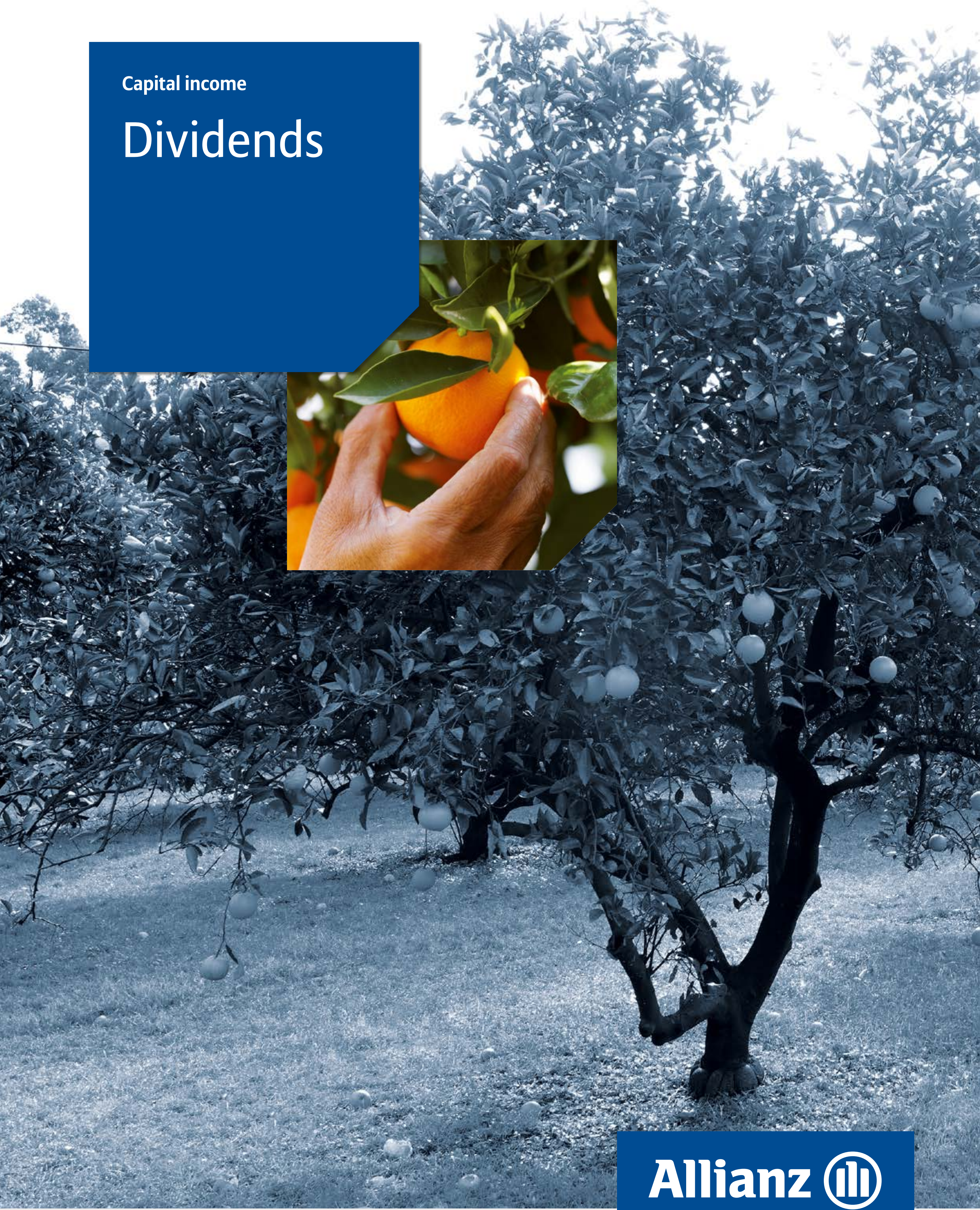
Capital income

Dividends



Allianz Global Investors

Understand. Act.

Content

Imprint

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Data origin – if not otherwise noted:
Thomson Reuters Datastream

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Capital income: Dividends

In a large number of advanced countries, the current yields of governments bonds are hovering in negative territory or, at the very least, are at an insufficient level to preserve capital. Consequently, attention is increasingly shifting to dividends as a way of generating capital income; and they are becoming even more relevant as the issue of "reflation" comes to the fore with a gradual uptick in inflation rates.

