NORTHERN TRUST
ASSET MANAGEMENT

HOW TO INVEST IN DIVIDEND STRATEGIES NOW

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Companies globally are slashing dividends as they face a combination of declining revenues and regulatory measures discouraging dividend payments. Not surprisingly, companies are now prioritizing liquidity and solvency over returning capital to shareholders.

While dividends are being eliminated or suspended, we note that dividend cuts are not uniform in sectors, regions and companies. Regulatory restrictions notwithstanding, many companies will be able to maintain their dividend payouts despite ongoing market events.

Falling dividends are a challenge for investors who see dividend income as an important component of their portfolios. We think this problem can be alleviated with an investment approach that addresses two key aspects of dividend investing that can help maintain healthy dividend yields, even in this environment. First, dividends should be sourced from across the economy and not only from a few companies, regions or sectors. Second, company fundamentals are important in security selection, which can be accomplished quantitatively by looking at each company's quality characteristics and combining that with an assessment of how well a company is managing its exposure to environmental, social and governance (ESG) risks and opportunities.

Investors are bracing for dividend cuts, with dividend futures indicating cuts of 15% for companies in the S&P 500 Index and 35% for companies in the Eurostoxx 50 Index by the end of 2020. When investing in dividend strategies in this market, design matters.

DIVIDEND OUTLOOK: DIFFICULT BUT NOT DIRE

The sharp drop in economic activity has significantly worsened the cash flows of several companies, making it difficult for them to sustain the dividend payments. Further, regulators have been encouraging companies, in particular banks, to curtail dividends and support the broader economy and restricting companies benefiting from government liquidity programs from paying dividends. As a result, investors are bracing for dividend cuts, with dividend futures indicating cuts of 15% for companies in the S&P 500 Index and 35% for companies in the Eurostoxx 50 Index by the end of 2020.

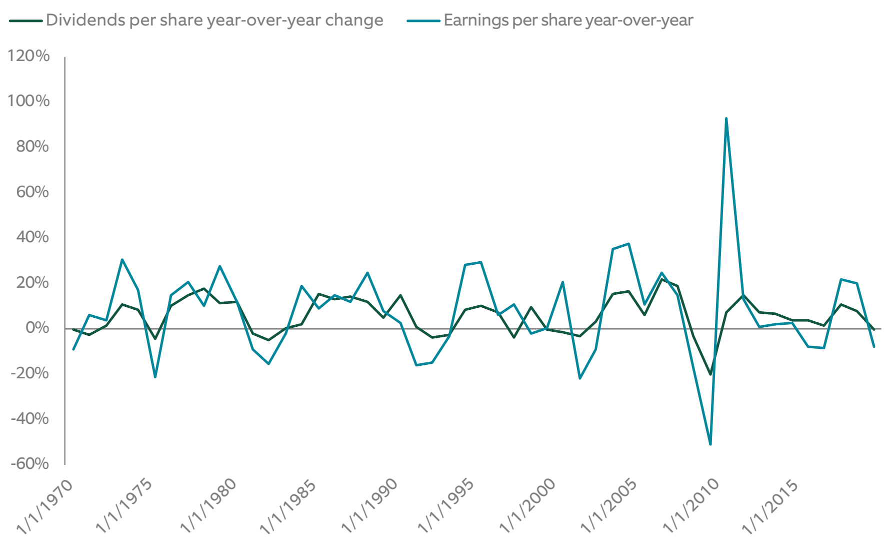
The degree of dividend cuts, henceforth, is likely to differ across sectors, regions and companies, depending on their sensitivity to economic decline and the regulatory measures. The challenge is that companies that have historically been reliable dividend payers over the years — such as those in the energy, financial, consumer discretionary, and industrials sectors — are particularly susceptible to the deterioration in the underlying business prospects and/or the impact of regulatory measures. These sectors contributed half of the income received from MSCI World Index prior to the onset of the coronavirus crisis. Since then, a large majority of companies that have cut their dividends within the MSCI World Index is concentrated in those sectors.

We believe that dividends can be a steady source of investor return, even during times of stress

This may sound altogether dire for investors looking to dividend strategies for both income and total returns. However, we believe that dividends can be a steady source of investor return, even during times of stress. As shown in Exhibit 1, over the last 50 years, the variability of dividends is much less than the variability of earnings, including during recessions. The dividend policy adopted by a company tends to be sticky. This leads to higher stability than earnings, even during recessionary times. Management of companies pays a close eye to the adopted dividend policy and the signals that policy changes may send to the market regarding the company's future outlook and hence they are reluctant to change it.

