TALARIA

Thought Piece
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INCREASINGLY CRITICAL TO CONSIDER

As investors we're aware that reinvested dividends are always an important component of long-term equity market returns. Equity investors today are presented with an unpalatable challenge when it comes to dividends as the risk around dividend strategies has never been higher. As a follow up to his piece in June 2018 Deputy CIO Hugh Selby-Smith discusses the challenges facing dividends and how important to generating total returns Talaria's differentiated source of income is.

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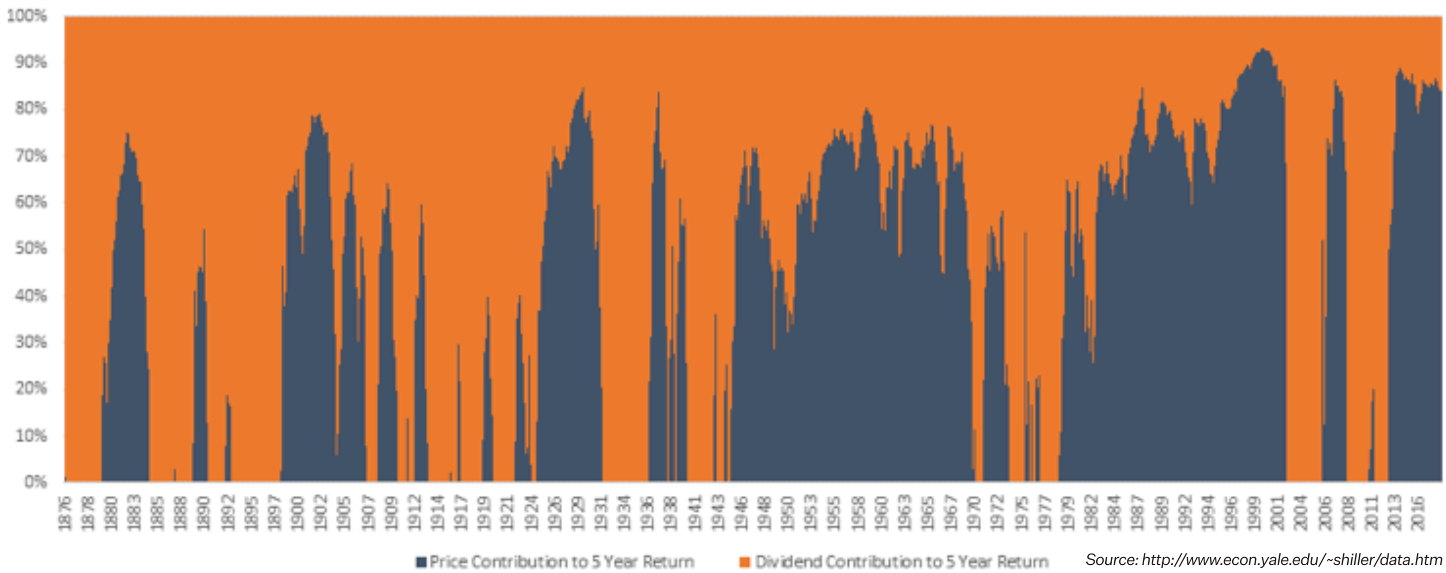
Whilst dividends are thought of traditionally as a "value" factor we continue to think of them as a discrete factor outside of the traditional value / growth lens. We are of the strong opinion that income will be vast majority of investor returns looking forward over the next 5 years - BUT given leverage ratios, payout ratios, absolute levels of yield & growth and issues of liquidity, many yield strategies will be very poor places to be.

While the significance of reinvested dividends as the major driver of long term equity returns is irrefutable, these contributions vary wildly over shorter time frames. Using Shiller data, the chart below shows the contribution of capital growth and dividends to total returns on a rolling 5 year time frame. This varies from situations where more than 100% of returns come from dividends (i.e capital returns are negative) to the other extreme – where more than 80% of returns come from capital and only 20% from dividends.

Over the most recent five year timeframe – a period where the equity market had a low absolute dividend yield and rose strongly – it should come as no surprise that 82.5% of the total return has come from price appreciation. This is an unusually large contribution from price - having contributed this much **only 7% of the time since 1870.**



Source: http://www.econ.yale.edu/~shiller/data.htm

When price appreciation has played such a dominant role in the preceding five years, the return from price in the subsequent five years is negative on average. Indeed, subsequent total returns appear to suffer once the preceding contribution from price hits a level of 75% of total returns, as the following table shows:

Contribution from Price	Band	% Frequency	Subsequent 5 Year % Contb'n from Price	Subsequent 5 Year Total Return avg
0%-25%	0	37%	53%	10.4%
25-50%	1	13%	51%	10.8%
50-75%	2	35%	55%	9.5%
75%-100%	3	15%	41%	4.7%

Without trying to glean a market timing signal from the above, **what is clear is that dividends are always an important component of returns for equity market investors - but never more so than when the preceding 5 year returns to capital growth are above 75%.** It's important to be thinking about income as a component of return - always - but certainly right now.

Equity investors today are presented with an unpalatable challenge today when it comes to dividends: there is a paucity of companies paying a dividend yield above 4%; they have never had such a high payout of company cashflows to achieve this; and these companies have never been more indebted. So while the importance of dividends appears to be critical as a component of future 5 year returns today - **the risk around dividend strategies has never been higher.** I think this has helped fuel the explosive growth in illiquid asset classes (Infrastructure comes to mind) and leveraged income products (Hybrids / leveraged bond portfolios for example). Nice choice that - the illiquid or the leveraged.

Whilst it's hugely important to our excellent 13 year track record that we have never generated less than 7% option premium - **it's never been more important that we generate this income in a differentiated way**. Our income generation is merely an outcome of our process which allows us always and without exception to avoid putting capital at risk to achieve a predetermined outcome.

Indeed - as risks to capital increases (expressed in higher volatility) our income actually increases. That's why in 2008-2009 when total dividends paid were cut around 30% globally, our income nearly doubled on average for the period. The median firm's indebtedness (ex Energy) is around 50% higher today than it was at the end of 2007.

Bottom-line:

At this macro and market juncture it is hard to advocate dividend strategies given the risks they are taking on to achieve their stated outcome (leverage or liquidity risk) - but I very strongly believe income is going to become absolutely critical as a component of equity market and indeed overall portfolio returns as one looks out on a 3 - 5 year time frame. And perhaps sooner.