Figure 1: Negative yields are a global phenomenon

Generic government bond rates, in %

	3M	1Y	2Y	3Y	4Y	5Y	6Y	7Y	8Y	9Y	10Y	15Y	20Y	30Y
Germany	–0.99	–0.78	–0.77	–0.78	–0.68	–0.55	–0.41	–0.29	–0.15	0.00	0.19	0.44	0.69	0.93
France	–0.90	–0.74	–0.66	–0.51	–0.33	–0.14	–0.10	0.04	0.25	0.49	0.66	1.05	1.34	1.62
Italy	–0.46	–0.28	–0.18	–0.07	0.19	0.54	0.82	1.13	1.37	1.50	1.74	2.12	2.41	2.88
Netherlands	–1.11		–0.72	–0.72	–0.66	–0.38	–0.35	–0.18	0.01	0.18	0.33			1.02
Belgium	–0.85	–0.69	–0.68	–0.61	–0.54	–0.41	–0.24	–0.13	0.14	0.35	0.52	0.99	1.05	1.60
Austria		–0.64	–0.66	–0.63	–0.50	–0.38	–0.21	–0.12	0.07	0.23	0.41	0.88		1.30
Finland		–0.71	–0.66	–0.65	–0.54	–0.48	–0.29	–0.06	0.00	0.23	0.34	0.73		1.00
Switzerland*		–0.94	–0.96	–0.89	–0.76	–0.67	–0.56	–0.48	–0.35	–0.29	–0.19	0.09	0.21	0.39
Sweden*	–0.80	–0.84	–0.63		–0.38	–0.13		0.12			0.89			
Denmark*	–0.68		–0.53			–0.28					0.31			0.95
UK*	0.16	0.12	0.08	0.12	0.34	0.49	0.69	0.81	0.95		1.24	1.63	1.77	1.88
US	0.50	0.81	1.19	1.45		1.93		2.25			2.44			3.07
Japan	–0.39	–0.31	–0.18	–0.16	–0.12	–0.11	–0.08	–0.06	–0.02	0.01	0.05	0.24	0.58	0.72

*Non-EWU Countries

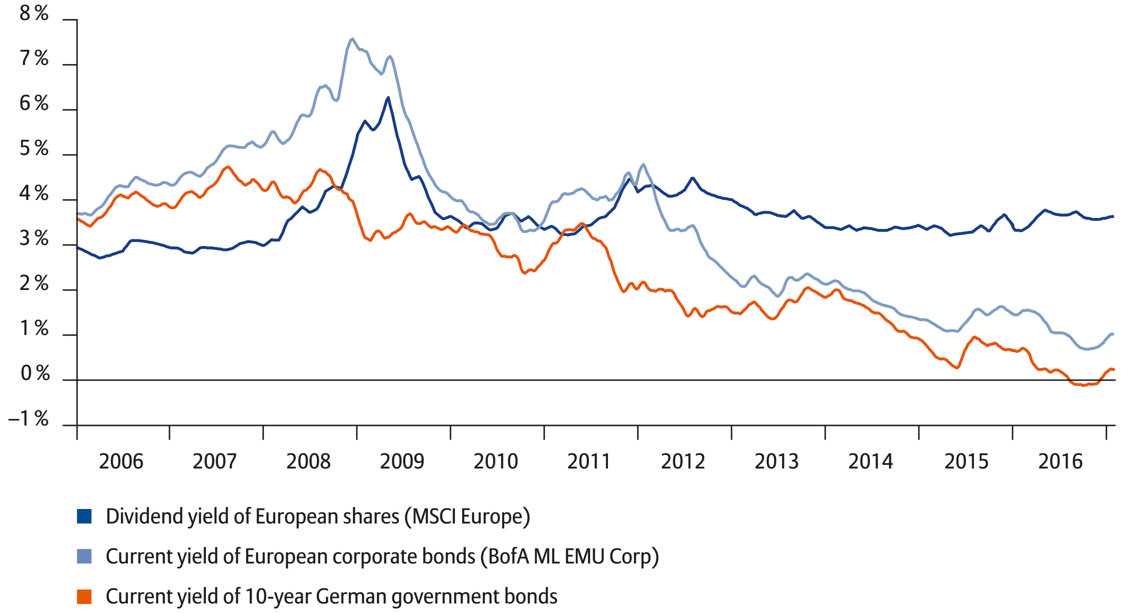
Generic government rates monitor yield changes for government benchmark bonds. Past performance is not a reliable indicator of future results. Sources: Bloomberg, AllianzGI Global Capital Markets & Thematic Research, Data as of 02.01.2017

As at the end of 2016, approximately 28% of all government bonds of advanced economies in circulation sported negative yields, as shown by our AllianzGI QE Monitor. The situation is particularly dramatic in Japan and Europe. However, by the time investors factor in the effect of inflation it becomes clear that nominal yields in other parts of the fixed-income universe are not sufficient to preserve real purchasing power, either. Although current yields may well be positive in the United States, for example, real yields (nominal yields minus the inflation rate) are negative and even apply to maturities of up to ten years. If you save in this way, you are certain to lose purchasing power. An investment such as this is not appropriate for maintaining purchasing power and most definitely not suitable for accumulating capital. Thus, it is understandable that dividends are increasingly viewed as the new "**interest on equities**", despite volatility being a fact of life with equity investments.

Dividend strategies certainly appear interesting amidst an environment of negative, or at least low, yields. Divergence between dividend yields and yields on government and corporate bonds has never been as large as it is today by historical standards, at least as far as European companies are concerned.

