the broader market. While each of the ETFs had the word dividend in its name, the methods by which the dividend-paying stocks were included in each portfolio were different. Some variously focused on higher-yielding stocks, while others were more selective still. Nonetheless, each generally was less volatile than the ETF representing the broader market as measured by standard deviation, which is a statistical metric that describes the variation of a set of data about its average. A higher number reflects more variation (or volatility). We chart those data in Figure 3. Note that we leave out any specific mention of the ETFs utilized. This is so that none is perceived as an investment recommendation.

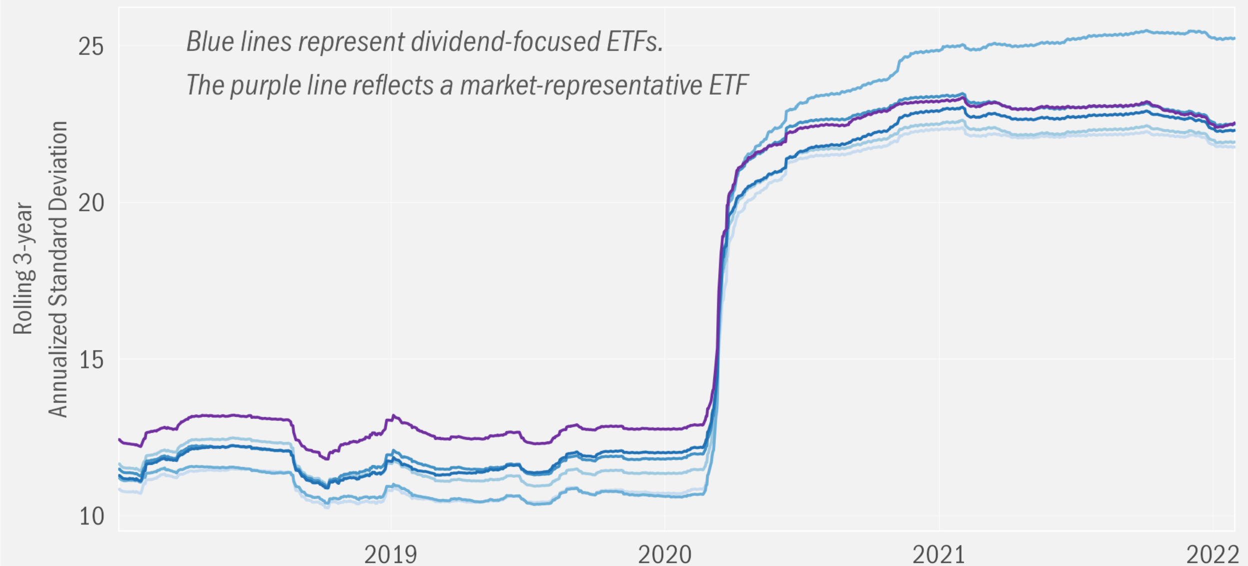
But that potentially modestly lower volatility among dividend-focused strategies doesn't bridge the gap to the still much less volatile bonds. A different perspective on risk further supports that thought. In Figure 4 we look at risk in terms of drawdown, or extended losses. Using that same set of ETFs, but this time looking at their respective losses from prior peaks, we see that several performed worse than the market during the drawdowns of 2018 and 2020. Not only that, many saw recoveries that progressed more slowly than the market (you can see that the blue lines stay lower for longer

[1] To be fair, the fixed income index only presents monthly data across some of its worst declines, so the actual declines using daily data (were they to exist) might have been worse. Even so, we think a read of the relative magnitude of the two sets of declines likely would not be materially different using daily data for the whole series.

after the deeper drawdowns). Investors most certainly should consider the potential that dividend-focused strategies may result in performance markedly different than the market and investor expectations.

