

Wealth Weekly

Beware the Allure of High Dividend Stocks

WEALTH MANAGEMENT RESEARCH

wmr@forsythbarr.co.nz

+64 4 499 7464

Last week was a dull one for equity markets. A resurgence of COVID-19 cases prompted several US states to reimpose restrictions, US banks got mixed signals from regulators, company-specific disappointments hammered blue chips Nike and Facebook, UK shopping centre landlord Intu Properties succumbed to its debt load and COVID-19 restrictions, German payment processor Wirecard went into administration after the revelation of an "elaborate and sophisticated" \$2billion fraud that its auditors failed to pick up for three years, and our central bank left its Official Cash Rate at 0.25%.

There's more to generating income than high dividends

One of the side effects of central banks' efforts to squash bond yields and interest rates is that it becomes **more tempting than ever to look for investments that pay a high dividend yield. But this strategy comes with risks.** For investors with income needs, we believe a strategy of investing in companies with high *total* return potential (from both ongoing dividends and earnings growth) and harvesting some of the gains when needed, is likely to provide better returns, lower risk (through greater diversification) and higher income in the long-term than focussing just on high yield stocks.

Themes of the week

Following the strong rally in equity markets — and in the face of artificially low interest rates for a very long time — **it may feel tempting to jump into equities with both feet.** As enticed as we are by the relative return potential of equities and the prospect of economic recovery, **our analysis suggests keeping a little bit of powder dry.** Equity valuations look fair for a normal interest rate world (and cheap if rates stay low), but economic and political risks globally remain, and so we could face months of alternating waves of pessimism and optimism. If economies, earnings and interest rates do recover quickly then valuations could perversely come under pressure, *a la* taper tantrum of late 2018.

The Reserve Bank of New Zealand (RBNZ) left the Official Cash Rate (OCR) at 0.25% last week, and said its staff are working on even more ways to deploy monetary policy in the coming months ... something to look forward to. One target might be the steepness of the yield curve (i.e. longer term interest rates are higher than shorter term ones).

Nike last week reported a surprise loss for the May quarter as sales fell considerably. But the current quarter's trading has started well, survey data looks favourable for Nike's market position, and there is long-term upside to earnings as sales move from retail stores to higher-margin online channels. Other survey data suggests **Walt Disney** is getting good traction with its D+ subscription video on demand service, which is a positive sign for one of the uncertainties it faces (the others being theme park reopening and cord cutting).

Looking ahead

Fisher & Paykel Healthcare unsurprisingly reported strong growth including a material boost from COVID-19, while FY21 guidance was in line with expectations. ANZ and NZIER confidence surveys are due out on Tuesday and Thursday respectively. On Thursday the US Federal Reserve will release the minutes from its early June policy meeting. **Arvida** will hold its AGM in Auckland on Friday. The US markets will be closed on Friday (our Saturday) for the Independence Day long weekend.

High Dividend Dangers

As central banks crush returns, sheltering in high dividend stocks may not be the answer

It's tough being an income seeking investor. They have spent years enduring financial repression and watching yields on major assets be crushed. Now this process has accelerated as central banks, once again, bail-out economies from crisis and force even greater financial repression upon investors.

One of our research partners ran the numbers across the ditch: An equally weighted portfolio of Australian bonds, cash, residential property and stocks would have yielded 4.5% in 2006. It now yields a paltry 2.2%. Worse still, those income seeking investors cowering in the Aussie equity market have been pummelled with the biggest dividend cuts in almost 50 years.

What to do?

There are no easy answers for income seeking investors. We suspect they will have to hold a larger position in equities than they really want to.

But rather than buying the highest yielding stocks, it may pay for investors to be a little more discerning. In Australia a simple high yield strategy underperformed over the last two decades by -1.5% p.a., which adds up when compounded over 20 years.