Figure 2 a: European Shares Offer Attractive Dividend Yields

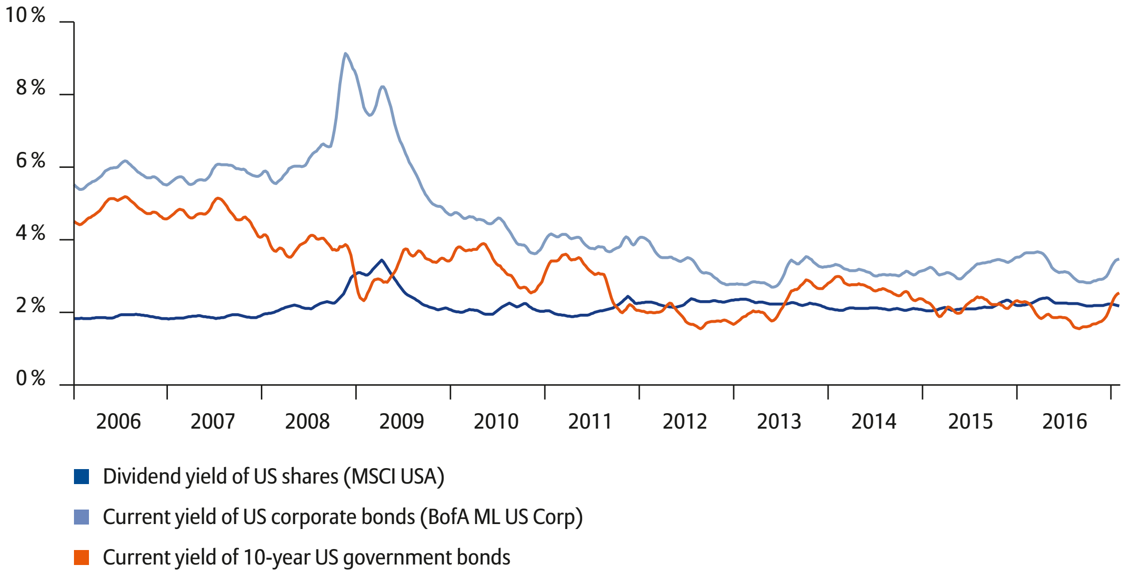
Dividend yields (MSCI Europe) versus yields of German government (10 year) and European corporate bonds



Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of 03.01.2017

Figure 2 b: Dividend Yields of American Shares

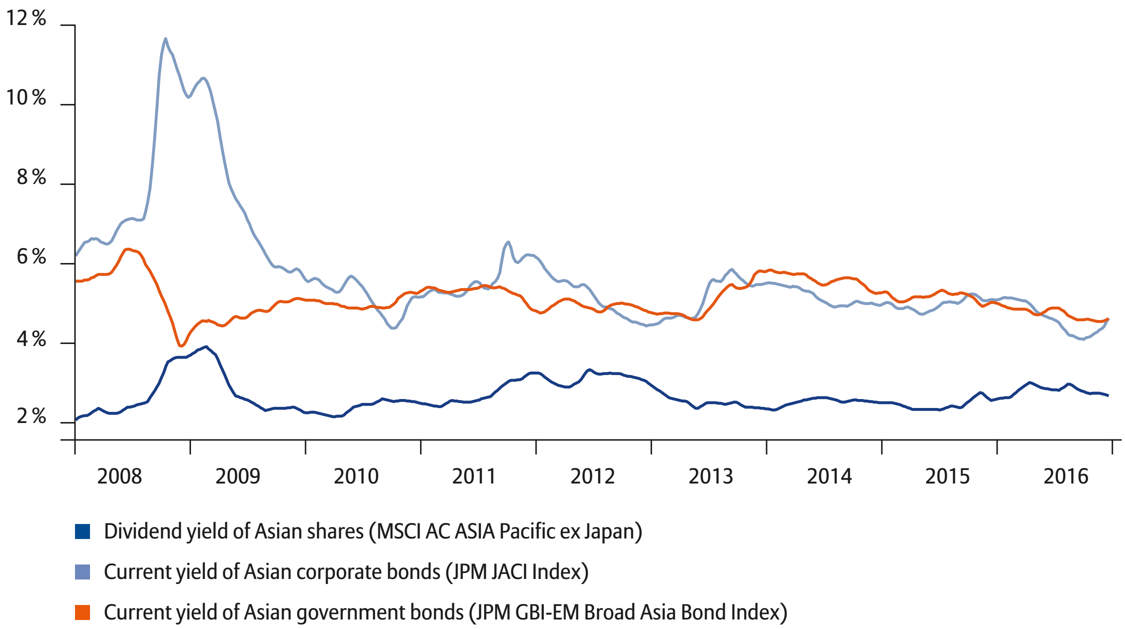
Dividend yields (MSCI USA) versus yields of US government (10 year) and American corporate bonds



Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of 03.01.2017

Figure 2 c: Dividend Yields of Asian Shares

Dividend yields (MSCI ASIA ex Japan) versus Asian government and Asian corporate bonds



Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of 03.01.2017

For investors, there are two key questions that are important to consider before any assertions can be made about the future success of dividend strategies:

1. What advantages can dividend strategies offer the long-term investor?
2. Taking the current market environment as a starting point, what can be expected in terms of the future performance of dividend yields?

