JULY 2022

Talking Themes: Income from the corporate world

Key Messages

1. **Dividends and buybacks** accounted for 44% of the S&P 500 returns since 2011
2. **Income-generating strategies** can help investors to diversify their portfolios in times of stress
3. **Tighter financial conditions** are indicating further room to rise for dividend yields in the US
4. **Not all high dividend strategies are created equal:** introducing a quality filter in index construction helps to avoid potential value traps
5. **Invest in income and dividend strategies via dedicated funds and ETFs,** in corporate bonds and stocks in different regions.

Investors have 3 ways to gain income from the corporate world. Firstly, more defensively-oriented investors may wish look at investment grade bonds. After the recent spread widening, nominal yields have reached levels not seen for years. We prefer US corporate credit over Europe, as economic tail risks (e.g. energy crisis) are much more contained in the US.

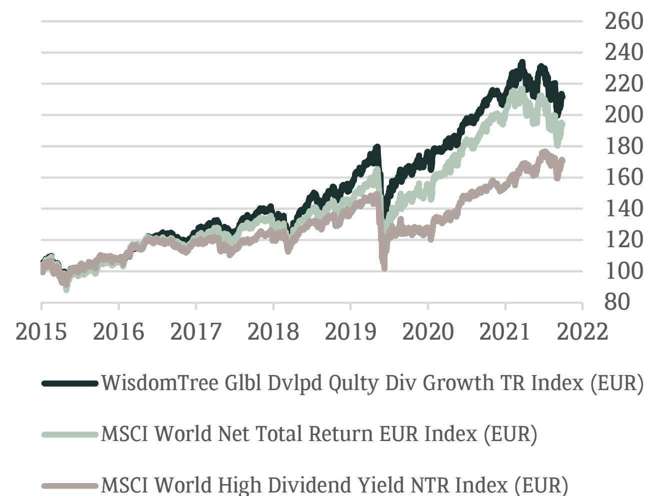
Since we forecast the EUR/USD reaching 1.12 (per 1 euro) in the next 12 months, **euro-based investors may prefer to look for currency-hedged solutions.**

Secondly, more dynamic investors could look for stocks with high dividend yields. This factor underperformed the broader market during the rally from the COVID-19 lows in March 2020. When growth is solid and inflation modest, dividends are of less importance as investors prefer then to invest in growth stocks. However, during times of high inflation this focus changes. Dividends are ultimately a function of revenues and profits. When inflation goes up, revenues tend to rise in conjunction with higher prices for goods and services. Today then, the macro stars seem to align for high dividend stocks.

Due to current economic headwinds**, we prefer a high dividend approach that also includes certain quality characteristics.** Over the logn term, this combination has outperformed both, the broader market and pure unfiltered high dividend strategies.

Thirdly, companies can return profits to investors by conducting share buybacks. This is a technical term for a company buying its own shares. By doing so, the company is reducing the amount of available shares. In turn, the companies profits are now split by fewer shares. Thus, the earnings per share rise and the P/E ratio falls. All else being equal, this should increase the attractiveness of a stock and lead to rising demand, i.e. eventually higher prices.

OUTPERFORMANCE OF A QUALITY DIVIDEND APPROACH



Source: BNP Paribas, Bloomberg

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Quality as a key performance factor

Share buybacks on the rise

While share buybacks are very common in the US, they are far less popular in Europe. This has partly to do with a shareholder base in Europe which is more oriented towards receiving income rather than just price gains. Further, European shareholders seem to appreciate the long-term management commitment that is signaled by stable or increasing dividends.

For the US market, share buybacks are a key driver of performance, though. A recent study found that **40% of the S&P 500 returns since 2011 can be attributed to buybacks**. We believe that elevated margins and healthy corporate balance sheets should support the ability of companies to conduct further buybacks going forward. The fact that the size of repurchase authorizations has hit a new all time high on a year to date basis comforts us further in this view.

This does not mean that we neglect the economic headwinds companies are facing. Times are undoubtedly challenging. Still, **some areas of the market should fare better than others. This should especially be true for quality stocks**. Those companies are better equipped on two distinct levels. Firstly, they generate more stable revenues, that allow them to grow and compound wealth in the future. Secondly, thanks to their solid business models and financial strength, they can much better withstand challenging economic conditions. As a consequence, those companies should be able to generate the earnings necessary to conduct buybacks in the future.

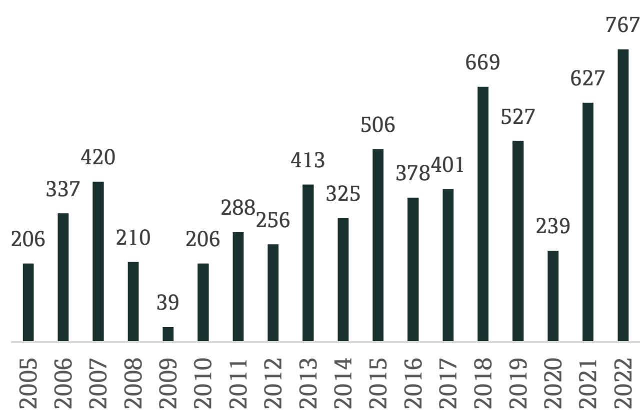
Not all dividend strategies are created equal

Avoiding dividend value traps. The possibility for a company to pay a dividend is vastly driven by its current profitability. Therefor investors may be well advised to not make a mistake by focusing solely on historic dividend payouts. A very costly mistake can in fact be to estimate the dividend yield based on the latest payout. The yield may be artificially inflated by a low share price. There is no guarantee though that the next dividend is as high as the previous ones. Actually, the lower share price could even be a signal of some underlying issues with the stock fundamentals. Thus, a purely high yield-focused investor may end up not only seeing the expected dividend cut, but also with a falling share price.

Hence, we prefer a quality dividend approach which takes into account the future capability of a company to maintain and grow its dividend payments over time. Quality companies tend to produce more stable cash flows. This enables them to generate the necessary proceeds to grow their payouts over time, be it via dividends or via share buybacks.

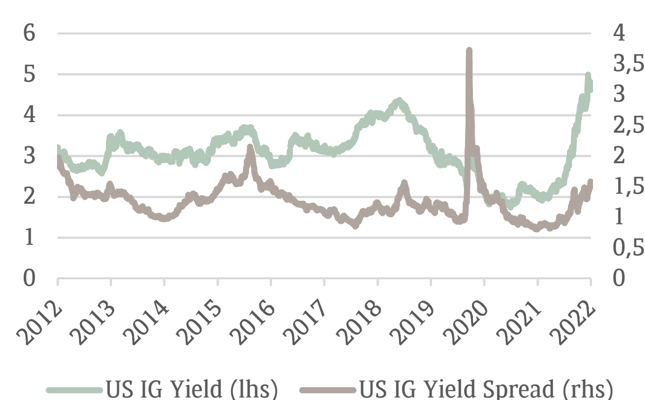
Investors should be aware that the dividend yield on those products may not as high as the ones that a pure high dividend yield approach would offer. More importantly though, the quality approach helps the strategy to perform well in different market environments. We believe that **quality dividend & buyback solutions are an interesting proposition** for investors to get a more defensive equity exposure in a high inflation environment.

YTD REPURCHARSE AUTHORIZATIONS (USD BN) IN THE US MARKET



Source: GS, BNP Paribas

US INVESTMENT GRADE CREDIT – HIGHER YIELDS AND WIDER SPREADS (%)



Source: BNP Paribas, Bloomberg

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