High dividend pay-outs can indicate a weak outlook

Not all high dividend payers will underperform, but there are three **risks to be aware of when investing in dividend stocks**:

- High dividend pay-outs could signal good capital discipline (a positive), or that a company's **board does not see opportunities to grow** organically (e.g. by investing in new products or new markets) or via acquisitions. Failing to invest in growth makes it very difficult to sustainably grow earnings over time.
- High dividend pay-out **companies may be under-investing in their existing operations** (e.g. not spending enough on maintenance, promotion or capacity increases), and at some time in the future this underinvestment can limit growth.
- Underinvesting can make high dividend pay-out **companies vulnerable to competition and disruption** from other companies that are reinvesting in their businesses.

Focus more on future yield than today's yield

A strategy that considers total shareholder yield and looks for bigger dividends tomorrow, instead of today, has performed much better in Australia.

Some of our preferred stocks which offer a relatively attractive yield and adequate total return potential include:

- Australia – **ANZ Bank, APA Group, BHP Group, Origin Energy, Scentre Group**
- NZ – **Argosy, Chorus, Contact Energy, EBOS, Investore, Vital Healthcare, Sanford, Spark**
- International – **Comcast, Medtronic**

Themes of the Week

Macro Snapshot

Let's not get ahead of ourselves

Our advice in recent months has been to keep a neutral allocation to equities in recognition of the risks still faced by economies and companies. Our conservative position has come up against the weight of money being poured into the markets and economies by central banks and governments. By suppressing rates and debt curves and removing credit risk from markets, policy makers have removed the normal price setting mechanisms, which we believe puts us in dangerous territory.

The panic has gone and markets have rallied hard. The rationale seems to be that if rates are to stay around 0% and if future returns from bond markets will be miserable then equity valuations could keep rising in the short term, so best to get in front of it by buying equities now before everyone else does. This TINA effect (There Is No Alternative to equities) seems to have played out over the last two months.

The market may continue to climb a wall of worry, but the stronger the melt-up, the more likely a melt-down will follow.

Underlying risks remain

Current risks facing the world economy include:

- **Uncontrolled virus:** Globally, COVID-19 is again claiming over 5,000 people per day and there is as yet no sign of an effective treatment or probable vaccine. Parts of the US look at risk of once again losing control of the pandemic, with infection rates resurging as the economy reopens while many Americans remain disdainful of social distancing and the need to wear masks in public. Florida and Texas are the latest states to reimpose restrictions.
- **Fiscal positions are stretched:** Putting aside the ability and willingness of central banks to print copious amounts of money, government, state and local authority budgets already blew out in the first wave of the pandemic, limiting their fiscal firepower to compensate for a second wave and associated restrictions.
- **Fiscal support for workers and those laid-off coming to an end:** The debt-fueled financial support for workers, unemployed and businesses around the world is nearing an end. They will either need to be renewed (fueling more debt blowouts) or we will see more households fall off their own fiscal cliffs as incomes dry up. Compounding the stress, households who took mortgage and debt repayment holidays will have to resume payments in 2–3 months.
- **SME businesses at the limit:** In the US, businesses are collapsing at record rates.
- **Global trade** remains weak and the US-China relationship continues to deteriorate.
- **Politics:** Trump's chances of re-election look to be slipping as infection rates rise in the US. Markets could view a Democratic President and Congress after the November election as net negatives if they raise taxes or increase regulation.

The latest IMF outlook for global growth recognises these risks. The IMF has downgraded estimated economic activity for both 2020 and 2021 again, with global GDP now expected to fall -4.9% this year. It may take 3–5 years to recover to 2019 activity levels.

NZ data not that promising either

Locally, data on fuel consumption last week suggests our economy is a long way from normal. Overall fuel volumes are still down -27% compared to pre COVID-19 levels as at the end of last week. **Is this level of activity as good as it gets, after having been in level 1 for most of June, and with our border likely to remain closed or tightly controlled for months if not years ahead?** Airlines, restaurants, live events, hotels, energy companies, schools and universities, and many businesses that rely on the skilled migrant labour could continue to struggle until the global economy fully re-opens. Many businesses will also be going on a capex strike, deferring or cancelling planned projects because of an uncertain outlook. The impact of this is likely to be felt in 6–12 months when existing projects are completed and not replaced by new ones.

