Could Income Investors Have Anticipated Intel's Dividend Cut?

Screening for dividend durability can help equity-income investors avoid yield traps.

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Intel is tech royalty. Founded in 1968, the semiconductor pioneer not only helped propel the rise of Silicon Valley, but a founder coined Moore's Law, which has become a metaphor for the exponential rate of innovation. Intel spent years as one of the world's 20 largest companies, dominating the market for microprocessors. These very words are being typed on an Intel-powered laptop.

So, it was quite a comedown when, in February 2023, **Intel** INTC announced a 66% reduction in its quarterly dividend amid miserable earnings results. Intel joins a long list of one-time dividend champions to reduce, suspend, or eliminate shareholder payouts because of deteriorating fundamentals. **Shell** SHEL in 2020, **General Electric** GE in 2018, **ConocoPhillips** COP in 2016, and **Citigroup** C in 2008 are other blue-chip dividend cutters.

Intel, whose trailing 12-month yield approached 6% at the time of the cut, illustrates a key risk for dividend investors. High-yielders can be troubled companies with unsustainable payouts. Dividend cuts don't just affect cash flows for income investors but are typically symptomatic of problems that have weighed on the share price. Intel closed February below $25 per share, down from nearly $64 in 2021—a bad investment from the perspective of total return as well as income.

Screening for dividend durability can help investors avoid yield traps. The original Morningstar Dividend Yield Focus Index,[1] which launched in 2010, selects U.S. dividend payers by Morningstar Economic Moat Rating, a gauge of competitive advantage assigned by Morningstar equity analysts, and distance to default, a quantitative measure of financial health. Now a global series, the Morningstar Dividend Yield Focus Indexes apply these screens to dividend payers across markets.

Since Intel fell out of the Morningstar Dividend Yield Focus Index in March 2018, its distance to default scores have prevented re-entry. Is Intel an anomaly? How effective are these screens?

Among the findings of this report:

- The Intel case study highlights the need to screen dividend payers for payout durability.
- The Morningstar Economic Moat Rating and distance to default measure have effectively anticipated dividend durability over time—globally.

1 For details on index methodology see: https://indexes.morningstar.com/our-indexes/details/morningstar-dividend-yield-focus-FSUSA0B86Q?tab=overview.

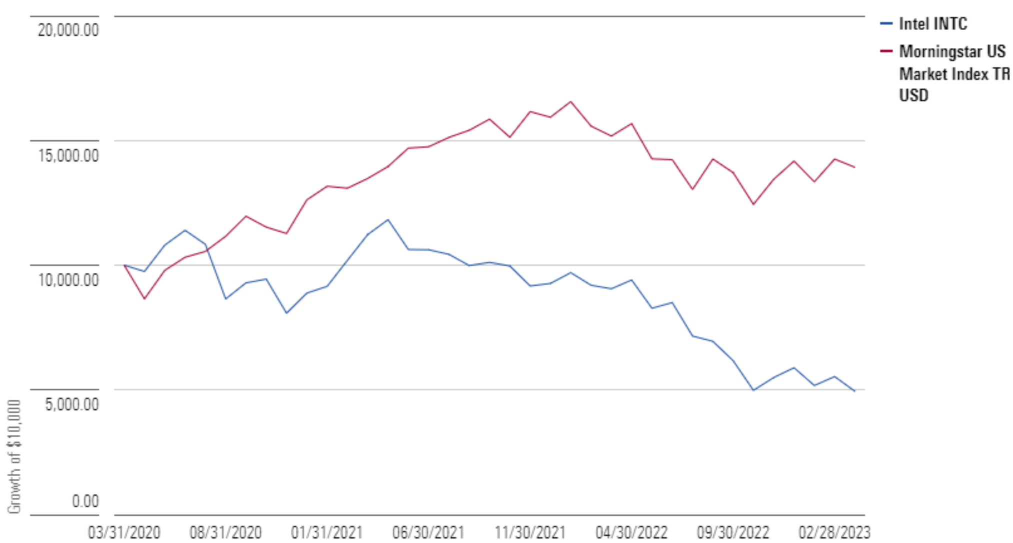
Intel Highlights the Risk of Dividend Investing

In explaining the reduction of Intel's quarterly dividend from $0.365 per share to $0.125, Morningstar strategist Abhinav Davuluri wrote: "The firm has been plagued by weak PC demand, competitive pressures from a resurgent AMD [**Advanced Micro Devices**], and ongoing execution issues that have culminated in market share loss and margin compression." Davuluri actually praised Intel's decision to cut: "The firm's roughly $6 billion in dividend payouts was valuable cash that we think is better served by being put toward investments in new process technologies and research and development."

