Could Investors Have Avoided 2020's Dividend Disaster?

In the biggest year for dividend cuts since 2008-09, high-quality, financially healthy companies were likelier to maintain payouts.

Morningstar Inc.
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Bear markets have a way of humbling the mighty. Among the victims of the 2007-09 global financial crisis were companies considered blue chips—names like Bank of America, General Electric, and General Motors. In each of these cases, a dividend cut marked the fall. Bank of America had made a reliable shareholder payout since the 1980s before its exposure to an imploding real estate market triggered a precipitous share price decline, a government bailout, and a massive dividend cut.

For equity income investors, the pandemic-driven market of 2020 was the worst year since 2008. Even after stocks rebounded from the February-March bear market, a 16% gain for the Morningstar Global Markets Index for 2020 masked significant divergence at the sector level. Technology stocks benefited from the work-from-home, learn-from-home, shop-from-home new normal. Meanwhile, the economic downturn took a heavy toll on many dividend-rich, value-leaning sectors, such as energy. Oil and gas giant Royal Dutch Shell cut its dividend for the first time since World War II.

The pandemic has been described as a "black swan event." Blindsided companies reduced, suspended, or eliminated dividends so they could live to fight another day. In some cases, cuts were even mandated as a condition of government assistance. Dividend investors, for their part, may be tempted to chalk 2020 up to unforeseeable events and move on.

But the dividend disaster of 2020, like 2008 before it, provides a valuable stress test for screens of dividend sustainability. Could investors have avoided cuts by approaching dividend payers selectively? In this paper, we examine two screens employed in Morningstar dividend indexes: the economic moat rating, which gauges competitive advantage, and Distance to Default, a measure of financial health.

Key Takeaways

- In the biggest year for dividend cuts since 2008, the energy, real estate, financial-services, and consumer cyclicals sectors were among the hardest hit.
- In the United States and Canada, larger companies sustained their dividends better than smaller ones.
- Companies across the globe with economic moats, or sustainable competitive advantages, were less likely to cut their dividends than no-moat companies.
- Companies with superior financial health, measured by Morningstar's Distance to Default metric, were likelier to sustain their dividends.
- The predictive power of moats and Distance to Default in 2020 is consistent with the long-term trend.

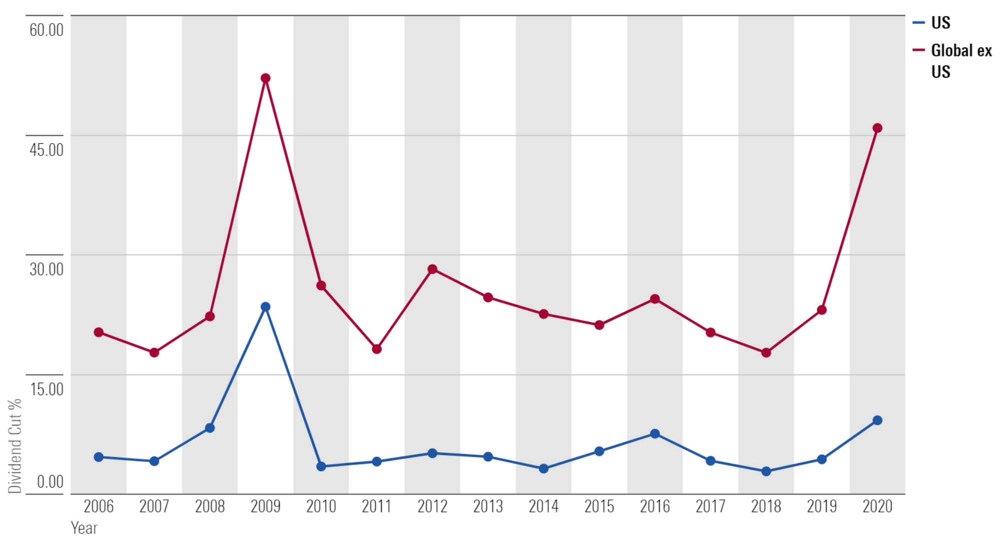
An Annus Horribilis for Dividend Investors

"The world has seriously changed over the last few months," said Ben van Beurden, CEO of Royal Dutch Shell, in an April 2020 statement announcing that the company was reducing its dividend for the first time since World War II. "The global economic decline and uncertain outlook may have significant impacts on our profitability, cashflow and balance sheet." Van Beurden went on to explain that by reducing its quarterly dividend to $0.16 per share from $0.47, Shell will "reinforce our resilience, preserve the strength of our balance sheet and support value creation in the long term."

