The Equity Market Sell-Off and the Impact on Dividend Investing

The recent equity market sell-off related to the ongoing coronavirus pandemic has caused an unprecedented level of market volatility with institutional investors scrambling to adjust their portfolios in light of the long-term effects the virus may have on the global economy.

Following a tumultuous March 2020, where highly correlated markets made it more difficult for stock pickers to select winners from long-only investments, some semblance of stability returned to markets in April 2020, albeit supported by base rate cuts and substantial government stimulus packages. Subsequently, investors had to survey the new landscape to identify new areas of opportunity, whilst abandoning previously lucrative ideas. **Conversations conducted with the buy-side in April, as detailed in our** blog post**, provided insight to how the buy-side was changing in their own words. We've turned our focus to the numbers to show how these changes are showing up across estimates and portfolio holdings.**

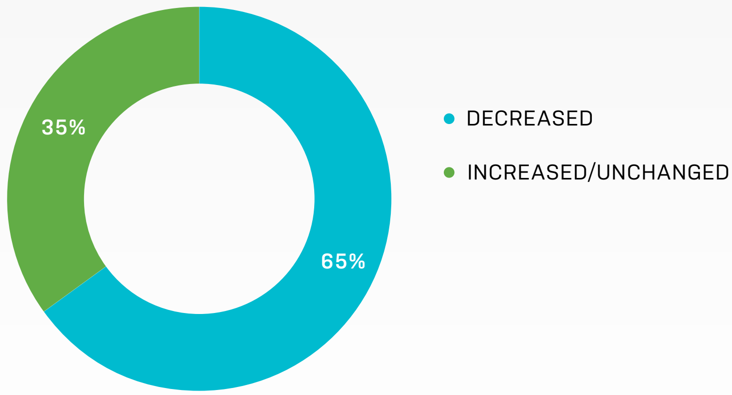
One of the main themes to emerge from the crisis has been concerns over the ability of companies to maintain dividends at current levels, given the impact the pandemic will have on earnings, and ultimately, profitability and cash generation. As such, dividend-focused investors have been especially busy in terms of rotating their portfolios. In addition to this, lower stock prices and resultant higher dividend-yields, coupled with lower government interest rates (and therefore bond yields) means that company dividends could be especially attractive to those investors who know where to put their money.

This report analyses the impact that the recent market sell-off has had on analyst consensus estimates for dividend pay-outs in 2020. Using estimates data across a global list of over 5,000 of the world's largest companies from January to April 2020, it has been possible to identify the following trends:

- Almost **two-thirds of 2020 consensus DPS estimates were downgraded** over the analysed period
- There were **significantly more negative 2020 DPS estimate revisions in Europe,** compared to North America and Asia
- On a sector basis, **negative 2020 DPS estimate revisions closely mirrored sector index performance** with cyclicals seeing the most and largest estimate downgrades, while defensives fared better
- Dividend yields have increased across all sectors due to declining stock prices, but the **increases in yield were naturally more exacerbated in the most beaten-down sectors**
- Using *The Capital Group's* income funds as a proxy for dividend investor behaviour, **the change in sector allocation appears to closely track wider market performance** when analysed on a proportional basis. However, on a market-adjusted basis, evidence of stock selection and general sector preference becomes more apparent

Section 1: A global universe of consensus estimates

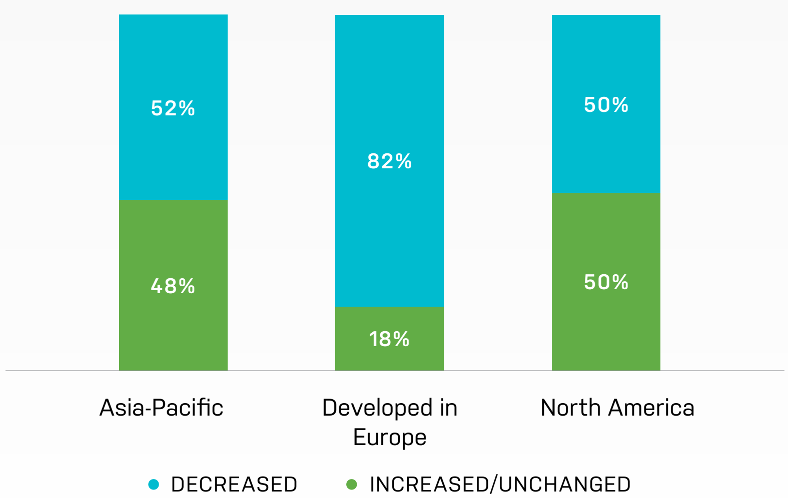
Using the Datastream Total Market World Index (source: Refinitiv), which contains over 5,000 companies across 68 countries and using 2020 DPS consensus estimates, it was possible to identify that 64.9% of consensus estimates were reduced (either downgrades or cancellations) between January and April 2020.



