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Are Better Days Ahead for Dividend Investors?

Current challenges facing equity-income investors are not insurmountable.

Morningstar Inc.
June 2024

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From one perspective, 2024 will go down as a big year for dividends. Meta Platforms, Salesforce, and Alphabet all initiated quarterly payouts to shareholders. Nvidia announced it would raise its cash dividend by 150%. Among US corporate giants, Amazon.com, Berkshire Hathaway, and Tesla increasingly stand out as nonpayers. Asia and Europe's largest public companies—Taiwan Semiconductor and Novo Nordisk—pay dividends.

While the embrace of dividends certainly validates the centuries-old legacy of companies distributing cash to shareholders, it also comes at a trying time for equity-income investing. First, yields are low. While the dollar value of declared dividends from Meta, Salesforce, Alphabet, and Nvidia is massive, none exceed 1% of share price. The Morningstar US Market Index's[1] yield is less than 1.5%, and global equities outside the US yield below 3% in aggregate. Meanwhile, high-quality bonds pay more than 5%.

Second, US dividend-payers as a group have delivered subpar total returns recently. In 2023, the Morningstar US High Dividend Yield Index,[2] which represents the higher-yielding half of the US dividend-paying universe by market capitalization, lagged the broad market by 20 percentage points. So far, 2024 has been another sluggish year. US dividend-payers' five- and 10-year record is also weak.

Third, prominent companies have cut their payouts, illustrating a key risk for equity-income investors. At the start of the year, Walgreens slashed its quarterly dividend by nearly half. Vodafone of the UK also announced a large reduction in its payout. Both stocks offered yields in the region of 10% in 2023.

Key Takeaways

- High interest rates could help explain the Morningstar US High Dividend Yield Index's underperformance over the past 18 months. That said, dividend-payers were resilient amid rising rates in 2022.
- The Morningstar Global ex-US High Dividend Yield Index has outperformed in a rising interest-rate environment.
- Despite recent struggles, dividend-payers, especially high-yielders, have an enviable long-term track record relative to the equity market.
- The Morningstar Economic Moat Rating and the Distance to Default financial health metric have been effective screens for dividend-payers, helping to identify yield traps like Walgreens and Vodafone.

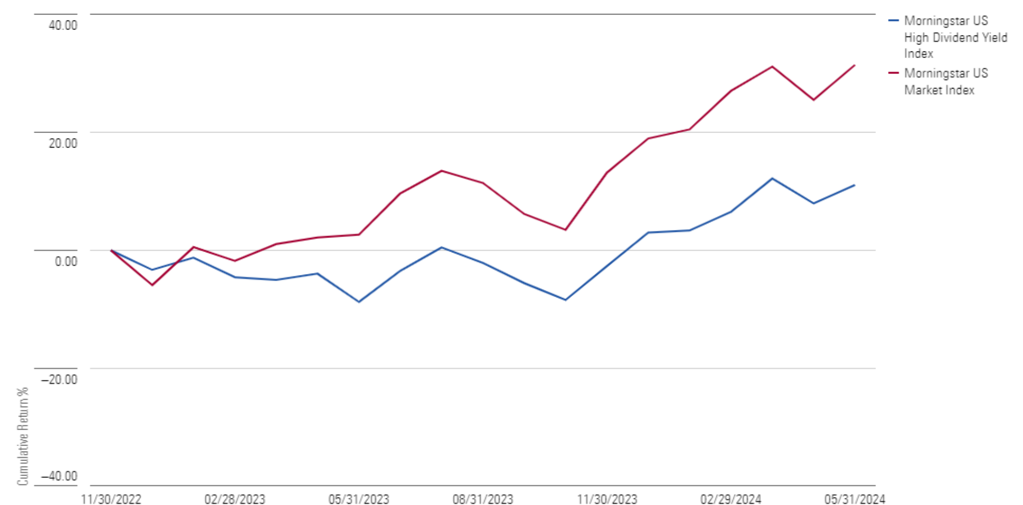
1 For a full discussion of index methodology, see "Construction Rules for Morningstar US Market Indexes."
2 For a full discussion of index methodology, see "Construction Rules for Morningstar High Dividend Yield Indexes."

- The future for dividend investing could be brighter than the recent past. Higher interest rates, among other factors, could lead companies to pay out a greater share of profits as dividends. Meanwhile, Morningstar Equity Research sees value in dividend-rich sectors.

