The hunt for capital income continues

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→ The Ulysses-Strategy of investments (part2)

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Asia-Pacific

Content

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The hunt for capital income continues

Overshadowed by the Covid-19 pandemic, 2020 was perhaps a uniquely challenging year for investors. Interest rates remain low or even negative. More and more banks are paying negative interest on savings deposits. It has become even more difficult to identify profitable investments. Against this background, the hunt for capital income continues.

2020 was a year in which central banks around the world implemented even more expansionary monetary policies. They sought to supplement their governments' fiscal policy efforts to counteract the economic impact of the Covid-19 pandemic. This meant it was the year in which the next round of financial repression began. In effect, financial repression means that creditors help to reduce (public) debt by accepting low or even negative yields.

It was also the year in which identifying profitable investments became even more difficult. Investors are looking more and more urgently for useful alternatives. As they lose money with bank deposits and government bonds, they are hunting for capital income. That is one reason why equities have become more attractive over the last few years. The share of dividend payouts in overall capital income is increasing. However, dividends have not been completely resilient to the slowdown in economic activity. Dividends (which are distributed out of corporate profits) will not remain unaffected if corporate profits decline. We will take a closer look at the issue in this article.

See also our study **"Who is going to pay? Public debt and the low/negative yield environment"**.

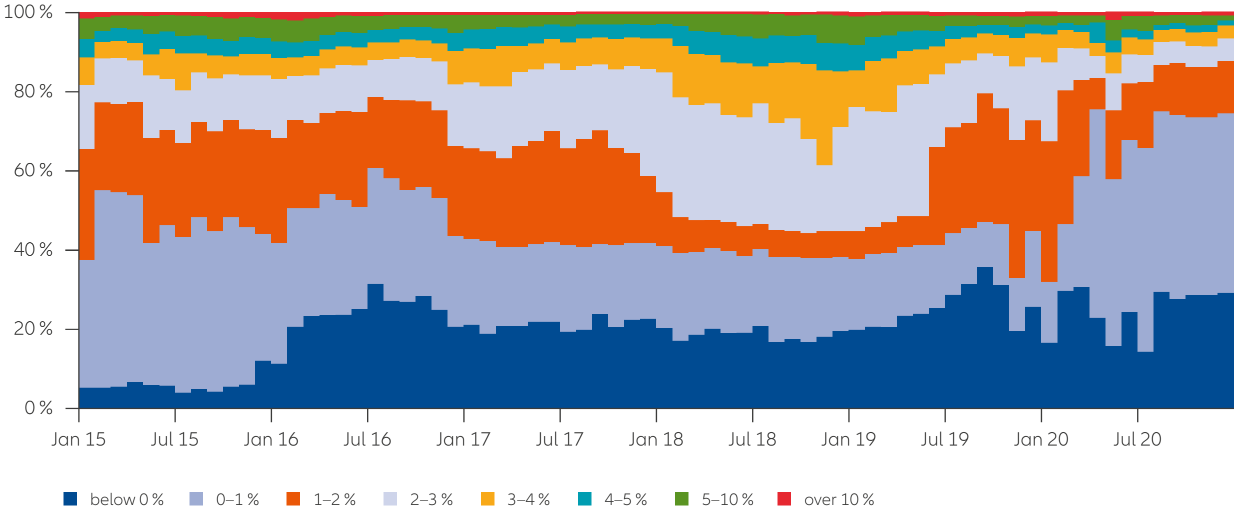
Please see our **"Capital Markets Monthly"** for our monthly capital markets update.

2020: the year of the Covid-19 pandemic

In response to the Covid-19 pandemic, central banks around the globe provided massive liquidity injections and bought huge amounts of government bonds. Investors' hunt for income has intensified further as a result. Almost 80 % of all bonds worldwide (as measured by the global bond index ICE BofAML Global Fixed Income Markets) carried yields below 1 % in December 2020. In fact, nearly 30 % offered negative yields (see Chart 1a).

Figure 1a: The global yield drought

% share of bond market capitalization per yield bucket of the ICE BofAML Global Fixed Income Markets Index



Past Performance is no reliable indicator for future performance
Source: Bloomberg, ICE BofAML Global Fixed Income Markets Index, AllianzGI Global Capital Markets & Thematic Research, Data as of December 3, 2020

In Europe, the picture is even more sobering – at least for those who hope to earn money with government bonds. In some countries, maturities of up to 30 years carry negative yields. And even if yields are positive, they are rarely higher than the rate of inflation.

Figure 1b: Negative yields are a global phenomenon

Generic government bond rates, in %

	3 M	1 Y	2 Y	3 Y	4 Y	5 Y	6 Y	7 Y	8 Y	9 Y	10 Y	15 Y	20 Y	30 Y
Germany	–0,77	–0,70	–0,74	–0,78	–0,76	–0,75	–0,74	–0,68	–0,66	–0,62	–0,55	–0,36	–0,33	–0,14
France	–0,68	–0,66	–0,70	–0,70	–0,69	–0,65	–0,58	–0,54	–0,46	–0,39	–0,32	–0,14	0,11	0,37
Italy	–0,52	–0,47	–0,41	–0,25	–0,13	0,04	0,12	0,26	0,37	0,50	0,61	0,98	1,21	1,48
Netherlands	–0,74	–0,70	–0,72	–0,73	–0,71	–0,69	–0,66	–0,61	–0,58	–0,53	–0,47	–0,39	–0,22	–0,07
Belgium	–0,68	–0,65	–0,73	–0,71	–0,69	–0,66	–0,61	–0,53	–0,50	–0,43	–0,36	–0,14	0,13	0,35
Austria		–0,61	–0,71	–0,70	–0,69	–0,67	–0,61	–0,59	–0,54	–0,48	–0,40	–0,16	–0,02	0,12
Finland		–0,71	–0,74	–0,73	–0,71	–0,68	–0,65	–0,56	–0,51	–0,46	–0,38	–0,14	–0,04	0,00
Switzerland		–0,88	–0,83	–0,81	–0,80	–0,77	–0,74	–0,69	–0,65	–0,61	–0,56	–0,42	–0,36	–0,38
Sweden	–0,24	–0,15	–0,38			–0,31	–0,23		–0,15		0,02		0,33	
Denmark	–0,58	–0,57	–0,64	–0,66		–0,60		–0,53			–0,45		–0,21	–0,02
UK	–0,11	–0,04	–0,04	–0,03	–0,02	0,01	0,05	0,13	0,20	0,29	0,34	0,57	0,86	0,91
US	0,11	0,11	0,16	0,21	0,31	0,41		0,68			0,93	1,14	1,47	1,68
Japan	–0,09	–0,13	–0,13	–0,14	–0,14	–0,11	–0,10	–0,09	–0,07	–0,03	0,02	0,20	0,39	0,64