Shell was hardly the only company whose dividend fell victim to a "seriously changed" world. The pandemic-driven economic slowdown had a sudden and significant impact on many dividend payers. Hardest hit were the so-called BEACH stocks—booking, entertainment, airlines, cruises, and hotels. Companies like Hyatt Hotels, Six Flags Entertainment, Royal Caribbean, and American Airlines cut dividends as travel restrictions and societal lockdowns froze their businesses. But plenty of companies across economic sectors were forced to reduce, suspend, or eliminate shareholder payouts.

Exhibit 1 shows that 2020 was the biggest year for dividend cuts since 2008. Of the 7,365 constituents of the Morningstar Global Markets Index, which spans developed and emerging-market equities across large-, mid-, and small-capitalization segments, 6,083 paid dividends as of January 2020. Of those, 2,434 companies cut their dividends in 2020. Cuts are defined differently depending on region. For the U.S. and Canada, where dividends are paid regularly, we calculate the indicated dividend per share by annualizing the latest dividend paid by the company. If the company reduces its total dividend per share compared with the previous year, it's considered a cut. For stocks outside North America, 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's considered a cut.

Exhibit 1 Dividend Cuts Spiked to Their Highest Level Since 2008-09



Source: Morningstar Indexes. Data as of Nov. 30, 2020.

In absolute terms, dividend cuts are more frequent outside of North America. The dividend commitment is strongest in the U.S. and Canada, where in some markets, dividends are often paid out opportunistically when the company has excess cash on hand. This is especially true in emerging markets. The number of companies cutting dividends outside the U.S. in 2020 exceeded the 2008 level. In the U.S., 91 companies cut dividends in 2020 compared with 225 in 2008.

Why are dividend cuts a problem? For investors who depend on dividends for income, a cut represents a cash flow disruption. Just as distributing cash to shareholders signals financial health, a dividend cut is often a sign of deterioration. Share price declines often accompany cuts. Shell's stock fell roughly 40% in 2020, for example. Whether the cut leads to "value creation in the long term" remains to be seen.

Exhibit 2 depicts dividend cuts by sector, showing that:

- The energy sector was the biggest cutter, with 30% of dividend-paying energy stocks in the U.S. cutting, and more than 60% in emerging markets. Energy suffered from falling demand and a price war among oil producers. Companies like Marathon, Occidental, and Halliburton in the U.S., Suncor in Canada, Australia's Woodside Petroleum, Italy's ENI, Equinor of Norway, China's CNOOC, Russia's Gazprom, and Brazil's Petrobras were all among the cutters.
- The financial-services sector was undermined by low interest rates and loan losses, with more than half of the dividend-paying financials outside the U.S. cutting, including UBS, AXA, Deutsche Bank, Barclays, SEB, and Westpac, as well as Capital One and Progressive in the U.S.
- Real estate was another badly affected sector, as offices and commercial spaces closed, forcing cuts among companies like Vornado in the U.S. and Mitsubishi Estate in Japan.
- Consumer cyclicals suffered from falling demand, prompting cuts at companies like Gap, Nissan, and Adidas.
- Industrials were hit by falling economic activity, explaining cuts at Raytheon, Komatsu, and Vinci.
- Utilities stocks, which had been market darlings in previous years for their rich yields, retreated on an anticipation of lower electricity use by industrial and commercial customers, which is why CenterPoint Energy in the U.S., France's EDF, and Korea Gas, cut.
- Even the high-flying technology sector saw cutters—Western Digital, Electrolux, and SK Hynix, for example.