Rising Rates Aren't Always Bad for Dividend-Payers

To some, the fact that dividend-payers are underperforming in today's higher interest-rate environment makes perfect sense. The conventional wisdom holds that when interest rates go up, the equity-income section of the market suffers. Higher rates lift yields on bonds and cash deposits, making dividends less attractive for income investors. Plus, elevated borrowing costs are especially challenging for leveraged companies. Many dividend-payers in sectors like utilities, energy, consumer cyclicals, real estate, and communication services, are indebted. So, the fact that the Morningstar US High Dividend Yield Index has lagged over the past 18 months of higher interest rates, seems logical. Exhibit 1 displays the extent of dividend-payers' underperformance in the US equity market.

Exhibit 1 US Dividend Payers Have Struggled Against the Broad Equity Market Over the Past 18 Months



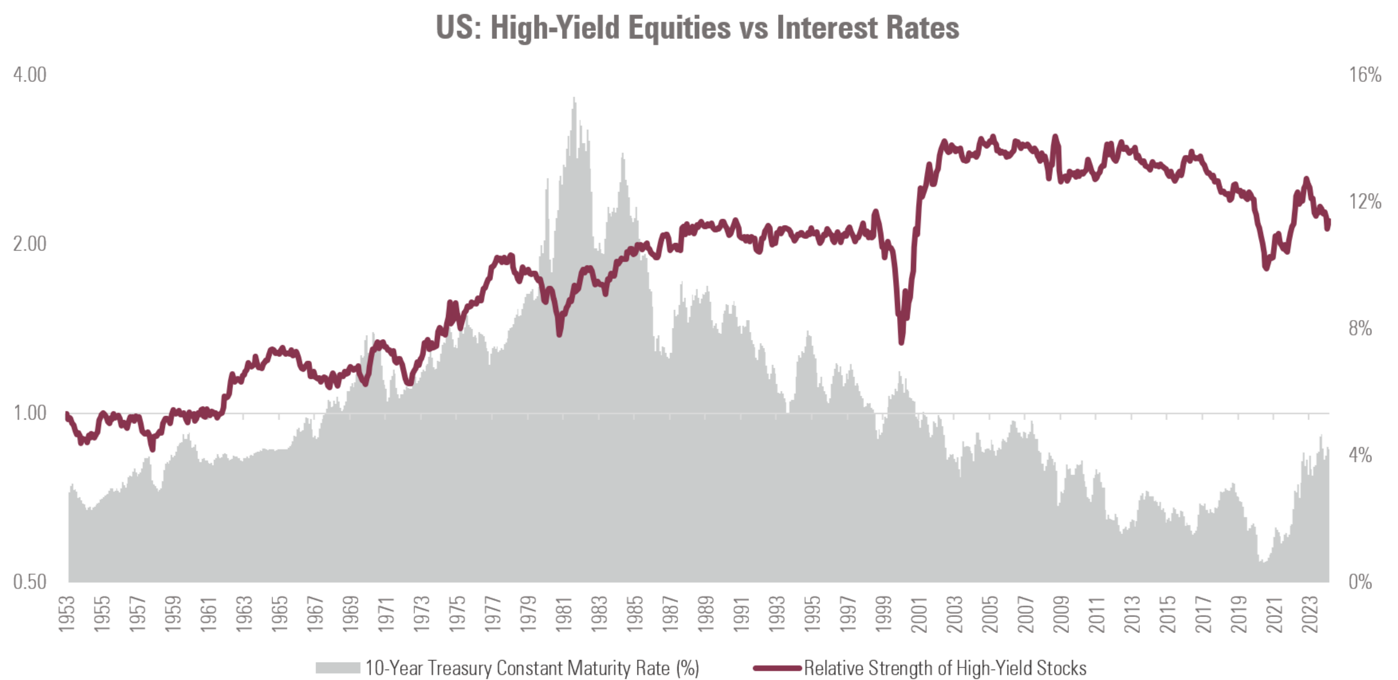
Source: Morningstar Direct. Morningstar Indexes' Total Returns Displayed in USD. Data as of 5/31/24.

That said, performance during 2022 challenges the theory that rising rates are bad for dividend-payers. The Federal Reserve hiked its federal-funds rate seven times in 2022 to combat persistent inflation, including four consecutive hikes of 75 basis points. Yet the Morningstar US High Dividend Yield Index declined by only 1% that year even as the broad equity market lost nearly 20%. Light exposure to plummeting technology stocks, heavy exposure to defensive sectors, and twice the market's weight worth of high-flying energy shares boosted the dividend index in 2022. Sector effects seemed to have trumped interest rates.