What's good for long-term strategy, though, comes at the expense of income investors. Intel's trailing 12-month yield of 5.8% as of January 2023 far exceeded the 4.3% yield of the Morningstar US Core Bond Index, which made it attractive to investors looking to their portfolios for a regular paycheck. Quarterly dividend checks for Intel shareholders will be much diminished going forward.

Total-return-focused investors, for their part, will attest to the fact that the dividend cut followed serious share price depreciation. After an early pandemic bump in 2020, Intel's stock has been a value-destructive investment, severely underperforming the U.S. equity market.

Exhibit 1 Intel's Share Price Has Badly Lagged the U.S. Equity Market Over the Past 3 Years



Source: Morningstar Direct.

The Intel saga highlights the risk of dividend investing. Dividends are not guaranteed. Owners of regular shares don't have the kind of claims on a company's assets enjoyed by debtholders.

Buying stocks with high yields can lead investors to risky pockets of the market. When a stock's price declines, its yield rises. Therefore, healthy payouts are often found in unhealthy sectors, industries, and securities, where business challenges have weighed on share prices.

Was Intel's Dividend Cut Foreseeable?

Here we examine two complementary screens used by Morningstar Indexes to weed out dividend cutters—economic moat and distance to default—in the context of Intel. The former is qualitative, long-term-focused, and structural. The latter is quantitative and short-term-oriented, and it incorporates market sentiment.

Morningstar Economic Moat Rating

The economic moat rating gauges a company's competitive positioning. Just as medieval castles used water-filled trenches to prevent enemy incursion, an economic moat protects a company's profits from competition. Morningstar equity research has turned the Warren Buffett concept into a robust methodological framework, assigning ratings of either wide, narrow, or none to roughly 1,500 companies across the globe. To earn a narrow or wide economic moat rating, a company must possess a structural feature that prevents excess returns from quickly eroding. A company with an economic moat should be able to sustain profitability, and therefore dividends.[2]

Intel earns a narrow economic moat rating, making it eligible for inclusion in the Morningstar Dividend Yield Focus Index. Morningstar equity research believes Intel enjoys cost advantages in the design and manufacturing of microprocessors, though these advantages have somewhat eroded. Another moat source is intangible assets, related to Intel's x86 architecture license and chip design expertise.

Distance to Default

Distance to default is a quantitative measure of financial health. Morningstar Indexes' distance to default metric gauges the likelihood of distress, using option-pricing theory to evaluate the risk that a company's assets will fall below the sum of its liabilities. Balance-sheet data, including short- and long-term liabilities, is a critical input. So is market-related information. A company's equity value, most importantly the volatility of a company's equity, can be a leading indicator of financial distress, reflecting deterioration well before it shows up in financial statements. If a company has a shaky balance sheet, struggles with solvency, or experiences share price volatility due to questions regarding its long-term viability, future dividend payments may be in jeopardy.[3]

The distance to default changes more frequently than moat ratings. Since its removal from the Morningstar Dividend Yield Focus Index in March 2018, Intel has consistently placed in the worse half of the technology sector on distance to default, which precludes it from entering the index (lower scores are better). Below are Intel's distance to default percentile ranks within the technology sector as of the December 2022 index reconstitution.

2 For more, see: Morningstar Analyst Rating for Equity Research Methodology.
3 For more, see: Morningstar Indexes Distance to Default Methodology Paper.

Exhibit 2 Intel's Distance to Default Score Puts It in the Bottom Half of the Tech Sector, Preventing Index Inclusion

	Morningstar (US) Dividend Yield Focus Index - Distance to Default Percentile Rank	Morningstar Developed Markets Dividend Yield Focus Index - Distance to Default Percentile Rank
December 2022	76	86

Source: Morningstar Indexes.

