Wealth Management
PH&N Investment Counsel

Stu's View

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The Risk of Dividend Disruption

John D. Rockefeller once said "Do you know the only thing that gives me pleasure? It's to see my dividends coming in." As the global economy has moved from growth to contraction in a very short period of time, many companies have had to scramble to find sources of liquidity, or cash, in order to make it through a period of lower demand. In this article we look at the risk of dividends being reduced, suspended, or eliminated. Historically, dividends have done well by investors, with higher returns earned on average with dividend-paying companies compared to non-dividend paying companies.

What is a dividend, and a dividend yield?

A dividend is a distribution paid to a company's shareholders. Dividends are declared (i.e., authorized) by a corporation's board of directors, whose actions may or may not require approval by shareholders. In contrast to the payment of interest and principal on a bond by its issuer, the payment of dividends is discretionary rather than a legal obligation, and may be limited in amount by legal statutes and by debt contract provisions. Dividend payments and interest payments in many jurisdictions are subject to different tax treatment at both the corporate and personal levels. For the purposes of this article, when we reference dividends, we are referring to common equity dividends and not necessarily preferred share dividends.

Some of you may use dividend-paying investment strategies to generate portfolio income, and/or serve as a way to diversify interest income generated by fixed-income securities in the portfolio. Also, dividends received from Canadian companies are taxed at a lower rate than the same amount of interest income.

Historically, the dividend yield (a measure of dividends received divided by the current price of the security) on common equities has been higher than the current bond yield for government securities. This intuitively makes sense as there is more inherent risk associated with the future income from an individual company, when compared to the risk of a government being able to pay the interest on its debt. Yet on an absolute basis for those looking for current portfolio income, common dividend yield relative to other

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income-generating securities may offer an attractive proposition. After all, as we look back in history, once a company has started to pay out a percentage of its profits as dividends to shareholders, they tend to commit to those dividends and look to grow them over time. Suspending, cancelling or reducing dividends in the future is not a decision to be taken lightly. The dividend component of investor returns typically assumes into perpetuity that the dividend will get paid, and continue to grow with company profits.

How significant have dividend returns been for shareholders?

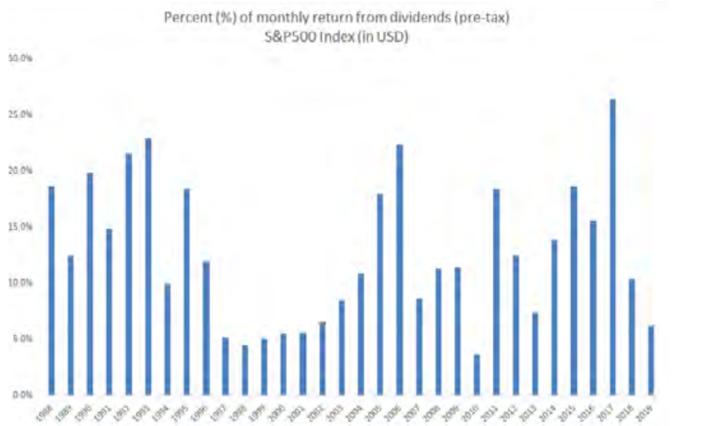
Pre-tax, dividends have historically been a material factor when it comes to investor returns. From a high level, looking at Chart 1, the percentage of monthly returns attributed to dividends paid for companies within the S&P 500 index averaged about 13% of monthly returns.

Not only have dividends been an important component of shareholder returns, but dividend-paying stocks, on average, enjoy higher returns and lower volatility than broad equity markets, across all regions. As we show in Chart 2, annualized returns for dividend-paying stocks compared to all-stocks is higher in regions shown here. In addition, Chart 3 shows the volatility (i.e. standard deviation, a measure of price dispersion of monthly returns) for dividend-paying and all stocks across the regions.