The weakness in underlying activity, capex, and stresses on household, business and government budgets — all while the virus continues to spread globally — suggest a very challenging time ahead. **Recovery could be a long game.**

Consolidation ahead?

A period of consolidation is possible. **The risks could prompt a pullback in equities, but the wall of cash sitting on the sidelines, and the willingness of central banks to intervene in markets, suggest that any pullback is likely to be shallow in the near term.**

In 6–12 months we will have a better idea of how this plays out:

- Do we see a severe capex strike, with delayed or cancelled projects which will hit supply? Will the banks stop lending as deteriorating credit conditions force more defaults and credit events?
- Or do we see an effective treatment or vaccine that reopens borders and normalises activity?

The key to equities over the longer term will be interest rates. Rates held down around zero will ensure equity markets meander along with many investors bidding into shallow corrections. Any sign of recovery (a medical breakthrough), and normalisation of global activity – especially if accompanied by inflation – should eventually see interest rates start to rise. Unless that is accompanied by growth in earnings, the risk at that point would be a normalisation in equity valuations, i.e. a fall in equity prices.

We suspect we are going to have to be patient as waves of optimism alternate with pessimism until one side capitulates.

Fixed Interest

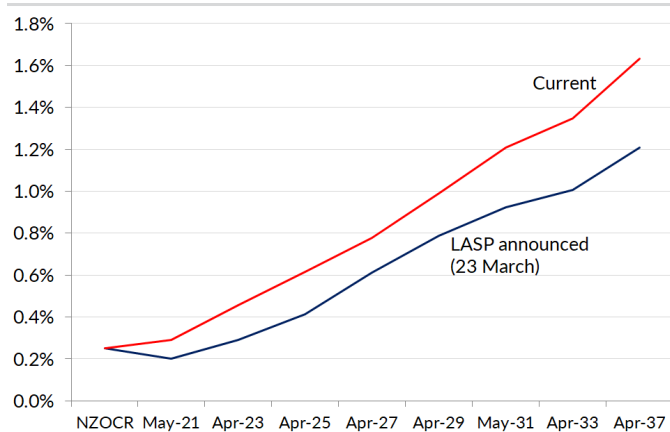
Making more tools for the tool-box

The Reserve Bank of New Zealand (RBNZ) left the Official Cash Rate (OCR) at 0.25% last week, indicating that there were still significant unknowns present as the COVID-19 pandemic ramps up across the globe. The RBNZ stated that *"staff are working towards ensuring a broader range of monetary policy tools would be deployable in coming months, including a term lending facility, reductions in the OCR, and foreign asset purchases, as well as reassessing the appropriate quantum of the current LSAP"* (Large Scale Asset Purchases, aka quantitative easing, QE). Some experts believe that the RBNZ will increase its QE programme when it next meets in August, possibly just to illustrate to the market that it has considerable firepower should it wish to use it.

To date the RBNZ has purchased over NZ\$18bn of New Zealand Government Bonds (NZGBs) and Local Government Funding Authority (LGFA) bonds as part of its QE programme. The current programme allows for up to NZ\$60bn worth of purchases to be made. An area of concern or potential catalyst for increasing the size or breadth of the QE program could be the steepness of the yield curve (Figure 1). Longer term interest rates are 71bp higher than the shorter end and New Zealand's yield curve is also steeper when compared to both Australia and the US. Some further ammunition may be added in August to deal with that particular issue.

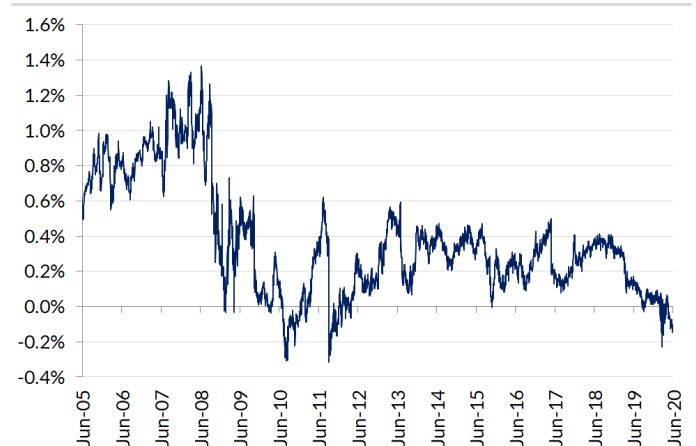
Another interesting aspect of the COVID-19 interest rate world is that swap rates remain lower than NZGB yields (Figure 2). This is not usually the case, with NZGBs considered to be 'risk-free' and therefore swap rates (which is basically the bank interest rate curve which mortgages etc. are priced off) are usually a few basis points higher to reflect the higher credit risk of banks. This is no doubt the consequence of market intervention from the RBNZ in the NZGB market and the large debt load being taken on by the New Zealand Government.