Exhibit 2 Dividend Cuts by Sector in 2020 Show Energy, Real Estate, Financials, and Consumer Cyclicals Among the Heaviest Cutters

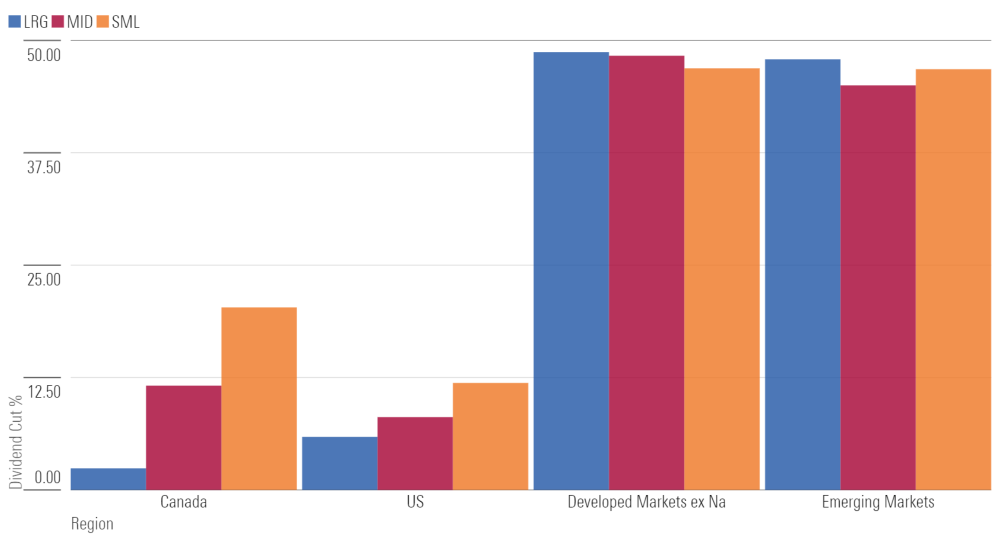
Sector	U.S.	Canada	Developed ex-North Am	Emerging Markets
Basic Materials	5.5	13.6	46.1	60.9
Communication Services	0.0	0.0	40.1	39.4
Consumer Cyclical	10.4	20.0	62.0	51.4
Consumer Defensive	2.0	7.7	39.3	31.6
Energy	30.2	38.5	51.7	62.4
Financial Services	7.1	4.0	55.4	45.5
Healthcare	0.0	0.0	28.1	36.9
Industrials	6.3	0.0	52.9	48.6
Real Estate	25.2	14.8	43.5	55.6
Technology	2.6	25.0	40.6	40.9
Utilities	3.4	0.0	21.5	28.3

Source: Morningstar Indexes. Data as of Nov. 30, 2020.

Exhibit 3 depicts dividend cuts by market capitalization. In the U.S. and Canada, large companies were likely to sustain their shareholder payouts in 2020. For example, all the U.S. technology stocks that cut dividends in 2020 were mid- and small caps—J2 Global, DXC, and Sabre, for example.

In Canada, most of the energy companies cutting dividends were also small- and mid-caps, names like Husky Energy and Crescent Point Energy. Outside North America, size did not seem to play a role in the likelihood of a dividend cut. Some investors will be surprised by the sheer prevalence of dividends among smaller stocks.

Exhibit 3 Dividend Cuts by Market Cap Show U.S. and Canadian Large Caps Cut Less in 2020



Source: Morningstar Indexes. Data as of Nov. 30, 2020.

