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WHITE PAPER

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A Man from a Different Time

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As those who know me can attest, I've never worried about being fashionable. Not for me, the fads and fashions of this contemporary age. Indeed, I'm known affectionately to some of my colleagues as "the Amish," for my shunning of the modern world. Touch-screen technology and person-less check-ins at airports haunt my nightmares. Perhaps I am just a man from a different time.

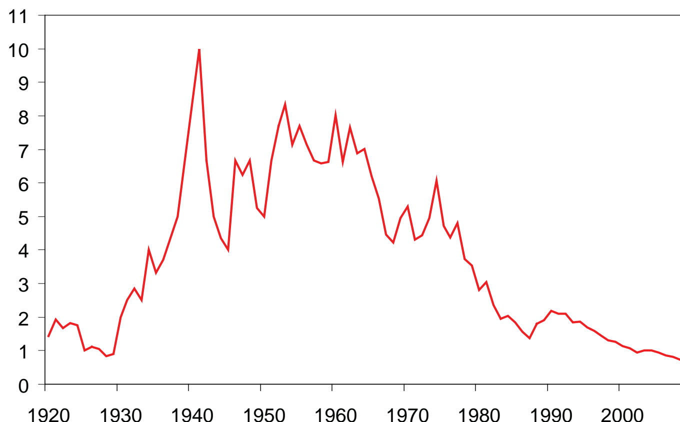
Given these predilections, it is little wonder that I often sit and stare at the farce that passes for modern day investment. The churn and burn of an 8-month average holding period is anathema to me. Call me old-fashioned, but I like to focus on the things that matter, both in life and in investing.

Dividends still matter

To those who charge around in markets trying to guess the next quarter's make-believe earnings number, the concept of dividends seems wholly irrelevant. However, to those with an attention span measured in longer than milliseconds – who are few and far between, to judge from today's markets – dividends are a vital element of return. Exhibit 2 illustrates this point graphically. Looking at the U.S. market since 1871, on a 1-year time horizon, nearly 80% of the return has been generated by fluctuations in valuation. However, as the time horizon is extended, "fundamentals" play an increasing role in return generation. For example, at a 5-year time horizon, dividend yield and dividend growth account for almost 80% of the return.

Exhibit 1

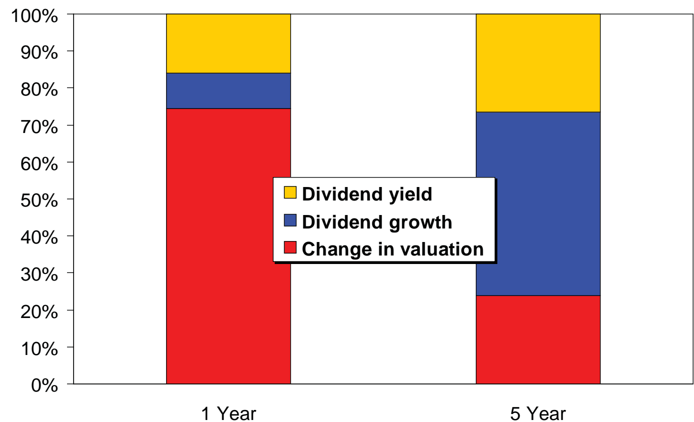
The Churn and Burn Age
(Average holding period for NYSE listed stocks, in years)



Source: NYSE, GMO

Exhibit 2

Return Generator by Time Horizon
(S&P 500)

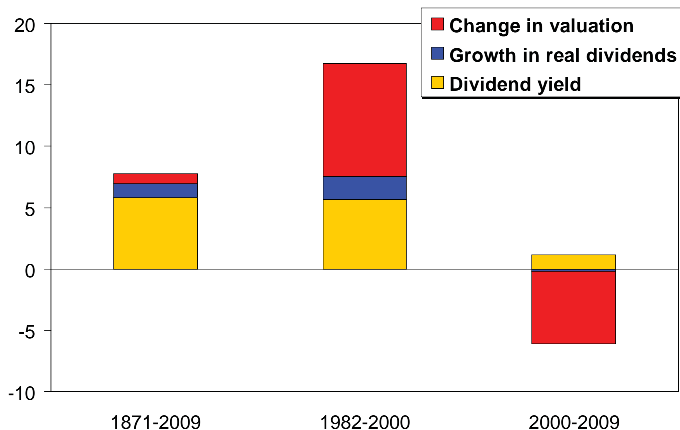


Source: GMO

Exhibit 3 shows the contribution that dividends have made to total returns over various periods. On average, over the very long term, dividends have accounted for some 90% of total return.

