

EQUITY INCOME INVESTING—ALIVE AND WELL

Power of Compounding | Capital Appreciation + Dividends | Lower Volatility | Equity Diversification

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Executive summary

Equity income investing is alive and well. Returns over the past five years, including dividend yields, are in line with past performance.

Equity income provides both capital appreciation and dividend income, which have historically delivered lower volatility and helped buffer losses in extreme market drawdowns—all benefits for a more conservative equity investor. This investing factor also should not be ignored for more growth-oriented investors, as it can provide equity diversification.

What has happened?

In recent years, the equity income or Dividend factor has underperformed both the overall market and the Growth style / Momentum factor.

Much of the gains for the Growth style can be attributed to the Information Technology sector, which experienced very strong growth and returns. This was additionally fueled by persistent low interest rates, which particularly benefit growth-oriented stocks.

What you need to know

Total returns from equity income in recent years have not deviated much from historical experience. This implies that equity income investing is not broken.

For dividend stocks, dividends make up 2-4% of total returns. This can help buffer downside risk and drawdowns.

Historically, no sector, style or factor has continuously outperformed. Equity exposure should be diversified.

The current focus on inflationary concerns, higher long-term interest rates and the next phase of the recovery all favour equity income.

Recent developments

Value style has outperformed year-to-date to May 2021. Most high dividend-paying stocks fall into this category.

Recent inflationary concerns have caused long-term interest rates to rise—this can be more detrimental to growth-oriented when compared to income-oriented stocks.

Examples of sectors that have historically outperformed when inflation rises are Energy, Materials, Utilities and Consumer Staples. These are also sectors that have higher expected dividends than the market.

Financials tend to have higher dividend yields than the overall market. Potential relaxing of regulatory¹ guidelines for Canadian banks would allow dividend increases in the latter half of 2021 and provide potential tailwinds for the Canadian financial sector.

Background

Past performance: Income vs. Growth

Equity income investing offers two sources of return: Capital Appreciation + Dividends

Companies that pay dividends are typically large, well-established and more mature with stable revenues and earnings. Equity-income-oriented funds (i.e. funds that typically invest in dividend-paying securities) cater to investors that are seeking both capital appreciation and income. These more conservative equity investors are not suited to owning only growth stocks, just as more growth-oriented/aggressive investors will not have the bulk of their portfolios in dividend-paying stocks.

Growth stocks tend to benefit in an environment with persistent low interest rates², conditions we have experienced for at least

the past decade. In addition, the constant evolution in technology and innovation over the past 5-10 years has further fueled higher expectations for these types of stocks (i.e. Technology sector, Growth style, Momentum factor). As illustrated in Figure 1, capital appreciation accounts for most of growth stocks' total return. Compare various growth indices³ price return vs. total return (i.e. including dividends reinvested), and it can be observed that 15-year returns between the two are very similar. In other words, capital appreciation drives most of the growth indices' total return.

In contrast and not surprisingly, dividends have a big impact on the total return of dividend-paying stocks⁴. Price return over 15 years was 6.89%, but with dividends reinvested the total return was 10.62%, a difference of 3.73%. The stable dividend income also helps limit maximum drawdowns⁵, lowers overall average drawdowns⁶ and improves overall risk-adjusted returns⁷.

Figure 1: 15 year price returns vs. total returns*

Index	Return (%)	Standard Deviation (%)	Loss Standard Deviation (%)	Max Drawdown Valley Date (%)	Max Drawdown (%)	Average Drawdown (%)	Sharpe Ratio
S&P 500 TR	11.25	11.65	8.03	2/28/2009	-42.41	-7.76	0.84
S&P 500 PR	8.98	11.65	8.25	2/28/2009	-45.06	-8.24	0.64
<i>Difference</i>	2.28	0.00	-0.22		2.64	0.48	0.19
NASDAQ 100 TR	17.34	14.71	9.80	2/28/2009	-32.78	-8.49	1.07
NASDAQ 100 PR	16.20	14.69	9.82	2/28/2009	-33.35	-8.64	0.99
<i>Difference</i>	1.14	0.02	-0.02		0.58	0.15	0.07
MSCI USA High Dividend Yield GR	10.62	11.49	9.78	2/28/2009	-42.81	-6.85	0.79
MSCI USA High Dividend Yield PR	6.89	11.49	9.81	2/28/2009	-47.37	-7.63	0.47
<i>Difference</i>	3.73	0.00	-0.03		4.56	0.78	0.32
MSCI USA Growth GR	13.80	12.65	7.98	2/28/2009	-36.62	-7.92	0.97
MSCI USA Growth PR	12.47	12.64	8.11	2/28/2009	-38.14	-8.16	0.86
<i>Difference</i>	1.33	0.01	-0.13		1.52	0.25	0.10
MSCI USA Momentum GR	12.65	13.31	10.00	2/28/2009	-40.95	-8.48	0.83
MSCI USA Momentum PR	11.00	13.28	9.97	2/28/2009	-42.67	-8.75	0.71
<i>Difference</i>	1.65	0.02	0.03		1.72	0.27	0.12