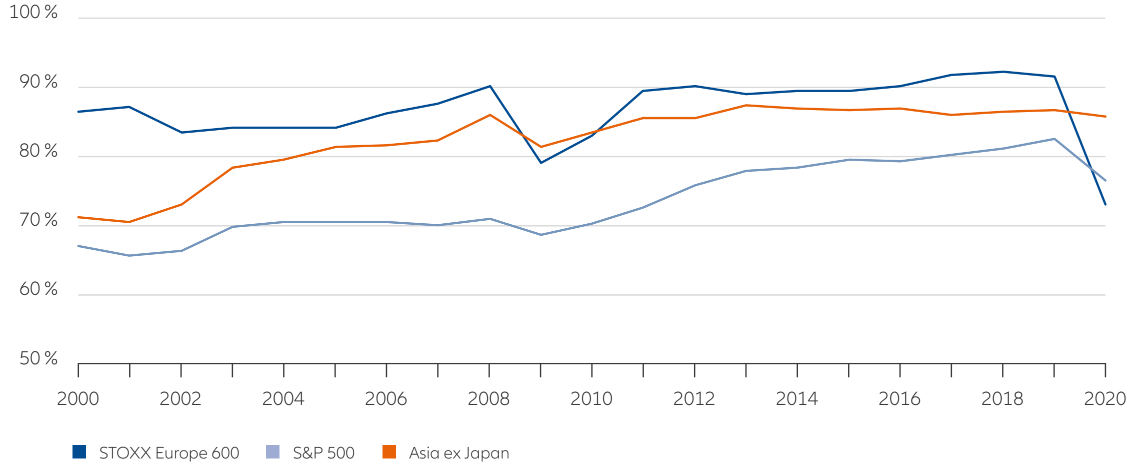
Generic government rates monitor yield changes for government benchmark bonds. Past performance is not a reliable indicator of future results. Sources: Bloomberg, AllianzGI Global Capital Markets & Thematic Research, Data as of December 2020

Investors who want to earn capital income will probably need to rely on dividends as well. However, the Covid-19 pandemic has considerably reduced dividend income in Europe, the US and Asia Pacific in 2020. While distributions are typically funded from the previous year's earnings, many companies have cut or even suspended dividend payments in 2020 as a precaution. And some companies may not have been allowed to distribute earnings because they received money from Covid-19 support funds. In fact, the proportion of dividend-paying companies (measured as the number of dividend-paying companies in an equity index compared to non-dividend payers) has considerably declined for both the S&P 500 and the STOXX Europe 600. Only the MSCI Asia (ex. Japan) escaped this trend. Nevertheless, in both the US and Europe more than 70 % of all index companies paid a dividend. In Asia, the percentage remained stable above 85 % (Chart 2a).

In Europe, distributions varied across the country-specific benchmark indices, per the trend of recent years.

Figure 2a: Proportion of Dividend payers in the years 2000–2020

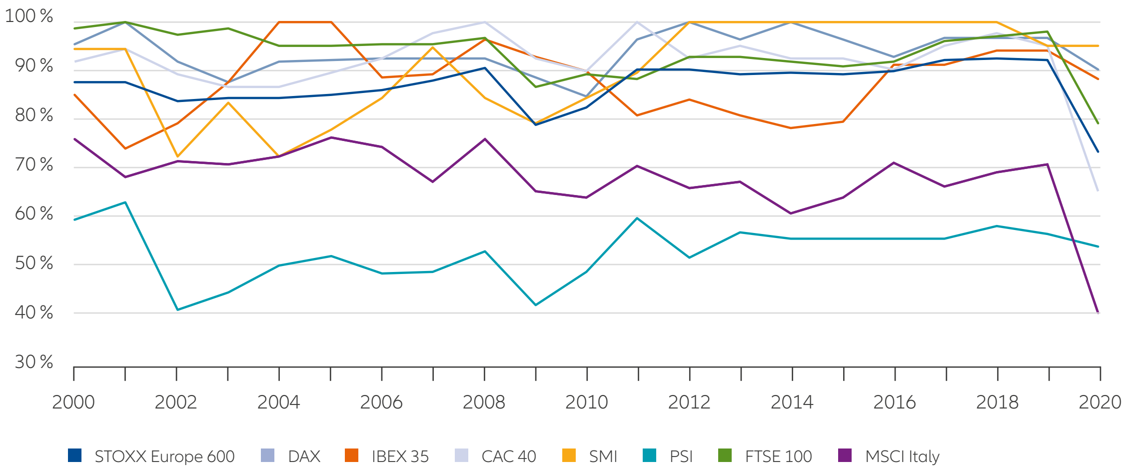
% Proportion of Payers



Source: Datastream, Allianz Global Investors Global Capital Markets & Thematic Research.
Past performance is not a reliable indicator of future results. Data as of 2 December 2020