Exhibit 3

The Importance of Dividends (S&P 500)



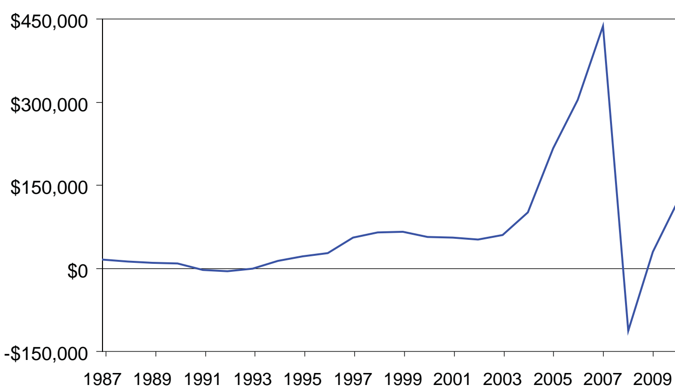
Source: GMO

Of course, with management incentivised to focus on the share price (via enormous option positions), dividends have fallen out of favor with CEOs as well as "investors" (although it pains me to use that term for the seeming ADHD-afflicted speculators who dominate the investment scene today). Instead, the focus has been on repurchases.

However, I don't regard repurchases as equivalent to dividends, least of all in their permanence. Whilst dividends are generally raised and lowered relatively slowly, repurchases seem to be used to distribute excess earnings that are temporary in nature. Witness the explosion and implosion of repurchases over the last few years (Exhibit 4).

Exhibit 4

The Rise and Fall of Repurchases
(Net, U.S. $ millions, S&P 500)



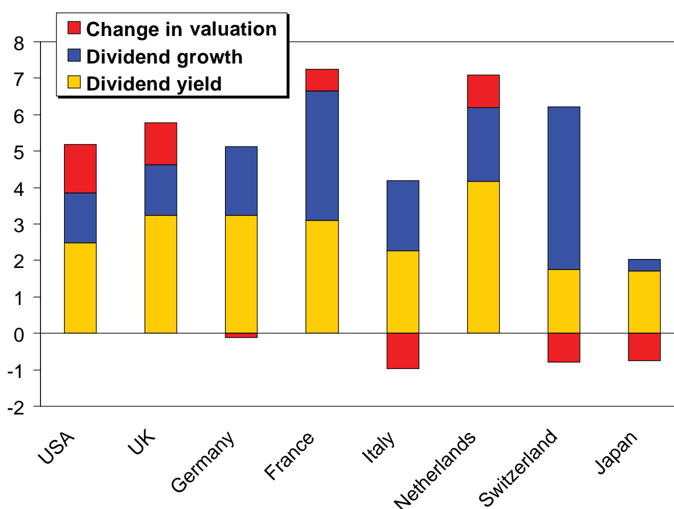
Source: GMO

If repurchases were to truly benefit investors, then we would expect to see the "growth" element in the above decomposition increasing. Yet, there has been no evidence of this. So the kindest thing one can say is that, so far, the idea of repurchases replacing dividends is the Scottish legal verdict "case unproven."

The importance of dividends over the long term isn't just a U.S. phenomenon. The same patterns hold true across a wide variety of global equity markets. For instance, in Europe, 80% to 100% of the total returns achieved since 1970 have come from dividends (combining yield and real dividend growth).

Exhibit 5

Dividends Matter Around the World



Source: GMO

European dividends: still priced for the Great Depression

Now, what if I told you that you could purchase these dividends at a fraction of their potential worth? You'd probably think I was running a dubious advert in one of those magazines aimed at those who think they can get rich quick. But it really is possible – although patience is vital – this is no get-rich-quick scheme.

There is a market for dividends. The reason it exists is that investment banks and the like end up owning dividends as a direct result of the structured products they create.