As a rule, dividend strategies are characterised by companies that:

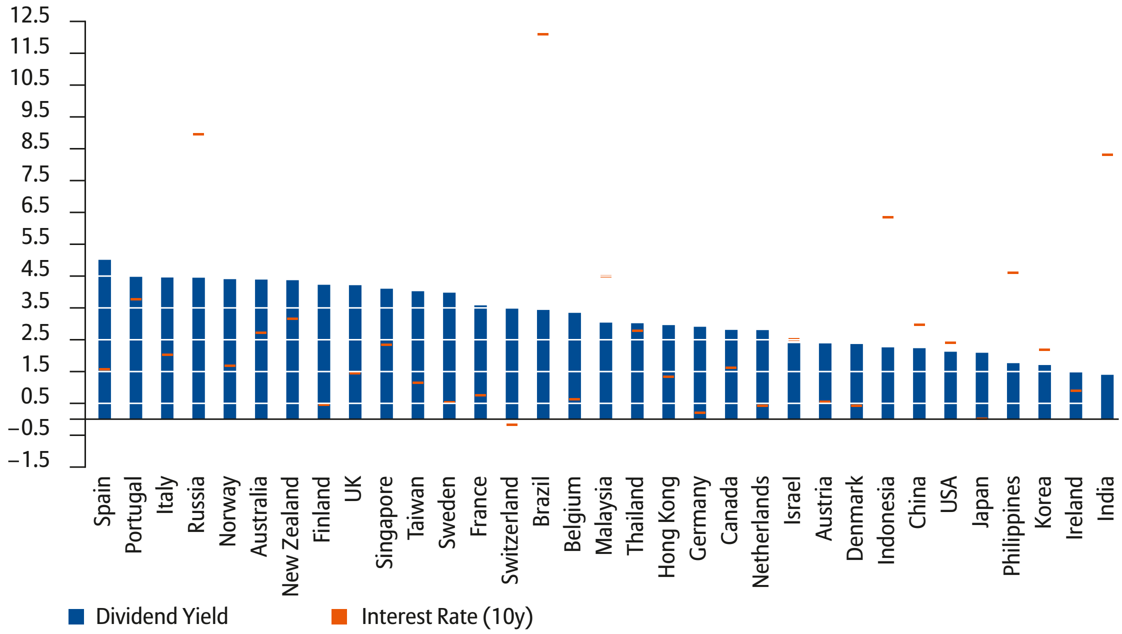
1. can be expected to generate an above-average dividend yield on the respective market index,
2. have potential for growing future dividends while simultaneously
3. providing a reliable dividend policy and dividend track record.

Dividends – a key performance driver in a low-interest and low-yield environment

European companies, in particular, have an investor-friendly dividend policy compared to their international peers. At the end of 2016, their average dividend yield across all market segments was around 3.5 % (basis: MSCI Europe). Focusing on high-dividend stocks meant that the expected dividend yield in the portfolio rose even further. However, in some cases the dividend yield in other regions is considerably higher than that on 10-year government bonds, too (see figure 3). Companies from the Euro countries of Spain, Portugal and Italy are heading the field, which can be explained by the fact that these markets still have low valuations. The dividend yield on the MSCI-USA seems positively modest in comparison, although you have to bear in mind that US companies, in contrast to European ones, for instance, have a stronger tendency to launch share buyback schemes than to pay out dividends. Share buyback schemes, though, are nothing other than corporate profits being paid out to a smaller, residual circle of shareholders.

Figure 3: Dividend Yields Are Attractive Around the Globe

Dividend yield (MSCI Indices) and interest rate of 10 year government bonds in comparison



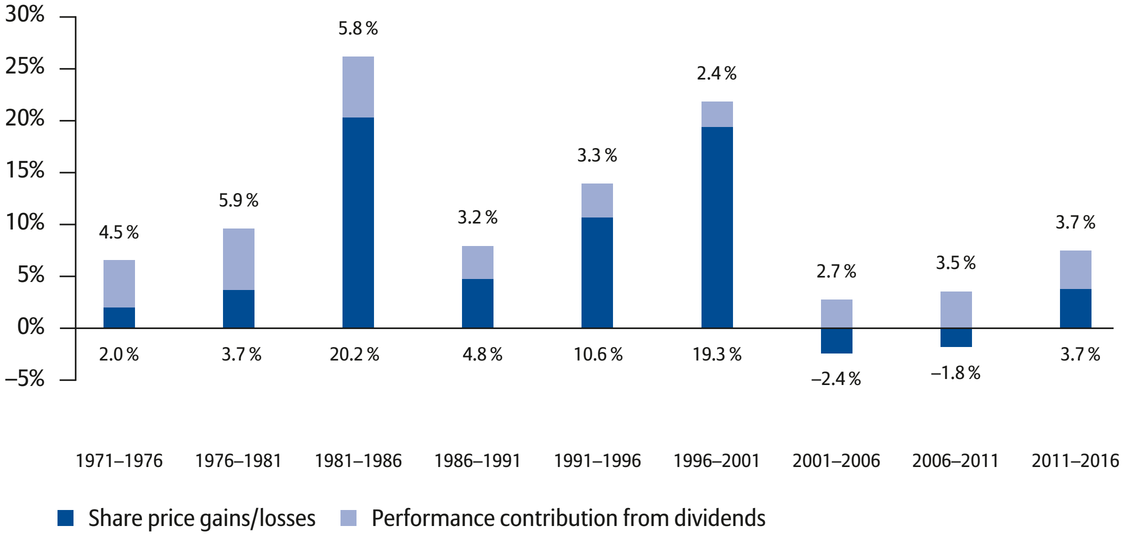
Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of 30.12.2016

Dividends – stability for the portfolio

At the same time, what is noticeable is that dividends can potentially help achieve additional stability in the portfolio. In the past, investors in European equities were the main beneficiaries of high dividend payouts that also helped in stabilising the overall performance in years of declining stock prices. Dividends were able to partially or even totally compensate for any price losses (figure 4 a – c). Over the entire period (1971 – 2016), the performance contribution of dividends to the annualised total portfolio return for the MSCI Europe was approximately 38 %. But in other regions, such as North America (MSCI North America) or Asia/Pacific (MSCI Pacific), around a third of overall performance was determined by dividends, albeit the absolute dividend yield was lower here (see figure 4 a – c).

