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Buyback or Pay-Out?

WINTER 2016

The Boston Company
Asset Management, LLC®

The U.S. is a market as known for its share buybacks as for its pay-outs. Here, **John Bailer, U.S. equity income manager at The Boston Company**, explores U.S. dividend trends and looks at what income investors might expect in the year ahead. What headwinds do companies face in 2017?

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Against a backdrop of elevated anxiety, income-producing stocks are often the first place investors turn to for so-called 'safe harbor' allocations. This has arguably led to valuations of such dividend payers looking steep, with the U.S. utilities sector, for example, trading at 18.2x P/E in the summer of 2016, following a Brexit-fueled volatility spike.[1]

Often termed bond proxies, these large-cap defensive stocks have enjoyed investor favor due to their higher-yielding profiles in an investment environment where as much as $12 trillion of the fixed income market was negative-yielding by October 2016.[2]

The question for 2017 is whether such equities can continue to curry investor support and whether their pay-out ratios are sustainable. The historical average pay-out ratio of the S&P 500 is 57.3%, with the 1930s marking a peak in ratios of 90.1%.[3] In the 1970s, 80s, 90s and 2000s, the average pay-out ratio dropped significantly below this long-term average and buybacks were more the norm, says John Bailer, U.S. equity income manager at The Boston Company Asset Management.

"The pay-out ratio now is around 45%, so there is some room before it hits the historical average. Part of the culture of buybacks has been driven by taxation—capital gains were taxed at a lower rate so companies were better off buying back stock.

"The other important factor has been management compensation, which has been very stock option-orientated. When you're dealing with stock options, the value of the stocks goes down when you pay out dividends. Management compensated largely with stock options

1. *FactSet*, July 31, 2016.
2. *Bloomberg*, October 2, 2016.
3. *Ned Davis Research* – Historical Average for Period March 31, 1926 to December 31, 2015.

FIGURE 1:
DIVIDEND PAY-OUT RATIOS S&P 500

Decade	Average payout ratio
1930s	90.1%
1940s	59.4%
1950s	54.6%
1960s	56.0%
1970s	45.5%
1980s	48.6%
1990s	47.6%
2000s	35.3%
HISTORICAL AVERAGE = 57.3%	
CURRENT PAYOUT RATIO = 45.5%	

Source: Strategas Research Partners, 1930-2009, Ned Davis Research for historical average (see footnote on page 1) and TBCAM for current pay-out ratio, as of December 31, 2015.

are much better off buying back stock and this has encouraged the wider trend of buybacks."

CHANGING MANAGEMENT CARROTS

Since the financial crisis, the composition of management compensation packages has changed and boards are starting to allocate a higher percentage via restricted stocks, says Bailer. "This has prompted management teams to favor a combination of stock buybacks and dividends so we are seeing a slow movement towards more of the latter."

Management teams have seen companies with higher yields obtaining higher valuations on the stock market and Bailer believes this is encouraging them to think again about dividend distributions. The current low-growth environment has led to company caution when it comes to building out capacity and investment, so firms have over $4 trillion in cash on their balance sheets, he adds.[4] This means companies have ample capital to return to shareholders.

In 2016, firms were not shy in doing so: S&P 500 dividends increased 5.2% year over year in the third quarter, putting the yield of the index at 2.1%.[5]

Bailer believes if the perception of the market changes and U.S. economic growth starts to look more robust then capex could increase, but he is not concerned this capital would be taken out of dividend pools. "I think the higher capex goes, the more companies will move out of buybacks. The last thing they want to do is to cut dividends because it is deemed a taboo by the market and share prices tend to suffer as a consequence."

He believes the current pay-out ratio of the S&P 500 is not egregious and, as such, he does not see it diminishing in 2017.

SECTOR SCOUT

"I believe in the majority of industries dividend cuts are not a significant threat. A few areas like the energy explorers and producers and the owners of energy infrastructure cut their dividends following the oil price drop. But I believe those cuts have now filtered through," says Bailer.

Meanwhile, he believes financials are an interesting sector from an income investor's point of view and that an active manager can find good value in higher-dividend-yielding stocks, particularly in financials (see Figure 2).

"The market still treats financials as risky and is skeptical of them due to the overhang from the financial crisis. The valuations of many financials in the sector are at all-time lows and while governments are forcing banks to hold a lot more capital, in the past five years they are making the best loans they have ever made. Yet everyone

4. Cash balances based on S&P 500 balance sheet and include short-term equivalents as of September 30, 2016.
5. *Evercore,* October 4, 2016.

FIGURE 2: FINANCIALS VERSUS UTILITIES

	Income stock financials (Incl REITs)	Utilities Select Sector SPDR Fund (XLU)
Dividend yield	3.4%	3.3%
YTD Performance	3.6%	22.4%
Projected 3-Yr Dividend Growth Rate	9.9%	5.5%
Historical 3-Yr Dividend Growth Rate	21.0%	4.9%
Price/Earnings Ratio (FY2)	11.9x	18.2x
Price/Book Value ratio	1.2x	2.0x

Source: FactSet, July 31, 2016.

still thinks first and foremost of the dividends cut in the wake of the global financial crisis."

Yet Bailer notes how the Tangible Common Equity ratio (a measure of the losses a bank can take before shareholder equity is wiped out) for financials is at its strongest since the 1930s. So balance sheets are in "incredibly good shape," he says, even as Comprehensive Capital Analysis and Review (CCAR) severe adverse scenario tests carried out by the Federal Reserve show the banking sector should have resilience in the face of a range of even serious headwinds.

TAX IMPLICATIONS

Another potential boon for pay-out ratios in 2017 could be if the new president, Donald Trump, manages to pass a repatriation tax holiday. "According to some reports, U.S. companies are holding in excess of $2.1 trillion in profits overseas, so if even a fraction of that is brought back onshore, I believe it would feed into dividends. M&A (Mergers & Acquisitions) would also likely be a beneficiary," says Bailer.

Over the longer term, he hopes Washington will work towards reforming the tax code so the corporation rate no longer sits at 35%: "We believe it is a bipartisan issue that needs to be fixed."

The tech sector in particular could be ripe for increasing pay-outs if tax reform is approved. Bailer says management teams in big tech are gradually moving to compensation through restricted stocks like the rest of the market. He hopes to see greater pay-outs from the tech sector following this development.

For the long term, Bailer notes sustainability remains key when it comes to dividend payments. Even so, he stresses high pay-out ratios should not always be viewed as a red flag. "There are some instances when pay-out ratios as high as 90% are sustainable—REITs (Real Estate Investment Trust), for example, are mandated to pay out a high portion of earnings and some utilities can also maintain such levels. What it comes down to is whether investors can be confident in the company's ability to generate sufficient cash consistently."

The main headwind he could envisage in 2017 would be a further drop in energy prices, which could see more companies in that sector cutting dividends, but this is not his base case. "I think a lot of that played out in 2016 and I think the rest of the sectors in the U.S. are in pretty good shape," he concludes.

What to Watch in 2017

- A repatriation tax holiday.
- Sustained pay-out strength in the financial services sector.
- Progression in favor of dividends and away from buybacks.

The **price-to-earnings ratio (P/E)** is the relationship between a company's earning and its share price, and is calculated by dividing the current price per share by the earnings per share. **Payout ratio** is the proportion of earnings paid out as dividends to shareholders, typically expressed as a percentage.

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MARK-2016-12-06-0838
DRY-BBPOCMTY-1216

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