Figure 2b: Proportion of Dividend payers in the years 2000–2020

% Proportion of Payers

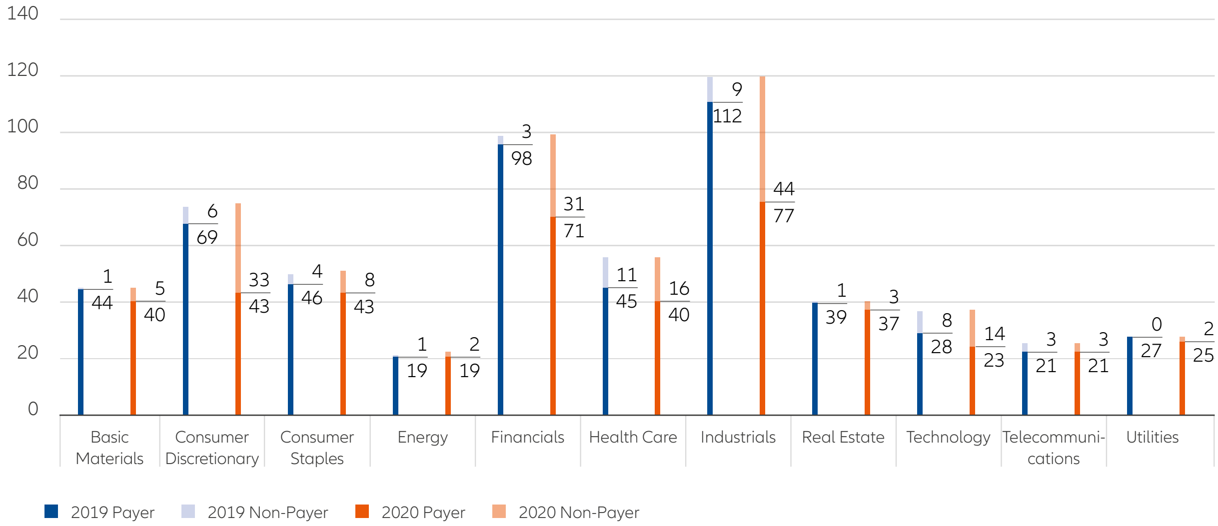


Quelle: Datastream, Allianz Global Investors Global Capital Markets & Thematic Research. Die Wertentwicklung der Vergangenheit ist kein verlässlicher Indikator für die zukünftige Wertentwicklung. Stand: 2. Dezember 2020

A sector-level analysis shows that the number of non-dividend payers rose above all among cyclical consumer goods producers, cyclical industrial goods producers and some financial companies.

Figure 3a: Number of dividend payers and non-payers by sector in the years 2019 and 2020

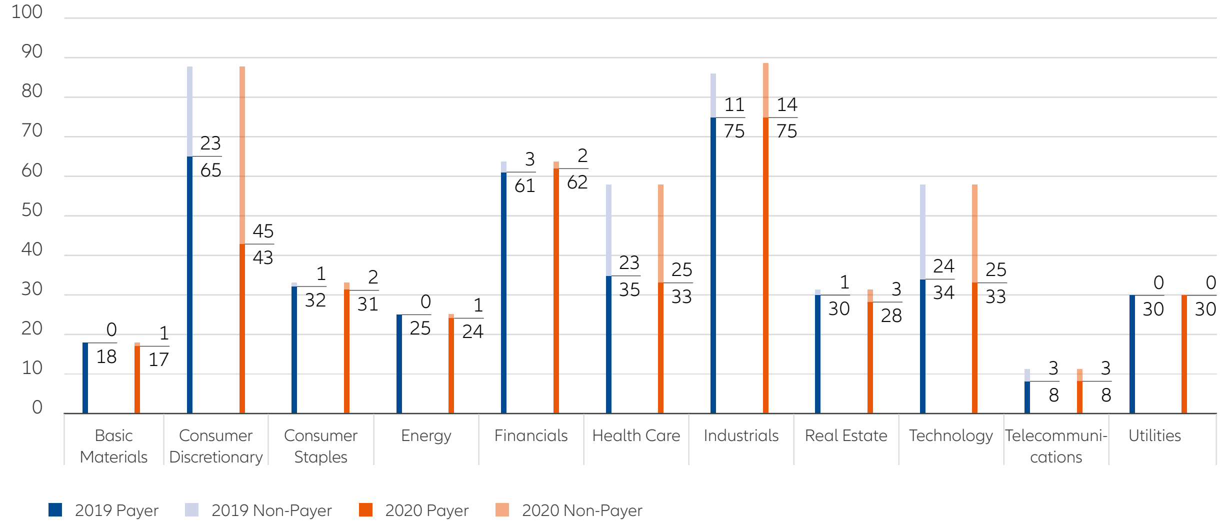
STOXX Europe 600



Source: Datastream, Allianz Global Investors Global Capital Markets & Thematic Research.
Past performance is not a reliable indicator of future results. Data as of 2 December 2020

Figure 3b: Number of dividend payers and non-payers by sector in the years 2019 and 2020

