MATARIN CAPITAL

Investing with Insight and Integrity

Reaching for Yield in the Stock Market

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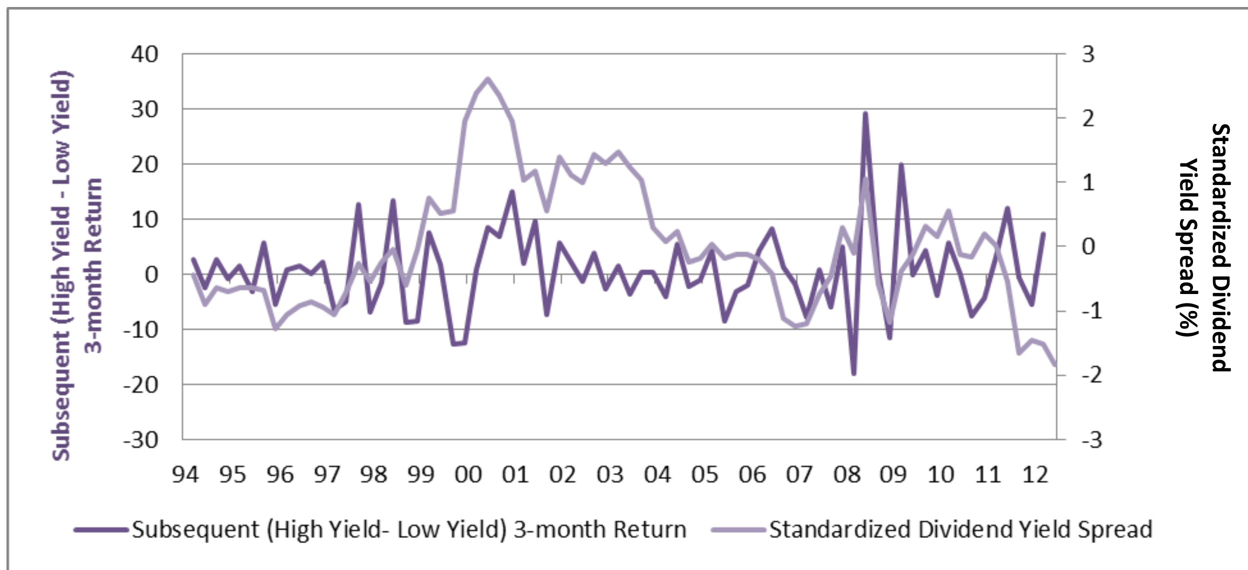
For investors seeking capital preservation and income from their portfolio, these are challenging times. Given the record low yields available in most fixed income securities, we are not surprised to see investors plowing into high dividend yielding stocks. According to EPFR Global, in the first half of the year, despite delivering slightly below market returns, dividend focused funds attracted net inflows of $14.1 billion, compared with net outflows of $10.3 billion for all U.S. equity funds. Investors have flocked to the highest yielding segments of the equity market, as the 5.5% average yield available in real estate investment trusts (REITs) and the 4.0% average yields available in the electric utilities industry look quite attractive relative to the 1.5% yield available on the 10-year Treasury note. As noted in our Q4.2011 quarterly letter, at Matarin we do not utilize dividend yield as a criteria in our stock selection process. We are more focused on companies' ability to pay a dividend (free cash flow generation), rather than on the payout itself. Also, we love to see companies repurchasing their own shares, particularly when their stock is cheap. Nevertheless, given the market's current fascination with dividends, we decided to perform an analysis looking at the prospects for higher dividend yielding names from here.

A reasonable means to gauge the future opportunity for dividend-yield-focused strategies is to look at dividend yield spreads across a broad universe of stocks. Historically, when the dividend yield spread across stocks has been high, the strategy of purchasing the highest yielding names, and underweighting (or shorting) the lowest yielding names has outperformed the market. However, when dividend yield spreads are low, with most stocks trading at similar yields, this is typically an environment where dividend yield strategies have already been working for some time, and are poised to underperform. In the below graph, we plot the market's standardized dividend yield spread back to 1994, along with the subsequent 3-month returns for the top quintile dividend yielders minus the subsequent 3-month returns for the lowest quintile of dividend yielders (excluding companies not paying a dividend).



As you can see, when using this methodology, the dividend yield spread across stocks is at its narrowest point over our analysis period. As you can also see, dividend yield spreads tend to be fairly good predictors of how well dividend yield will perform as a stock selection strategy in the future. So, all else held equal, this analysis leads us to believe that simply purchasing the highest dividend yielding stocks may not be a highly successful strategy from here.

Interestingly, when we remove the industry effect and look at dividend yield spreads on an "industry-neutral" basis (rather than "universe-neutral"), we do not get a similar result. In fact, when the industry effect is removed, and we simply compare stocks within industries to their peers, dividend yield spreads are actually slightly wider than normal right now. So, essentially this means that the market's current low dividend yield spread is largely an industry/sector effect. The industries or sectors in the market that have historically paid much higher dividend yields relative to the market (e.g. utilities, REITS, etc.), no longer distance themselves from the pack quite as much in terms of yield.

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At Matarin, we are keenly focused on risk control, and only allow modest industry and sector bets. With that said, we urge investors to be cautious. Many investors make the mistake of equating dividend payouts with safety and risk of loss. It is commonplace to hear the comment, that “stock X has a dividend yield of Y%, so at a minimum, investors are getting paid to wait.” At Matarin, we are more of the mindset that one of the largest determinants of an investment’s safety is its valuation.

For example, let’s simply review the facts as it relates to the utilities sector at this time. The utilities sector has historically been (by far) the highest yielding sector in the market at roughly 4.1% going back to 1994. As you can see below, utilities have historically traded at a large discount (on an operating earnings yield basis) relative to the market. This makes sense, given that utilities have also been the (expected) lowest growth sector. So, historically, investors in utilities sector names have been purchasing high yield, low growth, CHEAP stocks.

Sector	Time Period	Average Dividend Yield	Average Long-term Expected Growth	Average Earnings Yield	Average Earnings Yield Discount / Premium vs. S&P 1500
Utilities	1994 --> 2012	4.1%	6.0%	7.0%	24% discount
	Current	3.8%	4.8%	6.2%	1% premium
Technology	1994 --> 2012	0.3%	17.9%	4.1%	38% premium
	Current	0.7%	13.8%	6.0%	5% premium

Contrast this with today’s market environment, where utilities buyers would actually be purchasing high yield, low growth, NOT (relatively) cheap stocks. Again, many investors may be overlooking that fact that these names may look attractive because they have high payout ratios, but not because they are cheap. It is interesting to compare the utilities sector to the technology sector. As you can see, the two sectors actually trade at similar valuations at this time despite the technology sector being expected to grow at almost 3x the rate. A large difference here is that technology names often do not pay dividends, or choose to return excess cash via stock buybacks. It is also notable that technology names are not as stable, and thus investors are “right” to mark them down somewhat.

Therefore, our advice for investors purchasing stocks solely based on dividend yield is caveat emptor – buyer beware. Should the investing landscape change (changes in growth, interest rates, taxation policy, sentiment, etc.), investing in high yielding stocks may not prove as safe as some investors think.