Figure 1. Steepness of the NZGB curve



Source: Forsyth Barr analysis, Thomson Reuters

Figure 2. 5yr swap spread (swap rates are lower than NZGBs)



Source: Forsyth Barr analysis, Thomson Reuters

International Equities

Nike reports surprise loss in quarter to the end of May, but future remains bright

Nike's (NKE) 4Q20 results highlighted the significant impact of COVID-19 lockdowns on retail spending, with total sales in constant currencies down -36% on the prior quarter and with a net loss at the bottom line.

However, UBS thinks the negative impact from COVID-19 will end sooner than previously thought, given indications of strong 1Q21 trading thus far. They also see opportunities for Nike to accelerate its direct-to-consumer (DTC) online strategy, which should improve gross margins longer-term. Nike's growth is expected to be driven by four key areas:

- Strong athletic wear category tailwinds which have been boosted by the pandemic
- Nike's position as the industry's strongest brand (UBS Evidence Lab's survey indicates the Nike brand currently is #1 in mindshare globally, and the company has significant room to reduce promotions)
- Excellence in digital commerce and an accelerating DTC strategy
- Continued product innovation.

UBS retains a BUY rating on Nike.

Walt Disney's online strategy is gaining traction

In the near-term Walt Disney is likely to face headwinds in its theme parks segment due to ongoing crowd aversion, and the risk of accelerating cord-cutting to its ESPN sports franchise. However, Disney has lower exposure to the traditional TV relative to industry peers, and its direct-to-consumer platform, D+, positions it well over the long-term.

UBS Evidence Lab conducted a Media Consumption Survey in June, asking 2,000 US consumers about theme parks and streaming media. Notable takeaways from the survey were:

- Roughly 50% of respondents who had to cancel or postpone Disney theme park visits plan to visit within 6 months of re-opening, a solid sign for demand. That said, over 50% of those planning to attend expect a discount
- Disney+ (D+) was the second most popular SVOD service during COVID, capturing 19% of sign-ups (down from 30% in the 1Q when D+ was newer). It trailed Netflix which had 28% of sign-ups
- Among those who signed up during COVID-19, D+ subscribers had the lowest intent to churn (switch out or cancel their subscription).

UBS retains a BUY rating on Walt Disney.

We continue to hold Nike and Walt Disney in our International Model Portfolio and the Forsyth Barr Global Equities Fund.

Research Worth Reading

New Zealand

Equity Strategy – Recovery Heat Map; Regression

Our high frequency data heat map shows that the domestic recovery has stalled, with many of the indicators reversing some of the improvements made in recent weeks. Despite the country remaining in Alert Level 1 there have been reductions in workplace mobility, credit card usage, vehicle traffic and economic sentiment. In particular, economic sentiment is back to the level observed during Alert Level 3 (28 April 2020 to 13 May 2020). With an influx of new imported, yet quarantined, cases being reported over the past week or so, there is greater risk of a re-emergence of the virus in the community. The increasing rate of new cases in Australia will further reduce the likelihood of a trans-Tasman bubble in the coming months. However, the upcoming school holidays may provide some temporary relief for the heavily affected travel and tourism sector, which we expect will benefit from higher levels of domestic visitation. (Published by Forsyth Barr)