Figure 4 a: Dividends – A Stabilising Factor for Investors

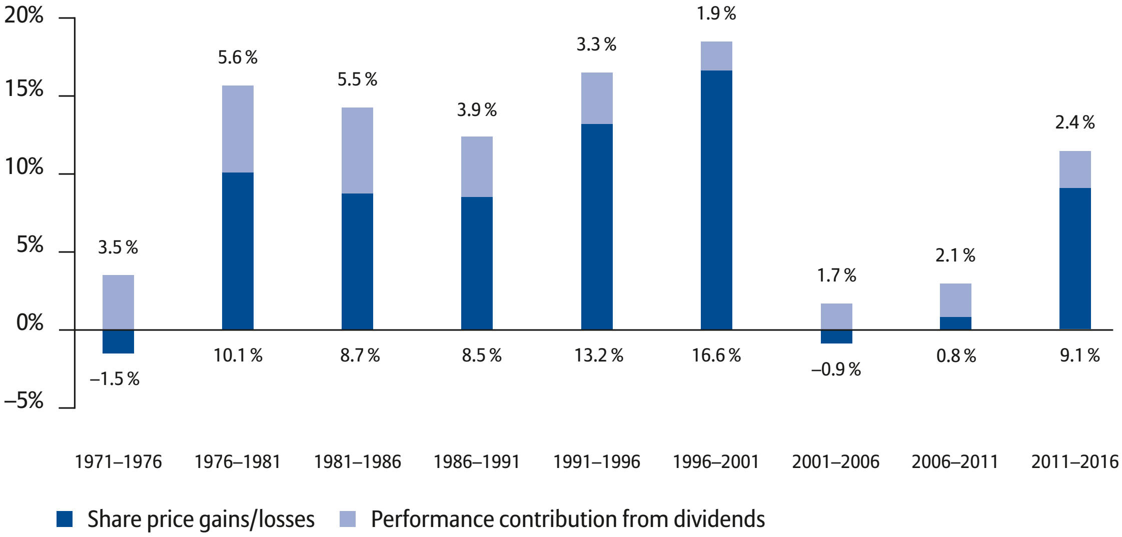
Performance contribution from dividends and MSCI Europe share prices since 1971 in five-year periods (% p. a.)



Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of 30.12.2016

Figure 4 b: Dividends – A Stabilising Factor for Investors

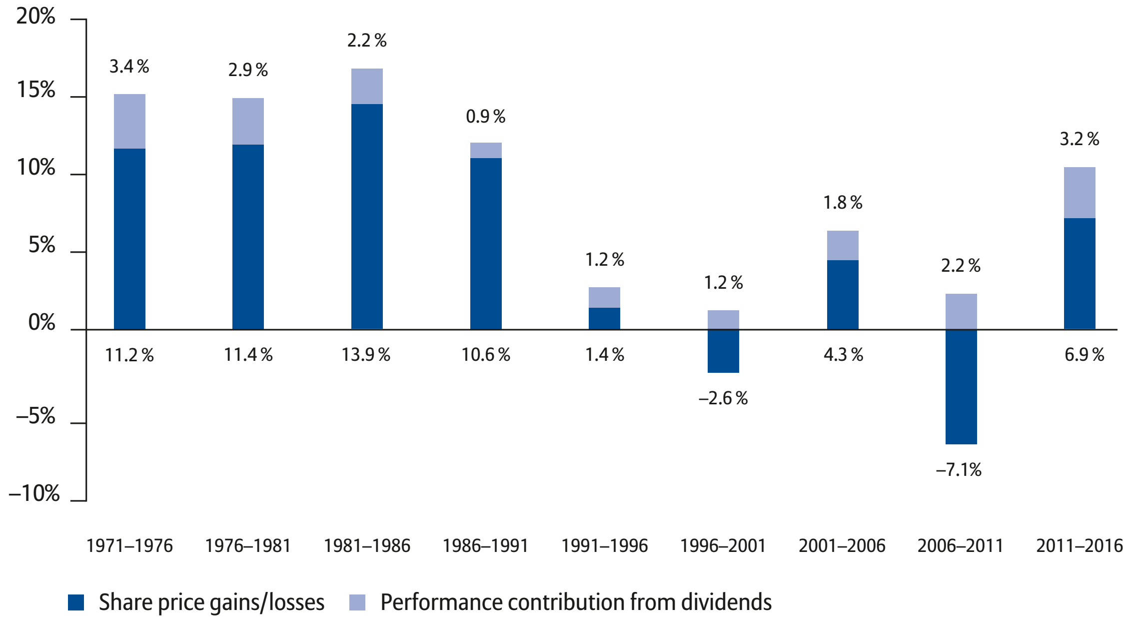
Performance contribution from dividends and MSCI North America share prices since 1971 in five-year periods (% p. a.)



Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of 30.12.2016

Figure 4 c: Dividends – A Stabilising Factor for Investors

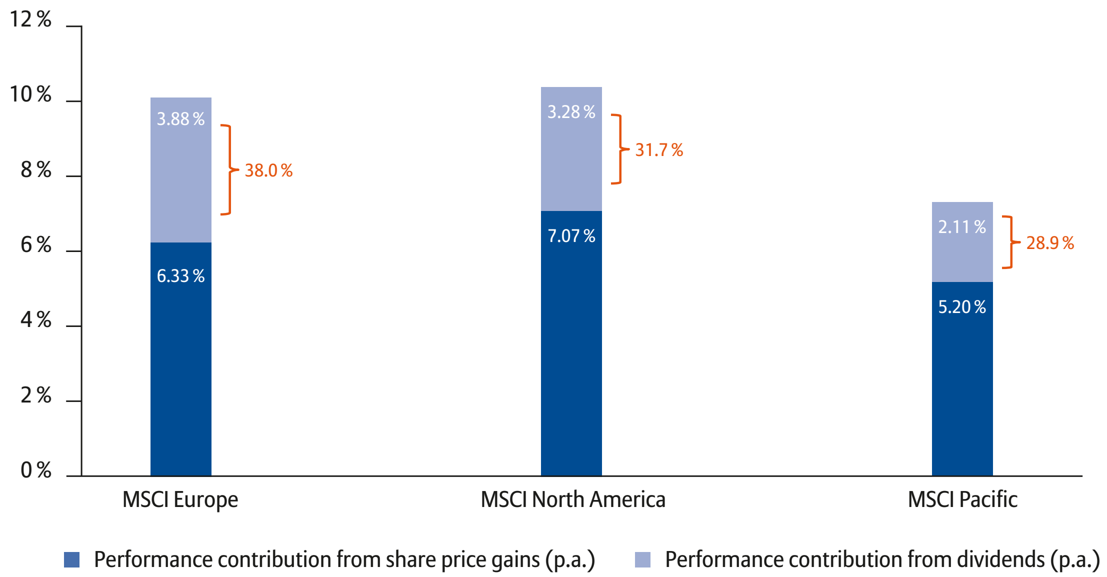
Performance contribution from dividends and MSCI AC Asia ex Japan share prices since 1971 in five-year periods (% p. a.)



Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of 30.12.2016

Figure 5: Shareholder-Friendly Dividend Policies, Especially in Europe

Global comparison of how dividends and share price gains contributed to performance between 1971 and the End of 2016 (annualised)

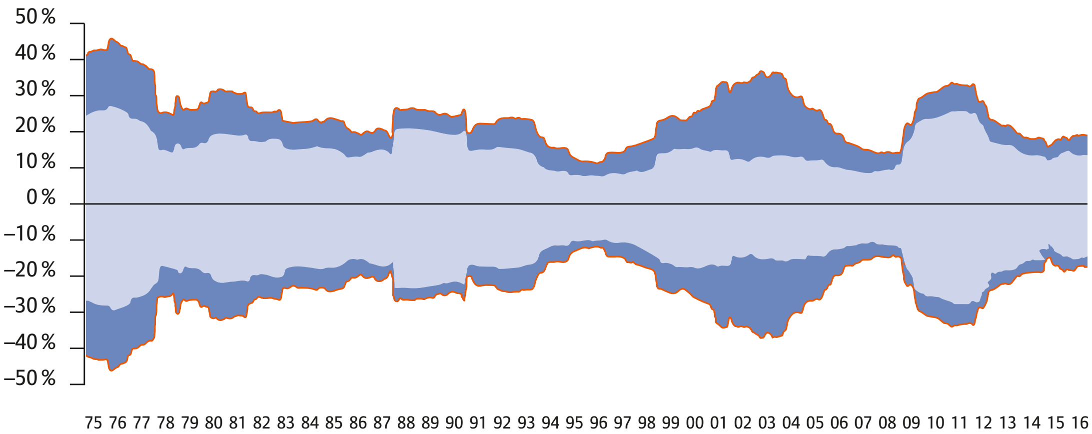


Past performance is not an indication of future results.
Sources: Datastream, AllianzGI Global Capital Markets & Thematic Research, Data as of 30.12.2016

However, dividends alone cannot ensure more stability with equity investments. High-dividend equities in themselves seem to have a less volatile performance than those of companies with lower dividend payouts. This is demonstrated by analysing the past performance of US stocks, for which the longest time series are available. This analysis shows that the volatility of US equities (measured in terms of a 36-month rolling standard deviation as a gauge of price fluctuation) has been lower since 1972 among companies paying out a dividend than among stock corporations that did not distribute any profits (see figure 6). Analogous behaviour is also discernible for European dividend stocks since the 1990s.