Effectively, when you see products such as capital-protected bonds, which offer exposure to the upside of the equity markets (and a floor on losses), they are written in terms of capital gains. To hedge this exposure, the banks buy equities. But they only want the capital part of the return, leaving them long dividends. Institutions have taken to swapping these dividends in the same way that a plain vanilla fixed for floating swap works.

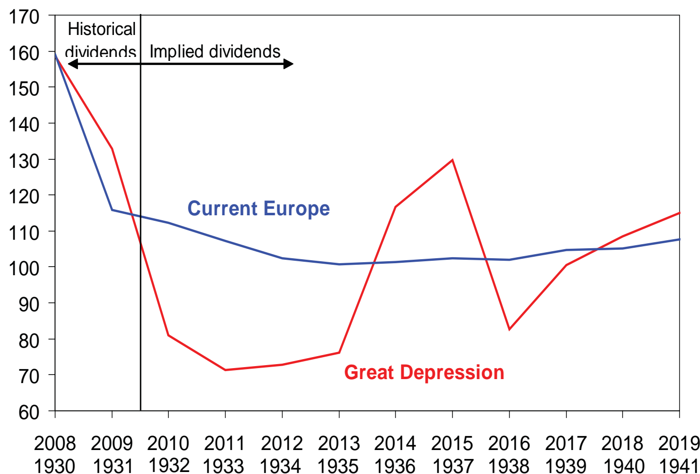
This market allows investors to trade dividends independent of the market. Effectively, we can isolate the dividends and not have to worry about the multiple that the market places upon that cash flow.

Of course, as with all investments, the price you pay determines the attractiveness of the opportunity. The good news is that European dividends appear to be priced cheaply at the moment.

Exhibit 6 shows the current pricing structure of European dividends (for the Eurostoxx 50, the vertical line marks the point at which we switch from actual dividends to the market's implied view of dividends), and shows the experience of U.S. dividends during the Great Depression as a comparison. In essence, the market is saying that dividends will have virtually zero growth between now and 2019. This is a worse outcome than the U.S. witnessed in the wake of the Great Depression!

Exhibit 6

European Dividends Priced for a Depression



Source: GMO

Of course, we need an estimate of intrinsic value to truly assess the scale of opportunity that the dividend swap market presents. Historically (since 1988), dividends for the Eurostoxx 50 have grown at an impressive nominal 11% annually. Broader European indices (with longer histories) show a dividend growth rate of around 8% annually.

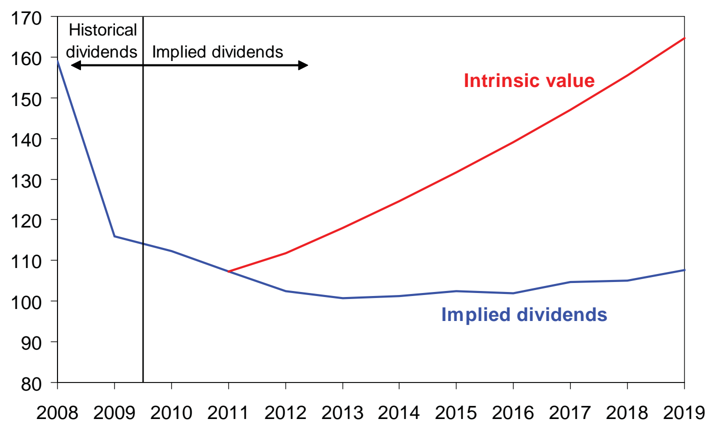
However, as Ben Graham noted, any estimate of future growth "must err at least slightly on the side of understatement." So, we've constructed an intrinsic value estimate for European dividends based on three possible paths: a poor outcome in which dividends grow at only 2% annually (assigned a 25% probability); a base case, which assumes dividends grow at a 6% annual rate (a 50% probability); and a bull case, where dividends are expected to grow at an 8% rate annually (a 25% probability).

The bear case of 2% annual growth may seem generous when one considers that the 10-year U.S. annual dividend growth rate has been below 2% about one-third of the time since 1871. However, this would ignore the 33% decline we have already witnessed in European dividends. Looking at 10-year annual growth following periods of 33% declines in U.S. dividends, we see an average growth rate of 5% annually, making our bear case assumption of 2% conservative. Even Japan has managed to grow its dividends by just over 2% annually during its two decades of post-bubble economic stagnation.

