# “The first cut is the deepest”

*Cat Stevens 1967*

*I doubt greatly that Cat Stevens was thinking about dividend growth investing when he penned his timeless classic. However, the first dividend cut is usually the deepest and can have a hugely destructive effect on total returns and long term savings.*

*This paper explores why it is important to avoid dividend cuts, what causes them and how to anticipate them with some examples of Dundas’ approach to dividend risk management.*

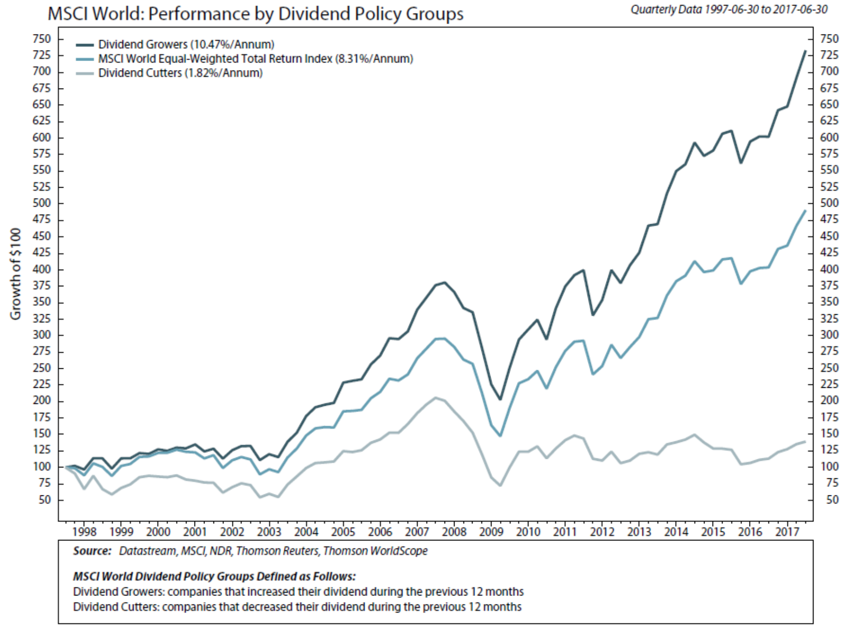
*Russell Hogan, October 2017*

DUNDAS GLOBAL INVESTORS

# Dundas and dividend growth

Companies that are able to sustain good dividend growth have a number of desirable characteristics for investors. They have strong business models leading to high profit margins within their industries, superior revenue growth and financial flexibility. These businesses get stronger because the first call on their cash flows is to reinvest for future growth and to ensure that they sustain their competitive edge. In the good times these companies manage the growth in their dividends to ensure that when the bad times come they can weather the storm, and indeed, have the strength to gain market share while others struggle.

The benefits of dividend growth over time can be seen in the chart below from Ned Davis Research. From January 1997 to June 2017 this chart exhibits the meaningful improvement in annual total return through selecting stocks that have superior dividend growth and also highlights the corrosive effect on returns of dividend cuts.




| | |
|---|---|
| Dividend growers | 10.5% |
| Equally weighted Index | 8.3% |
| Dividend cutters | 1.8% |

*Source: Ned Davis Research. 30 June 2017.*
*All figures are annualised.*

A key element of our strategy is avoiding cuts. We will now explore what happens when businesses get into trouble and how Dundas detects the early warning signs.

# Why it is so important to avoid dividend cuts

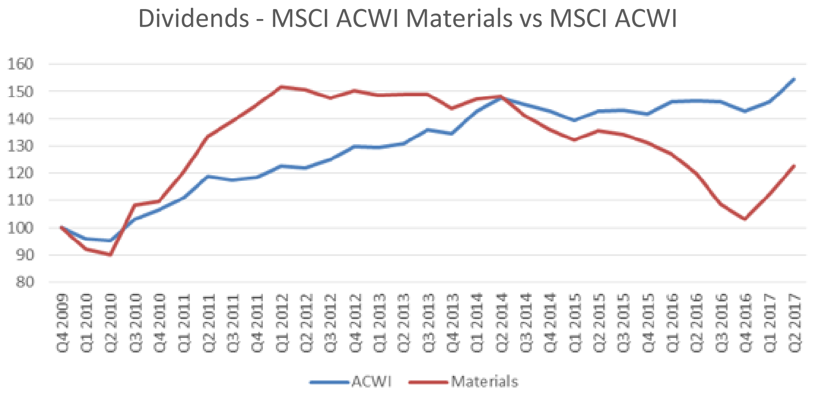
When a Board of directors sits to discuss a dividend cut, it will come after quarters or maybe even years of procrastinating. Seldom at this juncture is a ‘trim’ enough. When it comes, the cut will be deep for two reasons; first, it is overdue and therefore has to resolve a problem that has not been fully addressed and second, the Board does not want to have to do it again. Therefore cuts tend to be 50% or more.

