

*Matarin Capital Management aspires to be a symbol of stewardship within the investment management industry. We are dedicated to delivering excellent investment performance through insight, passion, and diligence. We aim to build strategic alliances with our clients based on the highest ethical standards.*

## When Birds of a Feather Don't Flock Together, Prepare to Fly Away

Dividend yield is not what it used to be. Historically, the return patterns associated with equity valuation measures have been correlated. Valuation metrics like dividend-to-price, earnings-to-price, cash flow-to-price, book-to-price, all share in common a business' financial metric in the numerator, and an identical denominator, the share price. But since the 2008 financial crisis, the correlation between the return pattern of dividend yield and other measures of valuation has broken down.

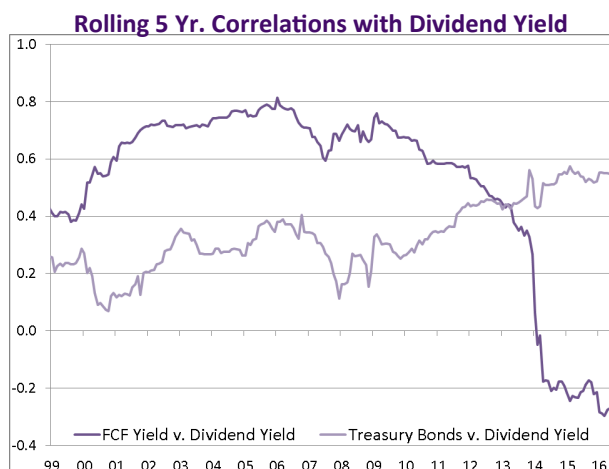
	Correlation with Dividend Yield	
	1994-2008	2009-Present
Cash Flow Yield	0.66	-0.28
Earnings Yield	0.78	0.05
Sales Yield	0.43	-0.25

Also since the financial crisis, interest rates have fallen to unprecedented lows, such that today the income on sovereign bond yields across the developed world is less than the yield on large cap stocks. In their search for yield, investors have flocked into these dividend paying stocks, which are perceived as a safe alternative. So today, as investors have increasingly turned to dividends instead of bonds as a source of income, dividend yield can no longer be considered a measure of relative cheapness. Dividend yield as a valuation metric is becoming expensive as the highest dividend yielders are no longer also the highest free cash flow generators. This also implies that the highest dividend yielders may be stretching themselves financially to pay the current dividend.

The dark line on the chart shown below tracks the correlation between the returns of a dividend yield investment strategy and that of a free cash flow yield investment strategy. Interestingly, correlations have gone from high to NEGATIVE as chasing dividend yield has become more popular. In other words, it used to be that the relationship between these two strategies was similar, but not any more.

The chart also tracks the correlation between the returns of a dividend yield investment strategy and a US Treasury Bond index. In this comparison, correlations have gone from low to high as investors have begun to treat dividend stocks as bond substitutes. Investors should remember that unlike interest rates on Treasuries or other government securities, dividends are not guaranteed and can be cut or eliminated as companies deem necessary.

With regard to timing, this theme could revert to modern-era norms in the near term, with higher interest rates than dividend yields, but it could also persist for much longer. Who knows when the Federal Reserve may normalize its policy rate to a level where it is higher than the S&P 500 dividend yield? While the current regime of interest rates below dividend yields, which began at the beginning of 2016, is the first extended period since 1958 in which this has been the case, the relationship is not unusual. In fact, dividend yields had actually been higher than bond yields for most of the U.S. market history from 1871 to 1957 – 87 years.



If the current relationship persists, as it has over extended time periods in the past, it is probable that high-yielding stocks will continue to perform more like bonds going forward than other value stocks. This implies that if interest rates rise, the prices of these high yielding stocks could suffer more than investors realize. A recent example of this occurred on Friday September 9th when interest rates rose from 1.61% to 1.67%, the S&P 500 declined 2.5%, and the highest dividend yielding stocks declined 3.2%.

Our advice for investors purchasing stocks solely based on dividend yield remains *caveat emptor* – buyer beware. It is not only changes in interest rates, but changes in tax policy, growth, or even investor sentiment which could reverse the rising path of high dividend-yielding stocks. And ironically, given their above-average valuations, even a broad market correction could result in unusual downward volatility in this group of stocks to which investors usually turn for downside protection and safety.

As noted in Matarin's [Q4 2011](#) quarterly newsletter, we do not include dividend yield in our investment process (except when treated as a negative signal for certain kinds of stocks!). We believe that what really matters is whether the company has the ability to pay and sustain a dividend via internally generated cash flow, and not whether the company ultimately chooses to pay the dividend. In fact, in that newsletter, we demonstrated that among stocks which have a high cash flow yield, the *non* dividend payers had actually somewhat outperformed the dividend payers since January 1994. As dividend yield becomes ever more popular and more expensive, the case for focusing on other types of valuation metrics in picking stocks becomes even stronger.