FINDING OPPORTUNITIES IN THE PROS WHILE MITIGATING THE CONS OF HIGH-YIELDING EQUITIES

by Isaac Braley, President and Co-Portfolio Manager, BTS Asset Management

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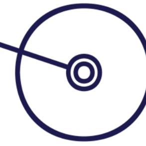
In BTS' view, high-yielding equities certainly have a place in most investor's portfolios, but managing the risks these securities may bring to a portfolio is essential. Warren Buffett once said, "We all hope for capital gains, but the only thing we can really count on is the dividend." This is a very true statement until it is not, as not all companies may be able to hold this maxim true. Many companies paying very high yields may be at risk of cutting these dividends and seeing further price declines. There are numerous Pros and Cons of investing in high-yielding equities. Some are outlined in the table below:

1. Steady Income
2. Inflation Hedge
3. Historical Stability
4. Attractive Total Returns
5. Tax Advantages
6. Share Accumulation Tool
7. Diversification
8. Compounding Returns

1. Risk of Dividend Cuts
2. Interest Rate Sensitivity
3. Price Declines
4. Growth Potential Limitation
5. Organizational Health
6. Opportunity Costs
7. Mindlessly Purchasing for Yield
8. Liquidity Risks

Based on these pros and cons, in BTS' view, it is paramount that we balance our search for Yield with strong diversification and strong fundamental analysis. As investors look to generate regular cash flow, high-yielding equities may be an excellent diversification tool to introduce to the portfolio. Risk mitigation needs to be a heavy part of the analysis to reduce the risk of investors catching a falling knife. Understanding the importance of analyzing certain vital areas may significantly improve a portfolio's risk/return impact. In our view, the primary focus on security selection should be centered around some critical considerations.