Source: IBES/Refinitiv – DS Total Market World Index

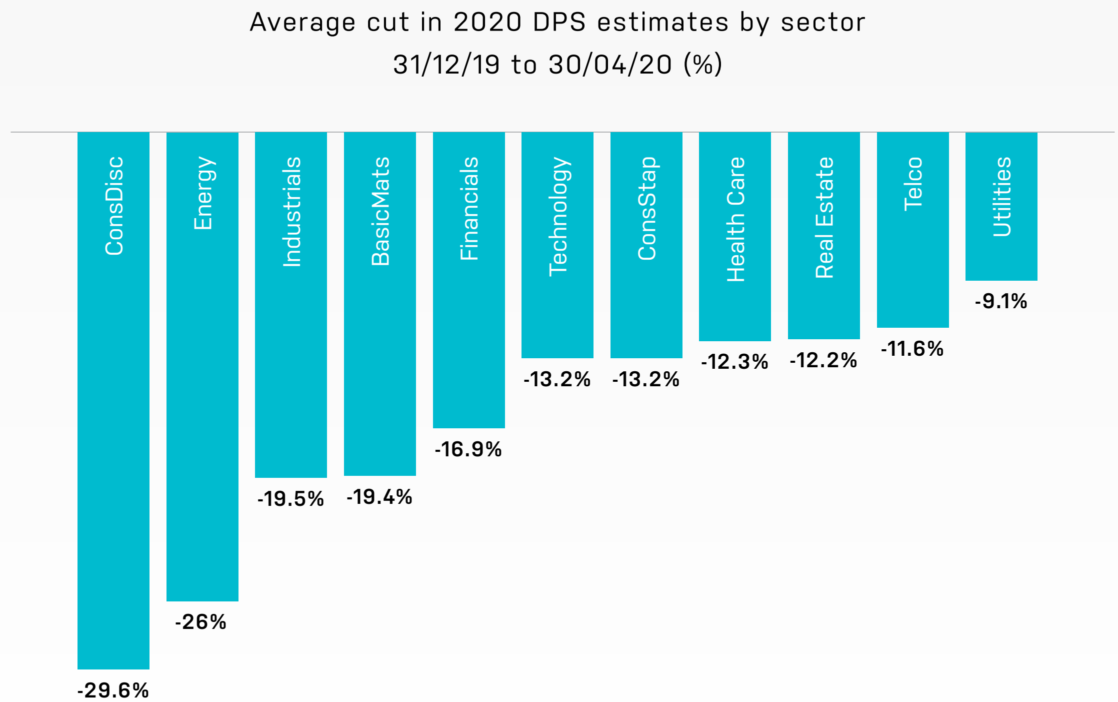
When analysed on a global region basis, there were some differences when comparing estimate revisions in Europe with North America and Asia Pacific. While around half of DPS consensus estimates were reduced in North America and Asia Pacific, this figure jumped to 82% in Europe, suggesting that pessimism for the sustainability of dividends in this region is much higher.

