Breckinridge CAPITAL ADVISORS

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NAVIGATING THE RISKS: HIGH PAYOUT RATIOS & STABLE DIVIDEND INCOME

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Key Takeaways

- We believe payout ratio is a critical metric in evaluating dividend-paying securities and avoiding the potential pitfalls associated with targeting solely high dividend yield.
- Payout ratio may provide a more forward-looking assessment of a company's ability to sustain and grow dividend payments over time.
- Since the global financial crisis, a disproportionate number of total dividend cuts have been made by firms with the highest payout ratios.
- We believe prioritizing lower payout ratios is an important factor in identifying financially healthy firms that are poised to be robust dividend payers over time.

DIVIDEND YIELDS CATCH ATTENTION, PAYOUT RATIOS OFFER INSIGHT

In our paper *Looking Beyond Yield for Stable Dividend Income*, we discussed evidence that suggests high dividend yield, while appearing attractive, may ultimately disappoint investors through lower-than-expected income returns as well as less potential for long-term capital appreciation when compared to lower dividend-yield equities.

We believe a key component of this phenomenon is attributable to high and consequently, unsustainable payout ratios at many of these firms. Payout ratio measures a firm's dividend payments as a proportion of its earnings. Ultimately, payout ratios provide a snapshot of the level of financial burden that a dividend has on a firm and is useful in measuring the capacity of the company to continue and potentially grow payments over time.

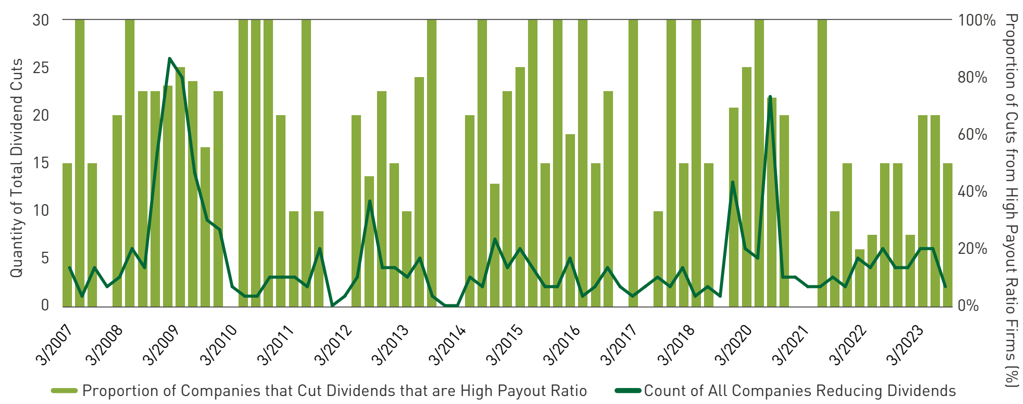
HIGH PAYOUT-RATIO FIRMS ARE VULNERABLE TO FINANCIAL STRAIN

High payout ratios suggest a firm may have less organic capacity to continue to pay dividends. For high payout ratio firms, deteriorating profitability may prompt them to issue additional debt to cover dividend payments, thereby increasing financial leverage and potentially diminishing future financial flexibility, or they consider cutting dividends outright.

Firms that have high payout ratios with inadequate free cash flow to cover dividend payments, which is a common characteristic of the cohort, must assess the trade-off between maintaining dividends at the cost of increased debt expense and potentially lower credit ratings or confronting the tough decision to reduce or eliminate dividends, which is a strong negative signal to investors about the future prospects of the firm.

Historically, dividends originating from high payout ratio firms have proven to be quite susceptible to cuts. In instances when firms reduced dividends, approximately 60 percent of those occurrences stemmed from the highest payout ratio cohort (See Figure 1). Since 2007, in nearly 25 percent of the occurrences when a company reduced dividends, that company was in both the highest dividend-yield and highest payout ratio cohorts. Additionally, the average dividend cut in those instances was significant, at 36 percent.