Screening Out Dividend Cutters

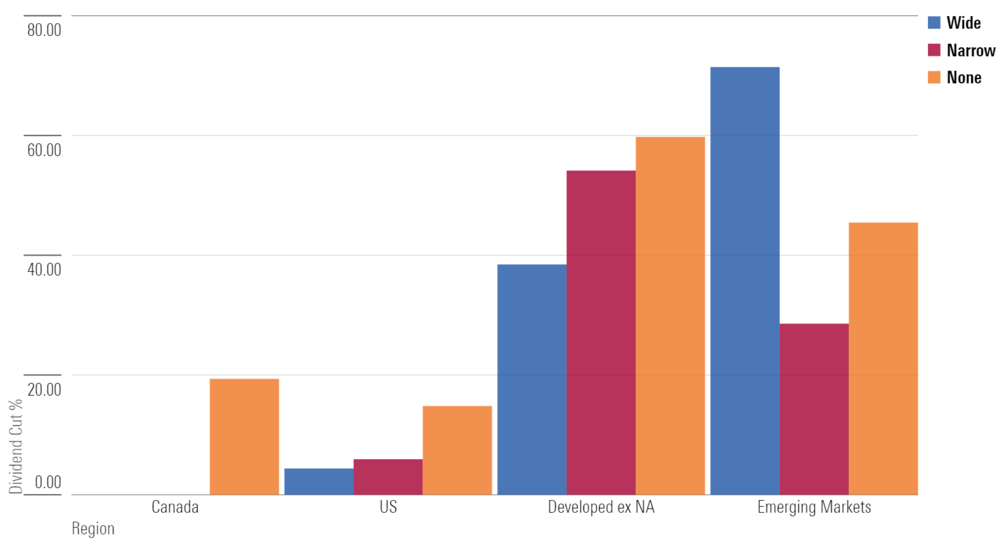
Morningstar employs several screens to identify at-risk payouts in its indexes. Here, we examine two: economic moat and Distance to Default.

A company that has an economic moat around its business possesses a sustainable competitive advantage. Morningstar's Equity Research team turned a Warren Buffett concept into a robust methodological framework, assigning economic moat ratings to the roughly 1,500 companies it covers—split roughly evenly between the U.S. and the rest of the world. A moat protects a company's profits from competition—in the same way that medieval castles kept enemies at bay with water-filled trenches. Profits are defined as returns on invested capital over and above our estimate of a firm's cost of capital, or weighted average cost of capital.

To earn a narrow or wide economic moat rating, a company must possess a structural feature that prevents excess returns from quickly eroding. Morningstar Equity Research has identified five sources of economic moat: intangible assets, switching costs, network effect, cost advantage, and efficient scale. Moat ratings are determined through a rigorous, peer-reviewed process using both quantitative and qualitative inputs. For a thorough discussion of moat, see Morningstar's Equity Research Methodology.[1]

As displayed in Exhibit 4, companies with economic moats around their businesses were likelier to sustain their dividends across geographies. Within the troubled energy sector, narrow-moat companies Exxon and Chevron, and wide-moat-rated Enbridge of Canada all managed to sustain payouts, while no-moat Suncor Energy of Canada cut. The five wide-moat-rated U.S. stocks to cut dividends in 2020 were Walt Disney, Wells Fargo, Boeing, Harley-Davidson, and Blackbaud.

Exhibit 4 Companies With Economic Moats Were More Likely to Sustain Dividends in 2020



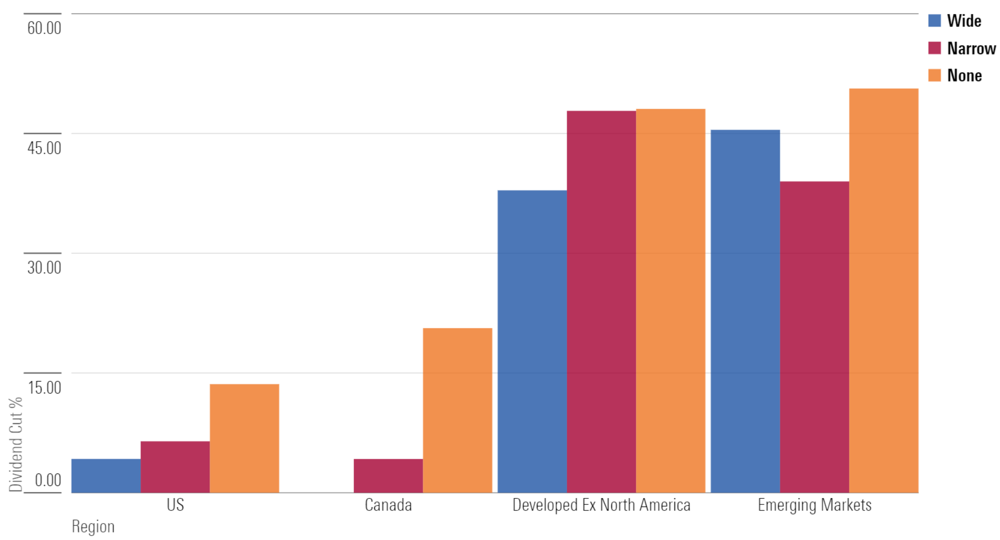
Source: Morningstar Indexes. Data as of Nov. 30, 2020.

