Global dividends

Weighed and found wanting

Investors at Belshazzar's Feast

DUNDAS GLOBAL INVESTORS

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In 1980 Alan got his first investment job in the Edinburgh office of a UK private equity company, where he spent three years learning how businesses deal with deep recession and high interest rates - lessons etched for life.

Since then he has managed global and international equity portfolios for institutional investors around the world.

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Investors at Belshazzar’s Feast

The biblical story of Belshazzar’s Feast has given the English language two vivid phrases still used today. The best known, derived from the story without appearing in the Bible, is up to date enough to be the latest James Bond theme song:-

‘...the writing’s on the wall...’

The second, less often used, is just as powerful and is shown below as it appears in the Authorised Version of the Bible, commissioned by King James VI of Scotland & I of England, published in 1611:-

‘...thou art weighed in the balances, and art found wanting...’

The summary of Belshazzar’s story is this. Two thousand five hundred years ago he was king of Babylon, located in modern day Iraq. One night as he feasted with a thousand guests, the fingers of a man's hand appeared and wrote on the palace wall in a language that no-one present could translate. The queen called for Daniel, a member of the captive Israelite minority who, despite his ethnicity, had risen to become the chief advisor to Belshazzar’s father but was now retired from public life. Daniel translated the writing on the wall. It predicted Belshazzar’s imminent downfall; he was murdered that night.

Dividends’ dominant role in long run global equity return, set out in our recent paper ‘*Dividends – the long run drivers of equity investing*’, is confirmed by the 2015 edition of London Business School’s *Global Investment Returns Yearbook*‘;

‘...dividend yield has been the dominant factor historically. This may seem surprising since on a daily basis, investors’ interest tends to focus largely on the capital gains element of returns, namely, share price and market movements. Indeed, over a single year, equities are so volatile that most of an investor’s performance is attributable to capital gains or losses. Dividend income adds a relatively modest amount to each year’s gain or loss. But while year-to-year performance is driven by capital appreciation, long-run returns are heavily influenced by reinvested dividends. The difference in terminal wealth arising from reinvested income is very large.

The longer the investment horizon, the more important is dividend income. For the seriously long-term investor, the value of a portfolio corresponds closely to the present value of dividends. The present value of the (eventual) capital appreciation dwindles greatly in significance.’

The common meaning of many English words has changed since 1611. Today, *wanting* is synonymous with *desiring*. Back then, it meant *lacking*. Belshazzar was found wanting because he didn’t measure up as a monarch.

Long term investors want dividends. So our equity research must distinguish between those stocks capable of sustained dividend growth and those at risk of being found wanting.

That’s the writing on the wall that we have to translate.

Weighed and found wanting

At the end of Q1 2016 just over half of global dividends were produced by five of the ten big industry groups within the MSCI ACWI. In four of them, dividend distributions exceed 50% of net income. The fifth, Financials, generates a quarter of global dividends.

MSCI GICS sector	*% of global dividends*	*% of global capital*	*Pay-out ratio %*
Energy	11	7	208
Materials	5	5	75
Utilities	5	3	63
Telecommunications	6	4	70
Financials	25	21	41
Total	**52**	**40**	

Source: MSCI.

In the 12 months to Q1 2016, Energy and Materials, sectors dominated by big oil and big mining, produced 16% of global dividends. These companies' revenues depend upon volumes shipped and prices realised, so collapsing commodities have hit them hard. Many have already cut their dividends but the Energy sector's 200%+ pay-out ratio tells us there's more to come. Absent sustained recoveries in commodity prices, the medium term dividend outlook for these two sectors is grim.