*in CAD (June 1, 2006 to May 31, 2021)

GR= Gross Return TR=Total Return PR=Price Return

Source: Morningstar Direct as at May 31, 2021

Note: 15 year period was used so all indices had the same drawdown period. Looking at other periods have shown similar results

What happened in 2020?

High Dividend indices experienced negative returns in 2020, while broad-based benchmarks for these regions all had positive returns—making 2020 unique in recent memory. High Dividend indices also underperformed Growth and Momentum indices by at least 20% (Figure 2).

Figure 2: Annual performance (2011 to 2020) - Total returns % (CAD)

Region	Index	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Canada	MSCI Canada High Dividend	1.68	15.25	20.40	6.22	-14.23	25.31	11.00	-12.13	25.93	-7.34
Canada	MSCI Canada Momentum	-4.59	8.86	17.79	15.60	3.06	9.22	10.24	-9.33	29.12	14.61
Canada	MSCI Canada Growth	-15.08	2.79	9.92	19.39	-5.67	9.56	7.67	-8.35	22.33	17.87
Canada	S&P/TSX Composite	-8.71	7.19	12.99	10.55	-8.32	21.08	9.10	-8.89	22.88	5.60
USA	MSCI USA High Dividend	17.11	8.15	37.53	25.27	20.78	12.23	11.69	6.48	16.28	-0.09
USA	MSCI USA Momentum	8.71	12.55	43.84	25.02	31.08	1.50	28.77	7.25	21.62	27.34
USA	MSCI USA Growth	4.92	14.70	41.71	24.68	25.41	2.80	20.27	6.80	30.75	40.55
USA	NASDAQ 100	6.23	15.73	46.10	30.16	31.63	3.56	24.25	9.05	32.41	46.27
USA	S&P 500	4.64	13.43	41.27	23.93	21.59	8.09	13.83	4.23	24.84	16.32
World	MSCI World High Dividend	7.43	10.79	31.13	12.59	17.08	6.46	11.34	1.71	18.06	-0.82
World	MSCI World Momentum	7.38	12.24	39.02	16.68	25.38	1.12	23.88	6.41	21.78	26.45
World	MSCI World Growth	-2.79	14.04	35.74	16.15	24.12	-0.36	20.05	2.01	27.36	31.82
World	MSCI World	-2.67	13.96	35.91	15.01	19.55	4.41	14.99	0.06	21.91	14.45

Source: Morningstar Direct as at May 31, 2021

The Momentum factor has outperformed the market⁸ in 7 of the last 10 years (Figure 3). It has also ranked consistently in the top three based on factor performance.

The MSCI World Momentum Index has about 22% exposure to the Information Technology sector as at May 31, 2021⁹ and has averaged about 29% over the past 3 years. As seen

in Figure 4, Information Technology has been one of the best performing global sectors as well.

Dividend factor performance has shown the opposite—it has consistently ranked in the bottom three and outperformed the market only three times in the last 10 years. The Value and Minimum Volatility factors have been laggards as well. These factors are important drivers of risk and return for the Dividend factor¹⁰.

Figure 3: Global factors – Annual performance (%)