Change in 2020 DPS estimates by global region
31/12/19 to 30/04/20



Source: IBES/Refinitiv – DS Total Market World Index

Looking at industry sectors, on a nominal basis, there were no notable trends between the number of estimate reductions as a proportion of total estimates, which suggests that cuts were seen across the board regardless of industry group. However, when the actual size of estimate downgrade was analysed, there were some notable differences, many of which mirrored stock index performance. For example, stock indices that performed the worst during the March 2020 sell-off (Consumer Discretionary, Energy, Basic Materials and Financials) also had the largest DPS consensus estimate reductions, while classic defensive sectors such as Utilities, Telco and Healthcare, alongside Technology and Consumer Staples revealed a lot more resilience in terms of the outlook for dividends in 2020.

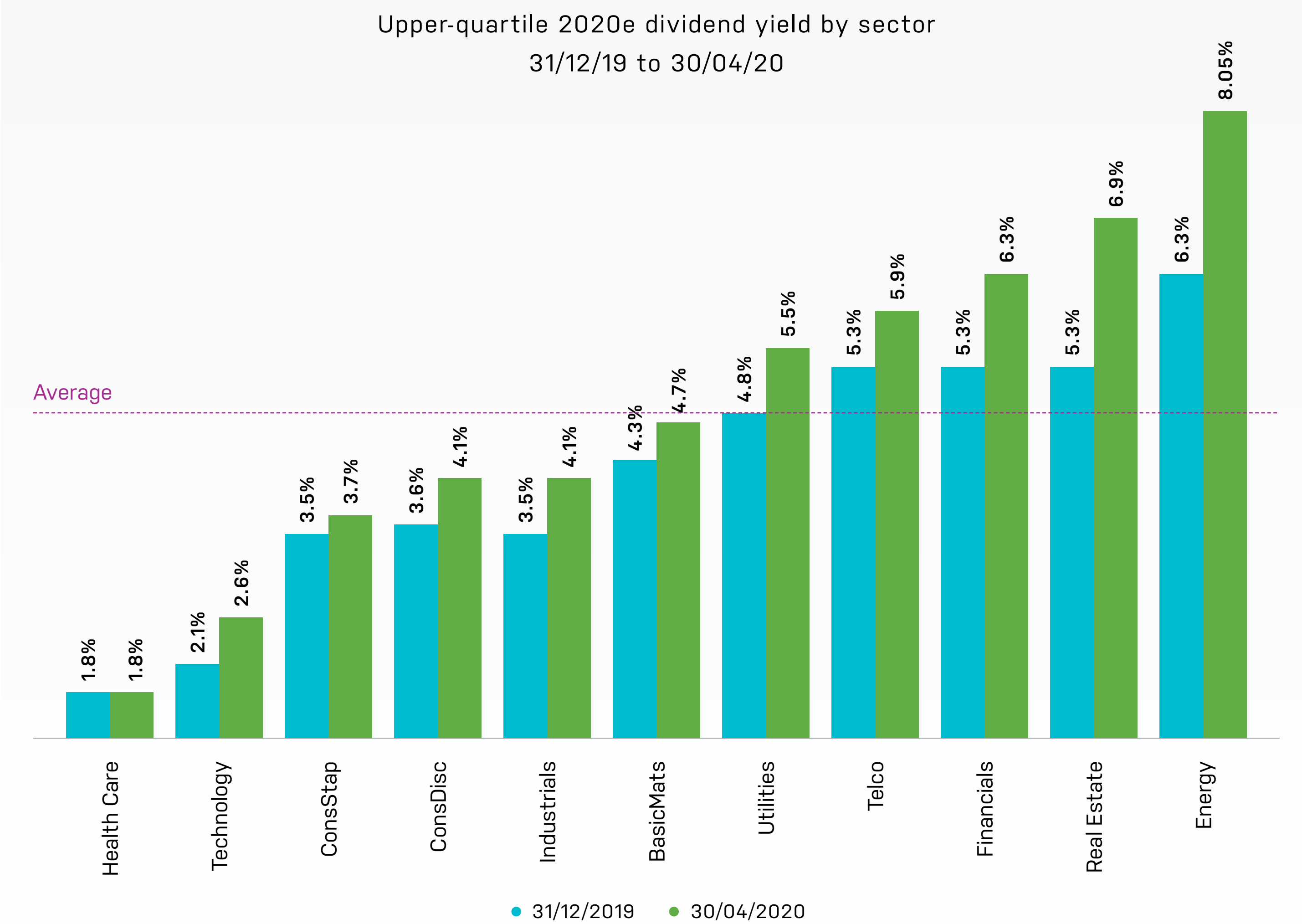


Source: IBES/Refinitiv – DS Total Market World Index

Section 2: Growing yields across the board, but not at the same rate

As a result of the sharp decline in stock prices related to the ongoing coronavirus pandemic, dividend-yields grew on an aggregate basis as stock prices fell at a greater pace than estimate revisions. One factor driving this would have been the effects of an oversold market, which should normalise over time. However, beyond market efficiency will be the effect of companies looking to provide reassurance to their investors over their ability to generate profits and cash flows into the future. As such, many companies have tried to maintain dividends as high as feasibly possible, even if this means increasing leverage in the short-term.