1 For full methodology, see: https://direct.morningstar.com/research/doc/1014544/Morningstar-Analyst-Rating-for-Equity-Research-Methodology

In 2013, Morningstar developed a Quantitative Economic Moat Rating designed to extend coverage beyond analysts' ratings. The quantitative moat rating spans more than 50,000 stocks across developed and emerging markets. The Quantitative Economic Moat Rating is analogous to Morningstar's Economic Moat Rating in that both are meant to describe the strength of a firm's competitive position. It is calculated using a machine-learning algorithm designed to predict the economic moat rating a Morningstar analyst would assign to the stock. The quantitative rating is expressed as none, narrow, or wide. For more information, see Morningstar's Quantitative Equity & Credit Ratings Methodology.[2]

As displayed in Exhibit 5, companies with quantitatively assigned moats were also likelier to sustain their dividends across geographies.

Exhibit 5 Companies With Quantitatively Assigned Moats Were More Likely to Sustain Dividends in 2020



Source: Morningstar Indexes. Data as of Nov. 30, 2020.

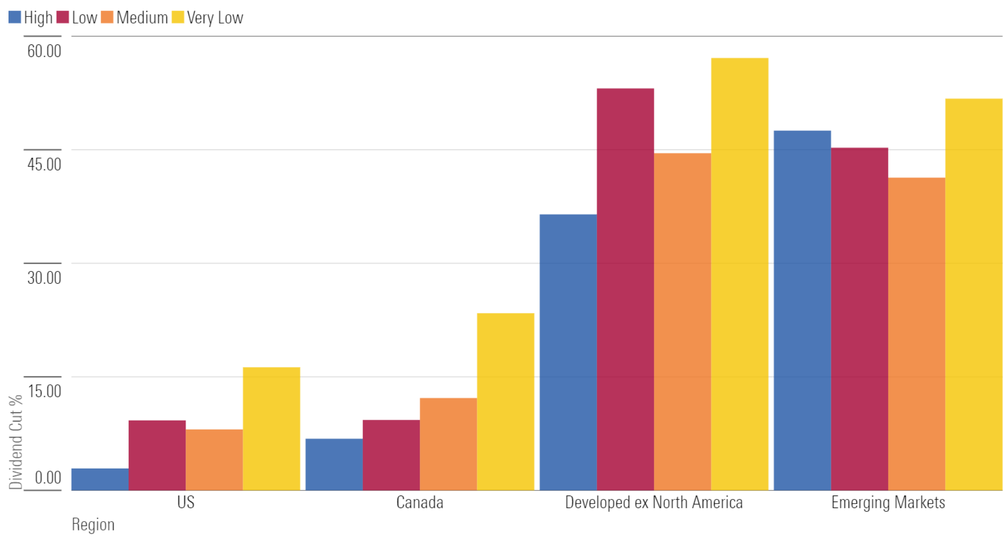
Distance to Default is a quantitative measure of financial health.[3] Morningstar's DTD metric ranks companies on likelihood of distress, using option-pricing theory to evaluate the risk that a company's assets will fall below the sum of its liabilities. Balance sheet data, including short- and long-term 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. After all, dividends are not guaranteed. Owners of regular shares don't have the kind of claims on a company's assets enjoyed by debtholders. For the purposes of dividend index selection, stocks are compared with peers on the basis of DTD score, and companies that fall under a given threshold are ineligible for consideration.

