

# INVESTMENT INSIGHTS

October 2011

## Dividends: For both income and total return growth



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### Introduction

*High dividend paying stocks offer two things to the investor: a source of income that currently exceeds that available from US, UK and core-eurozone government bond markets, and, secondly, a valuable source of total return in an environment of uncertain capital growth. Longer term, it is through the reinvestment of dividends that value tends to outperform growth stocks. When investing for dividends, it is important to think globally to maximise the opportunity set of the most useful of stocks: those with both a high yield and an increasing dividend.*

### For the income seeker

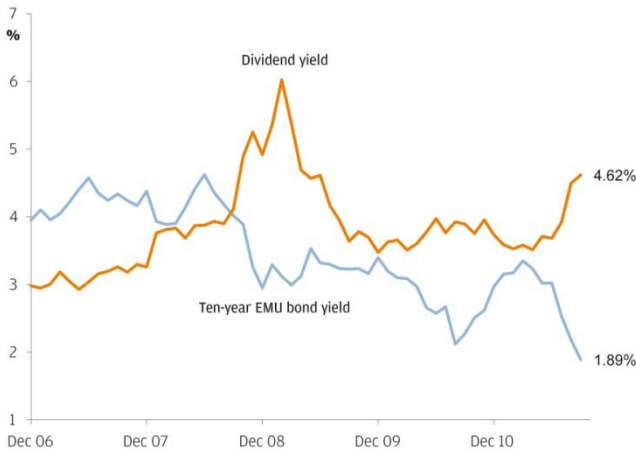
Investors looking for income have traditionally sought the security of risk-free government bond markets, which preserve the nominal value of the underlying capital and – when inflation is lower than the bond yield – offer real capital growth. But with yields on the most favoured government bonds currently below inflation, and so delivering a negative real yield, many income seekers are today looking to the equity market to provide an attractive level of income.

**Exhibit 1** shows the dividend yields from major blue-chip stock markets in the developed world, against the yields from comparable government bond markets, since January 2006. The traditional relationship, which existed in all the major markets over prior decades, was for the dividend yield to be lower than the government bond yield to compensate for the capital gain offered by holding equity. But as the charts show, this has been inverted – in some cases sharply – in recent months.

This suggests that the financial markets are perhaps pricing in a recession throughout the developed world: stock markets, by reducing share prices (and so increasing dividend yields), and core government bond markets by driving up the price of risk-free income (and so decreasing the bond yield). Quantitative easing, and other monetary measures from the major central banks, have also contributed to bond yields being lower than they would otherwise be.

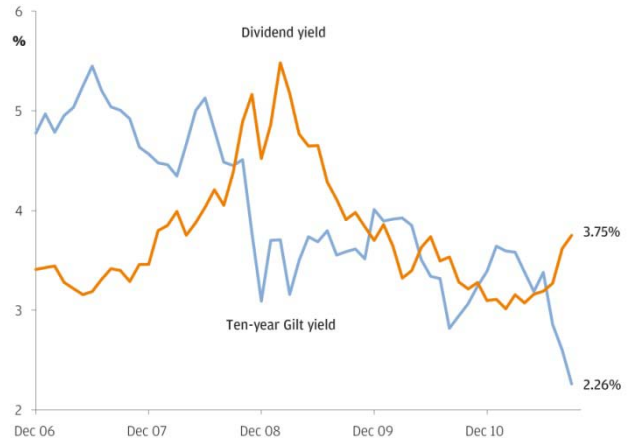
Exhibit 1

MSCI EMU yield vs EMU bond yield



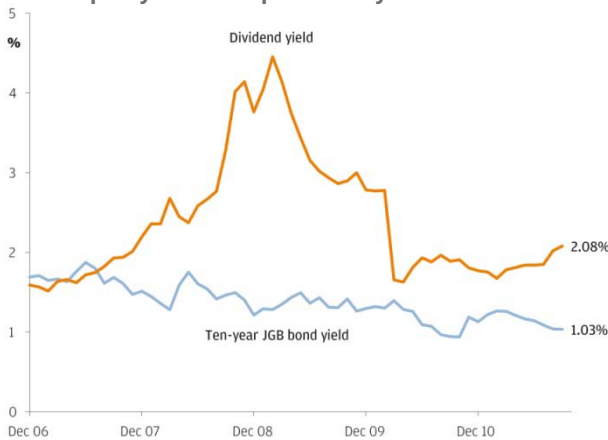
Data as at September 2011. Source: MSCI, Tullet Prebon Information, J.P. Morgan Asset Management.