When analysing changes in dividend yield across sectors, there were few changes in terms of the general order of things. Higher-yielding sectors such as Energy, Financials, Utilities and Telco remain the preferred location for dividend-focused investors in terms of return, relative to the initial investment. Meanwhile, sectors with the highest levels of R&D, namely Healthcare and Technology, remain at the bottom of the pile. However, what is perhaps more interesting is the change in yield across the analysis period. The upper-quartile level of dividend yield (an indication of where things may start to get interesting for a dividend-focused investor) for the Financials sector rose by 1.0%, while for the Energy sector it was as much as 1.75%. Meanwhile, the increases for traditionally high yielding Telco and Utilities was much less (0.5% and 0.6% respectively). This could be an indication of the growing risk premium of investing in Energy and Financials, which were especially beaten-down during the market sell-off. For dividend-focused investors, therefore, it could be important to weigh up the potential additional returns of investing in sectors that offer higher yields as a result of market underperformance alongside the increased potential for variability in those returns. At 4.85% the upper quartile level of dividend yield across all sectors as of the end of April 2020, is just 0.18% higher than that at the start of the year. Not a significant change, which suggests that attractive entry points into sectors yielding below this level could be less numerous.



Source: IBES/Refinitiv – DS Total Market World Index

Indeed, the level of yield at which dividend-focused investors could become interested in a particular company is a topic of growing interest for issuers as the recent market sell-off could result in both opportunities to attract new investors for those companies whose yield profile has improved, and conversely risk of investor divestments for those companies who have had to make the difficult decision to cut. Smart Targets, which is a proprietary investor analytics tool owned by Nasdaq, indicates that the yield threshold for ownership by dividend-focused investors is currently around 5.2%, a sharp increase from 4.5% at the start of the year.