2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Minimum Volatility 10.71	Size 14.11	Value 41.56	Minimum Volatility 22.16	Minimum Volatility 26.92	Dividend 6.46	Momentum 23.88	Minimum Volatility 7.46	Quality 29.79	Momentum 26.45
Dividend 7.43	Market 13.96	Momentum 39.02	Quality 18.83	Momentum 25.38	Size 5.60	Quality 18.32	Momentum 6.41	Market 21.91	Quality 20.57
Momentum 7.38	Value 12.46	Quality 36.31	Momentum 16.68	Quality 25.02	Value 5.10	Size 15.78	Quality 3.49	Momentum 21.78	Market 14.45
Quality 7.01	Momentum 12.24	Market 35.91	Market 15.01	Market 19.55	Minimum Volatility 4.44	Market 14.99	Dividend 1.71	Size 18.22	Size 8.19
Market -2.67	Quality 11.14	Size 35.02	Value 13.98	Size 18.68	Market 4.41	Value 14.80	Market 0.06	Dividend 18.06	Minimum Volatility 1.45
Size -7.09	Dividend 10.79	Dividend 31.13	Size 12.74	Dividend 17.08	Quality 1.48	Dividend 11.34	Size -3.86	Minimum Volatility 17.70	Dividend -0.82
Value -8.85	Minimum Volatility 6.46	Minimum Volatility 27.42	Dividend 12.59	Value 16.65	Momentum 1.12	Minimum Volatility 10.29	Value -5.60	Value 13.78	Value -5.04

Source: Morningstar Direct as at May 31, 2021

From a global sector perspective (Figure 4), Energy has ranked at the bottom for 6 of the past 10 years. Recently, Financials and Consumer Staples have lagged as well. However, this has a bearing on their potential future outlook.

Figure 4: Global sectors - Annual performance (%)

2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Health Care 12.90	Financials 27.24	Consumer Discretionary 49.18	Health Care 29.40	Consumer Staples 28.48	Energy 23.16	Information Technology 29.63	Health Care 12.33	Information Technology 40.66	Information Technology 41.73
Consumer Staples 12.06	Real Estate 26.82	Health Care 46.25	Information Technology 27.12	Health Care 28.43	Materials 18.79	Materials 20.98	Utilities 12.16	Industrials 22.00	Consumer Discretionary 34.59
Telecom Services 4.40	Consumer Discretionary 22.14	Industrials 41.71	Utilities 26.70	Consumer Discretionary 27.06	Industrials 9.62	Industrials 17.62	Information Technology 6.55	Telecom Services 21.46	Telecom Services 21.27
Energy 3.20	Health Care 15.74	Telecom Services 41.25	Real Estate 25.42	Information Technology 26.18	Financials 9.26	Consumer Discretionary 16.06	Consumer Discretionary 3.45	Consumer Discretionary 20.69	Materials 18.38
Information Technology 0.25	Industrials 14.14	Information Technology 37.97	Consumer Staples 17.72	Telecom Services 24.00	Information Technology 8.10	Financials 15.30	Real Estate 2.95	Financials 20.02	Health Care 12.10
Utilities 0.16	Consumer Staples 11.65	Financials 36.54	Consumer Discretionary 13.83	Real Estate 21.19	Utilities 3.19	Health Care 12.51	Telecom Services -0.94	Real Estate 17.70	Industrials 10.22
Consumer Discretionary -1.94	Information Technology 11.25	Consumer Staples 30.21	Financials 13.01	Industrials 18.13	Telecom Services 2.86	Consumer Staples 10.06	Consumer Staples -1.34	Materials 17.67	Consumer Staples 6.62
Real Estate -4.08	Materials 9.31	Energy 26.82	Industrials 10.05	Financials 16.49	Real Estate 0.20	Real Estate 7.98	Industrials -6.36	Health Care 17.63	Utilities 3.78
Industrials -5.41	Telecom Services 5.17	Utilities 21.36	Telecom Services 7.80	Utilities 12.98	Consumer Discretionary 0.06	Utilities 7.08	Energy -7.55	Consumer Staples 17.34	Financials -3.89
Financials -16.04	Utilities 0.62	Materials 10.88	Materials 3.95	Materials 2.09	Consumer Staples -1.26	Telecom Services -0.26	Financials -8.94	Utilities 17.33	Real Estate -5.90
Materials -17.57	Energy 0.23	Real Estate 10.50	Energy -3.00	Energy -6.66	Health Care -9.56	Energy -1.08	Materials -9.04	Energy 6.79	Energy -31.74

Source: Morningstar Direct as at May 31, 2021

Historical performance, the last 10 years

- High Dividend indices generally underperformed the broader market.
- Relative to Growth and Momentum, Dividend has generally underperformed.
- Both the Momentum factor and Growth style have been in favour for the better part of the past decade. The Information Technology sector is a big part of the reason.