Dividend paying companies provide further diversification from market volatility

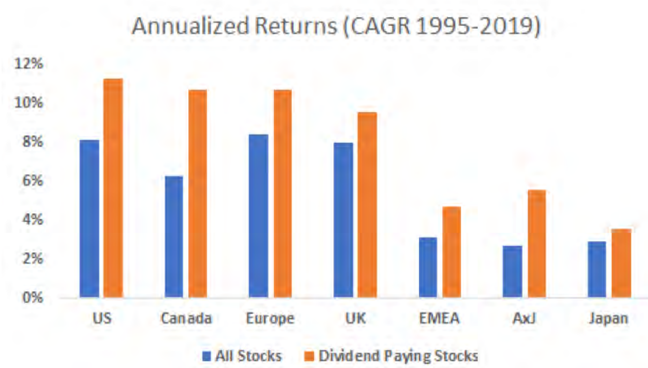
Portfolio diversification is another important aspect to holding dividend-paying stocks in your portfolio. Historically, the correlation between

Chart 1: Dividend income as a % of investor return:



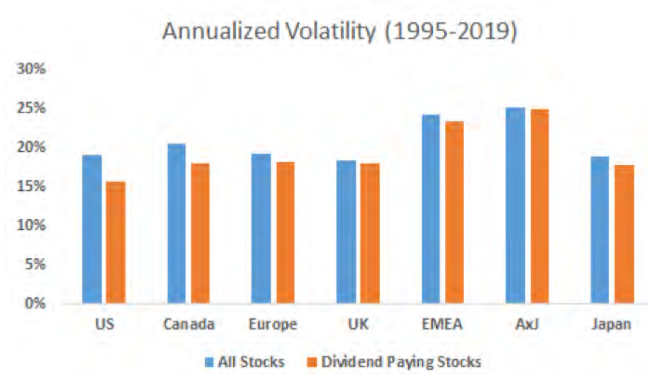
Source: Bloomberg, RBC Capital Markets Equity Strategy. As of March 31, 2020, pre-tax, USD, S&P 500 average monthly return from dividends in each calendar year period (monthly return from dividends / total return including dividends for S&P 500). Dates reflected in the chart Feb 29 1988 through March 31, 2020. (Please see disclosures for full description of the index.) Past performance is no guarantee of future results. An investment cannot be made directly into an index. The graph does not reflect transaction costs, investment management fees or taxes. If such costs and fees were reflected, returns would be lower.

Chart 2: Annualized Return (all stocks vs dividend-paying stocks)



Source: Wolfe Research, LLC. Reprinted with permission. Indices as of Dec 31, 2019 (US = Russell 3000, Canada = S&P/TSX Composite, Europe = S&P Europe BMI, UK = S&P United Kingdom BMI, EMEA (Europe, the Middle East and Africa) = S&P EMEA BMI, AXJ (Asia ex-Japan) = S&P Pan Asia Developed Ex-Japan BMI, Japan = S&P Japan BMI). Please see the disclosure for a full description of each index used in the chart. The CAGR is calculated using monthly returns, annualized by cumulating the monthly returns, all in USD. Past performance is no guarantee of future results. An investment cannot be made directly into an index. The graph does not reflect transaction costs, investment management fees or taxes. If such costs and fees were reflected, returns would be lower.

Chart 3: Volatility (standard deviation)



Source: Wolfe Research, LLC. Reprinted with permission. Indices as of Dec 31, 2019 (US = Russell 3000, Canada = S&P/TSX Composite, Europe = S&P Europe BMI, UK = S&P United Kingdom BMI, EMEA (Europe, the Middle East and Africa) = S&P EMEA BMI, AXJ (Asia ex-Japan) = S&P Pan Asia Developed Ex-Japan BMI, Japan = S&P Japan BMI). Calculation methodology (volatility is from monthly returns 1995-2019, annualized as the standard deviation of the monthly return times square root of 12. Please see the disclosure for a description of each index used in the chart. Past performance is no guarantee of future results. An investment cannot be made directly into an index. The graph does not reflect transaction costs, investment management fees or taxes. If such costs and fees were reflected, returns would be lower.

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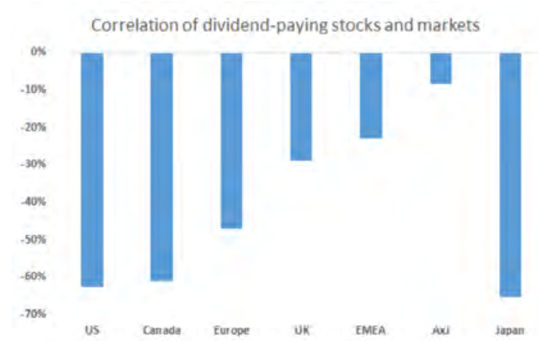
the excess return of dividend-paying stocks (compared to the benchmark) and the market is negative in all regions, which suggests that dividend strategies are generally defensive and perform well during market downturns.