Figure 3: Volatility Comparison: Dividend Payers, versus the Market

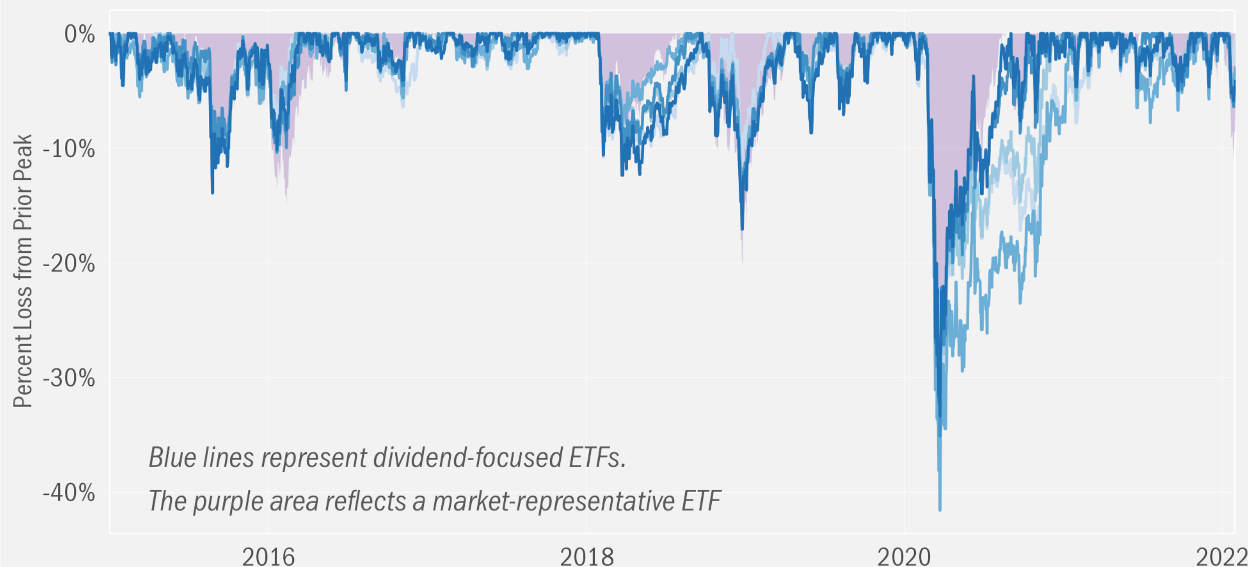
Standard deviation is a measure of risk: a higher number means more risk. These particular dividend-focused ETFs mostly-not all and not always-have expressed lower volatility than one reflecting the broader market



From 12.31.14 to 01.31.22. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. Standard deviation is a statistical metric that describes the variation of a set of data about its average. A higher number reflects more variation (or volatility). The choice of these or any ETFs are not intended as an investment recommendation and should not be considered as such. SOURCE: SRCM using data from Bloomberg

Figure 4: Drawdown Comparison: Dividend Payers, versus the Market

These particular dividend-focused ETFs have seen drawdowns that have been as or more negative and/or longer in duration than one reflecting the broader market



From 12.30.14 to 01.31.22. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. Standard deviation is a statistical metric that describes the variation of a set of data about its average. A higher number reflects more variation (or volatility). The choice of these or any ETFs are not intended as an investment recommendation and should not be considered as such. SOURCE: SRCM using data from Bloomberg

Not Just a Dividend Focus

That note brings us to our final point with regard to dividend-focused investment strategies: many tend to look a lot like Value strategies. And that should make sense. After all, Value stocks generally are defined by price ratios, and dividend yield, which is the dividend per share paid by the company divided by the price per share, is exactly such a measure. It works in the opposite direction as most others, such as price-to-book value and price-to-earnings, where higher means more expensive. For dividend yields, a higher value means the stock can be seen as less expensive, since it means more income for the price paid.

So, when we performed our historical review of the select dividend-focused ETFs, we saw that their performance metrics often had a lot in common with those of Value-focused indexes. Likely reflective of that Value factor orientation, many dividend-focused ETFs have underperformed the broader market over the past several years as Growth stocks took charge. That's not surprising to us and we are by no means opposed to a Value orientation when it comes to investing. But having that knowledge can help investors more properly establish expectations for future performance.

An Ingredient in the Soup

As readers likely know we aren't huge fans of single-factor exposures within a portfolio, as we are rather more interested in sprinkling into a portfolio mix a diversity of stock characteristics that have demonstrated relatively stronger performance in history. Dividend paying stocks, being a subset of Value stocks, in turn being a subset of the multifactor approaches we tend to incorporate into our portfolios, are certainly among those characteristics. They just aren't the only characteristic.

The thought brings us back to the notion that investors should be careful to understand the characteristics of the exposures they intend to include in their portfolios. And those characteristics should be placed in the context of the broader goals for the portfolio. Those goals likely will include a mix of growth, income and preservation in varying amounts that change through time. Portfolio exposures may be tailored to emphasize each of those and other goals as appropriate to individual client situations.

With that in mind, we've sought to demonstrate that dividend-focused strategies likely are not entirely suitable substitutes for bonds in a portfolio where aggregate portfolio risk matters, even though they might still be offering yields in excess of U.S. Treasuries. Such strategies tend to express day-to-day volatility not substantially different than the overall market, while also not providing much, if anything, in the way of downside protection during market crises. When seeking to bolster portfolio income, then, we think substituting dividend payers for non-payers in the stock component of the portfolio might be part of a more defensible approach that leaves the job of providing greater portfolio stability to bonds and true bond substitutes.

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