Equity income experience and outcome

- When looking back at 20 year annualized returns, the High Dividend Index for Canada, US and the World has outperformed the broad market (Figure 6).
- Each 5 year interval over the past 20 calendar years saw a different leader in Canada, US and the World with the High Dividend Index generally outperforming in the 2001-2005 period (Figure 6).
- The 2008 financial crisis and 2011 Euro crisis had significant impacts on the financial sector. This was more detrimental to the Dividend indices vs Momentum and Growth in those impacted 5 year returns for the 2006-2010 period and 2011-2015 period (Figure 6).
- However, there are benefits to diversifying equity exposures by style and factor. One of the key benefits of the High Dividend Index is its dividends which, as expected, have been significantly higher than both the Growth and Momentum Indices. (Figure 5).

Recent developments and conclusion

- New leadership seems to be recently¹¹ emerging amongst factors, styles and sectors (Figure 7). Growth and Momentum

have been the worst performers year-to-date with returns of +1.0% and +0.7% respectively. Value has returned +10.7 to +12.5%, while High Dividend has returned +6.2%. These factors and styles also have the highest expected dividend yields, ranging from 2.6% to 3.6%. Furthermore, the High Dividend Index tends to have exposures to the Value factor (Figure 8).

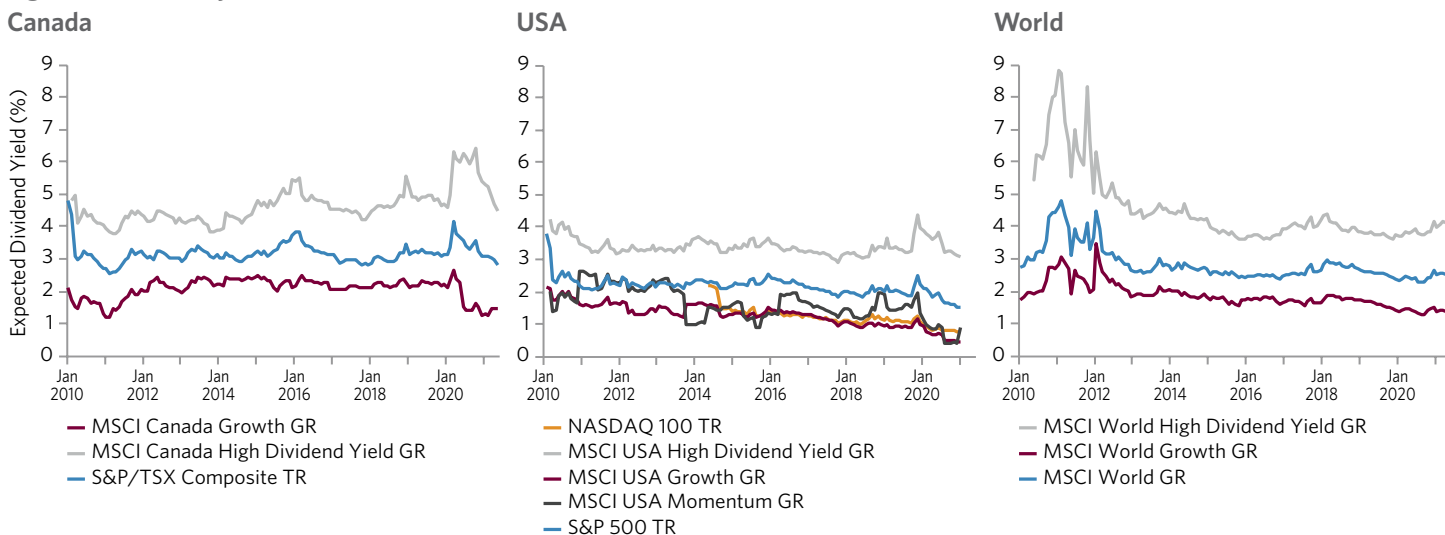
- From a global sector perspective, Energy and Financials led the way with returns of +22.5% and +18.9%. These groups also have higher expected dividends vs. the broad market and the Information Technology sector.
- The current focus on inflationary concerns, higher long-term interest rates and the next phase of the recovery (mid-cycle) all favour equity income.

Watch the financial sector

The new ratio level for Canadian banks further increases the stability of the underlying Canadian bank system, a fundamental positive over the long term. Importantly, it does not decrease the excess capital levels that banks can ultimately return to shareholders via dividends. Canadian banks currently hold excess capital approximating \$43B. We expect OSFI will allow dividend increases to resume in the latter half of 2021 and this will be very supportive of equity income strategies.

Looking at the dividend yields for Canada, US and the world (Figure 5), we see that the High Dividend Index has delivered similar and fairly constant dividend yields over time. This is a key benefit for an income-oriented investor.