For a dividend growth portfolio one cut can undo ten increases elsewhere in the portfolio. Moreover, if not on the day but certainly in the run up to a dividend cut, the capital loss from the fall in the share price will be substantial – likely on a par with the size of the dividend cut when it comes. A further drop in share price is then likely because investors very often infer that additional bad news will follow any meaningful cut.

# What causes dividend cuts?

Some industries are more prone to dividend cuts than others. Why? They may rely on the price of a commodity, be more susceptible to changes in the economic climate or regulation, or at greater risk of disruption from new technology or competition.

In the Materials sector for example, the unprecedented demand from an industrialising China fuelled commodity price surges and major producers brought forth the largest ever investment in new capacity ever. As supply grew and demand slowed, dividends from the sector peaked in 2012 and have been in decline until the start of 2017. Total returns from Materials have been just 1.9% per annum over the seven and a half years to 30 June 2017.



*Source: MSCI. 30 June 2017. All figures are normalized in USD.*

At the company level, a combination of negative operational and high financial leverage can turn a modest reduction in revenues into a major event for some firms. Negative operational leverage means a high level of fixed costs and generally slim profit margins, so when revenues decline, costs stay the same and margins disappear. A good example might be the car industry. High financial leverage means a high level of debt in relation to equity. This is then made worse by the cost of servicing the debt which consumes a good proportion of profits - good on the upside when revenue growth is strong and interest rates are low or falling, but the perfect storm on the downside.

Over-distribution is emerging as another key risk factor. The problem here is that the cash going out of a business exceeds the cash coming in for a number of years or as we call it 'negative cash flow'. The cash going out will be dividends, reinvestment and increasingly share buy-backs. This over distribution can only be continued by reducing reserves or increasing debt – neither is sustainable.

Finally, investors need to pay attention to the difference between profits and cash. Generally dividend cuts due to a lack of cash flows are more severe than those due to a downturn in profits.

## How does our stock monitoring anticipate those cuts?

### *Pay-out ratio*

A simple but effective measure is pay-out ratio - how much of the firm's profits are being paid out as a dividend. We aim for that to be around 40% for the portfolio as a whole, and seldom above 60% for individual companies. This provides security to the dividend in two ways; first, profits can halve and still cover the dividend and second, by retaining more than 50% of profits firms can invest to sustain their market position and build up reserves for the bad times. This helps to smooth out dividend payments.

### *Financial leverage*

We seek to avoid companies with high levels of debt relative to their equity capital, or those firms where interest payments consume a substantial part of profits. This may limit the 'animal spirits' of the firm's leadership in the good times but more than compensates in any downturn by providing much greater financial flexibility.

### *Opportunity for cost control – 'levers'*

Every firm will have a degree of operational leverage – if revenues rise and costs are contained, profit margins go up. We seek to avoid companies with little control over their costs, which is best evidenced by variable profit margins.

### *Competitive edge*

Not every industry is blessed with high margins – we would define that to be after tax profits of around 10% of revenues. We prefer companies that have the highest margins within their particular industry. Why? It demonstrates that they have a particularly good business relationship with customers and most importantly, they have some ability to increase prices when necessary.

### *Governance*

Board behaviour is a factor in stock selection and more specifically in Environmental, Social and Governance issues. How have the Directors acted as stewards of the firm's resources? Have the investments made generated a good return? Have they built reserves in the good times to see them through the bad? What are the priorities for the use of cash generated by the business?

We look not only at what Boards say they will do but also at what they have actually done. Dividend policy can be explicit or implied by actions. Culture plays a part; in some countries it is typical to have a strict pay-out ratio so that, if profits fall, the dividend will too. Elsewhere the pay-out ratio is allowed to flex so dividends can be maintained or even grow modestly as profits fall.