Meanwhile, outside the US, dividend-payers have outperformed despite higher interest rates. The Morningstar Global ex-US High Dividend Yield Index is well ahead of the broad equity market, despite monetary policy tightening from the European Central Bank, the Bank of England, and even the Bank of Japan. In Europe, the financial-services sector has thrived for a number of reasons, including a widening of spreads between deposit and lending rates prompted by monetary policy tightening.

History shows that the relationship between interest rates and dividend-payers isn't as straightforward as the conventional wisdom indicates. In Exhibit 2, the relative performance of US high-yield stocks is compared with the yield on the 10-year Treasury bond, relying on data from the French Data Library and the St. Louis Federal Reserve. This graph demonstrates no clear relationship between interest rates and the relative performance of income-generating equities.

Exhibit 2 The Relationship Between Dividend-Paying Stocks and Interest Rates Is Unclear



Source: Morningstar Indexes calculations based on French Data Library and St. Louis Federal Reserve data. Data as of March 31, 2024.

In some periods of rising US interest rates, such as in the mid-1970s, dividend-paying stocks outperformed the market. As rates fell from the mid-1980s to the mid-1990s, the performance of high-yield stocks relative to the market was fairly flat. When the Federal Reserve cut rates in the late 1990s in the wake of the Asian financial crisis, it did not benefit dividend-payers. During the technology bubble of that time, investors cared little for earnings, let alone dividends. Then, in the extremely low interest-rate environment extending from 2008-15, high-yield equities lagged again. The problem this time was the struggles of high-yield sectors, from financial services to energy and materials.

Globally, the same complicated relationship between interest rates and dividend-payers holds. Morningstar Indexes has found that in Australia, Germany, Japan, and the United Kingdom, interest rates did not seem to explain the relative performance of dividend-payers.

Recent Struggles Have Not Diminished Dividend-Payers' Strong Long-Term Record

The upward trajectory of the red line displayed in Exhibit 2 demonstrates a critical point about dividend-payers: Their long-term track record is strong. It is true that over the past 15 years dividend-payers have lagged in the US equity market. The Morningstar US High Dividend Yield Index has underperformed the broad equity market over the past three, five, 10, and 15-year periods. Strong returns for dividend-light technology (and tech-adjacent) stocks goes a long way to explaining poor relative returns. The fact that the Morningstar Global ex-US High Dividend Yield Index has been ahead of the market over the past 15 years can be explained by the much smaller share of technology companies outside the US.

US dividend-payers still boast an impressive record of wealth creation over the very long term. Exhibit 3 displays the dramatic outperformance of the high-yield section of the US equity market, measured by portfolios created through the French Data Library. Though non-dividend-payers are often the top stocks in the market in any given year, they tend to disappoint over time. Dividend-payers beat nonpayers and higher-yielding stocks have beaten the overall market.

Exhibit 3 The High-Yield Section of the US Equity Market Has an Enviable Long-Term Risk/Return Profile

1927- 2023	Annualized Return %	Risk %	Growth of $1 (from 1927)
Non-Payers	8.7	29.3	2,968
Low Yield	9.4	19.6	5,536
Mid Yield	10.3	17.7	12,175
High Yield	10.9	19.7	19,875
Market	9.7	18.6	6,983

Source: French Data Library.

Several explanations could explain this record. First, investing in dividend-payers screens out the most speculative portion of the market. Dividend-payers tend to be established, steadier-than-average companies, confident enough in their cash flows to commit to returning cash to shareholders. Second, dividend-payers are disproportionately found on the value side of the equity market, and stocks with lower prices (and expectations) have done well. Third, dividend-payers have a loyal shareholder base. Because investors are extracting income from their stock holdings, they are less likely to sell on bad news.

Fourth, and perhaps most importantly, committing to a dividend instills discipline. Corporate managers and directors find cash piles tempting. Rather than use excess cash to fund acquisitions that may or may not create value, buy back shares at questionable prices or fund speculative growth initiatives,

executives must act prudently to maintain payouts. The story is the same for other developed markets in Europe and the Asia-Pacific region.