Dividend disruption – understanding the risks

Business disruption caused by the COVID-19 crisis has resulted in some companies suspending, canceling or lowering their dividend, as revenue and margins have been materially reduced. Firms that cut down, suspend or terminate dividends are often penalized by investors, with selling and downward pressure on their stock price. Part of the reasons for the selling pressure on a stock where the dividend has been reduced or eliminated has been referred to in academia as the "dividend signaling effect". This theory suggests that a company announcement of a change in dividend payouts is an indication of future developments. As of April 21, 2020 there were only a handful of companies in the United States, Canada and in Europe where dividends were suspended or reduced (chart 5).

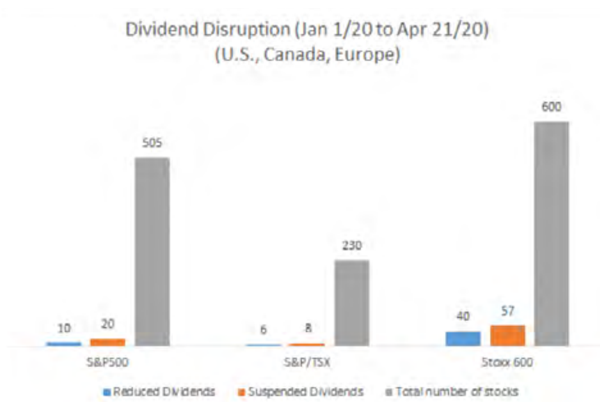
During prior bear markets, more companies reduced or eliminated their dividends than in prior periods (Chart 6). In the last bear market of 2008-09, at the peak in the S&P 500 Index in October 2009, approximately 15% of the 500 companies in the index had suspended, reduced or eliminated their dividends. Today, approximately 4% of the S&P 500 index has reduced or eliminated their dividends, so we may have some room to go over the next few quarters in relation to the overall index.

Chart 4: Correlation between the excess return of dividend-paying stocks (compared to the benchmark) and the market



Source: Wolfe Research, LLC. Reprinted with permission. Indices as of Dec 31, 2019. Please see the disclosure for a description of each index used in the chart. Calculation methodology (note the correlation coefficient is a statistical measure of the strength of the relationship between the relative movements of two variables. The values range between -1.0 and 1.0. Variables used in the chart are monthly excess return of dividend-paying stocks compared to each index over the period of 1995-2019, compared to the overall returns in the index, all in USD). Past performance is no guarantee of future results. An investment cannot be made directly into an index. The graph does not reflect transaction costs, investment management fees or taxes. If such costs and fees were reflected, returns would be lower.

Chart 5: Count of dividend reductions, dividend suspensions in United States, Canada and Europe



Source: Bloomberg as of April 21, 2020. Dividend reduction (company has decreased the quarterly dividend payment to shareholders), Dividend Suspension (company has set its dividend payment to CAD$0.00, USD$0.00, or EUR0.00, respectively, during the period of Jan 1/20 through April 21/20). Please see the disclosure for a description of S&P500, S&P/TSX, and STOXX 600 used in the chart. Past performance is no guarantee of future results.

Chart 6: Percentage of companies decreasing dividend rate year over year

Source: RBC Capital Markets Equity Strategy, with permission. Chart shows the percentage of companies within the S&P500 index that have reduced their dividend payout ratio (previous 12-month dividend payment / previous 12-month net income) on a year-over-year basis, over the period Dec 31, 1989 through March 31, 2020. All in USD. Past performance is no guarantee of future results.

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Quality in focus – potential to reduce dividend variability

One way to potentially reduce the risk of being exposed to a dividend disruption is to invest in higher quality companies. Quality can be defined in many ways, but here we suggest quality companies are typically those which are less financially levered than their peers, and have ample cash flow to support revenue growth and capital expenditures over a business cycle. Companies with these attributes may have more sustainable dividends through an economic cycle than companies that are more financially levered. Dividend-paying companies with a history of paying and growing their dividends over time is suggestive of an economic "moat" – or, said another way, they have a sustainable competitive advantage. This might result in the company earning an above-average return on capital that can be supportive of sustainable dividend growth, thereby potentially reducing the risk of dividend reductions or suspensions.