Figure 6: Share Prices of Dividend Securities Tend to Be Less Volatile

36-month rolling standard deviation of S&P 500 companies that did and did not pay dividends (Jan. 1972 – End of Sept. 2016)



Past performance is not an indication of future results.
Source: Datastream, Ned Davis Data, NFJ Research, Allianz Global Investor, Data as of 30.09.2016

Reasons for the value and price stability of dividend-bearing equities include, among others:

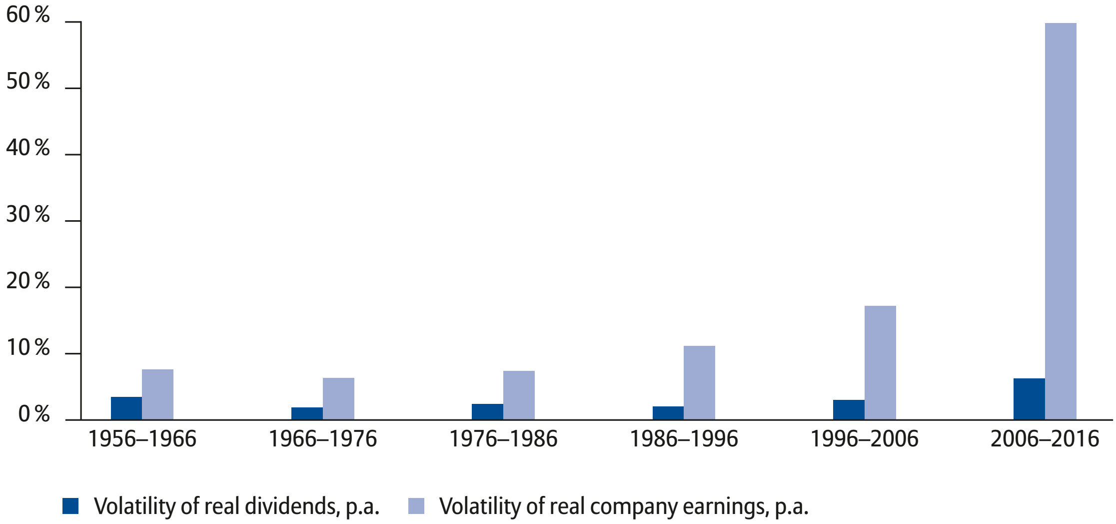
- Dividend policy is often an active component of a company's strategy. The dividend sends out an extraordinarily strong signal. Reaction on the market to reductions in or the absence of dividend payouts is very negative, since they sow doubts as to the future viability of the company. Consequently, companies go to great lengths to guarantee continuous dividend payments. A comparison of dividends and profits of members of the S & P 500 index since 1956 shows that corporate profits have been subject to far greater volatility than dividends. Particularly in the last 10 years, the volatility of profits has been considerably larger, at almost 60 % on an annualised basis, than the fluctuation observed in the case of dividends of around 6 % p. a. (see figure 7).

- Higher dividend payouts as well as a desire to reliably and continuously maintain them due to the signal they send out have a tendency to discipline companies. They are forced to manage their financial resources prudently and to use them efficiently. In contrast, share buyback programmes, due to their discretionary nature, neither have a comparative signal effect nor a similarly disciplining impact on the company.

- Companies with high dividend yields usually have sound balance sheet ratios with a relatively high level of equity capital and stable cash flows.

Figure 7: "Exhibited Low Volatility of Dividend Payments"

Volatility of company earnings and dividends, S&P 500, from 1956 till mid of 2016 (% p.a.)



Past performance is not an indication of future results.
Sources: Shiller, R., "U.S. Stock Price Data since 1871"; AllianzGI Global Capital Markets & Thematic Research, Data as of 31.06.2016

Looking ahead: How sustainable are dividends?

The lessons of the past, however, must be put into the perspective of expected future performance. Current dividend yields only describe the status quo but not what an investment in equities can actually achieve.

Factors suggesting stable or even rising dividend yields in the current market environment are:

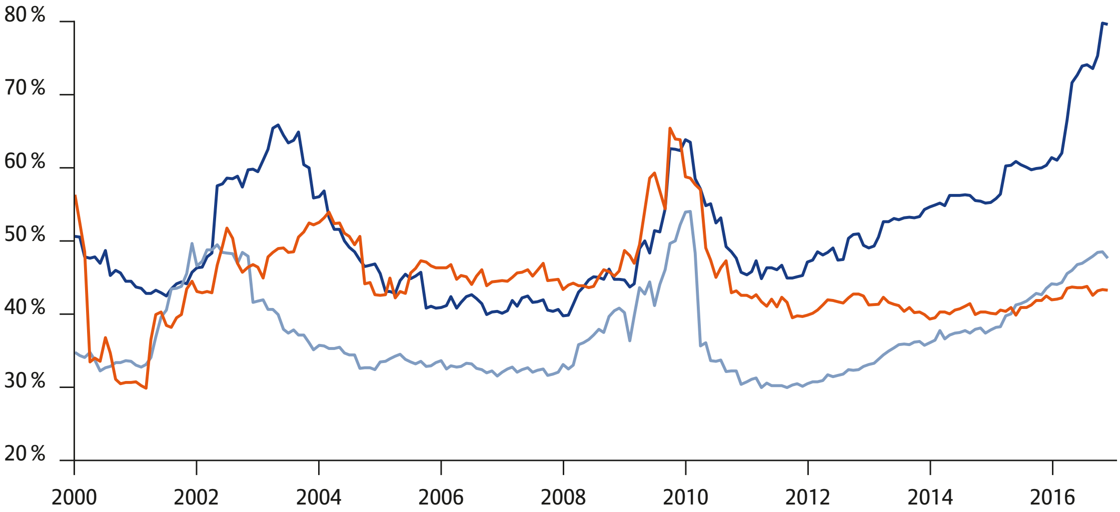
1. While the ratio of dividend payout to earnings per share, at around 80%, is considerably above its pre-crisis level in Europe at the moment, the distribution ratio in the United States and Asia, at approximately 50% and about 45% respectively, is more modest (see figure 8). Therefore, there is still scope for companies in these markets to boost dividends in the future.