Exhibit 7 shows the implied dividends and our conservative estimate of intrinsic value. The implied margin of safety between the current price and our estimate is between 40% and 60% on the long-dated contracts.

Exhibit 7

European Dividends (Implied vs Intrinsic Value)

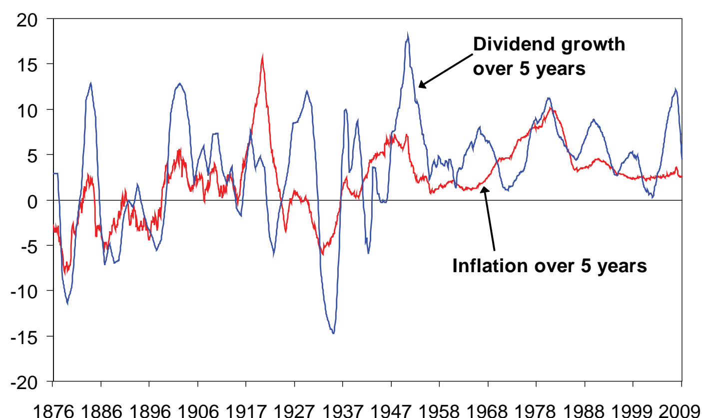


Source: GMO

Dividend swaps have two other noteworthy features. First, they offer an implicit inflation hedge. Dividends are a nominal concept (paid as they are in today's prices).

They tend to track inflation relatively well over periods greater than 5 years – see Exhibit 8, which shows the 5-year annual growth of U.S. dividends and inflation. Even looking over more recent periods shows similar relationships. For instance, over the last four decades, dividend growth has shown an "inflation beta" of around 0.94 over a 10-year period, whereas the market's total return has an "inflation beta" of 0.0 over a 10-year period. The reason, of course, is that often inflation seems to result in multiple contractions.

Exhibit 8
5-Year U.S. Dividend Growth vs Inflation (CPI, % annually)



Source: GMO

The other intriguing feature of dividend swaps is that, for once, survivor bias is actually on your side. So when you buy the index dividends for, say, 2019, you are buying the dividends that are generated by the stocks that are in the index in 2019, rather than the stocks that are in the index today. In general, the stocks that get added to an index are mature, large cap, dividend-paying stocks (especially in the context of the Eurostoxx 50). The ones that drop out of the index are more likely to be the dividend cutters, so survivor bias works in favor of the dividend swap owner.

Of course, there is always a chance (hopefully small) that we witness another "growth" bubble à la TMT, when all sorts of non-dividend paying stocks were added to the index. To try to mitigate this risk, as well as the obvious risk that any single year could turn out to be a recession, one should diversify across multiple maturities of these dividend swaps.[1]

As ever, patience will be required. Convergence between the implied dividends and actual dividends is likely to be painfully slow in the longer maturities. The volatility of dividend swaps is also pronounced (with the swaps trading with a "high beta" to the underlying equity market rather than the "low beta," which might have been expected given that dividends tend to be less than two-thirds as volatile as equity prices[2]). However, this is likely to be a function of the relative youthfulness and illiquidity of the market – neither of which should be permanent features.

European dividend swaps offer an intriguing opportunity to capture one of the main generators of returns, protected against the vagaries of Mr. Market's assigned valuations, at a cheap price (thanks to oversupply from investment banks), as well as a large margin of safety and an offer of some long-term inflation protection. What's not to like?

[1] Another risk that arises with dividend swaps is counterparty risk. For those who can trade on Eurex, there is an exchange listed future. CFTC approval is still pending in the U.S.

[2] This lower fundamental volatility has to be balanced against the fact that holding the underlying equities gives you an option not to "redeem" at any given point, whereas dividend swaps terminate at a given point in time. Another reason to diversify across maturities as discussed above.

Mr. Montier is a member of GMO's asset allocation team. He is the author of several books including Behavioural Investing: A Practitioner's Guide to Applying Behavioural Finance; Value Investing: Tools and Techniques for Intelligent Investment; and The Little Book of Behavioural Investing.

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