In addition, quality companies may be considered those that reflect positively when it comes to Environmental, Social and Governance (ESG) matters. According to RBC Global Asset Management, in periods of uncertainty, some factors may have more headline risk than others, but one thing is certain, the way in which companies mitigate ESG risks can make all the difference in how they manage their operations through these uncertain times, while continuing to add value over the long term.

RBC Global Asset Management Portfolio Managers on dividends at risk

Jennifer McClelland, Vice President & Senior Portfolio Manager, Canadian Equities:

- The investment process means that Jennifer and her team are always focused more on the cash flows that underlie the dividends rather than the absolute level of dividends themselves. They try to get a good understanding about these cash flows, looking at where they come from and how sustainable they are. As a result, they spend a lot of time stress-testing these cash flows when the team works through their scenario analysis framework.
- The energy sector is the top area of concern, and in Jennifer's funds, they have pared back exposure to exploration and production very significantly in the last month.
- While acknowledging the difficult environment in which they are operating in, Canadian banks have an incredible amount of support from the government as well as their regulator, the Office of the Superintendent of Financial Institutions, which has actually lowered the minimum capital ratio requirements in an effort to encourage the banks to continue supporting Canadian businesses.
- While Jennifer does envision some of the Canadian bank earnings will suffer in the near term, when considering a worst-case scenario, their capital seems to still be above where it needs to be in terms of the mandated minimum, and the sustainability of their dividends still seems to be quite high, so that gives us some comfort.

Brad Willock, Vice President & Senior Portfolio Manager, U.S. Equities:

- As a result of the viral outbreak and the monetary/fiscal policy reaction to it (shutdown the economy), dividend policy for many companies has become a concern for investors. However, Brad noted that dividend changes have been in a handful of industries impacted by COVID-19, including: hotels, cruise lines, airlines, and aerospace more broadly, auto-related, retail and energy.
- In terms of the companies that Brad and his team invest in, they focus on avoiding companies that are cyclical and have significant leverage and those companies in non-regulated businesses with high dividend payout ratios. Given the current unique environment, some companies have suspended their dividends until business conditions return to normal. TJX Companies (Winner's) is an example of a retailer that expects to suspend its dividend until stores open up again and traffic returns to normal. When the economy opens up, Brad and his team believe that TJX will gain market share from department stores which have

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been weakened by the crisis.

- The large U.S. money center banks have halted their stock buybacks to conserve capital but have not changed their dividend policy. As far as the banks are concerned, they believe their dividends are safe in most scenarios, but there are scenarios which could put their dividends at risk. For example, an unlikely scenario, but if the economy remained shut down for six or nine months, the banks would suffer huge credit losses and would likely have to suspend or cut their dividends. Investors are also clearly concerned about dividend policy in the energy sector. The only energy exposure the team has is to Chevron, which has said it was confident it could maintain its payout, but that was before the price of oil fell below $20 per barrel in recent days. Brad and his team believe that a cut in Chevron's dividend is possible and are reviewing the position.

Dominic Wallington, Head of European Equity & Senior Portfolio Manager, RBC Global Asset Management (UK) Ltd.:

- European companies have a long-standing culture of sharing profits with shareholders in the form of growing dividends, and many companies in Europe have grown dividends faster than inflation, producing favourable returns for investors. By contrast, in other major markets such as the U.S., there tends to be more of an emphasis on reinvesting earnings.
- At present, this dividend culture is understandably at risk, as many European companies – particularly the lower-quality ones – need to cut dividends to ensure their continued survival. This is especially true for European banks, where management behaviour is likely to change as a consequence of the crisis.
- Today, European banks receive their returns largely from leverage, which is particularly problematic due to the cyclicality of their earnings. As this is not consistent with the RBC European Equity team's philosophy of investing in highly cash-generative, capital-light businesses, there is considerable underweight exposure to these banks in their strategies.
- After WWI, most people wanted to return to the past, but after WWII, they wanted to look toward a new future. Dominic believes that the mindset of most bankers may follow a similar path – although they wanted to return to the past following the Global Financial Crisis of 2008-09, they are more likely to look toward a new future in the wake of the COVID-19 pandemic. In his view, this could lead to these businesses being operated similarly to "boring" utilities with resilient balance sheets and healthy dividend streams.
- For the high-quality franchises in which the RBC European Equity Team invests, Dominic expects their long-term dividend sustainability to be preserved. Notwithstanding this, he believes that it is prudent for any business facing material pandemic-related uncertainty to temporarily halt dividends until there is more clarity with respect to how this crisis will unfold. The key points for investors to consider are the extent to which the long-term sustainability of a company's dividend stream may be impacted by the crisis, and the efficacy of a company's actions today in preventing any long-term impairment in its sustainable earnings and dividend growth rates.