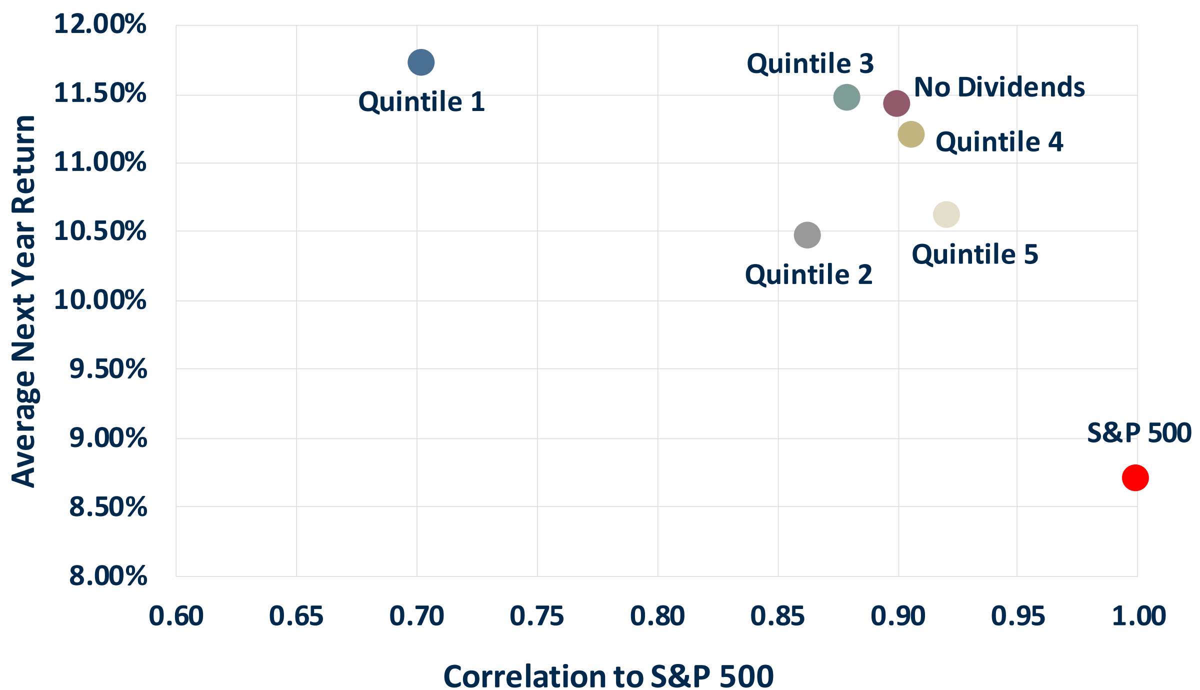


1. Financial Health of the Corporations
2. Dividend History
3. Industry Stability
4. Industry Diversification
5. Company Size

Analyzing the above considerations, as well as the four types of financial ratios, Profitability, Leverage, Liquidity, and Efficiency, may help us assess the financial health, long-term viability, and the early warning signs (both good and bad) of potential companies to invest in. But, it may be surprising how simply starting our search for a great company by looking at dividend yield alone may help increase returns and the diversification of a portfolio.

Consider breaking up the dividend paying stocks in the S&P 500 at the end of each year into quintiles based on the highest dividend yield and calculating the average next year return of the stocks in each quintile for each year. Below, we see that the average of those future, equal-weighted yearly returns may provide outperformance against the market capitalization weighted S&P 500 and may add diversification to a portfolio.

Average Next Year Return vs Correlation to S&P 500 by Quintile based on Highest Dividend Yield 12/31/1999-12/31/2023



For illustration and informational purposes only. The performance shown above is not a recreation of any BTS portfolios or products, nor a recreation of any investable product. The dividend paying constituents of the S&P 500 are divided into five quintiles based on their Dividend Yield using the constituents of S&P 500 available at the end of each year. Quintile 1 includes the top 20% of companies with the highest Dividend Yields, Quintile 2 includes the next 20% of companies, Quintile 3 includes the middle 20% of companies, Quintile 4 includes the next 20% of companies, and Quintile 5 includes the bottom 20% of companies with the lowest Dividend Yields. Each year, the quintiles are calculated with market data as of 12/31 and the Average Next Year Returns for each security in each quintile is calculated. Then the average Next Year Return for each quintile across all years is calculated and is shown above. The average next year returns for stocks paying no dividends as of 12/31 of each year is also shown. Correlation is calculated using the Next Year Returns of each quintile and for stocks paying no dividends against the yearly returns of the S&P 500 over the same periods. An investment cannot be made directly in an index.

Source: BTS Asset Management, Morningstar, and Bloomberg.

While the risk of a falling knife may occasionally affect the returns of those stocks in the upper quintiles, such as in Quintile 2, the data generally shows a trend of lower correlation and higher outperformance against the S&P 500 when looking from lower yield (bottom quintiles) to higher yield (top quintiles). The top quintile of highest yields at the end of each year, Quintile 1, had an average next year return of 11.72% with a correlation of 0.70 against the S&P 500, which returned 8.70% on average over the same years. This may serve crucial for diversification in a market increasingly dominated by growth (low dividends). The correlation between the bottom 2 quintiles, Quintile 4 and Quintile 5, had correlations against the S&P 500 of 0.91 and 0.92, respectively. The average future returns of non-paying dividend stocks, which may be even more growth-centric, also had high correlations to the market, with a correlation of 0.90 against the S&P 500.

Another point that this analysis shows is that the market capitalization weighted S&P 500 may have drawbacks when it comes to return. From BTS' experience, investors are traditionally told that investing in a total market index is the best thing to do with their money. However, looking at the average return of quintiles, which is an equal weighted return, showed that even bottom quintiles by dividend yield or stocks that pay no dividends outperformed the S&P 500's average yearly return when you considered the average or equal weighted return of those stocks. For instance, the average returns of Quintile 4 and Quintile 5 (bottom 40% of stocks by dividend yield) still returned 11.19% and 10.60%, respectively, which outperformed the S&P 500's average yearly return of 8.60%. Stocks that paid no dividends also outperformed on average, returning 11.41%.