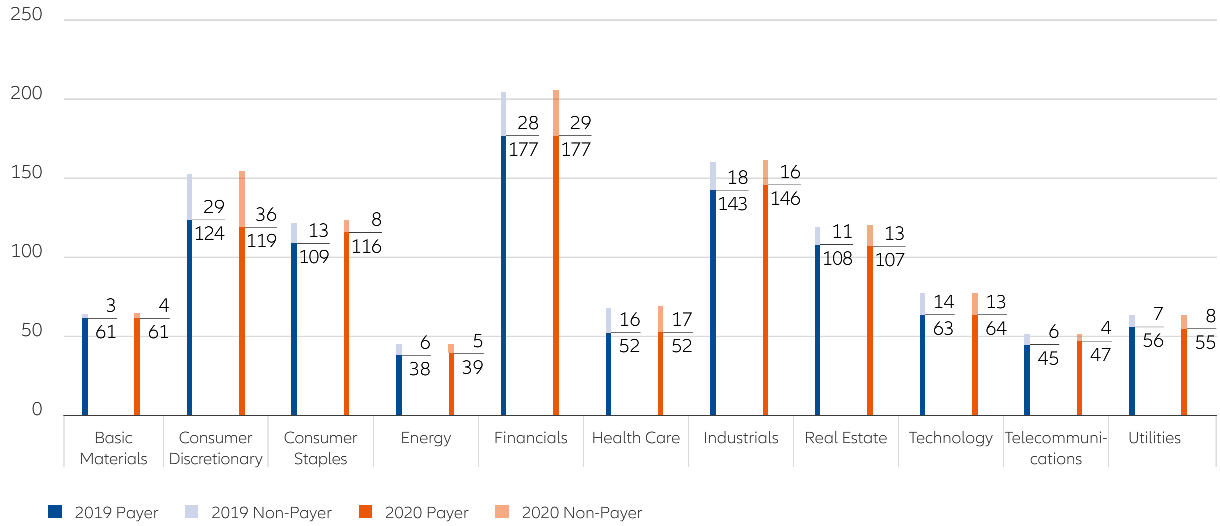
S&P 500



Source: Datastream, Allianz Global Investors Global Capital Markets & Thematic Research.
Past performance is not a reliable indicator of future results. Data as of 2 December 2020

Figure 3c: Number of dividend payers and non-payers by sector in the years 2019 and 2020

Asia ex Japan



Source: Datastream, Allianz Global Investors Global Capital Markets & Thematic Research.
Past performance is not a reliable indicator of future results. Data as of 2 December 2020

Capital income from dividends

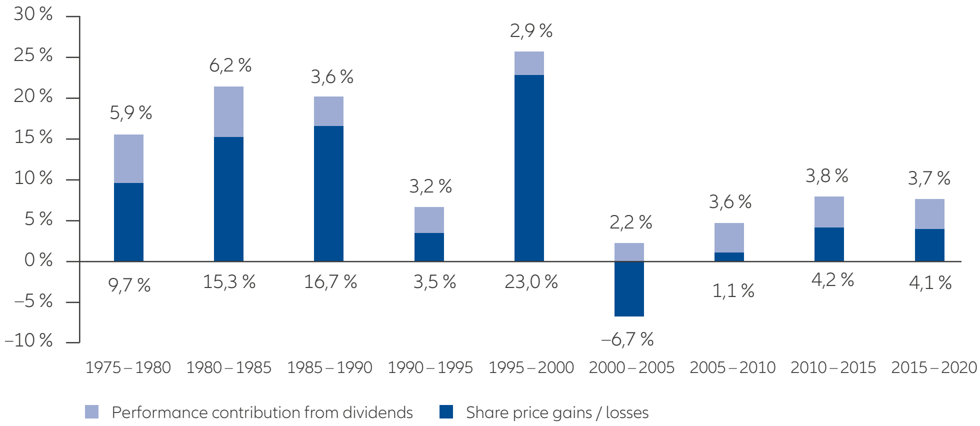
While the past never really repeats itself, it may hold some interesting lessons. Dividends can obviously stabilise both a portfolio as a whole and distributions – except in crisis years such as 2009, the year after the global financial market crisis.

In particular, investors in European stocks have previously enjoyed high dividend payments, which have helped to stabilise the overall portfolio performance, even in years in which stock prices fell. In fact, dividends fully or partially offset price losses (see Charts 4a-4c). During the whole period under observation, dividends contributed about 35 % of the annualised total return of the MSCI Europe. In North America (MSCI North America), 26 % of the overall performance came from dividends; in Asia Pacific (MSCI Pacific), the figure was 36 % (see Chart 5).

> "As data from previous years show, dividends tend to be comparatively stable, even if they have never been (and never will be) completely free of volatility. This is cause for optimism that the considerable decline in dividend payers and total dividend distributions in 2020 was a pandemic-related glitch."
>
> **Dr. Hans-Jörg Naumer, Director, Global Capital Markets & Thematic Research**

Figure 4a: Dividends – a stabilising factor for investors

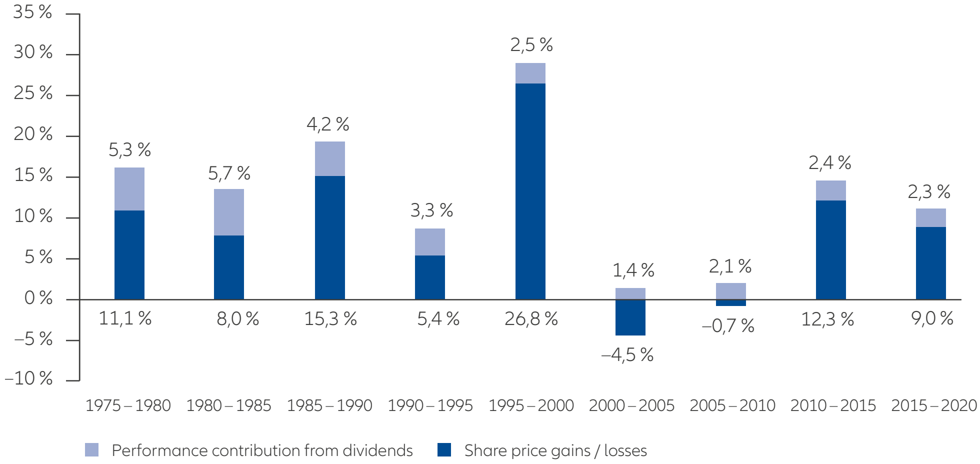
Performance contribution from dividends and MSCI Europe share prices since 1975 in five-year periods (% p. a.)



Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of December 2020

Figure 4b: Dividends – a stabilising factor for investors

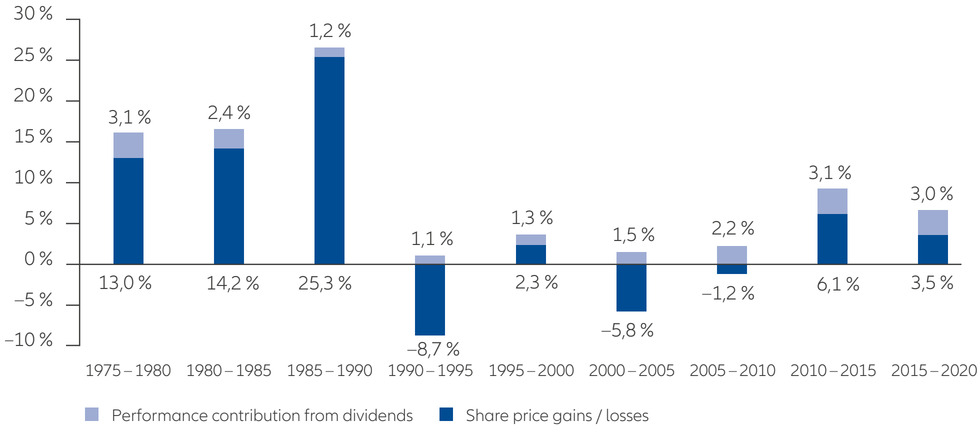
Performance contribution from dividends and MSCI North America share prices since 1975 in five-year periods (% p. a.)



Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of December 2020

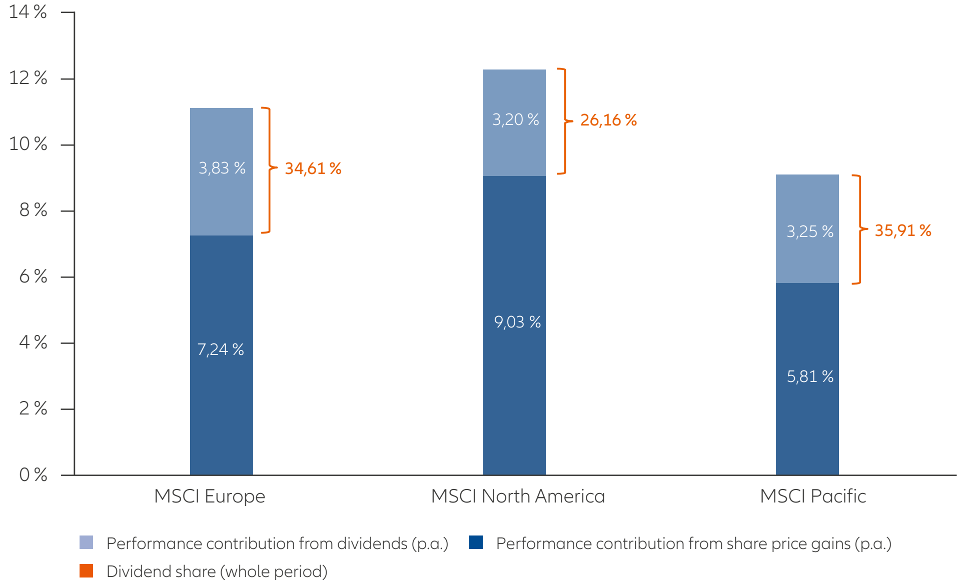
Figure 4c: Dividends – a stabilising factor for investors

Performance contribution from dividends and MSCI AC Asia ex Japan share prices since 1975 in five-year periods (% p. a.)



Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of December 2020

Figure 5: Shareholder-friendly dividend policies, especially in Europe
Global comparison of how dividends and share price gains contributed to performance between 1975 and the end of December 2020 (annualised)



Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of December 2020

At the same time, dividends are not the only factor that can stabilise equity investments. Our calculations show that dividends are less volatile than corporate profits. A look at the dividend distributions and earnings of S&P 500 companies since 1960 shows that corporate profits have fluctuated considerably more strongly than dividends. During the past 10 years, earnings volatility amounted to **almost 25 % (annualised), considerably exceeding dividend volatility at just under 5 % p. a.** (see Chart 6).

There may be several reasons for this phenomenon:

– Dividend policy is often an important, active element of a company's strategy. Dividends tend to send disproportionately strong signals. Market participants respond negatively to dividend cuts or suspensions, as such steps raise doubts about a company's future viability. That is why companies try to keep dividend payments reliable and steady.

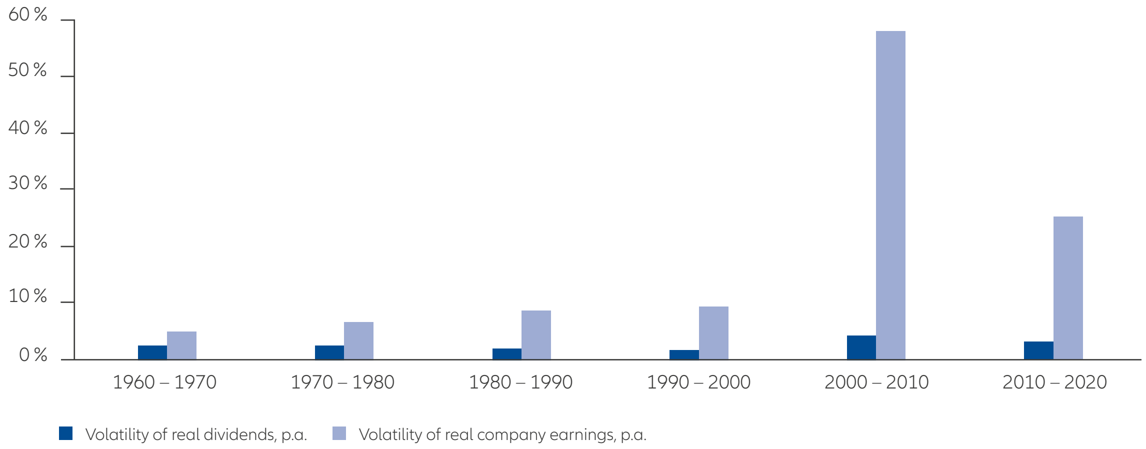
– Many (but not all) companies with high dividend yields can rely on healthy balance sheets ratios, comparatively high equity capital, and stable cash flows.

