Equity returns and dividends: it depends on the market phase

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To most people, the notion of the performance of shares relates to changes in the share price. This does not take into account the second component of return, i.e. the dividend. Simply looking at the share price development seems too one-sided to me. After all, dividends may account for up to a third of total return, as is the case for example for the shares listed on the Vienna stock exchange. However, shares with strong dividends do not generate the highest total return in every phase of the market.

Dividends are more important in a bear market

Globally speaking, dividends account for about a fifth of total return. Over time, this share has remained relatively stable. In difficult phases on the stock exchange, dividends may constitute the only return when share prices are not increasing.

Dividend income plays an important role on all stock exchanges

Source: Thomson Reuters Datastream

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Total return including dividends twice as high as share price performance alone in the long run

In a long-term comparison, dividends are of great importance. In the past 40 years, total return has been more than twice that of share price gains alone – provided of course that dividends are re-invested.

The performance is calculated in accordance with the OeKB method. It does not include fees or taxes (except 28% tax on dividend yields). However, the illustration is net of the one-off load, which falls due at the time of purchase, and of other fees that reduce the return as well as of the individual account and deposit fees. Past performance is not a reliable indicator of the future performance of a fund.

Cost-average effect on the basis of re-invested dividends

Investors benefit from anti-cyclical strategies especially in phases of strongly fluctuating prices with heavy corrections or setbacks. When prices are falling, the reinvested dividends buy you more shares. Investors fully benefit from this so-called cost-average effect. This of course requires investors to re-invest their dividends immediately without waiting.

Depending on the performance of the investment fund, the performance of an s Fund Plan will differ from that of a one-off investment (higher or lower). A loss of capital is possible in both cases.

Dividends as inflation protection

In contrast to coupon payments by bonds, dividend payments rise continuously. On average, the companies in the MSCI World Equity index have stepped up their dividends by 5.2% per year. This means that dividends have increased by a factor of 10 over a period of 40 years. From the 1970s to far into the 2000s, dividends offered excellent protection against inflation. Since the financial crisis, dividends have increased even more significantly than inflation.

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High-dividend shares – a question of style?

The importance of factors/styles has increased drastically in the past years again. In addition to "high dividend" (i.e. shares with high dividend yields), "value" (shares with low valuation metrics), "quality" (shares with features of high quality), "momentum" (shares that have outperformed the market in the past) and "small caps" have become popular among investors.

I am not happy with the term "high dividend" as style. The group of such dividend shares is very heterogeneous: some belong to the value category, some to quality.

The risk/return profile yields the following picture:

Source: Bloomberg

Quality shares improve the risk/return ratio

High-dividend shares have slightly outperformed the MSCI World Equity index in the past 15 years. However, the risk was higher. If one wanted to improve the risk/return ratio over the past years, one would have had to focus on quality shares, i.e. companies with high profitability, low gearing, and stable earnings development. Some high-dividend shares belong to this category, but not all of them. In particular, financials and commodity shares tend to not fulfil these criteria.

Lower risk does not mean lower return

The performance of the "minimum volatility strategy" in the past 15 years is interesting. It refutes the academic assumption that the reduction of risk entails lower returns. If as an investor you are considering investing in funds that pursue a high-dividend strategy, you will want to look carefully at what the fund management team does: does it focus on quality shares with stable dividends? Or do cyclical companies, i.e. those with strongly fluctuating earnings, also play a role? Or is the fund management team indeed trying to embed a minimum-volatility component into the fund?

This, for example, is the case for ERSTE RESPONSIBLE STOCK DIVIDEND, a sustainable dividend share fund from ERSTE-SPARINVEST's range of funds. The fund focuses on companies with strong dividends, high quality, and below-average volatility. This means the fund is defensively structured. In phases of downturns, this fund focuses on cutting losses. In bull markets such as we have seen in recent years, it underperforms funds that focus on growth (such as the ESPA STOCK GLOBAL). This feature is supported by the analysis of the investment style.

Differences in performance: before or after the financial crisis

While high-dividend shares have outperformed the market slightly in the past years, they have failed to match the performance of the other popular styles, particularly in the past five years. Since the financial crisis in 2008, mainly quality and momentum shares have outperformed the market significantly. Prior to the financial crisis, value shares were the top performers. A dividend strategy could have been successful across the entire observation period of 15 years. However, this kind of investors would have had to focus on commodity shares with high yields prior to the crisis. After the financial crisis, defensive consumer goods or healthcare shares would have been better. It is easy to see that the minimum-volatility strategy works best during times of crises on the markets. Given that there was little in the way of crisis on the equity markets from 2016 to 2018, the minimum-volatility strategy could not match market performance during that time.

Source: Bloomberg

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In summary, investors focus on different segments of high-dividend shares during different market phases: in a difficult phase (weak economy), dividend shares from the consumer goods and healthcare segments will perform better. When the economy is strong and interest rates are rising, financial and commodity shares will have the edge. It is this heterogeneous composition of the high-dividend segment that makes it difficult to treat it as one group.

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