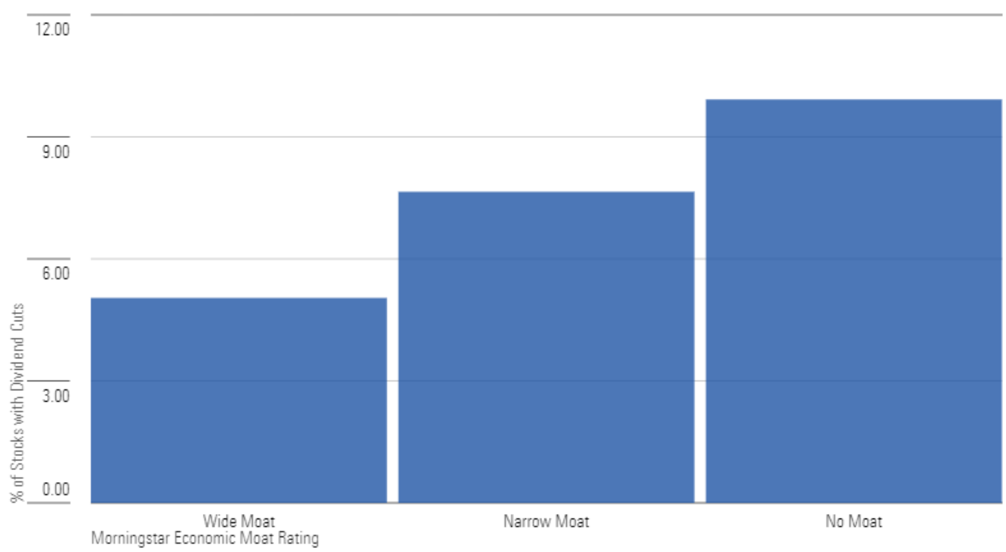
Have Economic Moat and Distance to Default Predicted Long-Term Dividend Durability?

How effectively have economic moat ratings and distance to default scores predicted dividend durability over the long term? The exhibits below examine the percentage of stocks at various moat levels and distance to default scores that have reduced, suspended, or eliminated their shareholder payouts between 2005 and 2022.

Dividend cuts are defined differently depending on region. For the United States and Canada, where dividends are paid regularly, indicated dividend per share is calculated by annualizing the latest dividend paid by the company. If the company decreases its dividend per share any time within a one-year period, it is considered a cut. For the global equity universe excluding North America, dividend cuts are determined by comparing adjoining fiscal year-end dividend per share figures over a multiyear period. If the company decreased its dividend per share year over year, it is considered a cut.

Exhibit 3 demonstrates that in the U.S., companies with wide economic moats have sustained their dividends best, while narrow-moat stocks have cut less frequently than no-moat stocks. Intel, a narrow-moat-rated company, will contribute to the 2023 numbers, which are not reflected below. The low absolute number of dividend cuts reflects the strength of the dividend commitment in the U.S. market.

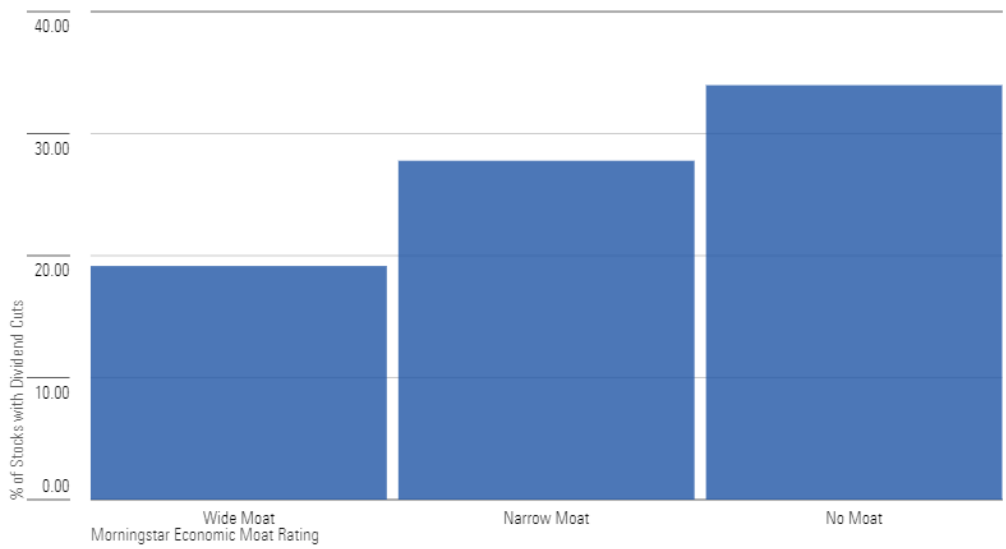
Exhibit 3 U.S. Companies With Economic Moats Have Better Sustained Their Dividends Over Time



Source: Morningstar Indexes. Time period studied: 2005-22.