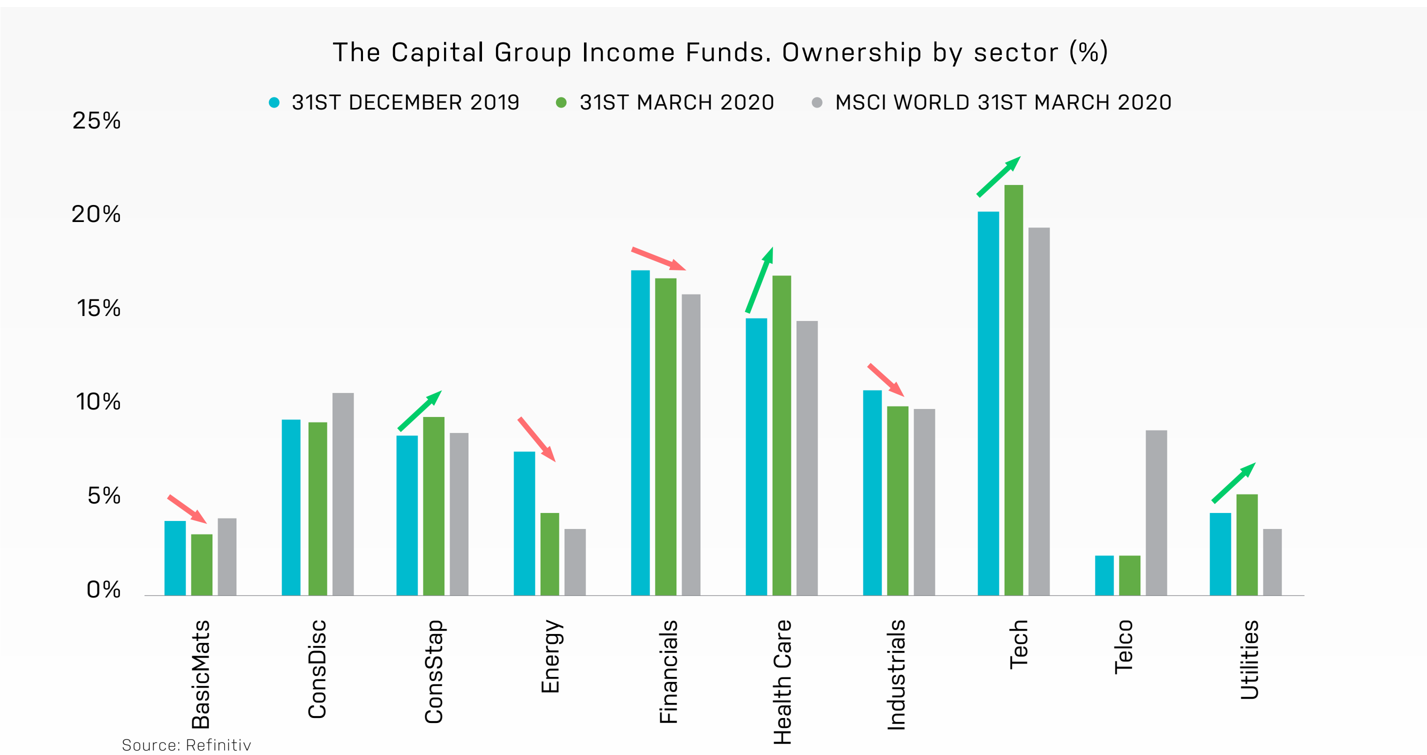
5.20%

The average threshold level forF12M DY at which dividend-focused investors will hold a company, (up from 4.5% at the end of 2019). Source: Smart Targets

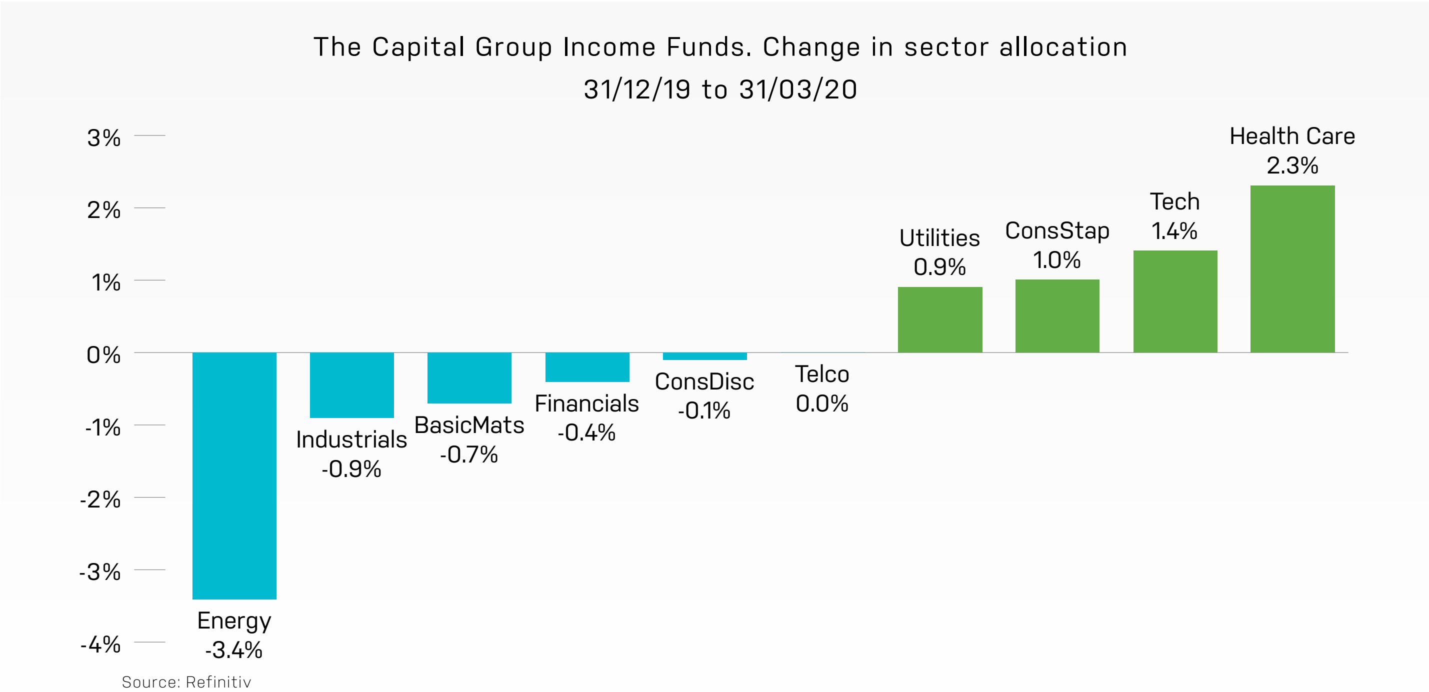
Section 3: Case study: What has The Capital Group been doing?