Figure 5: Dividend yields



Source: Morningstar Direct as at May 31, 2021

Appendix

Figure 6: 20 year total returns – Dividends vs momentum vs growth vs broad market – Total returns % (CAD)

Region	Index	2001-2005	2006-2010	2011-2015	2016-2020	2001-2020
Canada	MSCI Canada High Dividend	13.85	6.15	5.15	7.36	8.07
	MSCI Canada Momentum	10.91	10.48	7.83	10.07	9.81
	MSCI Canada Growth	-1.88	6.66	1.56	9.29	3.82
	S&P/TSX Composite	6.63	6.51	2.30	9.33	6.16
USA	MSCI USA High Dividend	-1.50	0.44	21.39	9.17	7.01
	MSCI USA Momentum	-0.10	-1.82	23.60	16.77	9.08
	MSCI USA Growth	-6.11	0.10	21.67	19.40	8.10
	NASDAQ 100	-11.20	3.38	25.21	22.13	8.85
	S&P 500	-4.39	-0.97	20.37	13.24	6.59
World	MSCI World High Dividend	1.86	-0.56	15.52	7.14	5.81
	MSCI World Momentum	0.75	-0.49	19.64	15.47	8.48
	MSCI World Growth	-4.54	0.55	16.75	15.42	6.64
	MSCI World	-2.39	-0.29	15.69	10.88	5.71

Source: Morningstar Direct

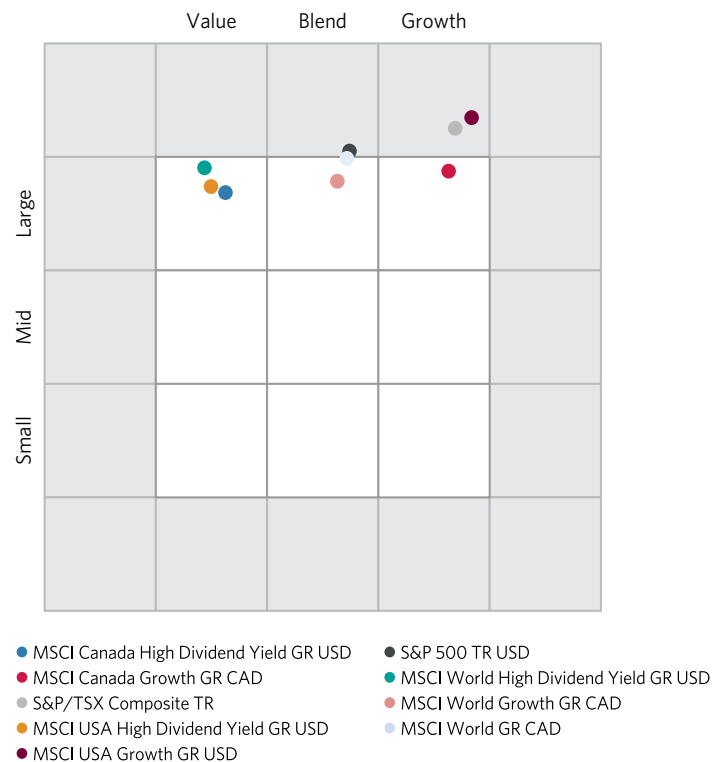
Figure 7: YTD returns (CAD): MSCI factors / styles, MSCI global sectors (Jan 1 to May 31, 2021)

MSCI World Indices	Total return YTD (Jan 1 to May 31)	Expected dividend yield
MSCI World High Dividend Yield GR	6.19	3.56
MSCI World Enhanced Value GR	12.53	2.74
MSCI World Value GR	10.66	2.64
MSCI World Minimum Vol GR	0.82	2.19
MSCI World Equal Weighted GR	6.54	1.86
MSCI World GR	5.85	1.71
MSCI World Quality GR	4.41	1.47
MSCI World Momentum GR	0.73	1.22
MSCI World Growth GR	1.00	0.75

Global sectors	Total return YTD (Jan 1 to May 31)	Expected dividend yield
MSCI World/Energy GR	22.51	4.51
MSCI World/Utilities GR	-2.19	3.57
MSCI World/Real Estate GR	8.79	2.76
MSCI World/Consumer Staples GR	0.34	2.61
MSCI World/Materials GR	10.31	2.41
MSCI World/Financials GR	18.87	2.25
MSCI World/Health Care GR	1.46	1.80
MSCI World GR	5.85	1.71
MSCI World/Industrials GR	8.35	1.43
MSCI World/Comm Services GR	8.23	1.26
MSCI World/Information Tech GR	0.44	0.89
MSCI World/Consumer Disc GR	2.30	0.78