Outside the U.S., the absolute number of dividend cuts is far higher, but the pattern is the same. Companies with wide economic moats have sustained their dividends best, while narrow-moat stocks have cut less frequently than those with no moat.

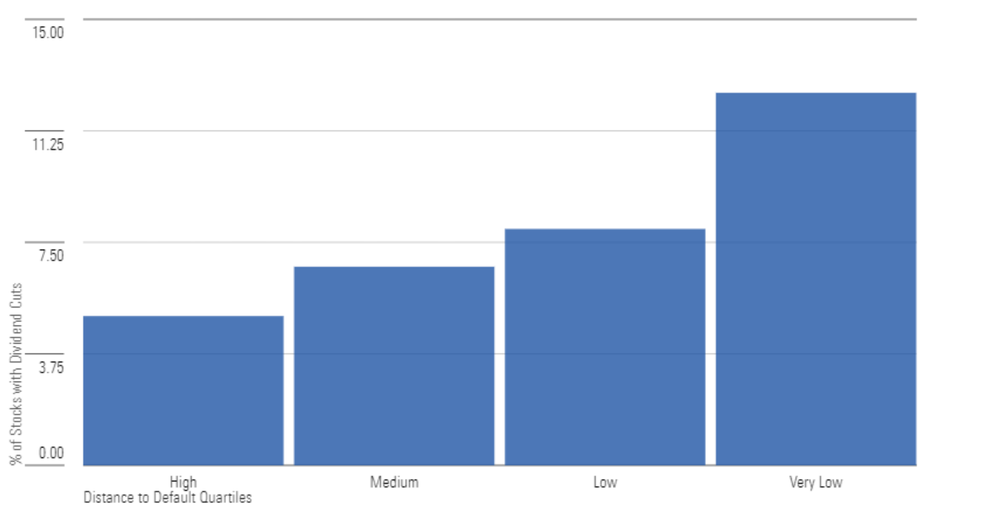
Exhibit 4 Companies Outside the U.S. With Economic Moats Better Sustained Their Dividends Over Time



Source: Morningstar Indexes. Universe: Global ex-U.S. Time period studied: 2005-22.

Did companies with better distance to default scores sustain their dividends better than lower-ranked companies? The threshold for inclusion in the Morningstar Dividend Yield Focus Indexes is the best 50% within an economic sector by distance to default score. So, "very low" and "low" quartiles would be ineligible for index inclusion. Here too, the better the score, the better the dividend durability.

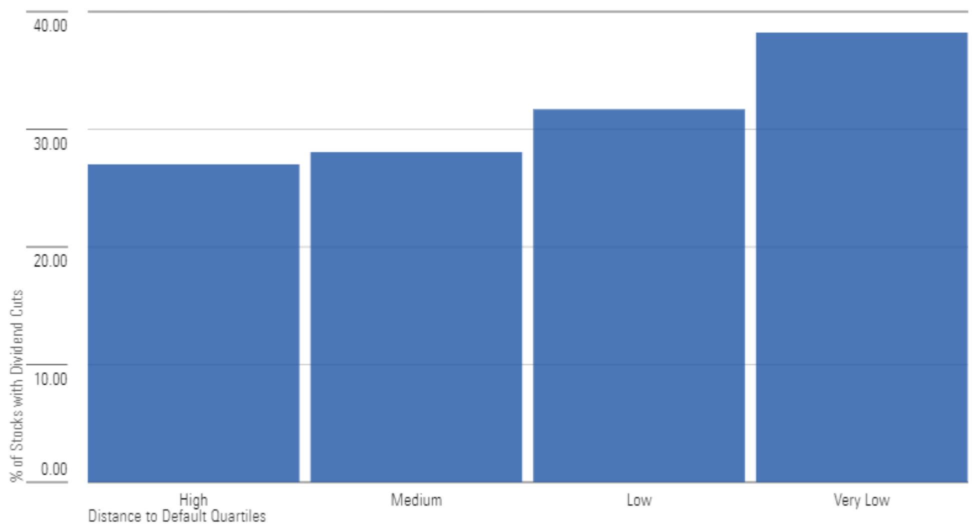
Exhibit 5 U.S. Companies With Better Distance to Default Scores Were Likeliest to Sustain Dividends Over Time



Source: Morningstar Indexes. Time period studied: 2005-22.