Sidestepping Yield Traps and Avoiding Dividend-Cutters

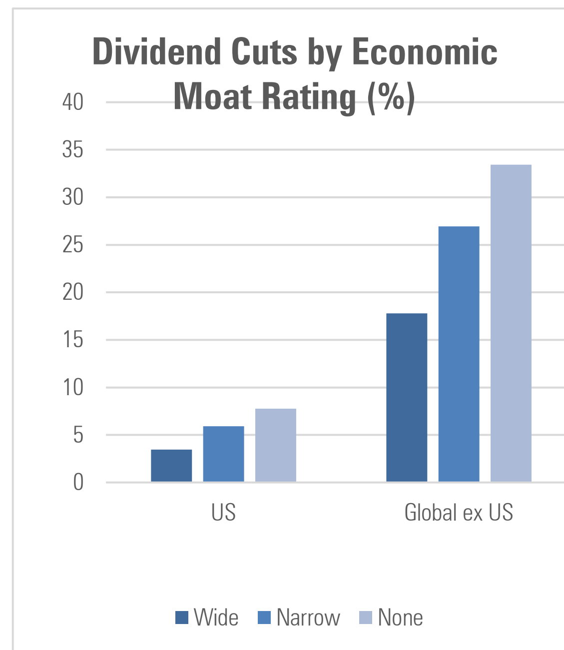
There's a reason that high-yield equities have been the most volatile of any dividend-paying cohort, though. When share price goes down, yield goes up. So, some of the market's highest dividend yields belong to companies and industries that are distressed due to fears surrounding their fundamentals.

Walgreens and Vodafone are two prominent examples of such "yield traps." Both stocks have sported yields of about 10%—a mouth-watering level of income in today's equity market. Those yields were ultimately too good to be true. Walgreens slashed its payout in January due to pressure from pharmacy benefit managers, acquisition-related issues, and seasonal weakness. Vodafone, a telecom giant, has struggled with regulation and competition in its home market of the UK, as well as in Germany and beyond. In March, it announced a future dividend cut.

Walgreens and Vodafone are both no-moat businesses. That means that Morningstar's Equity Research views them as lacking in durable competitive advantages that protect their profits from competition.[3] Morningstar Indexes employs the Economic Moat Rating as a screen for dividend-payers, on the logic that companies that can maintain profitability should also be able to maintain payouts. As displayed in Exhibit 4, companies with wide economic moats have been less likely to cut dividends than companies with narrow moats. No-moat businesses are most likely to cut. The relationship holds globally.

3 For a full discussion, see "Morningstar Equity Research Methodology."

Exhibit 4 Companies With Economic Moats Are Less Likely to Cut Their Dividends



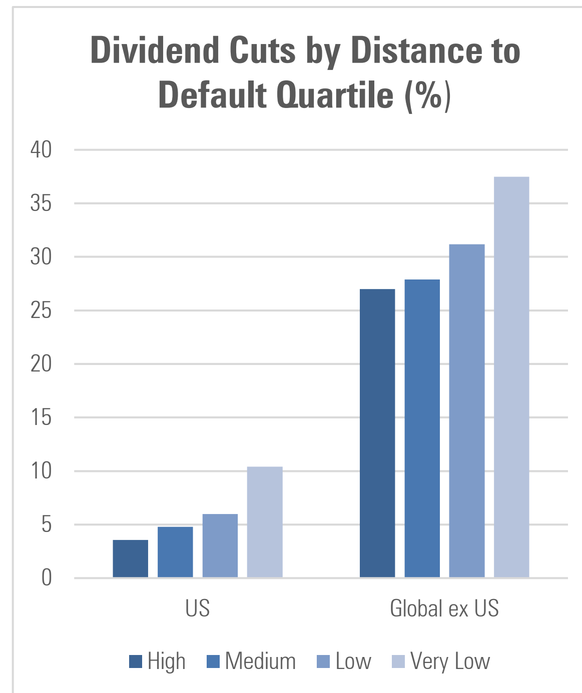
Source: Morningstar Indexes. Time Period Studied: 2005-23.

Methodologically, dividend cuts are defined by comparing adjoining fiscal year-end dividend per share. If a company decreased its dividend per share within the past year, it is considered a cut. The absolute number of cuts is much larger outside North America, where dividends are seen as less of a commitment. Dividend cuts are especially common in emerging markets. In 2023, large players in markets like Brazil, China, Mexico, South Korea, and India reduced their payouts.