However, to potentially take advantage of the pros and limit the cons mentioned earlier in this paper, we must deploy additional layers of analysis. The approach above may leave investors concentrated in too few sectors, thereby increasing the risk and potentially lowering the portfolio's overall return. In BTS' view, rule sets should be broadened to require better diversification. Diversifying between multiple industries can possibly help take advantage of the cyclical nature of industries. When looking at each sector, we must also understand that some types of financial ratio analysis may work better in one industry than another. Capital-intensive companies like manufacturing may need to focus more heavily on ratios like debt-to-equity than less capital-intensive industries like technology. High-growth industries may prioritize different ratios than stable or mature industries. For instance, a technology startup may focus more on return on equity and revenue growth, while a utility company may prioritize stability and dividend yield. So, once you have established high-yielding companies from each industry, you must compare the right corporate health metrics for each.

When the right metrics have been applied, you can attempt to remove or reduce the most considerable risk of a high-yield company. That is the risk of catching a falling knife. It is excellent if the Yield is big, but you are probably losing significant principle if it gets even bigger. If a company is not increasing its dividend payment and instead, the Yield is growing because the security price is declining, we have not improved the portfolio. It is essential to look for companies that have a high yield. Still, you are actually hoping that the Yield slowly comes down due to investors bidding the security price up because of the improvements in a company's underlying health.

Searching for Yield in the equity markets may bring additional sources of income to an investor wishing to create a distribution strategy or for an investor looking to grow a portfolio through further share accumulation by reinvesting dividends. No matter why you are looking to add these highly valuable securities, we must add fundamental analysis to make sure that we are giving ourselves the best opportunity to create an attractive sequence of returns.

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Definitions

A falling knife in BTS' view is a dividend paying stock that has seen an elevation in dividend yield from a large price decline and not from an increase in dividend payout.

The S&P 500 is an index that includes 500 leading companies in leading industries of the U.S. economy and is a proxy for the total stock market. Returns shown are total returns with dividends reinvested.

Correlation measures how two securities move in relation to each other.

Debt-to-Equity (D/E) Ratio is used to evaluate a company's financial leverage and is calculated by dividing a company's total liabilities by its shareholder equity. D/E ratio is an important metric in corporate finance. It is a measure of the degree to which a company is financing its operations with debt rather than its own resources.

Dividend Yield is expressed as a percentage, is a financial ratio (dividend/price) that shows how much a company pays out in dividends each year relative to its stock price.

Return On Equity Ratio is expressed as a percentage and can be calculated for any company if net income and equity are both positive numbers. Net income is calculated before dividends paid to common shareholders and after dividends to preferred shareholders and interest to lenders. A measure of financial performance calculated by dividing net income by shareholders' equity.

Profitability Ratio are financial metrics used by analysts and investors to measure and evaluate the ability of a company to generate income (profit) relative to revenue, balance sheet assets, operating costs, and shareholders' equity during a specific period of time. They show how well a company utilizes its assets to produce profit and value to shareholders.

Liquidity Ratios are used by financial analysts to evaluate the financial soundness of a company. These ratios measure a company's ability to repay both short-term and long-term debt obligations. Liquidity ratios are often used to determine the riskiness of a firm to decide whether to extend credit to the firm.

Leverage Ratios are any kind of financial ratio that indicates the level of debt incurred by a business entity against several other accounts in its balance sheet, income statement, or cash flow statement. These ratios provide an indication of how the company's assets and business operations are financed (using debt or equity).

Efficiency Ratios are used to measure how well a company is utilizing its assets and resources. These ratios generally examine how many times a business can accomplish a metric within a certain period of time, or how long it takes for a business to fulfill segments of its operations.

Fundamental Ratios are quantitative measures that are used to assess businesses.

Market Capitalization refers to the total dollar market value of a company's outstanding shares of stock.

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