Monthly Commentary 3rd of April 2024

Global equity markets ended the first quarter on a high note. In the US, optimism over the economy and interest rate cuts combined with exuberance about the business opportunity in artificial intelligence to stir up a booster cocktail for equities. The S&P 500 , MSCI Euro and Nikkei 225 indices all had considerable gains for the first quarter, their best in 5 years. Only the UK equity market lagged its peers with a return of “only” 2.84%, mostly due to the absence of technology. The quarter's rally became a buy-everything frenzy. From Oil and Gold to the dollar and Bitcoin, all finished the quarter with double digit returns. On the other hand, and despite their monthly gains bonds finished the quarter slightly negative. While rates have probably peaked for this cycle, as attention turns toward rate cuts in response to softer growth and easing inflation. This will once again create an opportunity for bonds.

The Dividend Fallacy

There is widespread belief, especially among retail investors that buying and holding equities that have high dividend yields is a sound investment strategy. The idea is that “they do not look at price movement, as long as they get recurring and predictable income”. There is a huge marketing machine that espouses high dividends, as it is a very easy sell in the finance community.

In our view, this is not a strategy that is beneficial in the long term. As we shall show, it is far more rewarding for investors to invest in companies that have much smaller dividend yields but where management have a proven track record of growing their dividends year after year. We refer to these stocks as “dividend growers”, as opposed to “high dividend stocks”.

To start with let us put some perspective. In the US market, the average company in the S&P 500 has a dividend yield of 1.32% (as of March 25). A high dividend yield would be more than 3%, while there are many companies that pay more than 4%. The UK market is especially “liked” by unsuspecting retail investors because of its high dividend yield, be it the current 3.79% of the FTSE 100 companies, or the multiple investment trusts that often use leverage to juice up their dividends. Does anyone look at their performance?

An obvious argument against investing in such companies is why do they pay such a high dividend when they can spend their money on capital expenditure, research & development or acquisitions, all with a view to increase shareholder value? Have management run out of ideas for more efficient capital allocation? Of course, it is the dividend payout ratio that matters, rather than the absolute yield, but it is mostly the case that high-dividend-yield equities have larger payout ratios than those paying lower yields.

The market corroborates our views in that it rewards low-yielding but dividend-growing companies with much higher performance than those with high yields. In the end, and not considering taxes, it is the total performance that counts to the investor.

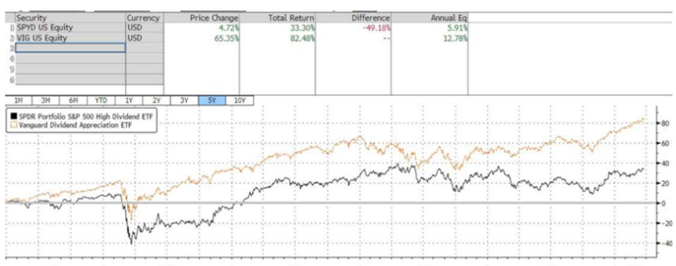
The charts on the next page make the point. We use two ETFs, one being the Vanguard Dividend Appreciation ETF (ticker VIG) and the other the SPDR S&P 500 High Dividend ETF (SPYD). VIG currently has a modest 1.69% dividend yield whereas SPYD sports one that is more than double at 3.69%. To the inexperienced investor who seeks income, it is almost a no-brainer to choose the second.

We compare VIG to SPYD over 1, 5 and 10 years. As you can see, the total return is much higher with VIG, which outperformed SPYD by a massive 7.84%, 6.87% and 4.33% **ANNUALLY**. Wouldn't an income investor prefer to have the money in their pockets rather than buying high-yielding "dogs"? We see no reason that the future should be any different.

SPYD vs VIG 10Y (4.33% annual difference)

Source: Bloomberg

SPYD vs VIG 5Y (6.87% annual difference)



Source: Bloomberg

SPYD vs VIG 1Y (7.84% annual difference)

Source: Bloomberg

As an example of individual companies, we compare 3M (MMM), considered a blue chip industrial company with Linde (LIN), also a blue chip company. 3M pays a current yield of 5.77% while Linde's is 1.19%. We use Linde in our Best Ideas portfolios but not 3M. The total return difference is huge.

MMM vs LIN 5Y (32.8% annual difference)

It is no coincidence that we use 7 out of the top 10 companies in VIG for our Best Ideas portfolios and zero out of the top 10 companies in SPYD. See below:

7) Top Fund Hlds | HLDR »	Net Fund	7) Top Fund Hlds | HLDR »	Net Fund
11) Microsoft Corp	5.540%	11) Iron Mountain Inc	1.443%
12) Apple Inc	4.198%	12) Ford Motor Co	1.429%
13) JPMorgan Chase & Co	3.289%	13) Citigroup Inc	1.422%
14) Broadcom Inc	3.275%	14) Hasbro Inc	1.417%
15) UnitedHealth Group Inc	3.088%	15) Public Service Enterprise Grou	1.412%
16) Visa Inc	2.721%	16) ONEOK Inc	1.395%
17) Exxon Mobil Corp	2.687%	17) Williams Cos Inc/The	1.367%
18) Johnson & Johnson	2.495%	18) 3M Co	1.354%
19) Mastercard Inc	2.442%	19) Prudential Financial Inc	1.348%
20) Procter & Gamble Co/The	2.427%	20) Best Buy Co Inc	1.347%

Top 10 VIG Top 10 SPYD

We hope the above analysis will make you think twice before jumping onto high-dividend equities just because they provide a high level of income.

The Elgin Analysts Team

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