Update: What we are watching

As we approach the end of April, we are marking the second month of physical distancing and various alternative employment arrangements. Looking at the factors that we continue to watch in order to better gauge where we are in the crisis, we have yet to see a definitive decline in the daily fatality rate. Over the last few days, we have seen various plans to start to reopen various economies around the world. Each country/state/city seems to follow their own pace. It is clear is that the economic recovery will be sluggish for a mix of artificial reasons (governments will only be able to partially restart economies), and natural reasons (skittish post-quarantine demand). Financial markets have continued to stage a recovery from March lows, as liquidity stresses have been eased, and investor sentiment has improved from extremely depressed levels.

As always, and especially during this time of stress, we welcome any, and all, of your questions related to financial markets and the impact COVID-19 may have on your investment portfolio, at any time.

Be well,
Stu

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What We Are Watching	
Factor	**Result**
Significant disease containment	Mostly
Major government stimulus	Mostly
A decline in the number of new daily cases in Italy	Yes
A decline in the number of new daily cases in the U.S.	No
A decline in the daily global fatality rate	No
A decline in the total number of people actively sick	No
Development of an important therapeutic treatment for COVID-19	No
End of quarantining (China, Hong Kong)	Partially
End of quarantining (Italy, Spain, UK)	No
End of quarantining (Canada, US)	No
A return to economic growth	No
Development of a vaccine	No

STOXX 600 Index: The STOXX Europe 600, also called STOXX 600, SXXP, is a stock index of European stocks designed by STOXX Ltd (Swiss globally integrated index provider). This index has a fixed number of 600 components representing large, mid and small capitalization companies among 17 European countries, covering approximately 90% of the free-float market capitalization of the European stock market (not limited to the Eurozone). The countries that make up the index are the United Kingdom (comprising around 27% of the index), France, Germany and Switzerland (accounting for around 15% of the index each)[1], as well as Austria, Belgium, Denmark, Finland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Spain, and Sweden.

S&P/TSX Composite Index: The S&P/TSX Capped Composite Index is designed to measure the performance of stocks listed on the Toronto Stock Exchange. The index includes approximately 275 of the largest Canadian companies & trusts. The index is weighted by market capitalization so bigger companies make up a larger proportion of the index than smaller companies. The maximum weight of any one constituent is capped at 10%.

S&P 500 Index: The S&P 500 Index includes 500 companies across many sectors of the U.S. economy. The index is weighted by market capitalization so bigger companies make up a larger proportion of the index than smaller companies. The index is designed to measure performance of the broad US economy through changes in the aggregate market value of the largest US companies.

Russell 3000 Index: The Russell 3000 Index is a capitalization-weighted stock market index, maintained by FTSE Russell that seeks to be a benchmark of the entire U.S stock market. It measures the performance of the 3,000 largest publicly held companies incorporated in America as measured by total market capitalization

S&P Global BMI: The S&P Global Broad Market Index (BMI) is the only global index suite with a transparent, modular structure that has been fully float adjusted since 1989. This comprehensive, rules-based index series employs a transparent and consistent methodology across all countries and includes more than 11,000 stocks from 25 developed and 25 emerging markets.

S&P Europe BMI: The S&P Europe BMI is a subset of the S&P Global BMI, our leading global equity index series. The S&P Europe BMI provides a comprehensive benchmark to investors

S&P United Kingdom: The S&P United Kingdom BMI is a country sub index of the S&P Global BMI that includes only UK-domiciled companies

S&P EMEA BMI: The S&P Europe, Middle East & Africa BMI is a regional sub-index of the S&P Global BMI, our leading global benchmark index. The index includes stocks from developed and emerging markets in Europe, the Middle East and Africa.

S&P Pan Asia Developed Ex-Japan BMI: The index is designed as a tool for institutional investors to invest in the overseas capital markets under the foreign exchange control system in China. This index covers Australia, Hong Kong, New Zealand, Singapore, and South Korea

S&P Japan BMI: The S&P Japan BMI, a sub-index of the S&P Global BMI, our leading global equity index series, is a comprehensive benchmark that defines and measures the investable universe of publicly traded companies domiciled in Japan

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