Kiwi Property Group (KPG) – Shoppers Return, Dividends to Follow

KPG has provided an update on shopping centre visitation and dividends. Pedestrian counts across its portfolio are up +1% yoy and KPG stated that it intends to pay a 1H21 dividend from underlying cash earnings given increased clarity around the post lockdown trading environment. Despite trading at a discount to its net tangible asset (NTA) value, we believe risks are skewed to the downside given KPG's leverage to the uncertain backdrop. UNDERPERFORM. (Published by Forsyth Barr)

Skellerup Holdings (SKL) – Delivering Through Disruption

SKL has issued FY20 guidance ahead of our expectations, highlighting its agility to adjust to new operating conditions and the resilient nature of demand for a number of product lines. SKL's Agri business has been a highlight and although the Industrial division experienced a slowdown, demand in recent months has rebounded stronger and faster than we would have expected. OUTPERFORM. (Published by Forsyth Barr)

Stride Property (SPG) – FY20 Result – Stepping up to OUTPERFORM

We believe the risk reward for SPG is favourable at current levels for the following reasons: 1) The market is giving SPG no credit for its management business, 2) SPG's valuation metrics are lower than peers, 3) Balance sheet capacity supports high yield: SPG trades on the highest cash yield in the sector at 5.9%. While quality concerns surrounding SPG's directly held portfolio are justified, we believe that the market's mispricing of its asset management business more than compensates for this. OUTPERFORM. (Published by Forsyth Barr)

Australia

Bapcor (BAP.AX) – Trading update confirms stronger May-June. What can BAP deliver in FY21?

BAP is well placed to leverage a 4Q20 recovery in the Auto Aftermarket. Recent industry feedback suggests the Australian Auto Aftermarket has experienced a 'V-shaped' recovery in demand through May, with momentum continuing in June (particularly in the Retail segment). This comes after BAP flagged a COVID-19-led deterioration in conditions through late March and April at its capital raise. UBS continues to see the risk-reward as favourable on BAP. BUY. (Published by UBS)

CSL (CSL.AX) – uniQure gene therapy licence agreement

CSL has paid US\$450m for the global licence to uniQure's largely derisked clinical gene therapy program AMT-061, which should support the viability of CSL's haemophilia B franchise. In Ord Minnett's view, the clinical trial risk is low, although there remains significant uncertainty around the regulatory pathway, pricing and patient uptake rates. The agreement still requires regulatory approval. Ord Minnett believes the trajectory of US plasma collections, which continue to track well below plan, will have a greater impact on near-term earnings and investor sentiment. HOLD. (Published by Ord Minnett)

James Hardie Industries (JHX.AX) — Expanding the total addressable market

JHX defines the total addressable market (TAM) for its US exteriors business as the wood-look category. In Ord Minnett's view, there is ample opportunity for further penetration in this segment, although JHX could expand the TAM to include hard or masonry-look surfaces, notably stucco. This could be a game-changer for JHX as stucco is now the most popular exterior wall material used in the US residential new construction market. BUY. (Published by Ord Minnett)

Qube Holdings (QUB.AX) — Strong Share Price Re-rating Leaves Us at the Dock

QUB's share price has risen +34% since its equity raising in early May 2020. With the near-term operating outlook still highly uncertain, Citi lowered its recommendation from BUY/High Risk to NEUTRAL. QUB's outlook remains catalyst-rich, especially from the announcement of the potential divestment of non-core property holdings, further progress updates on Moorebank, cost control in the face of lower volumes, and scope for improving Grain earnings in FY21e. NEUTRAL. (Published by Citi)

Seek (SEK.AX) — UBS SnapShot: Trading update

SEK has confirmed an improving trend in both ANZ/SEK Asia and Zhaopin billings, and a willingness to use cost-out to mitigate EBITDA impacts. However this is in line with the UBSe job trackers data published weekly, and is therefore does not change UBS estimates, which were upgraded the prior week. Another positive was the temporary increase to key covenant limits (out to 30 June 2021) which should assuage balance sheet concerns. BUY. (Published by UBS)