EXHIBIT 1: DIVIDENDS VS. EARNINGS

Annual variability in dividends is much lower than the earnings.



Source: MSCI, Bloomberg, Northern Trust Asset Management. December 1969 to December 2019.

We believe a thoughtful approach to portfolio construction can take advantage of the relatively lower variability of dividends, helping dividend investors navigate the current environment and achieve their income and return objectives.

For investors looking to maintain a healthy level of dividend income, we have two key recommendations: 1) diversify the source of dividends across sectors, regions and individual companies and 2) integrate a holistic view of sustainability through fundamentals and ESG to indicate a company's ability to sustain and grow their dividends.

High-dividend payers tend to be concentrated in mature industries, so certain sectors and regions tend to have higher pay-outs than others. This results in a significant concentration of sector and regional bets that add risk but not necessarily return.

DIVIDEND DIVERSIFICATION

Traditionally, in order to achieve income objectives, dividend strategies have focused on the high income payers. High-dividend payers tend to be concentrated in mature industries, so certain sectors and regions tend to have higher pay-outs than others. This results in a significant concentration of sector and regional bets that add risk but not necessarily return.

EXHIBIT 2: SECTOR CONCENTRATION IN DIVIDEND PAYERS

Relying heavily on high yield sectors such as financials, energy , industrials and consumer discretionary has proven detrimental to yield and performance.

Sectors	Sector yield contribution (%)	Sector relative performance (%)	Sector dividend cut (%)
Financials	20.6	-16.4	-9.8
Energy	9.7	-20.1	-7.9
Industrials	9.8	-6.7	-13.7
Health Care	10.8	10.3	3.3
Consumer Staples	10.0	0.8	1.6
Information Technology	9.9	8.2	1.7
Consumer Discretionary	7.9	-3.9	-22.8
Communication Services	6.1	-3.4	-12.6
Utilities	5.2	-5.4	6.0
Real Estate	4.6	-8.8	-3.7
Materials	5.4	1.7	1.5

Source: Northern Trust Asset Management, dividend payers in MSCI World Index, dividend contribution as of May 31, 2020, performance and dividend cuts from January 31, 2020 to May 31, 2020.

Relying heavily on one or two sectors for dividends can expose investors to significant risks. This was the case during the 2008 global financial crisis, when financial companies cut dividends by about 60%. In the current environment, for companies in the top quintile of dividend yield, two-third of dividend yield comes from four sectors where dividends are most at risk and have significantly underperformed. We believe that there is no need to take significant sector biases in a dividend strategy as higher dividend yield relative to that of the cap–weighted index can be achieved through an efficient dividend strategy that sources its income from all sectors. Dividend payers exist across sectors and a more balanced approach to dividend investing can help avoid the unintended risks of sector biases that may be helpful in the short-term but are uncompensated over the long run.

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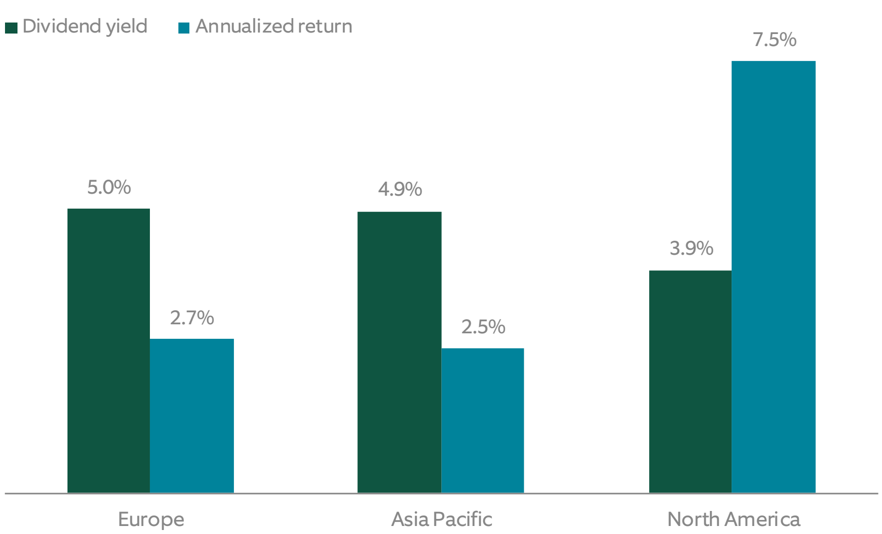
In a similar manner, dependence on specific regions for dividends can prove destabilizing. On a global basis, dividends have historically remained stable. However, there can be significant regional variations. In 2015, emerging markets and Europe ex-U.K. dividends declined by 10% and U.K. dividends fell 22%. However, higher dividends in North America and Asia counterbalanced these declines, resulting in only a 2% decline in global dividends for the year.