Again, the pattern repeats outside the U.S., where the absolute number of dividend cuts is far higher. Companies with better distance to default scores were more likely to sustain their dividends.

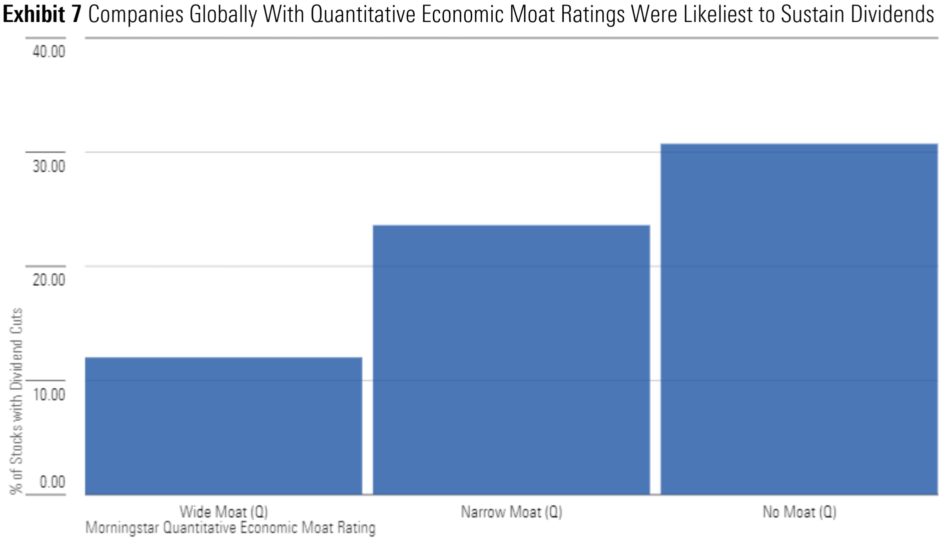
Exhibit 6 Companies Outside the U.S. With Better Distance to Default Scores Were Likelier to Sustain Dividends



Source: Morningstar Indexes. Universe: Global ex-US. Time period studied: 2005-22.

Finally, it is worth examining the Quantitative Economic Moat Rating,[4] which algorithmically mirrors the analyst-assigned rating and is used in some of the Morningstar Dividend Yield Focus Indexes to supplement coverage. Companies with wide quantitative economic moats have sustained their dividends best, while narrow-moat stocks have cut less frequently than no-moat stocks.

Exhibit 7 Companies Globally With Quantitative Economic Moat Ratings Were Likeliest to Sustain Dividends



Source: Morningstar Indexes. Universe: Global ex-US. Time period studied: 2005-22.

4 For more, see: Introducing Morningstar's Quantitative Equity Ratings

Mitigating Risk in Dividend Investing

For investors focused on both income and total return, dividend-paying stocks are a wonderful way to participate in equity markets. Dividend payers tend to be sturdier than average companies, secure enough in their cash flows to commit to returning some to shareholders. But equity-income strategies should screen dividend payers carefully.

Many dividend index methodologies simply chase yield, which can lead to unintended risk, as the highest-yielding stocks may have weak or deteriorating fundamentals that could threaten the sustainability of their payouts.

The Morningstar Dividend Yield Focus Indexes can help reduce risk by targeting stocks with attractive dividend yields and strong financial quality through screens that incorporate the economic moat rating and distance to default score.

About Morningstar Indexes

Morningstar Indexes was built to keep up with the evolving needs of investors—and to be a leading-edge advocate for them. Our rich heritage as a transparent, investor-focused leader in data and research uniquely equips us to support individuals, institutions, wealth managers and advisors in navigating investment opportunities across major asset classes, styles and strategies. From traditional benchmarks and unique IP-driven indexes, to index design, calculation and distribution services, our solutions span an investment landscape as diverse as investors themselves.

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