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Pandemic infects dividends & buyback policies



PART I: SHOULD WE FEAR DIVIDEND CUTS ?

In an attempt at balance sheet preservation while navigating the pandemic crisis, corporates are slashing dividend payments and suspending buyback programs. Where firms don't take this initiative on their own accord, they may be obliged to do so if in receipt of assistance under a government stimulus program, most of which come with preconditions that limit buybacks and dividends, as well as prohibiting "unethical" remuneration practices. Moreover, amidst the market turmoil, companies are seeing that share prices are getting little or no support from any commitments to defend a dividend. Finally, some companies may be deprived of the luxury of choice because both their top line and bottom line is washed out, given the

magnitude of the economic shock.

Dividends, and buybacks even more so, are traditionally polarizing topics. Without trying to address socio-economic considerations or more broadly what is good and what is bad, having a view on dividend and buybacks is crucial in navigating equity perspectives over the mid to long-term.

There are two primary factors that can be considered as determinants of long-term equity returns – value creation (i.e. growth) and the valuation. As a prudent disclaimer, it should be clear to any investor short term equity returns are a shot in the dark - daily prices having the ability to go anywhere. Investors are encouraged to adopt a longer-term investment horizon and, as the old adage goes, consider the stock market as “a warehouse of cash-flows, not a casino”.

The first rule of thumb is that the faster a business grows its earnings and cash flows, the greater the long-term returns it will generate for its stakeholders. In analyst jargon, this is referred to (quite unsurprisingly) as the “bottom-line” and is the first element of return for investors. The second determinant of returns, is the stock’s valuation. This is not simply the price paid for the stock, but the price in relation to the intrinsic value of the company, measured using different accounting metrics and then compared against cyclically-adjusted peers. In a ‘Goldilocks’ scenario, investors should not pay too much, nor too little relative to the intrinsic value of the stock. Considering that under normal circumstances, dividends are paid out of company earnings (or cash-flows), dividends should not be understood as a source of return, but rather as a contributor to long-term returns. Indeed, for some companies, activities, sectors and cyclical perspectives, dividends hold a great deal of importance, while for others, they may be totally irrelevant. The same is true when looking through the lens of an investor. Income thirsty investors will chase dividends, while return maximizers will probably give preference to growth stocks that offer little to nothing in the way of an income stream.

Although dividends are traditionally much less volatile than earnings during recessions, investors should nevertheless prepare for some sizeable cuts in payouts going forward. According to a recent research paper by Morgan Stanley, company announcements so far suggest that more than 30% of EU dividends already appear at risk of cuts or suspension (albeit, these figures understate the risk to dividends as they largely exclude Energy stocks, given that there has been little in the way of company comments at this stage.) In the US, dividends look likely to fall for the first time since 2009, when they dropped 21%. Retailers, Autos, Banks, Transport and Luxury companies have the highest proportion of vulnerable dividends on both sides of the Atlantic.

Should investors be scared of massive dividend cuts and a potential dividend drought? Basically, the answer mostly depends on the specific objectives of the investor. For those looking at the income component, perspectives will probably be depressing. However, for investors with a longer investment horizon, if a dividend cut is part of the near-term price that must be paid to ensure a firm's long-term survival, it looks more reasonable; a case of short term pain for longer term gain. Capital appreciation is still a decent assumption, as long as the valuation paid at the point of purchase is reasonable.

This is one of the key reasons for our current preference towards quality stocks (well-poised, high-cash, low-debt companies), despite the fact that the unprecedented context we operate in makes it a demanding task to forecast future cash-flows. Selling a quality stock that has slashed its dividend because of tough — but temporary — economic times may, in retrospect, be a classic case of selling low and buying high.

In essence, the ex-post diagnosis of return contributors should be split into three elements: earnings contribution, dividend contribution and price movement contribution. This is the traditional backward analysis to gauge what supported past price changes. Ex-ante analysis, or any attempt at forecasting or scenario building should primarily focus, in a simplified world, on only 2 factors: earnings growth and relative value.

Don't be confused by looking in the rearview mirror. Studies showing that X% of past returns were driven by dividends are valid. X will always depend on the specific market and time frame used in the analysis. But one shouldn't try to drive their car by only looking backwards, as long the objective is to progress forwards.

Ultimately lower equity dividends could see outflows as investors hunting yield depart. Prior to the sell-off, with the yields of so many assets close to or even below zero, equity dividends were being used as a way to satisfy the appetite for income.

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