2. Currently, companies have a large amount of free cash flow at their disposal. For example, the net cash flow of US companies in relation to US gross domestic product (GDP) is 12% and may be approaching the record level seen in 2011 (see figure 9).

3. Our global market outlook suggests that capital markets are gearing up for "reflation": Economic indicators are improving, not least thanks to an expected fiscal stimulus in the United States. Both of these mean better prospects for corporate profits. At the same time, additional interest rate hikes can be expected from the US central bank, the Federal Reserve. The latter coupled with inflation rates, which are once again on the rise, underpin expectations of weaker bond markets and stronger equity markets.

Figure 8: Distribution Ratios

Dividend payout ratios (dividends/earnings) of European, American and Asian companies from 2000 till the beginning of January 2017

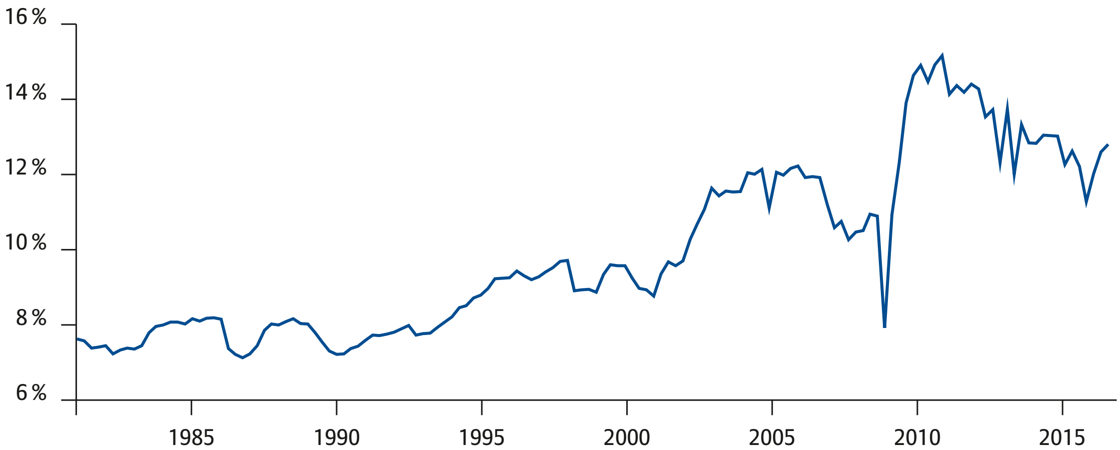


- Dividend payout ration of European companies (MSCI Europe)
- Dividend payout ration of US companies (MSCI USA)
- Dividend payout ration of Asian companies (MSCI AC ASIA ex Japan)

Sources: Datastream; AllianzGI Global Capital Markets & Thematic Research, Data as of 03.01.2017

Figure 9: US Companies Holding Substantial Cash

Net cash flows of US companies relative to US gross domestic product



- Net cashflow of US-companies / US GDP (real)

Sources: Datastream; AllianzGI Global Capital Markets & Thematic Research, Data as of 03.01.2017

4. Solid yet low global economic growth as well as the prevailing (as of December 2016) valuation data for the world's major equity markets suggest that dividends will contribute a significant share towards the overall performance of equities.

5. In respect of the profit outlook for 2017, supportive factors outweigh negative ones. In the United States, a recovery in the energy sector, expected tax cuts and spending programmes, among other things, should leave their mark on profits. On the other hand, the appreciation of the US Dollar and pressure on margins as a consequence of higher unit labour costs will have an adverse effect. Companies in the European Union should also benefit from the US fiscal stimulus, albeit only indirectly through higher economic growth, as well as from a recovery in the energy and – most likely – the banking sector. Political uncertainty should have a negative impact. It is unlikely that the consensus estimates of analysts in relation to profit increases will be fully met.

6. Since increased volatility can be expected in the context of monetary policy and the global geopolitical situation, dividends could potentially play their part as an anchor of stability.

Hunting solely for high dividend payments, though, can be misguided. Rather, in addition to a shareholder-friendly policy, it is particularly a company's business model that can justify expectations of sustainable returns. Factors such as market share, market entry barriers or the power to dictate prices play an important role in this regard. The right business model would also allow such companies to cushion the effects of inflation by raising prices.

Understand. Act.

- In the long run, dividends can deliver added value to the portfolio.

- Stock picking should not be based on the most recent profit distributions, since they may have come from equity capital, but on expected future dividends instead.

- From a historical perspective, dividends make a significant contribution to the total return of equities and have shown steadier performance than corporate profits. This has had a stabilising effect on the portfolio.

- Stocks of dividend-paying companies have proven to be less susceptible to volatility in the past than those of companies that do not pay a dividend.

- A comparison of global bond and dividend yields shows that dividends can be an attractive source of capital income, especially in times of extremely low, even negative bond yields.

- Capital income from dividends could even create an additional "basic income". Example: assuming an investor has 40,000 Euros that s/he invests at a dividend yield of 3%. If the companies' dividend payouts remain unchanged, s/he can expect a distribution of 1,200 Euros per year – equivalent to 100 Euros a month. It would not mean your pension is in the bag, but it would be a start.

Hans-Jörg Naumer with thanks to Dennis Nacken

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February 2017