Wealth Management Insights Audiocasts

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Dividend Yield Tradeoffs, Traps and Trends

Jodie Gunzberg, Chief Institutional Investment Strategist for Wealth Management, offers important considerations when incorporating dividend strategies in your portfolio.

Transcript

Welcome to another edition of Wealth Management Insights. I'm Jodie Gunzberg, and I am the Chief Institutional Investment Strategist for Wealth Management. Today is November 18, 2020, and I am recording this at my home outside of New York City.

Today I'm going to talk about dividend strategies, which are increasingly important since interest rates are near zero, and generating income from bonds is a challenge currently. Investors may be pushed higher along the risk spectrum and look to dividend-paying stocks as an income substitute for what would have otherwise been dedicated to bonds and interest income. Selecting an actively managed dividend fund may be an attractive alternative to stock picking among cash-generating securities and can lower risk in a portfolio by potentially providing downside support if the market corrects.

After all, dividend investors need to do a lot more than simply look for a stock with a high yield. The key consideration is whether a company can pay its dividends in the future. Many dividend yields become elevated when a stock price falls, since the yield is the dividend per share divided by the stock price. That decline may reflect negative views, which may persist and can make high-dividend-yielding stocks riskier. So, valuations matter as the price paid will impact the dividend yield received and also the potential downside.

Additionally, investors should evaluate a company's balance sheet. High debt service and other expenses relative to income can be an indicator that a company may not have enough cash flow to sustain dividends. High payout ratios can be an indicator that a company is using too much of its earnings to pay the dividends.

Rather than simply looking for higher dividend yields, many investors seek stocks with proven dividend growth. That may help them avoid "dividend traps," which may have high yields that are just too good to be true. Recently, many companies have curtailed their dividend policies as uncertainty in the current environment has prompted management teams to become more cautious and conserve cash as a buffer. Plus, we are generally seeing decelerating dividend growth because rising stock prices have the effect of reducing dividend yields.

That said, there are leaders and laggards in this environment, and the beneficiaries of the remote-work model seem better able to maintain and grow their dividends. More broadly, the percentage of public companies paying dividends has been increasing, with some technology growth companies initiating dividends in recent years. So, the dividend-yielding opportunity set has broadened over time, likely following investor demand for more current income from their stock investments.

From a portfolio perspective, income-seeking investors should be aware of volatility, yield on cost, and taxes when using dividend-paying equity strategies. Dividend stocks generally have been more volatile than bonds. Also, to the extent a company raises its dividend over time, this introduces the concept of "yield on cost," where an investor's dividend yield based on his or her cost basis is more attractive than the current yield.

Keep in mind that dividends are effectively taxed twice. They are taxed at the long-term capital gains rate, whereas bond interest is treated as ordinary income, and in addition, dividends are taxed first at the corporate tax level as earnings. This means dividend-income investing for payouts and living expenses can make sense, but if an investor is reinvesting the dividend to buy more stock, it may not be a tax-efficient use of capital.

One final point that is relevant to portfolio construction: Many smaller-cap and growth companies don't pay dividends, so limiting an overall equity asset allocation to dividend stocks may have the unintended consequence of giving a portfolio more of a large-cap and value bias, which can be less attractive for hedging against inflation, a declining dollar, and rising rates. Also, including active managers in the small-cap and growth space may improve potential price appreciation.

For more information on dividend investing, please reach out to your Financial Advisor.

Asset Class Risk Considerations

For index, indicator and survey definitions referenced in this report please visit the following:

https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

Hypothetical Performance

General: Hypothetical performance should not be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Hypothetical performance results have inherent limitations. The performance shown here is simulated performance not investment results from an actual portfolio or actual trading. There can be large differences between hypothetical and actual performance results.

Despite the limitations of hypothetical performance, these hypothetical performance results may allow clients and Financial Advisors to obtain a sense of the risk / return trade-off of different asset allocation constructs.

Investing in the market entails the risk of market volatility. The value of all types of securities may increase or decrease over varying time periods.

This analysis does not purport to recommend or implement an investment strategy. Financial forecasts, rates of return, risk, inflation, and other assumptions may be used as the basis for illustrations in this analysis. They should not be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. No analysis has the ability to accurately predict the future, eliminate risk or guarantee investment results. As investment returns, inflation, taxes, and other economic conditions vary from the assumptions used in this analysis, your actual results will vary (perhaps significantly) from those presented in this analysis.

The assumed return rates in this analysis are not reflective of any specific investment and do not include any fees or expenses that may be incurred by investing in specific products. The actual returns of a specific investment may be more or less than the returns used in this analysis. The return assumptions are based on hypothetical rates of return of securities indices, which serve as proxies for the asset classes. Moreover, different forecasts may choose different indices as a proxy for the same asset class, thus influencing the return of the asset class.

Any type of continuous or periodic investment plan does not assure a profit and does not protect against loss in declining markets. Since such a plan involves continuous investment in securities regardless of fluctuating price levels of such securities, the investor should consider his financial ability to continue his purchases through periods of low price levels.

Active or frequent trading to effectuate a dynamic allocation strategy entails greater risk and is more speculative, but also entails the possibility for above- average returns, compared with a long-term investment strategy. It may also entail more costs and fees, as well as a larger and more immediate tax liability.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Companies paying **dividends** can reduce or cut payouts at any time.

Investing in foreign markets entails risks not typically associated with domestic markets, such as currency fluctuations and controls, restrictions on foreign investments, less governmental supervision and regulation, and the potential for political instability. These risks may be magnified in countries with **emerging markets and frontier markets**, since these countries may have relatively unstable governments and less established markets and economies.

Investing in small- to medium-sized companies entails special risks, such as limited product lines, markets and financial resources, and greater volatility than securities of larger, more established companies.

The value of fixed income securities will fluctuate and, upon a sale, may be worth more or less than their original cost or maturity value. Bonds are subject to interest rate risk, call risk, reinvestment risk, liquidity risk, and credit risk of the issuer.

High yield bonds (bonds rated below investment grade) may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk, price volatility, and limited liquidity in the secondary market. High yield bonds should comprise only a limited portion of a balanced portfolio.

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies.

Nondiversification: For a portfolio that holds a concentrated or limited number of securities, a decline in the value of these investments would cause the portfolio's overall value to decline to a greater degree than a less concentrated portfolio. Portfolios that invest a large percentage of assets in only one industry sector (or in only a few sectors) are more vulnerable to price fluctuation than those that diversify among a broad range of sectors.

Growth investing does not guarantee a profit or eliminate risk. The stocks of these companies can have relatively high valuations. Because of these high valuations, an investment in a growth stock can be more risky than an investment in a company with more modest growth expectations.

Value investing does not guarantee a profit or eliminate risk. Not all companies whose stocks are considered to be value stocks are able to turn their business around or successfully employ corrective strategies which would result in stock prices that do not rise as initially expected.

Rebalancing does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy.

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