– Companies may use high distributions, and seek to keep these distributions reliable and steady, to have a disciplinary effect (because of the signals they send, as outlined above). Companies need to be prudent about their financial resources and use them efficiently. Compared to distributions, share buyback programmes send a less effective signal, and they subject companies to less discipline because they are discretionary.

Academic research confirms these hypotheses. In a study from 2005, 94 % of chief financial officer (CFO) respondents said that they aim for a long-term dividend payout ratio and want to avoid dividend cuts[1].

Furthermore, 65 % of respondents said that they might be willing to borrow money to keep distributions unchanged. That stance is quite understandable: after all, 90 % of the CFOs believe that a dividend cut would negatively impact their company's share price. Two-thirds of them regard investment and dividend decisions as equally important. Share buybacks appear to be a much more flexible instrument than dividends.

Figre 6: Exhibited low volatility of dividend payments
Volatility of company earnings and dividends, S&P 500, from 1960 till mid of December 2020 (% p. a.)



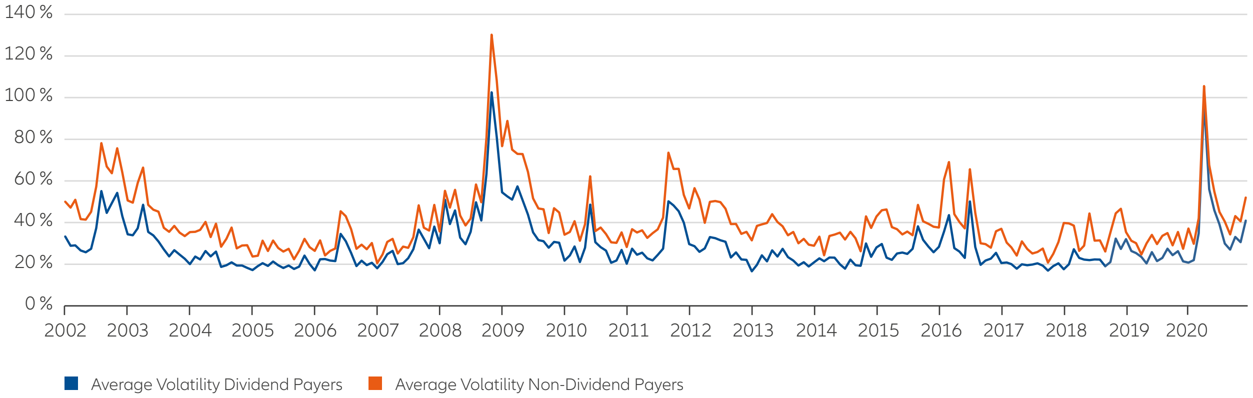
Past performance is not an indication of future results.
Sources: Shiller, R., "U.S. Stock Price Data since 1871"; AllianzGI Global Capital Markets & Thematic Research, Data as of December 2020

The survey was conducted among managers of 394 US stock corporations, among which dividend payers predominated. The result is in line with our view that dividends have been quite steady, at least in the past. There is also an interesting study by Skinner and Soltes from 2011[2]. The authors analysed annual dividend payments and earnings of companies listed on the NYSE, AMEX or NASDAQ between 1975 and 2005, except for utilities and financial services providers. They found that dividend-paying companies tend to generate steadier corporate earnings than non-dividend payers. In this context, the dividend level is unimportant; all that matters is that dividends are paid.

Charts 7a and 7b show that dividend-paying stocks tend to be less volatile than those that don't pay dividends. However, one should not forget that the number of non-dividend payers in the relevant indices has trended downwards over time.

Figure 7a: Volatility of dividend payers vs. non-payers – STOXX Europe 600

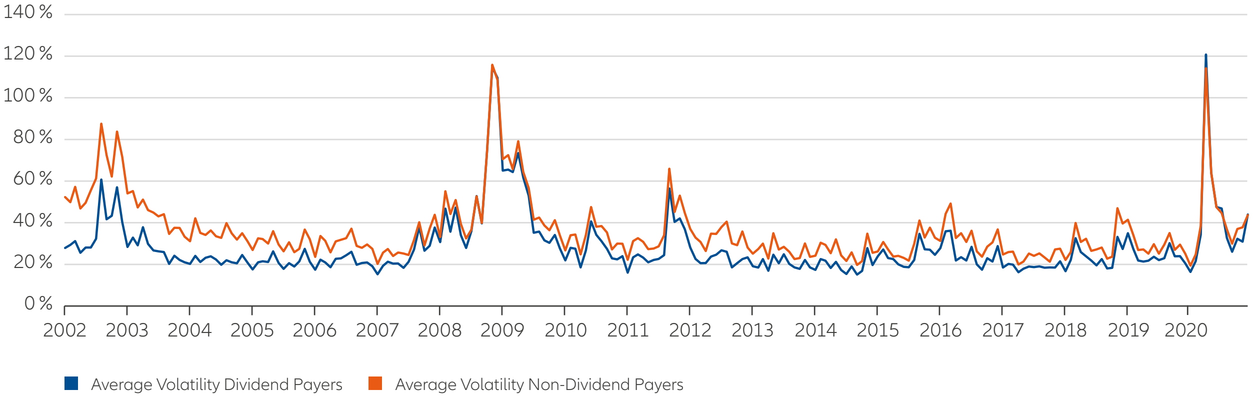
Non-dividend payers exhibited a higher volatility than dividend payers