2 https://direct.morningstar.com/research/doc/678203/Morningstar-s-Quantitative-Equity-and-Credit-Ratings-Methodology

3 https://assets.contentstack.io/v3/assets/bltabf2a7413d5a8f05/bltbb3e61d669c7741a/5ea011a8c81c45292c0d56a2/Morningstar_Indexes_DtD_Methodology.pdf

As depicted in Exhibit 6, DTD was also an effective predictor of dividend cuts in 2020. Dividing the universe of dividend payers into equal bands (quartiles) by their DTD scores, we looked at whether the company went on to cut its dividend. Several of the wide-moat-rated U.S. stocks that cut dividends in 2020 were screened out by DTD, including Blackbaud, Harley-Davidson, and Boeing. In Canada, DTD screened out dividend cutters such as CAE, Evertz Technologies, and Methanex. The DTD metric flagged Japan's Komatsu, JD Sports of the United Kingdom, Australia's Westpac, China's Everbright Securities, and Heineken of the Netherlands.

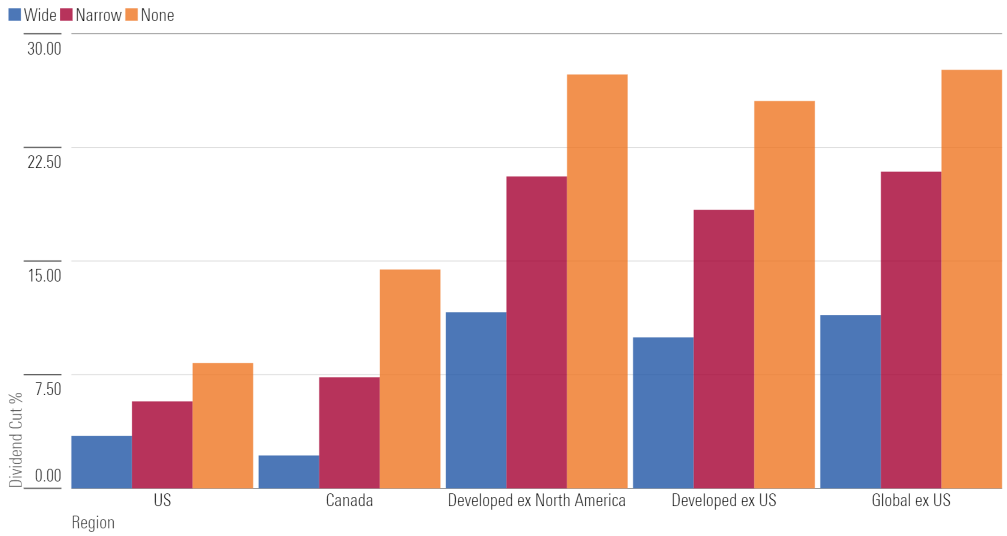
Exhibit 6 Companies With Better Distance to Default Scores Were Less Likely to Cut Dividends in 2020



Source: Morningstar Indexes. Data as of Nov. 30, 2020.

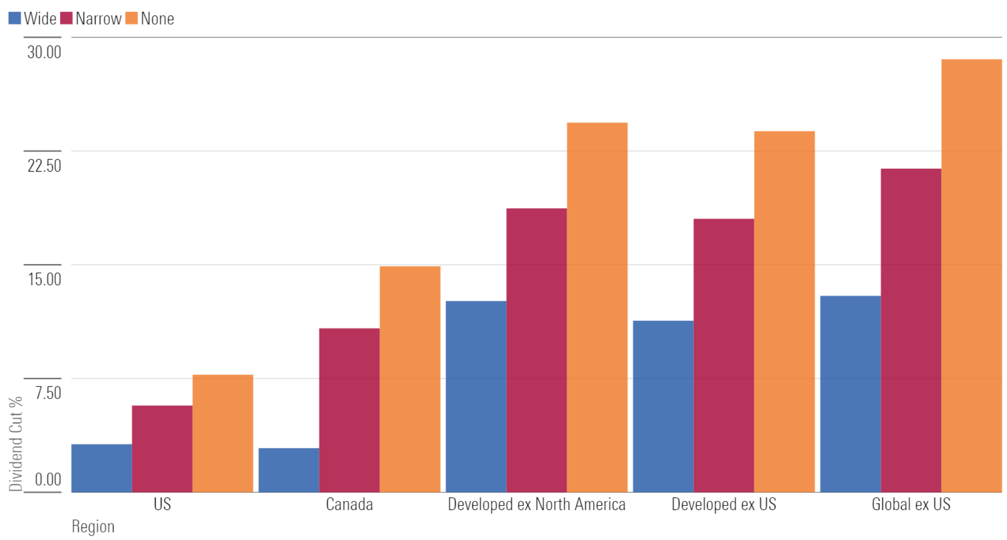
As depicted in exhibits 7-9, the predictive power of economic moat and DTD for 2020 dividend cutters was no aberration. Across time period and geography, moats and financial health have effectively identified at-risk dividends.