Historically, Europe tends to have higher yields than other regions, so a number of dividend strategies are significantly overweight to Europe. For global dividend strategies, reliance on the European region for dividends had resulted in underperformance over last decade as European equities lagged U.S. equities. In this environment as well, dividends cuts have been deepest in Europe on account of local regulatory measures and the economic deterioration.

Over the long run, it is evident that the regional bias has added to the risks but not to the returns.

EXHIBIT 3: EUROPE: HIGHER YIELD BUT LOWER RETURN

European high-dividend paying stocks have higher yield but have lagged in return over the last 10 years.



Source: Factset, MSCI. March 2010 to March 2020, MSCI World Index.

In summary, a high income portfolio that avoids unintended sector and regional biases and diversifies its sources of income is essential to avoid the adverse impact of dividend concentration in the portfolio. The lower the concentration to the source of income, the less the dividends are at risk.

ESG leaders tend to be better at managing risks and opportunities arising from environmental, social and governance themes such as physical climate, climate transition and regulatory risks.

QUALITY AND ESG: AN HOLISTIC VIEW TO DIVIDEND SUSTAINABILITY

Successful dividend investing has always been about identifying companies who can consistently pay and grow dividends over the long-term. In other words, seeking out dividend payers without considering future ability to maintain them is akin to buying high yield debt without considering its default likelihood.

Many times, higher yield is the result of a price decline. Seemingly cheap high-yielding stocks may be yield traps, as their attractive yield is the result of markets pricing in their impaired fundamentals such as lower sales, profits and cash flows. It has been observed that such price declines generally precede dividend cuts. For example, for companies in the top decile of dividend yield , the one-year forward dividend yield is 75% lower than their one-year trailing dividend yield, indicating that a number of them are yield traps.

We believe that investors should take a holistic view to judge sustainability of dividends and to avoid yield traps. They should focus on high quality companies, looking at companies' management efficiency, profitability, and cash flows to help identify financial sustainability. They should also integrate ESG to derive a non-financial sustainability perspective for a company by assessing how well it is performing in areas such as climate change, climate change risks, privacy and data security, corporate governance and diversity.

In comparison to peers, high quality companies tend to be more profitable, have more conservative balance sheets and generate higher cash flows, all which are important to protecting a company's dividend relative to peers during recessionary times. Further:

1. Companies with higher levels of profitability are more likely to generate free cash that can be distributed to shareholders while maintaining the ability to invest in the business to generate significant total returns.
2. Conservative balance sheets for companies, a result of the prudent and efficient management, translate into lower exposure to distressed market conditions.
3. Higher cash flows provide a cushion from short-term shocks, ensure that companies can internally finance their operations and help maintain dividend payments in stressed economic environment.

In a similar vein, companies that are ESG leaders tend to be better at managing risks and opportunities arising from physical and transition climate risk management, human and labor rights and good corporate governance. Effective management of these risks creates avenues for sustained long-term profitability and may protect firms from significant drawdowns in cash flows.

Superior corporate governance is an excellent example of how ESG issues can drive dividend sustainability. Companies with adequate board structures that require independence of key committees and strong shareholder protection measures are more likely to be prudent when adopting a long term dividend policy. They will also thoroughly consider any decisions to alter them, thereby insulating dividends from myopic short-term adjustments.

Our research shows that, among dividend payers, the combination of high quality and high ESG companies perform the best.