As for Walgreens and Vodafone, they also scored poorly for financial health before their cuts. Morningstar Indexes employs a quantitative metric called Distance to Default[4] to screen dividend-payers; it gauges the risk that the value of a company's assets will turn out to be less than the sum of its liabilities, considering equity value and share-price volatility. As displayed in Exhibit 5, companies with very low Distance to Default scores relative to sector peers (both Walgreens and Vodafone fell into this quartile in 2023) are more likely to cut their dividends than companies with high scores.

4 For a full discussion, see "Morningstar Indexes Distance to Default Methodology Paper."

Exhibit 5 Companies With Strong Financial Health Are Less Likely to Cut Their Dividends



Source: Morningstar Indexes. Time Period Studied: 2005-23.

The Future for Dividends Could Be Brighter Than the Recent Past

In his recently published book *The Ownership Dividend*, historian and portfolio manager Daniel Peris documents the centurieslong "tangible cash relationship" that companies maintained with their ownership through regular payouts.[5] Peris blames today's low yields on several factors. First are 40 years of falling interest rates from the early 1980s. By lowering yields on bonds and cash, declining interest rates reduced the competitive pressure on companies to offer attractive income streams. Lower interest rates also sent money flooding into the equity market, pushing valuations higher and supporting a "risk-on" approach toward investing.

The second factor cited by Peris for the decline in dividend yields is the rise of share buybacks. Spurred by a US regulatory change in 1982, share repurchases have become a more popular way to deploy cash. Buybacks are generally more flexible than dividends. Companies can undertake them opportunistically and don't get punished for withdrawing them. Third, Peris points to "innovative, technology-oriented companies" in explaining the dividend decline. This cohort, which led the US market in the late 1990s and then again for most of the years following the global financial crisis, have been focused on growth. Some have been phenomenally successful. Culturally, their relationship with shareholders centers on price appreciation, as opposed to cash distributions.

5 Peris, Daniel. *The Ownership Dividend*. May 21, 2024.

Looking forward, Peris anticipates a "paradigm shift." He envisions a "renewed cash nexus between investor and investment," where share-price appreciation alone is insufficient. Interestingly, he sees higher interest rates as a key catalyst. With stocks facing stiffer competition from cash and bonds for income, companies will need to raise their payouts to compete. Higher borrowing costs also diminish the appeal of share repurchases and investment backed by debt, so this could lead corporate management to channel cash into dividends.

Peris cites other factors that could contribute to the restoration of dividends' central role. With globalization under pressure from rising political tensions, more active organized labor, and regulation on the rise, future asset-price returns could be more subdued than the recent past. Dividend income could represent a bigger portion of total return. Sustainable investing, which is long-term-oriented and focused on the corporate relationship with stakeholders, could also boost dividend programs. The fact that some of the largest technology companies are now initiating cash payouts supports Peris' vision.

Morningstar Equity Research's sector-level research can also act as a guide. Looking forward, the team sees several opportunities in dividend-rich areas.

- Utilities: The equity market's second-highest-yielding area (after real estate), utilities are seen to be benefiting from multiple secular trends, including the energy transition and rising demand for electricity coming from artificial intelligence. "We continue to think the fundamentals for utilities are as strong as they have ever been."[6]
- Consumer Defensive: The equity market's third-highest-yielding sector, consumer defensive, including packaged food businesses "have been under pressure as they have struggled to raise prices as fast as their own costs, but as inflation moderates, we expect they will be able to raise their operating margins back toward historical averages as price increases and efficiencies improve."
- Healthcare: Analysts believe "the market is underappreciating pipeline innovation," in several therapeutic areas, including oncology, immunology, and rare diseases. Healthcare stocks in aggregate have a slight above-market yield. The sector is home to many dividend-growers and is typically an overweight exposure for dividend indexes. Aging demographics represent a secular growth driver.
- Industrials: Although the sector overall is seen as overvalued, pockets such as "aerospace and defense contractors" are viewed as bright spots. Some industrials companies are benefiting from the energy transition and many sport attractive dividends.

Meanwhile, the dividend-light technology sector is seen as overvalued in aggregate, with market enthusiasm for artificial intelligence more than reflected in share prices.

6 Sekera, David. "Where We See Opportunities After an Ugly Month for Stocks." May 3, 2024.

Equity-Income Investing for Total Return

Tempting as it might be, targeting stocks with fat yields is a risky strategy. Chasing yield without regard to dividend durability can jeopardize total return. Despite this, dividend investing remains a sensible means of participating in equity markets, so long as investors are mindful of quality and financial health. The future for dividends may be brighter than the recent past.

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