Exhibit 7 Companies With Moats Were Less Likely to Cut Dividends From 2005 to 2020



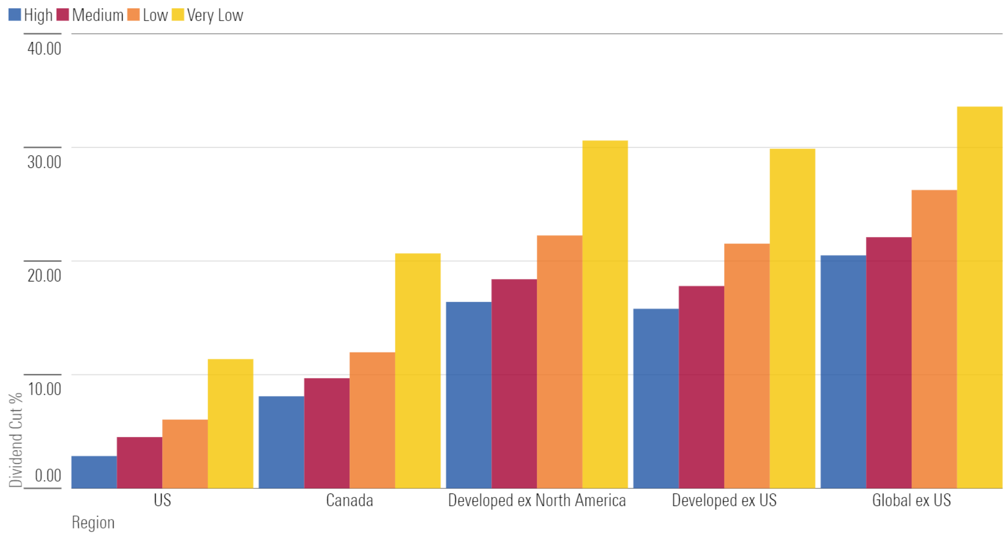
Source: Morningstar Indexes. Data as of Nov. 30, 2020.

Exhibit 8 Companies With Quantitatively Assigned Moats Were Less Likely to Cut Dividends From 2005 to 2020



Source: Morningstar Indexes. Data as of Nov. 30, 2020.

Exhibit 9 Companies With Better Distance to Default Scores Were Less Likely to Cut Dividends From 2005 to 2020



Source: Morningstar Indexes. Data as of Nov. 30, 2020.

Dividends for Total Return

Dividend-paying stocks have a long and impressive history of delivering for investors, not just income but also total return. But they are best approached selectively. Companies that can sustain profitability due to an economic moat are also well positioned to sustain their dividends. Financially healthy companies have more wherewithal to pay out cash to shareholders. Equity income investors who prioritize income over total return can end up sacrificing both.

About Morningstar Indexes

Morningstar Indexes combine the science and art of indexing to give investors a clearer view into the world's financial markets. Our indexes are based on transparent, rules-based methodologies that are thoroughly back-tested and supported by original research. Covering all major asset classes, our indexes originate from the Morningstar Investment Research Ecosystem — our network of accomplished analysts and researchers working to interpret and improve the investment landscape. Clients such as exchange-traded fund providers and other asset management firms work with our team of experts to create distinct, investor-focused products based on our indexes. Morningstar Indexes also serve as a precise benchmarking resource.

To learn more about Morningstar Indexes, visit: http://global.morningstar.com/indexes

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