Smith Group
ASSET MANAGEMENT

RESEARCH PERSPECTIVES

MAY 2020

Dividend Resilience in a Recession

STEVE SMITH, CFA

In every recession, the prospect of dividend cuts sends shivers down the spines of income investors. Headlines about the plight of cash-strapped companies ignite memories of a holding in the last recession that cut its payout, thereby reducing the cash flow so important to the investor. Because of the emotion attached to that reduction, it is much more memorable than the many other companies that persevered and did not cut their dividend. Companies understand the importance of this action and most often defend the payout fiercely.

By the Numbers

The deep recession of 2008-2009 created similar dividend angst as some income investors are experiencing today, so a look at that dividend history yields a guide for how this one may play out (see Exhibit #1). The sectors traditionally used in dividend growth strategies are Consumer Staples, Financials, Energy, Industrials, and Health Care. More recently, Information Technology companies have become more aggressive dividend payers so are also popular in such strategies today.

The 2008-2009 recession was one caused by financial stress. Therefore, it is not surprising that the financial sector bore the brunt of dividend strife in that recession. The problems created during the real estate boom of the early 2000's took several years to abate and dividends were a casualty of re-building capital levels and regulatory hurdles. In the current recession, financial stress is a symptom rather than a cause and capital buffers are quite full. No doubt there will be some fallout from the woes of Main Street, but U.S. banks are much better capitalized and stress tested than in the past. <u>How dividend policy plays out domestically will be very different than how it did in the last recession</u>.

There were dividend cuts In the other traditional dividend growth sectors as well, but the percentage of companies cutting (left hand column) varied from 41% in Health Care to only 12% in Consumer Staples. Yet, if you looked at the average dividend in 2009 (depth of the recession) vs. 2007 (pre-recession), the average dividend had risen in all of those sectors (2nd column from the left). There were over-leveraged companies or unfortunate industries that were forced to cut payments in that recession, just like there will be in this recession. But rising average dividends show that there were also many companies with strong balance sheets and good liquidity that were not forced to forego payments to shareholders. Many actually continued to raise dividends even as their weaker peers struggled.

During the recovery period, dividend restoration was swift. By 2011 (right two columns), the broad majority of companies in those sectors had meaningful increases in dividends. The average Health Care and Information Technology dividend had risen +81% and +78%, respectively. Even the average for the slow and steady growth Consumer Staples

(Continued on page 2)

Exhibit #1: A History of Dividend Growers in the '08/'09 Recession
(comparisons between 2007 [pre-recession], 2009 [depth of recession] and 2011 [1yr. post-recession] dividend levels)[1]

S&P 500 Dividend Paying Co.	% Cos. Cutting Div. in '08-'09	Avg. Div. in '09 vs. '07	% Cos. recovering '07 level by '11	Avg. Div. increase from '07 to '11
Traditional Dividend Growth Sectors				
Financials	65%	-34%	38%	-17%
Energy	26%	+16%	67%	+37%
Industrials	24%	+14%	82%	+46%
Health Care	41%	+19%	82%	+81%
Consumer Staples	12%	+14%	88%	+44%
New Dividend Growth Sector				
Information Technology	19%	+41%	96%	+78%

[1]: Includes companies initiating dividends during analysis period.

sector was 44% higher. Investors willing to step into these companies at the depressed prices early in 2009 were richly rewarded.

Predicting a Dividend Cut

We have always found that the market is one of the best predictors of a dividend cut. Generally investors sell shares long before a company announces that reduction. If a dividend looks too good to be true, it probably is. This is where diligence in digging into a company balance sheet is critical. A favorite Buffett quote is “when the tide goes out you see who is swimming without a suit”. But if you put your goggles on and look below the surface, you can often tell the companies with threadbare financials before low tide.

Playing to the Emotion

Investors are always tempted to let emotion play a role in decision making during a recession. Media plays to that emotion because it helps to attract viewers, listeners, and readers. This is their business and how they are able to sell advertising. They will always lead with the most interesting news. The latest dividend cut is much more newsworthy than the company that maintained their payout. <u>The result is the appearance of widespread dividend reductions, when the reality is that most companies are successfully defending their payouts</u>. Companies have a vested interest in maintaining the confidence of their investors.

While this recession will be different than the last, it will have similar characteristics as well. Dividend growth has been a strong contributor to total return through many recessions, recoveries, and expansions. It is likely to do so again.