The Capital Group's American Funds series of mutual funds includes some of the largest equity asset income and dividend-focused funds in the world. The nine separate dividend-income strategies it manages account for $544bn of equity assets under management (source: Refinitiv). As such, the funds offer good insight into the world of dividend-focused investment and could be regarded as a good proxy for dividend investing more generally.

An initial look at the sector allocation of these funds may be a little surprising, given the fact that Technology and Healthcare (two of the historically lowest-yielding sectors) are the two largest invested sectors. However, this may serve as a reminder that many thematic funds still have discretion to invest in stocks that don't necessarily fit with the primary investment objective, plus it is not only the yield that is important for dividend-focused funds, but also the progressiveness and sustainability of pay-outs. Perhaps less surprisingly, the funds are also marginally overweight (compared to the MSCI World index) in Financials, Consumer Discretionary and Utilities.



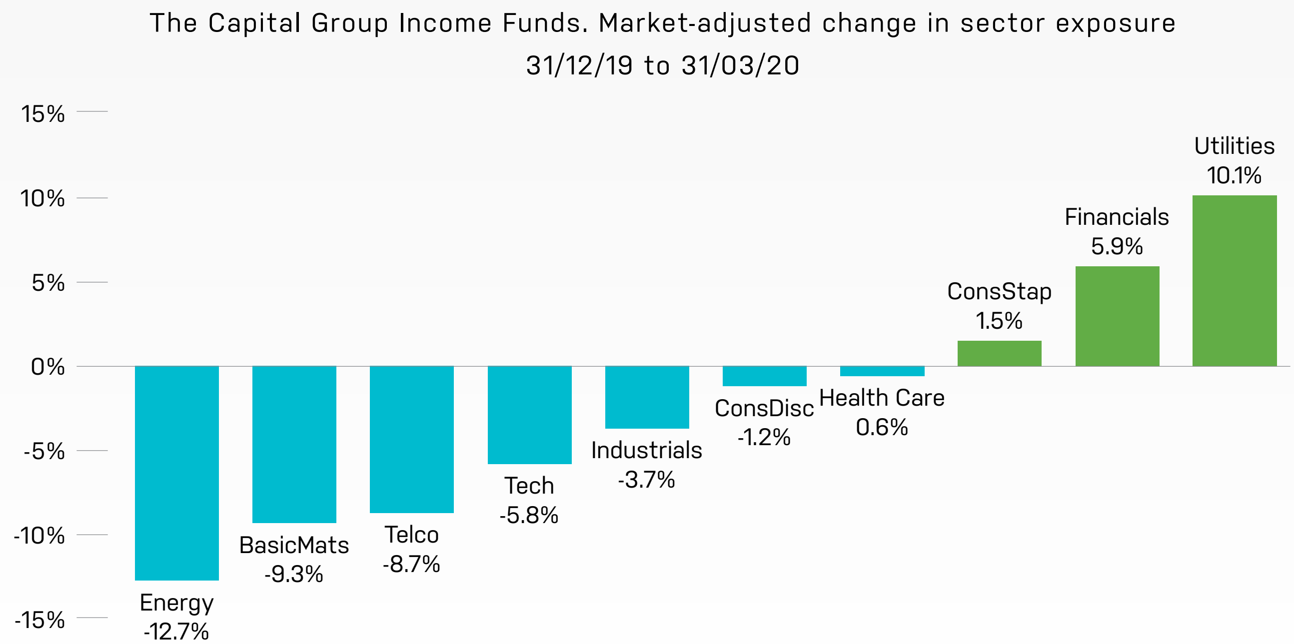
An analysis of the funds' most recent 31st March 2020 filings compared with the previous quarter reveal some interesting changes to sector allocation. At one end of the spectrum, there was a sharp pull-back from Energy (-3.4p.p.) and to a lesser extent, Industrials (-0.9p.p.) and Basic Materials (-0.7p.p.). Meanwhile, at the other end of the spectrum, sector allocations towards Healthcare and Technology increased, although the outperformance of stocks within this sector could be be a large contributor to the increase.