Source: Morningstar Direct

Figure 8: Holdings-based style map for factors, styles and the broad market (as at May 31, 2021)



Source: Morningstar Direct

References and definitions

Throughout this paper references are made to 'Dividend Yield factor', 'Momentum factor' and 'Growth style'. These are proxies that are rules-based where MSCI Research has identified that help explain excess returns over the market over the long-run. Each index reflects the performance characteristics of a range of investment styles and strategies (source: Introducing MSCI Factor Indices, MSCI). For the purposes of this paper, only these three factors and styles will be discussed in greater detail.

Dividend Yield Factor (MSCI High Dividend Yield Indexes):

Reflects the opportunity set of companies with high dividend income and quality characteristics that pass dividend sustainability, persistence and quality screens. These measures aim to omit securities with potentially deteriorating fundamentals that could force them to cut or reduce dividends.

Momentum Factor (MSCI Momentum Indexes):

Refers to the tendency of winning stocks to continue performing well in the near term. Momentum is categorized as a "persistence" factor, i.e. it tends to benefit from continued trends in markets.

Growth Style (MSCI Global Investible Market Value and Growth Indexes):

Captures large and mid-cap securities exhibiting overall growth style characteristics. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend.

Note: the 'Growth Style' attempts to group securities under the parent index as either 'growth' or 'value', which implies returns can be attributed to multiple factors (i.e. momentum and quality for 'Growth'). **For the purposes of this paper, return patterns and other characteristics are very similar between Momentum and Growth, and the analysis will include both and will be used interchangeably.**

MSCI High Dividend Yield employs the following:

- Dividend sustainability screens to exclude both securities whose dividend payout is extremely high or negative, and therefore, where future dividend payments might be in jeopardy, as well as securities with high dividend yield resulting from a plunging stock price without fundamental support.

- Dividend persistence screens to exclude securities without a good historical track record of consistent dividend payment.
- Quality screens to exclude firms with low valuation and weak balance sheets that could fall into a "value trap".

Source: MSCI Yield Factor Brochure

MSCI Momentum measures:

- Risk-adjusted excess return – which exceeds the benchmark – for 6-month periods.
- Risk-adjusted excess return – which exceeds the benchmark – for 12-month periods.

Source: MSCI Yield Factor Brochure

Momentum Index Methodology:

A momentum value is determined for each stock in the MSCI parent index by combining the stock's recent 12-month and 6-month local price performance. This momentum value is then risk-adjusted to determine the stock's momentum score. A fixed number of securities with the highest momentum scores are included in each MSCI Momentum Index, generally covering about 30% of the parent index market cap. Constituents are weighted by the product of their momentum score and their market cap. Constituent weights for broad MSCI Momentum Indexes are capped at 5%. The indexes are rebalanced semiannually; in addition, ad hoc rebalancing may occur, triggered by spikes in market volatility.

MSCI Growth Index Methodology:

The MSCI Global Value and Growth Indexes are based on the MSCI Global Investable Market Value and Growth Indexes Methodology—a comprehensive and state-of-the-art approach to index construction that reflects investor's views on style definition and segmentation and provides a precise representation of the opportunity set for global style managers. The MSCI style methodology adopts a two-dimensional framework for value/growth segmentation: each security is given an overall style characteristic derived from its value and growth scores and is then placed into either a value or a growth index (or is partially allocated to both). Style characteristics are defined using eight historical and forward looking variables (three for value and five for growth). The index is reviewed semi-annually—in May and November—with the objective of reflecting change in the style characteristics of the underlying equity markets in a timely manner, while limiting undue index turnover.

Source: MSCI World Growth Index, MSCI USA Growth Index, MSCI Canada Growth Index

¹In this case, Office of the Superintendent of Financial Institutions (OSFI)
²The lower discount rate makes future earnings worth more in today's money
³E.g. NASDAQ, MSCI USA Growth and MSCI USA Momentum
⁴as referenced by the MSCI USA High Dividend Index
⁵Improved by 4.56%
⁶Improved by 0.78%
⁷Sharpe Ratio increases from 0.47 to 0.79
⁸MSCI World
⁹Source: MSCI World Momentum Index Fact Sheet
¹⁰Source: MSCI World High Dividend Index Fact Sheet
¹¹(YTD) returns to May 31 2021

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