FTSE 100 yield vs UK gilt yield



Data as at 30 September 2011. Source: FTSE, Tullet Prebon Information, J.P. Morgan Asset Management.

MSCI Japan yield vs Japan bond yield



Data as at September 2011. Source: MSCI, Tullet Prebon Information, J.P. Morgan Asset Management.

MSCI world Index value total and price return



Note: Indexed to 31 December 1990. Data as at 30 September 2011. Local currency returns. Source: MSCI, J.P. Morgan Asset Management.

In the eurozone the gap between dividend and bond yields is widest, at 273 basis points, with the dividend yield of the MSCI EMU Index at 4.62%, compared to the yield on the ten-year EMU bond of just 1.89%. This reflects the greater risk of a eurozone recession beginning during the current quarter, led by Germany and Italy.

However, J.P. Morgan forecast that any eurozone recession will be shallow, with the region losing just 0.5% of GDP in 2012.

Consensus forecasts for the developed world as a whole suggest anaemic, low, but *positive* GDP growth in aggregate over the next twelve months. For example, J.P. Morgan is forecasting developed market growth to fall to an annualised low of 0.3% during the first quarter of 2012 over the previous quarter, before rebounding to 1.5% by the third quarter of 2012.



Therefore **Exhibit 1** suggests to us a mispricing. Not so much regarding core government bonds (ultra low yields would be appropriate for a prolonged period of low growth and declining inflation forecasts), but regarding higher yielding equities, particularly given the lack of alternative income sources.

Furthermore, we should remember that high dividend paying stocks are usually found in the defensive sectors most able to withstand negative macroeconomic shocks, and also that the stock market indices that we use in **Exhibit 1** will include no, or low, dividend paying stocks.

For capital growth

'Value outperforms growth in the long term', so the saying goes and as we will demonstrate. How is this achieved? Through re-investing dividends, which tend to be higher in value stocks than the no or low dividend payouts from growth-orientated companies. With the additional effect of compounding, dividend reinvestment leads to a substantial hurdle rate over long periods of time for growth-orientated stocks to overcome.

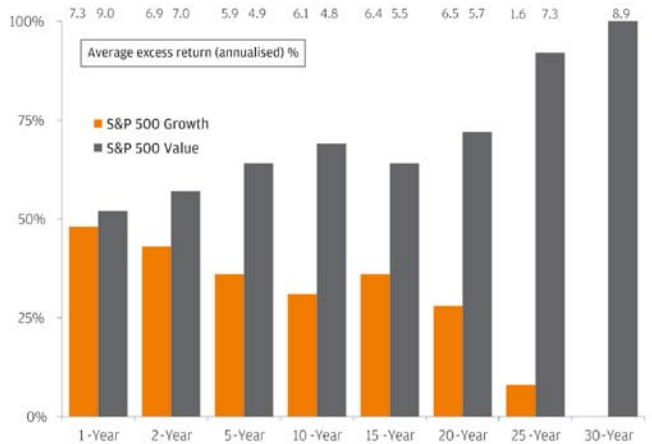
The effect of re-investing dividends over a sustained period gives a powerful kick to total returns, as **Exhibit 2** shows. The return on the MSCI World Index is 57% greater when re-investing dividends since 1991. If we just look at higher dividend paying stocks, using the MSCI World Value Index as a proxy, the difference is 77%.

Exhibit 2 – MSCI World index total and price return



Note: Indexed to 31 December 1990. Data as at 30 September 2011. Local currency returns. Source: MSCI, J.P. Morgan Asset Management.

Exhibit 3 – Growth and value since 1975



Note: Chart shows percentage of times one index has outperformed the other with rolling time periods since 1975. Latest data as at December 2009. Source: Bloomberg, J.P. Morgan Asset Management.