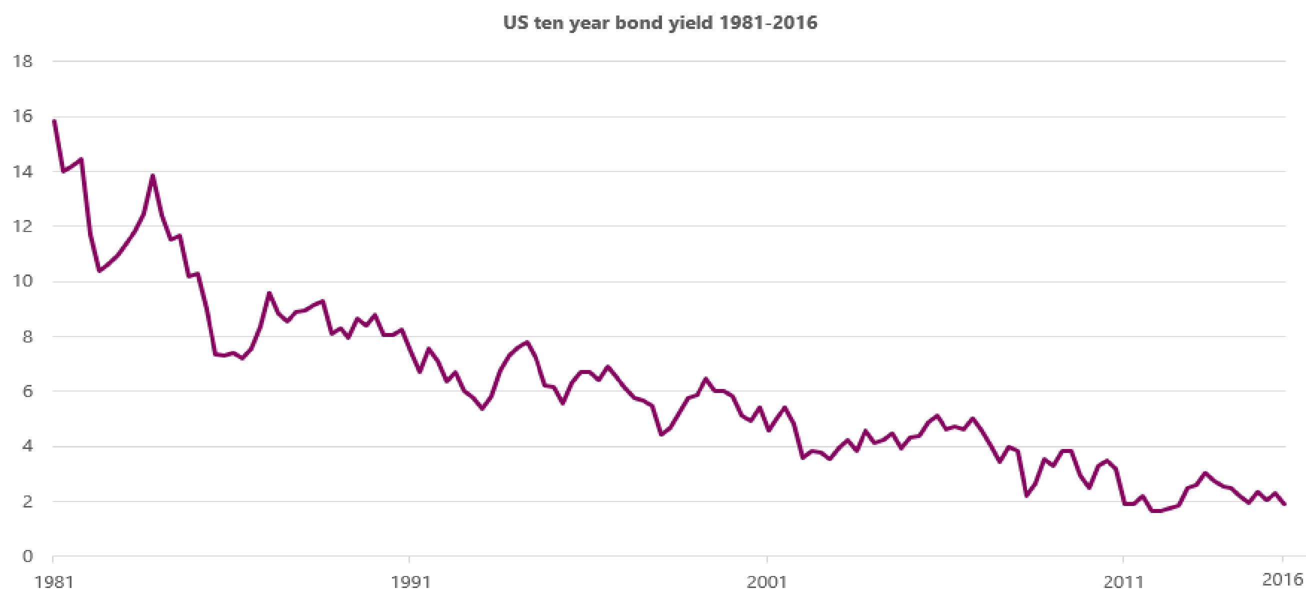
Utilities and Telecommunications stocks, together 11% of global dividends, must confront the consequences of years of over-distribution when too high a share of post-tax profits was paid out via dividends and buy-backs, making them an irresistible financial feast for yield-hungry investors. In both sectors, the need for capital investment must take precedence over distribution. The Telecommunications sector's average pay-out ratio of 70% shows that boards and management have treated these stocks as cash cows to be milked for dividends and buy-backs. Now they face big upgrade programmes to feed their customers' insatiable appetite for online and wireless services. Many power generating Utility companies need large scale investments in renewables at a time when the existing stock of generating assets is in poor condition.

A slowdown or reduction in dividends from these four sectors, together 19% of global market cap and 27% of global dividends, would be serious enough, but the big question rests with the big sector, Financials.

The writing on the wall

At first glance, Financials' 41% pay-out ratio looks reassuring. Banks, real estate companies, investment managers, insurers, brokers and others thrive when asset prices rise, interest rates fall, securities trade, credit demand grows and money is saved for lending and/or investment; in short, the conditions that have prevailed through much of the past 35 years.

The golden thread running through the sector's expansion since the late 1970s has been the long decline in global interest rates illustrated in the chart of US Ten Year Treasury yields. At the outset, central banks jacked up policy rates to attack chronic inflation. Helped by other factors - such as OPEC's disarray – this worked. Inflation ebbed and interest rates began their downward glide.



Source: Bloomberg.

Whenever the banking sector faced a crisis - of its own making or not - central banks cut rates and injected liquidity to avoid defaults. The response to the 2007/09 crisis is often described as a bail-out and some banks were of course helped to jettison toxic assets. However, it is more accurate to say that the entire banking system was buoyed up on an ocean of central bank-created liquidity.

Since then big western banks have reported significant profit 'growth' due entirely to this policy's beneficial effects. Rock-bottom interest rates cut the banks' funding costs faster than they reduced their customers' borrowing charges. Loan-loss provisions shrank as the monetary gush lifted the value of the assets securing bank loans. Profits 'grew' because costs and risks were supressed by central bank policy.

So the obvious question lies with the resilience of banks' profits if rates increase. Some banks are telling their investors that an increase in rates would boost their profits but, for the wider system, the risk lies with borrowers' financial health in such an event.

But what if rates keep falling? Policy rates and/or bond yields are already negative in economies representing more than 20% of global GDP. Inflation might be bad but for banks deflation is vile, cutting the value of assets upon which loans are secured and shrinking the nominal value of transactions. Falling energy and commodity prices have already triggered increased loan loss provisions. The dark concern lies with residential mortgages, the biggest part of most western banks' loan books.

So a 41% pay-out ratio offers little comfort if the 'profits' from which the industry's dividends are paid rest upon exceptionally benign but untenable interest rate and monetary policies.

Time for translation

The dividend outlook is deteriorating for the five sectors discussed in this paper. Taken together, the factors highlighted - falling commodity prices, over-distribution, rising internal investment demands and the impact of benign but untenable interest rate and monetary policies - weigh heavily upon companies producing half of the world's dividends.

Global equity markets stopped falling in March 2009; since then they have doubled. In the same period, yields on US Ten Year Treasuries declined by 38%, from 2.9% to 1.8%. Australian Ten Year yields fell 56% - almost modest when compared to the 96% collapse in German yields.

The evaporation of interest income created a thirst for high-yielding equities. But this party has been running for a long time. It's time to check the writing on the wall.

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