Indeed, the large differences in sector performance over the quarter, especially during March 2020, could be a significant driver of sector allocation. Therefore, by looking at a market-adjusted change (adjusting the change in ownership in each sector by the average market performance), it is possible to gain a clearer picture of the investment discretion applied by the funds themselves.

On a market-adjusted basis, the funds still sold heavily out of Energy and Basic Resources, an indication of pessimism towards the sustainability of dividends in these sectors. Meanwhile, the funds' exposure to Technology reduced, perhaps due to booking profit with a view to exploring opportunities elsewhere. Interestingly, the funds appeared to be net sellers of Telco, despite it being one of the more resilient sectors during the downturn, while they increased their exposure to Financials, which was one of the biggest underperformers. A possible explanation for this is that banks entered the downturn very well capitalised, having learned their lessons in 2008 and so are in a position to bounce-back once the economy stabilises. Finally, the funds increased their exposures to Consumer Staples and Utilities on a market-adjusted basis, perhaps in an attempt to de-risk the portfolios.

Nasdaq



Source: Refinitiv. % change is USD holding, adjusted by perfomance of DS Total Market sector indices 31st December to 31st March.

Section 4: What does this mean for Investor Relations?

The high levels of turnover seen amongst dividend-focused investors could present both opportunities and risks for issuers in the current environment. Given that investor activity during the downturn was very much along sector lines, the degree to which companies can take a "development" or "maintenance" stance to their engagement with dividend-focused investors will depend upon the sector they are in and the degree to which their company has been able to sustain dividends at pre sell-down levels. As such, it may be important for Investor Relations professionals to consider the following:

1. Understand the extent of dividend-focused firms and funds across their investor base and closely monitor how ownership from this group of investors is changing over time.

2. For companies that are looking to reduce or even cancel their dividends, it may be important to conduct a sensitivity analysis to understand the impact that the change will have on their investor base. Nasdaq conducted buy-side interviews in April with one analyst sharing,

> **"Well, I've never been a fan of share repurchases - ever. In rare conditions, only when companies have so much cash, some of these technology companies that have zillions and zillions. But, for the most part, I've always felt that people should pay down debt and keep more cash on their balance sheet for a rainy day because it rains and it rained."**

U.S.-based Buy-Side Analyst

3. For companies in traditionally defensive, high-yielding sectors, the recent market sell-off may present an opportunity to pick up investment capital from firms and funds that are looking to rotate into stocks where the sustainability of dividends is potentially more assured.

4. For companies in sectors where the sustainability of dividends is potentially less assured, this may be a time for them to consider switching into "shareholder maintenance" mode, focusing more time and higher-quality interactions to investors that may be at risk of selling. One U.S. based Portfolio Manager recently shared with Nasdaq, "All dividends should be suspended unless the issuer has no debt and resilient revenues."

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