**Exhibit 3** demonstrates value outperforming growth, based on the S&P 500 from 1975. It shows that the longer one invests the more likely it is that value will outperform growth, thanks in large part to the reinvestment of dividends. It shows the percentage of times that the S&P 500 Value index has outperformed the S&P 500 Growth index, over different rolling time periods.

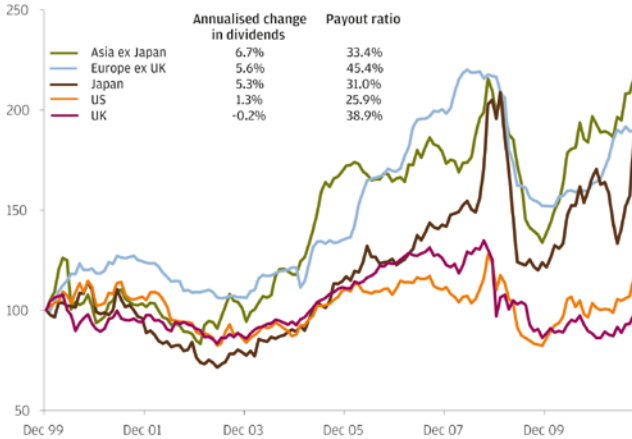
We can see that, for instance, in all the rolling two year periods between 1975 and 2009, value outperformed growth around 55% of the time with an average annualised excess return during those years of 7.0% over growth, compared to an excess of 6.9% by the growth index over the value index during the periods when growth outperformed. For the handful of 30 year periods available, there were no cases of growth outperforming value and the annualised outperformance of value over growth was 8.9%.

Dividends are a global phenomena

It used to be the case that stock markets in the UK and the US offered higher dividend *payouts* than Asian and continental European markets. This reflected a number of factors specific to the UK and the US, such as an older and more established equity culture that rewarded investors with dividends. Companies in continental Europe and Asia, in contrast, have historically tended to be financed more through debt with the majority of a company's equity held by founding families.



Exhibit 4 – Dividend growth 2000 to present



Note: Regular dividends only in Euro. Data as at 30 September 2011. Source: MSCI, J.P. Morgan Asset Management.

But as **Exhibit 4** shows, payout ratios today in continental Europe are higher than in the UK and the US, with the US the least generous payer of the regions shown. This reflects the structural changes that have taken place in the laggard regions. In continental Europe the European Union and globalisation have forced companies to run their assets more efficiently and to reward minority shareholders. In Asia, the financial crisis of 1997 and 1998 triggered a change in the management of many companies, from families to technocrats. With this came a fresh approach to using equity as a source of funding and improvements (as in Europe) to the treatment of minority shareholders.

The sharp increase in dividends from non-Anglo Saxon countries is clearly shown in **Exhibit 4**, with the Asia ex Japan region showing an annualised growth of 6.7% since December 1999, followed by Europe ex UK at 5.6%. The UK has actually seen a slight fall in dividend payout, at -0.2%, although it should be stressed that our chart excludes special one-off dividend payments (since they are by definition not reliable as a source of income).

## Conclusion

This paper set out to show the dual role of dividend paying stocks in a portfolio: to provide income, particularly in a world of very low interest rates and core government bond yields, and to provide a valuable source of total return over long investment horizons.

Dot com bubble-style rallies in growth stocks will come and go, producing outperformance for periods of time. But large cap, dividend paying value stocks will always be in fashion for the long-term investor because over the longer term they are likely to outperform thanks to the reinvestment of those dividends.

**Tom Elliott**, *vice president*, is a global strategist within the Investment Marketing Team at J.P. Morgan Asset Management, responsible for investment communications through the Guide to the Markets suite of products. An employee since 1995, he worked in the Global Multi-Asset Group (GMAG) until 2006 and before that he was head of the Investment Writing Team. Previously, he worked at Euromoney Publications as a feature writer for a year and prior to that he spent four years at Greig Middleton & Co. as a graduate trainee and securities analyst. Tom obtained a BA in History from Sussex University and an MSc in Economic History from the London School of Economics.

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