The essential guide to income investing

Why dividend investing remains a compelling income opportunity

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Why dividend investing remains a compelling income opportunity

In the post-pandemic era, interest rates are likely to remain lower for longer.

As a result, the cashflow from dividend payments will become an even more important source of income (and return) for investors.

At the same time, the pandemic and its containment measures have squeezed corporate earnings. And since dividends are paid out from earnings, dividend income would be expected to fall across the board, at least in the short term.

This is a double whammy for dividend investors and it raises an important question – in such a scenario, is dividend investing still a compelling income opportunity?

In our view, the answer is yes, and here's why.

The long-term perspective

While the pandemic is undoubtedly disruptive for dividend-paying stocks, it is essential to keep the long-term picture in mind.

Consider that, over the past 30 years, dividends have accounted for almost half of all returns of the US stock market (S&P 500).

Dividends account for nearly half of returns over the last 30 years

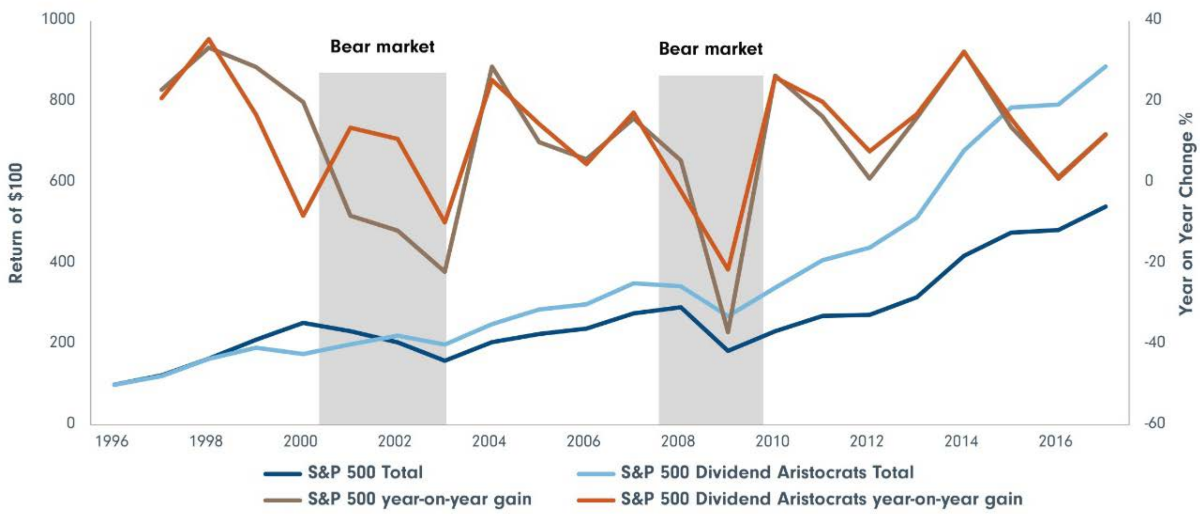
Source: Fidelity International, Bloomberg 2019. Past performance is not indicative of future performance.

Note that this timespan includes three significant recessions, meaning that over an extended time frame, history shows that dividend stocks are still an investment option worth considering.

A further breakdown of the data supports this, with dividend stocks outperforming in both rising and falling markets.

High dividend payers outperformed the market during the last two bear markets

Year-on-year returns for the S&P 500 Index vs S&P Dividend Aristrocrats



Source: Datastream, 8.3.2017. Past performance is not indicative of future performance.

Of course, what we have all experienced in 2020 is unprecedented. As the common investing disclaimer goes, past performance is no indication of future returns — something that makes careful security selection more important than ever.

Separating the winners from the losers

The official term for the differences in performance within the same asset class – such as dividend stocks – is 'dispersion'.

There are many reasons why such dispersions exist, and they all largely depend on the interaction between the broad economic environment and the individual company paying the dividend.

These reasons can also be complex, as linking dispersions to specific causes is not always easy. Yet, the evidence for such performance dispersions in the post-pandemic era is convincing.

The digital transformation of the global economy, for example, has boosted the software industry. At the other end of the spectrum, industries such as banks – as well as companies that have received state support – have been pressured by regulators to cut back on dividends.

We have also seen a shift in supply chains, driven by several factors, including trade disputes and, of the course, the pandemic. Therefore, companies with more robust and efficient supply chains should prove more resilient. And those with the capacity to quickly scale up should be better positioned to benefit from a demand recovery.

There are regional differences too. China was the first to deal with the pandemic, and, as such, looks to be the first to recover from its effects. In general, expectations in China are far more optimistic compared to the rest of the world. This has been reflected in dividend policies, with several Chinese companies announcing an increase in dividends.

What's more, our research reveals that companies with high ESG (environmental, social, and governance) ratings managed to outperform the broader index – even after adjusting for market volatility. One reason for this could be that a focus on sustainability reflects positively on the quality of a firm's management and its processes. This, in turn, leads to more resilient businesses that can weather the downturns and capture opportunities as the economy recovers.

Dividend investing remains a compelling income opportunity

As we have established, the short-term outlook for dividend investing is indeed challenging. However, it is also essential to keep in mind that, in the near term, cutting dividends is simply a prudent financial move — even for strong companies.

Yet when we look forward, the evidence for dispersion shows that select companies – depending on industry, country, and the quality of the business – should be better positioned to continue or even increase dividends over a longer time frame.

In such an uncertain environment, it will be challenging to capture most of these 'winners' by using a broad-based index fund. This is where active investing – one that bases its decisions on detailed analysis and on-the-ground insights — could certainly help.

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