The Cult of Equity Re-Visited

In last week's research report on *The Cult of Equity*, I suggested that the current dividend yield on the S&P500 of 2% implies that a period of low expected returns lies ahead. If the current yield holds, investors can expect the US stock market to produce a nominal return of 6% over the long-run and a real return of 4%, well below the 6.6% real return achieved since 1871 and a far cry from real return of above 8% posted over the past thirty years.

Alternatively, for those who believe that mid-single digit returns do not adequately compensate investors for taking on stock risk, a rise in expected returns requires either a significant market correction or a prolonged period of stagnation in the market to allow dividends to effectively catch up. Here I outline the possible paths to higher expected returns, each of which promises to be painful.

Based on Rob Shiller's comprehensive data set that stretches back to 1871, the current dividend yield lies well below the average of 4.4% over the past 140 years.

By observing the path of the dividend yield through time, it is obvious that something changes through the middle part of the 20th century which is associated with a structural and sustained decline in the yield. The average yield of 3.2% over the past 60 years is materially lower than the 5.4% average in the first 80 years of the sample. The dividend yield dips below 6% in 1952 not for the first time. Indeed, the yield had remained below 6% for most of 1885 to 1917. But since 1952, the dividend yield has remained below 6% for all but a number of months in 1982.

It is reasonable to think that investors expect a lower yield and therefore lower returns from owning stocks than a century ago due to lower risk.

Stock ownership was more concentrated in the late 19th century and early part of the 20th century. With greater risk sharing, investors demanded less compensation for owning stocks, leading to lower expected returns. As share ownership became more diffuse, investors increasingly came to own more diversified portfolios.

Two developments in the past fifty years – one theoretical and one technological - accelerated the trend towards diversification. Modern portfolio theory espoused the powerful benefits of diversification, while the first index fund - launched by Wells Fargo in the 1970s - led to a sharp decline in the costs associated with owing the market portfolio.

But are expected returns from the S&P500 so low now that they do not adequately compensate investors for taking on stock risk?

For illustrative purposes only, mean reversion in the dividend yield implies a significant market correction assuming dividends remain constant. Controlling for dividends, a rise in the yield to its 140 year average of 4.4% would be associated with a market decline of over 50%, while a rise in the yield to its average over the past 60 years points to a market correction of over one third.

The sensitivity analysis relies on the assumption that dividends remain constant at their current level. But higher dividends would provide an assist in the shift to a higher yield environment, so that lower stock prices do not bear the entire burden of adjustment. How realistic is this prospect?

First, the S&P500 dividend per share is far from depressed, having grown to be 30% higher than the pre-financial crisis peak in nominal terms. Much like earnings, dividends experienced a V-shaped recovery and have kept on growing strongly.

Second, there is limited scope for dividend growth to get an assist from higher payout ratios because US corporations have less capacity to raise payout ratios than is widely believed.

US companies currently pay out 35% of earnings, higher than the payout ratio that prevailed during the credit boom years of the mid-2000s but well below the median payout ratio of 60% over the past forty years.

But since the 1970s, US companies have increasingly relied on buying back their shares to return capital to shareholders, considered to be more tax effective than paying out dividends.

The corporate sector savings rate remains close to a record high, reflected in high levels of cash on balance sheets. Rather than skimp on paying dividends, US firms have shown little appetite for debt, new hiring or capital projects. When the corporate sector's animal spirits do eventually revive, dividend growth is thus likely to slow from current levels.

Stagnation or correction?

Suppose that higher dividends bear the entire burden of the reversion to a higher yield environment. Controlling for price, dividends would need to expand at the historical compound annual rate of 3.5% for fourteen years for the yield to rise to its 60 year average of 3.2%. An acceleration in annualised dividend growth to 5% reduces the catch-up period to ten years.

If I have under-estimated the capacity for US corporations to raise dividend payout ratios, this might still not make a material difference to future expected stock returns. A rise in the aggregate payout ratio presumably would signal lower growth options and be associated with lower expected future growth of earnings and dividends.

In summary, a market correction from current levels of at least one-third is necessary to raise the dividend yield to its 60 year average of 3.2%, controlling for dividends. Alternatively, the market would need to stagnate at current levels for the next decade if dividend growth accelerated well above historical trends to 5% pa.

Asset allocators beware

The key lesson for asset allocators is that caution needs to be exercised if treating realised or historical returns as being representative of future returns. The low current level of the dividend yield for the S&P500 confirms that there has been a significant decline in expected future returns from investing in stocks.

For those who believe that expected returns will continue to match the past, the analysis suggests to be careful what you wish for.

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Charts underpinning the analysis and references cited are available on request.

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