Sydney Airport (SYD.AX) — Traffic update, downgrade to Lighten

SYD announced total passenger numbers (PAX) were down -97% year-on-year in May, broadly in line with the April numbers. Ord Minnett sees SYD as a high-quality infrastructure asset that will recover, but will continue to face severe revenue headwinds until borders are opened. Ord Minnett does not believe the company will be forced to raise equity, although the risk is increasing as the international PAX recovery is pushed out further. LIGHTEN. (Published by Ord Minnett)

Transurban Group (TCL.AX) — Dividend headwinds, valuation, offsetting faster recovery

TCL's guidance that the FY21 distribution is expected to be in line with its free cashflow (excluding capital reserves) represents a change in payout policy. Citi is supportive of this change given TCL's high leverage. However, this also represents downside to consensus expectations and could lead to negative DPS revisions. While the COVID-related revenue impact has started to fade faster than other infrastructure peers, Citi sees downside to the share price given TCL's leverage is above that of its peers. SELL. (Published by Citi)

Treasury Wine Estates (TWE.AX) — US June Nielsen off-premise wine sales +22% y/y... TWE share loss accelerates

US off-premise wine sales for the 4 weeks ending 13 June was strong (+22% y/y) but slowed vs. May (+32%), with TWE slowing materially. Furthermore: 1. TWE's market share loss is accelerating and, 2. On-premise is weak but declines are easing. The near-term outlook for TWE remains uncertain, and UBS sees risk to forecasts for 2H20/1H21. That said, UBS does not foresee TWE having balance sheet challenges even in an environment where EBITDAS misses UBS estimates by more than -30%. UBS also sees potential catalysts via the re-structure of the Americas commercial business and the potential demerger of Penfolds. BUY. (Published by UBS)

International**Apple (AAPL.O) — Quantifying the Apple Silicon Switch + 5 Reasons Shares Can Trade Higher**

Last week AAPL held its annual World Wide Developers Conference (WWDC). One announcement at the conference was that it will switch from using Intel silicon processor chips to ones it develops itself. Citi believes this is to optimise its hardware and software roadmap and provide a more optimal user experience, while reducing reliance on external suppliers. The change is not expected to affect earnings materially. Various other software upgrades were also announced. BUY. (Published by Citi)

NVIDIA (NVDA.O) — CorpOur Take On The New Mercedes-Benz Partnership: An "iPhone Moment" – For NVDA

NVDA's new partnership with Mercedes-Benz to co-develop its next-generation autonomous software platform is a ground-breaking move in UBS's view. Unlike other partnerships (most significantly Toyota) this deal cements NVDA's position as a platform (not just technology) supplier of both hardware and software, and allows NVDA to play in what could be a big recurring revenue stream over the entire lifecycle of Mercedes Benz vehicles starting in late 2024. BUY. (Published by UBS)

Calendar

Figure 3. Calendar

Date	New Zealand	Australia	International
29-Jun	Fisher & Paykel Healthcare FY20		
30-Jun	ANZ Business Confidence (Jun) NBNZ Own Activity (Jun)	Housing Credit (May) Private Sector Credit (May)	US: Pending Home Sales (May) UK: GDP (Q1) EU: GDP (Jun) CH: Manufacturing PMI (Jun)
1-Jul	Building Consents (May)	AIG Manufacturing Index (Jun) Manufacturing PMI MI Inflation Gauge Private House Approvals (May)	US: CB Consumer Confidence (Jun) EU: German Manufacturing PMI (Jun) EU: German Unemployment Change (Jun) UK: Manufacturing PMI (Jun) CH: Caixin Manufacturing PMI (Jun) JP: Tankan Large Manufacturers Index (Q2)
2-Jul	NZIER Business Confidence NZIER QSBO Capacity Utilization	Building Approvals (May)	US: Nonfarm Employment Change (Jun) US: ISM Manufacturing PMI (Jun) US: Crude Oil Inventories US: FOMC Meeting Minutes
3-Jul	Arvida Group AGM	AIG Construction Index (Jun) Services PMI Exports and Imports (May) Retail Sales (May) Trade Balance (May)	US: Initial Jobless Claims US: Nonfarm Payrolls (Jun) US: Unemployment Rate (Jun) UK: Composite PMI (Jun) UK: Services PMI (Jun)

Source: Forsyth Barr analysis

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