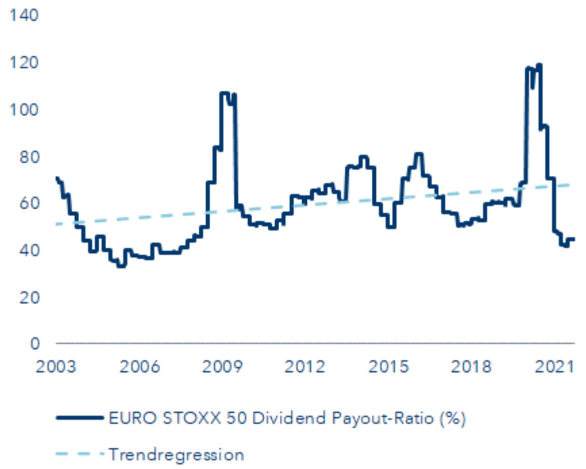
Augment portfolio yield with dividend stocks

Investment idea

IN TIMES OF HEIGHTENED UNCERTAINTY AND MARKET VOLATILITY, CAREFULLY SELECTED STOCKS THAT PAY GENEROUS DIVIDENDS CAN HELP INVESTORS STABILISE AND OPTIMISE THEIR PORTFOLIOS.

The Corona pandemic has also been a source of woe for dividend-oriented investors: companies in some sectors – banks, retailers and airlines, to name just a few – were simply not in a position or not allowed to pay dividends for the 2020 financial year. Many other companies opted to retain a large chunk of their profits as a precautionary measure. For 2021, the European stock dividends scheduled for payment in the coming weeks will be considerably higher than in the previous year, but the companies themselves remain cautious. The opposite has been the case in the US, where already last year record dividends were paid out, a trend that is expected to continue. But even in Europe, historically high profit distributions are projected for the 2023 financial year.

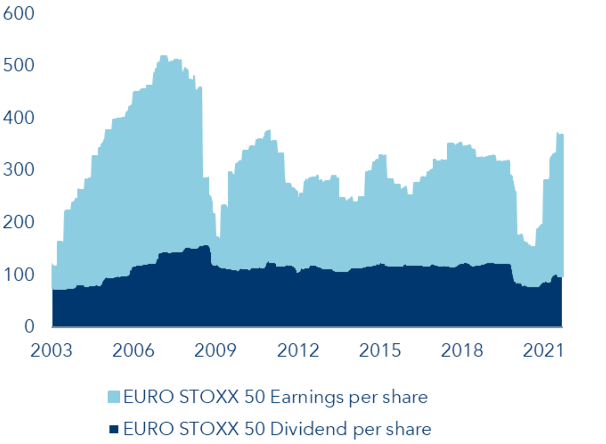
Profit distribution: Payout ratio in %



Sources: Bloomberg, VP Bank

Having said that, though, there is increasing uncertainty about how this year's corporate profits will develop, since they will form the base for dividend distributions in 2023. Global demand remains robust, but today's higher energy and raw material costs, on top of the worsening supply chain bottlenecks for semi-finished goods, can be expected to put the squeeze on profit margins.
These factors have yet to be fully reflected in analysts' forecasts. However, deteriorating margins or even a decline in net profits does not necessarily mean that corporate dividends will be trimmed. Most companies have a dividend policy that centres on continuity, and they try their best to avoid cuts. But this is only possible if there is sufficient upside leeway in the payout ratio; and this is the case at present. The most recent readings show that the payout ratio overall is at historically low levels both in the US and Europe. In other words, companies have been distributing only a relatively low proportion of their profits. With the exception of the Corona-related special situation in 2020, dividend payments have proven to be relatively stable even during crisis phases (see chart below).

Earnings versus dividend (in index points)



Sources: Bloomberg, VP Bank

However, what applies to the market as a whole is not to say that the same applies to every company. Today's daunting challenges are affecting companies in different ways and to varying degrees, hence prudent stock selection is of crucial importance. We have combed through our recommended stocks to determine their attractiveness to dividend-oriented investors and then divided the viable candidates into three groups:

- **Quality stocks**

  Thanks to their long-term track record of earnings stability and relative insensitivity to macroeconomic risks, these companies are of particular interest to conservative investors. Another plus is their pricing power, which results in hefty profit margins. Bear in mind, though, that the generally higher price-to-earnings-valuations (P/Es) of these stocks and their potentially weaker relative price performance in phases of high earnings growth do pose a certain risk.

- **Value stocks**

  As a general rule, these companies trade at a lower P/E than the overall market, even though most of them pay above-average dividends. That said, with value stocks investors need to consider the companies' somewhat dicey earnings predictability and higher vulnerability to macroeconomic risks.

- **Growth stocks**

  These companies enjoy above-average earnings growth and their shares offer compelling price potential, whereas increased short-term volatility is also part of the bargain. The risks during phases of market consolidation come from the usually higher fundamental valuation of such stocks. They are also sensitive to rising interest rates.

Summary

The explosion in energy and commodity prices, combined with the yet unresolved supply chain issues, will continue to challenge businesses for quite some time. However, the robust economic tendencies worldwide should provide support. Heightened volatility and geopolitical uncertainties can be expected to continue in the first half of the year. Nonetheless, we foresee good opportunities for long-term, dividend-oriented investors to benefit from select, fundamentally rock-solid companies.

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