FIGURE 1: HISTORICAL DIVIDEND CUTS & SHARE OF CUTS BY HIGH PAYOUT RATIO FIRMS



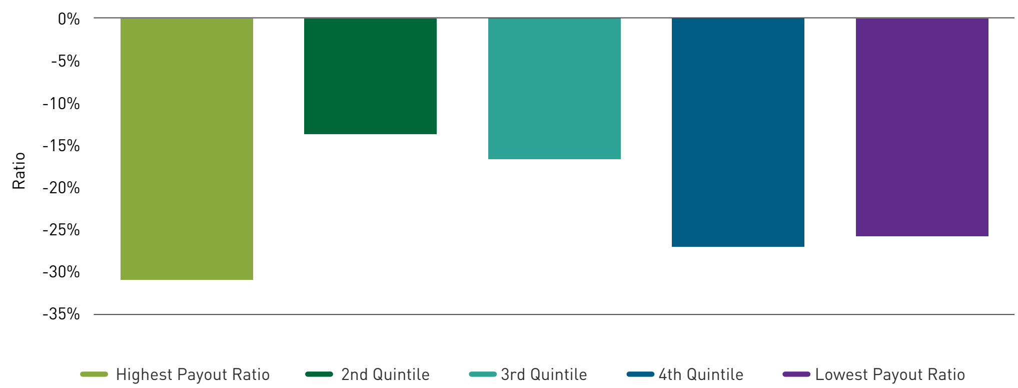
Source: Breckinridge Capital Advisors and Corporate Finance Institute, as of September 30, 2024.
Past performance is not indicative of future results.

These charts are based on the data used in our analysis of monthly index returns for the period January 1994 to September 30, 2024. The analysis is intended to illustrate that equity dividend yields are not as reliable predictors of realized income returns as bonds, especially at higher dividend yields. Historically, investment grade (IG) bonds have a low default rate compared to non-IG bonds. For example, S&P Global reported that the highest one-year default rates for AAA, AA, A, and BBB-rated bonds (IG bonds) were 0 percent, 0.38 percent, 0.39 percent, and 1.02 percent, respectively. It can be contrasted with the maximum one-year default rate for BB, B, and CCC/C-rated bonds (non-IG bonds) of 4.22 percent, 13.84 percent, and 49.28 percent, respectively. Yields are snapshot metrics for securities that can help investors in valuing a security, portfolio or strategy. Yields do not represent performance results but are one of several components that contribute to the return for a security, portfolio or strategy.

HIGH PAYOUT-RATIO COMPANIES ARE MOST AT RISK WHEN THE MARKET IS IN PEAK STRESS

Interestingly and perhaps intuitively, our research shows companies with the highest payout ratios underperform the most when the market is in peak stress, suggesting that the income stream isn't the only component of returns at risk amid stressful environments (See Figure 2).

FIGURE 2: PAYOUT RATIO COHORTS, 1-YEAR TRAILING RETURNS WHEN THE MARKET IS DOWN 10% OR MORE



Source: Breckinridge Capital Advisors and Corporate Finance Institute, as of September 30, 2024.
Past performance is not indicative of future results.

During large market sell-offs, defined here as when the trailing 12-month return of the S&P 500 Index[1] is negative by 10 percent or more, companies with the highest payout ratios have materially underperformed other companies with lower ratios in terms of absolute returns. We believe the underperformance stems from both dividend cuts and concerns about longer-term stress on these companies. Those concerns may include diminished profitability and cash flow generation ability, which reduces the ability of these companies to sustain or grow dividends, as well as a diminished ability to re-invest in the business.

WE VIEW FIRMS WITH REASONABLE LEVELS OF DIVIDEND PAYOUTS AS POSITIONED WELL OVER THE LONG RUN

Payout ratio, though at times receiving less attention from investors, is an invaluable tool to assess the health of a company's dividend payments. Dividend-paying equities are often a strategic allocation decision within a portfolio, suggesting that exposure to companies with sustainable payout ratios is a key investment criteria.

At Breckinridge, we focus on building high quality portfolios, placing significant emphasis on firms that have historically shown themselves strong stewards of their investors' capital. We believe elevated dividend yields paired with reasonable levels of payout, relative to earnings, is a key building block of high quality equity portfolios.

1. The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock's weight in the index proportionate to its market value. You cannot invest directly in an index.

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