## Examples

At Dundas, we sift out those stocks that we believe to be at risk of dividend cuts, and even those with only modest dividend growth prospects. Once we buy a stock we monitor the company itself, its competitors, the supply chain and the industry for signs of change that could impair prospects and cash flows. As a rule of thumb, if we need to revisit the investment thesis for buying a stock, it is time to reconsider its place in the portfolio.

UK publishing firm Pearson decided to substantially change the business it was in. It sold or spun off prize traditional assets such as the Financial Times, Penguin books and The Economist, reinvesting in education and in particular online education.

Initially, we decided to back this bold strategic move and monitored the company's progress carefully. However, it soon became evident that future cash flows were much less predictable than previously. Furthermore, many online courses were available free of charge, causing doubts over the new business model.

We sold Pearson in April 2014, and for a period that looked premature. However, the company admitted in 2016 that it had serious problems leading to a raft of actions including a substantial dividend cut. The share price also fell sharply.

A good example of the importance of cash versus profits would be aero engine maker Rolls Royce, a profitable business albeit one based on lots of long term contracts and accounting assumptions. Management's strategy was to focus only on the largest aero engines powering the world's largest planes.

As orders for these planes grew, the shares did well. However, delivery timetables started to slip and the demand for older engines waned. The combined effects of product cycles, fines for past misdemeanours and high expenditure on new equipment meant cash became very tight. Our monitoring process flagged up a risk to the security of the dividend.

We sold our position in September 2015. In February 2016 the dividend was cut substantially as part of a range of measures by the new leadership.

| | Dividend cut | Share price fall in year prior to cut |
|---|---|---|
| Pearson | 70% | -29% |
| Rolls Royce | 50% | -45% |

*Source: Bloomberg. All figures in USD.*

## Risk management

Risk management is very much about detecting early warning signs. In the 1930s Scottish inventor Sir Robert Watson Watt developed his early warning radar system to detect aircraft before they became a threat. Our early warning system at Dundas comes in two parts:

1. At the stock level, it is the continuous monitoring of the businesses in which we are invested and the potential threats to their growth rates - ultimately, the security of the dividend.

2. At the portfolio level, we take unintended concentration risk - the invisible threads connecting the different stocks that we hold. In the bad times these threads can become all too visible reducing the benefits of diversification. As well as from the traditional linkages of industry and geography we dig deeper into the business drivers of cash flows and revenues.

A good example of this would be our investments in travel and tourism, now 10% of the global economy. They include stocks from the IT, Industrials and Consumer sectors, but all are tied to the growth in airline passengers and visits to tourist cities.

### *Sell discipline – risk management is of no use unless you do something about it*

Investing for long-term returns through sustainable dividend growth stocks requires patience. However, this does not imply tolerance of companies with dividend disappointments. We will sell on concerns of dividend growth fading, a risk to the dividend or when we are being asked to pay too much for the dividend growth on offer.

A total of 24 stocks have been fully sold in the past five years on concerns about dividend security. 40% of those went on to cut while a further 50% made little, if any, subsequent increase to their dividend.

## About the author

**Russell Hogan, Managing Partner**

Russell joined Dundas at its inception in 2010. Prior to Dundas he spent 17 years at Aegon Asset Management, latterly in the role of CEO with responsibility for £33 billion across a range of equity and fixed income strategies.

## Disclaimer

Dundas Partners LLP is authorised and regulated by the UK Financial Conduct Authority and registered as an Investment Adviser with the US Securities and Exchange Commission. It operates as Dundas Global Investors and/or Dundas.

This document is for information purposes only and does not constitute a recommendation to purchase or sell any fund, security or investment. If it prompts an interest in Dundas, please contact us for detailed information on our strategies and funds. It is not a substitute for a fund's prospectus or disclosure document. The material in this document addresses general investment matters only, not Dundas' specific strategies. Past investment performance is not a reliable indicator of future investment performance. You should be aware of the risks associated with investments in any fund, security or investment strategy.



**For further information**
Dundas Global Investors
41 Northumberland Street
Edinburgh
EH3 6JA
United Kingdom

Tel: 00 44 131 556 2627
Web: www.dundasglobal.com
Email: info@dundasglobal.com

DUNDAS GLOBAL INVESTORS