Equally weighed 30-Day-Volatility of dividend paying vs. non-dividend paying stocks,
Past performance is no reliable indicator for future performance.
Source: Bloomberg, Global Capital Markets & Thematic Research AllianzGI As of December 2020

Figure 7b: Volatility of dividend payers vs. non-payers – S&P 500

In the USA dividend-paying stocks had been less volatile as well



Equally weighed 30-Day-Volatility of dividend paying vs. non-dividend paying stocks,
Past performance is no reliable indicator for future performance.
Source: Bloomberg, Global Capital Markets & Thematic Research AllianzGI As of: December 2020

[1] See Brav, Alon; Graham, John R.; Harvey, Campbell R.; Michaely, Roni; "Payout Policy in the 21st century"; Journal of Financial Economics; Vol. 77; 2005; pp. 483 – 527.

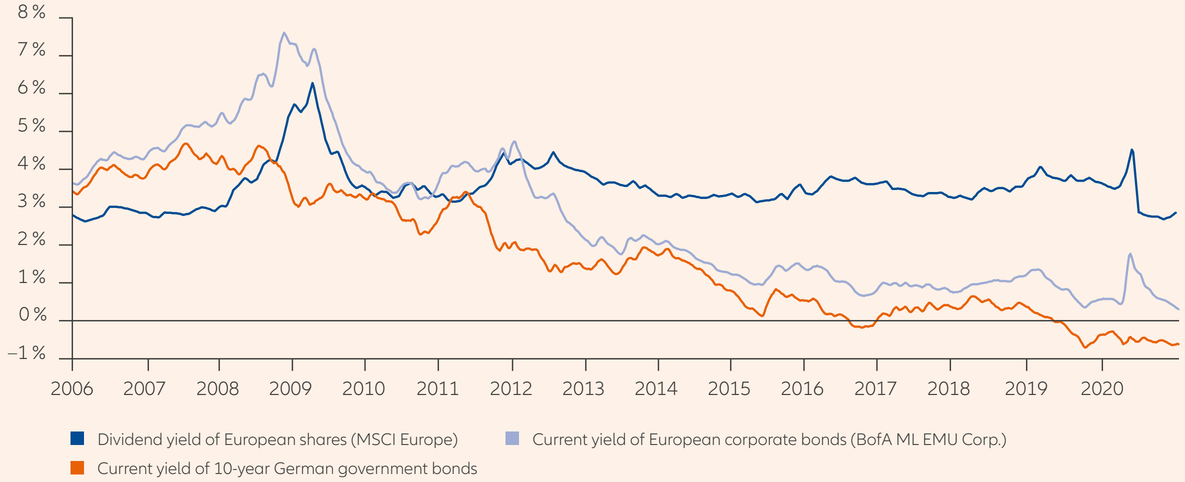
[2] Skinner, Douglas J.; Soltes, Eugene; "What do dividends tell us about earnings quality?"; Review of Accounting Studies, Vol. 16; pp. 1 – 28; 2011

2021: the year of recovery?

Dividend yields are quite attractive right now (as of December 2020). In Europe, they are considerably higher than corporate bond yields and, of course, government bond yields. In the US, dividend and corporate bond yields are similar, and both are higher than government bond yields. And in Asia Pacific, dividend yields are slightly above government bond yields. In many countries, dividend yields exceed 10-year government bond yields.

Dividend yields only reflect the past. They show the ratio between current equity prices and the most recent dividend payments, which are based on the previous year's earnings (in this case, the earnings of 2019). Following the dividend decline in 2020, the key question is: will dividends recover in 2021? Quite possibly. Around the world, large-scale monetary and fiscal policy packages have been implemented to counteract the crisis, and it seems that vaccines will finally be available, even though it will take considerable time to vaccinate enough of the population. All this suggests that the economy is going to recover in 2021, even though it may be some years before we see a return to the pre-crisis level. The business outlook for companies should therefore improve – and that means that dividends may rise.

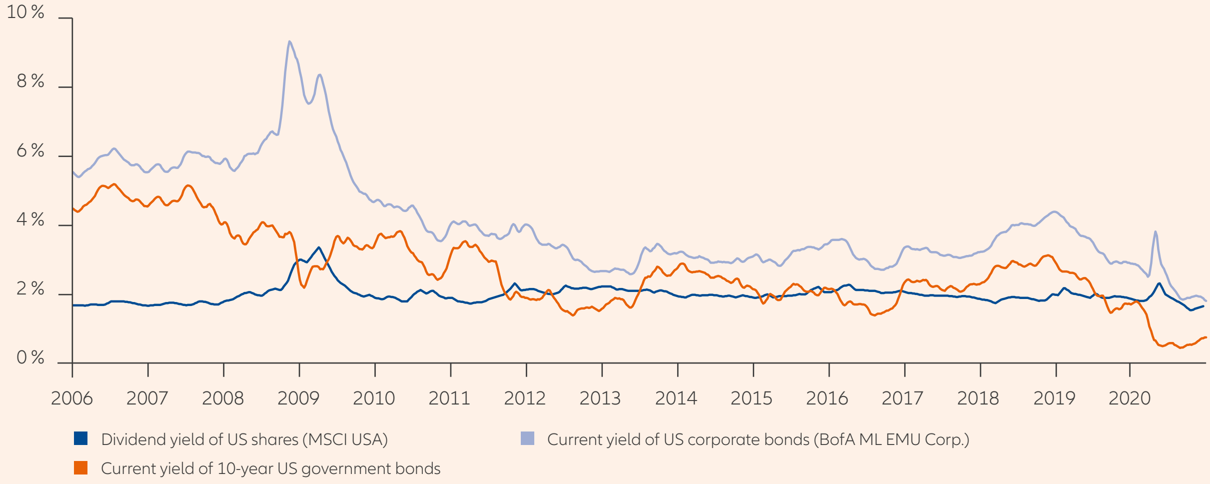
Figure 8a: European shares offer attractive dividend yields
Dividend yields (MSCI Europe) versus yields of German government (10 year) and European corporate bonds



Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of December 2020

Figure 8b: Dividend yields of American share

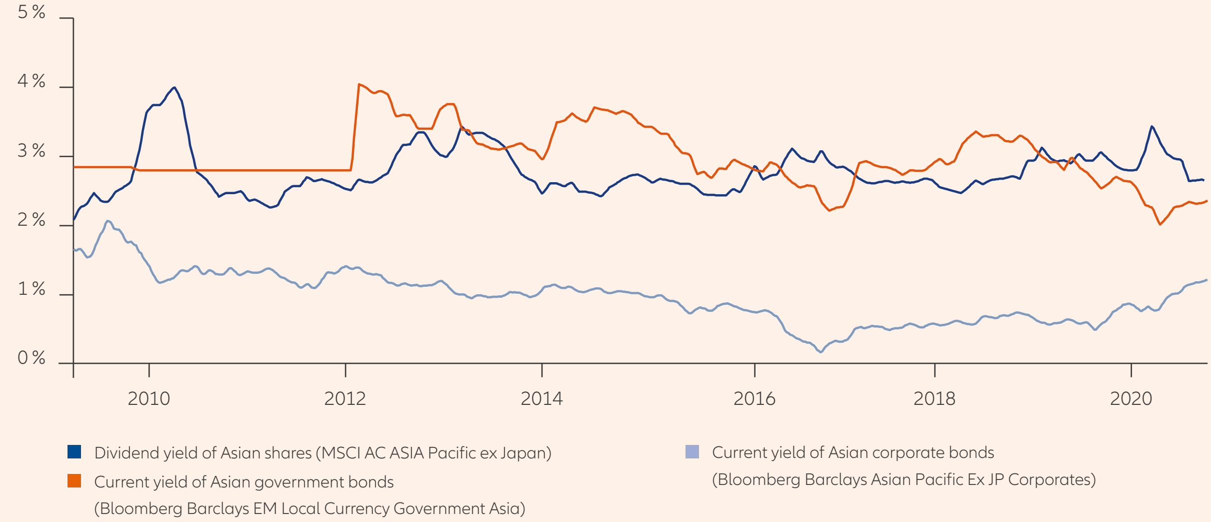
Dividend yields (MSCI USA) versus yields of US government (10 year) and American corporate bonds



Past performance is not an indication of future results.
Source: Refinitiv Datastream, AllianzGI Economics & Strategy 17.12.2020

Figure 8c: Dividend yields of Asian shares

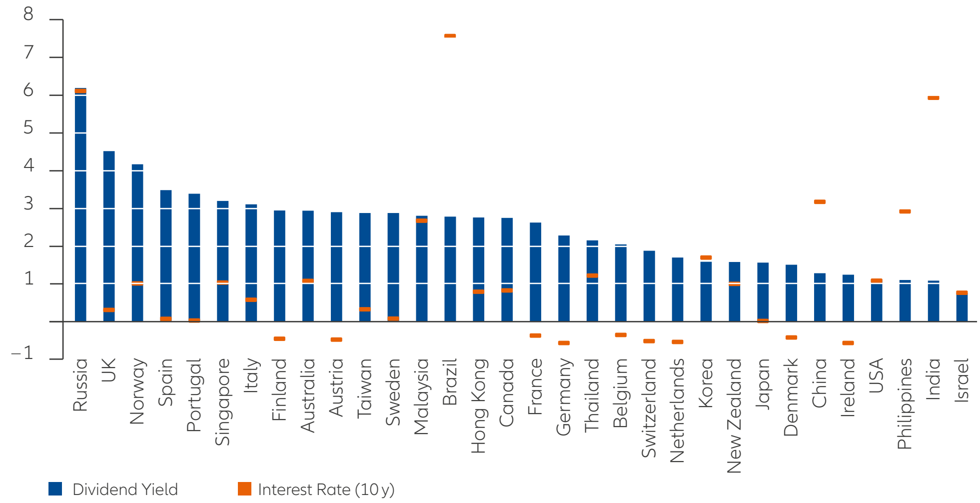
Dividend yields (MSCI ASIA ex Japan) versus Asian government and Asian corporate bonds



Past performance is not an indication of future results.
Source: Refinitiv Datastream, AllianzGI Economics & Strategy 17.12.2020

Figure 9: Dividend yields are attractive around the globe

Dividend yield (MSCI Indices) and interest rate of 10 year government bonds in comparison



Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of December 2020

"Negative interest rates will remain, and the hunt for income will continue."

Dr. Hans-Jörg Naumer,
Director, Global Capital Markets & Thematic Research

Conclusion: hunting for capital income

In the past, dividends have made a significant contribution to total equity returns and have shown a steadier development than corporate earnings. That way, they have helped to stabilise securities portfolios. Stocks of dividend-paying companies have turned out to be less volatile than stocks of companies which do not pay dividends. A comparison of global bond and dividend yields shows that dividends can be an attractive source of capital income, particularly if bond yields are very low or even negative. Still, there is always some risk attached to them, as we have seen in 2020, the year of the pandemic. As always, investors who want higher returns than those provided by risk-free money market rates (which are currently negative in Europe and large parts of the world) need to be willing to take higher risks. Still, diversification may help to reduce these risks. Remember: "don't put all your eggs in one basket." And while the situation is likely to normalise gradually, in terms of both the fight against the virus and an economic recovery, interest rates will remain negative, and the hunt for income will continue.

Dr. Hans-Jörg Naumer would like to thank Marvin Prante for his help in researching the data.

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