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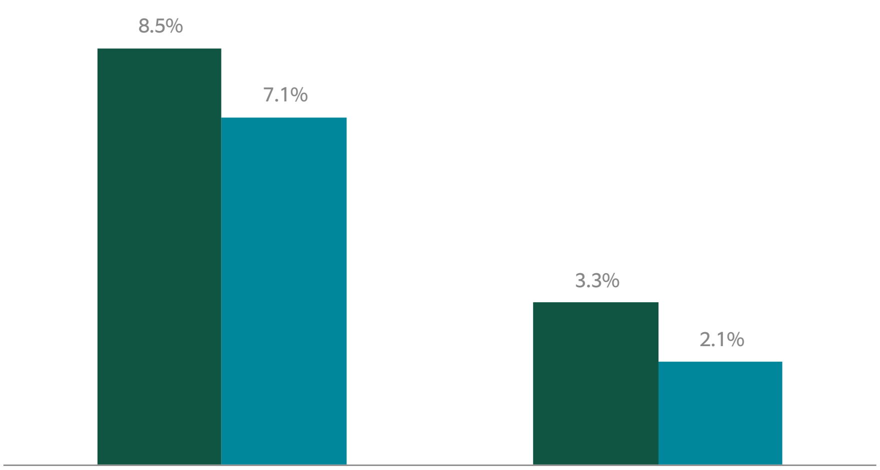
EXHIBIT 4: QUALITY AND ESG PERFORMANCE

Equities of high quality ESG leaders perform best among dividend payers.

Annualized Returns

■ ESG leader ■ ESG laggard

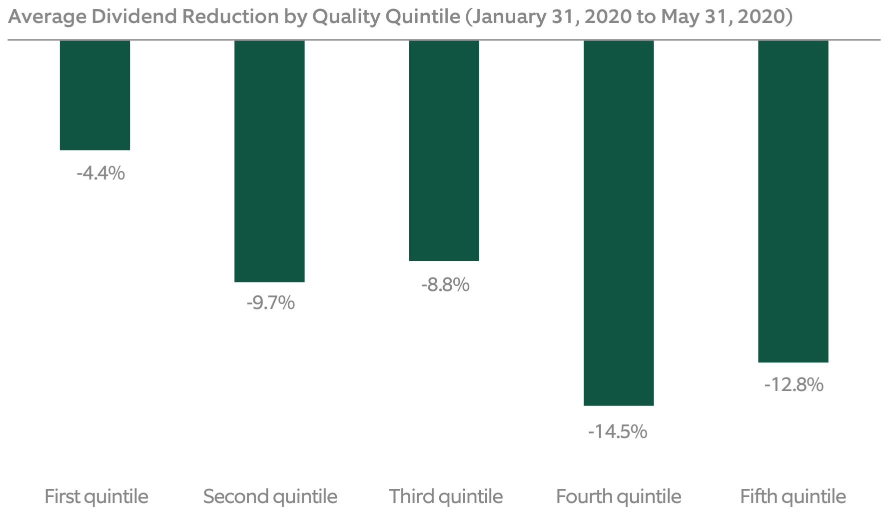


Source : Northern Trust Asset Management ,MSCI. March 2010 to March 2020, all dividend payers in the MSCI World Index.

The efficacy of this approach has been demonstrated in the current environment as high quality companies have experienced relatively lower reductions in dividend levels and lower volatility relative to the low quality companies. Further, as ESG leaders outperformed, high quality ESG leaders delivered superior risk-adjusted returns among the dividend payers.

EXHIBIT 5 : QUALITY AND DIVIDEND CUTS

The highest quality companies (first quintile) have cut dividends less severely than the lower quality companies



Source: Northern Trust Asset Management, FactSet. Average dividend per share reduction sorted in quality quintiles for MSCI World Index Dividend per share for an equally weighted portfolio in each quintile.

When investing in any strategy, we feel it is essential to focus on the areas where investors are getting paid to take risks, and avoid taking risks where investors are not getting paid. This philosophy applies particularly well to high dividend yielding strategies.

CONCLUSION: DESIGN IN DIVIDEND STRATEGIES MATTERS

Dividend investing has been popular for decades, and has only become more so in recent times as yields from fixed income markets have continued their secular decline and economic growth expectations have shrunk. However, not every dividend strategy will meet the investors' expectations, as we are in an environment that will separate the wheat from the chaff, when it comes to dividend payers.

Our High Dividend Yield World ESG Equity Strategy incorporates the two key aspects we've discussed to constructing reliable dividend portfolios. We diversify income sources and avoid heavy reliance on certain sectors or regions. We focus on high quality companies because our research shows that quality paired with ESG provides a holistic perspective on companies' prospects regarding sustaining their dividends, especially during times of stress. When investing in any strategy, we feel it is essential to focus on the areas where investors are getting paid to take risks, and avoid taking risks where investors are not getting paid. This philosophy applies particularly well to high dividend yielding strategies.

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