It’s looking a lot like the 1970s again. And that’s good for dividend stocks

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Soaring [inflation](https://www.theglobeandmail.com/topics/inflation/) and rising [interest rates](https://www.theglobeandmail.com/business/economy/interest-rates/) have put dividend investors on edge this year. Is there still a compelling reason to stick with dividend stocks in an environment where bond yields have become attractive and beaten-up technology stocks are looking cheap?

Quantitative analysts at CIBC World Markets provided some answers to this question in a report last week, with some encouraging conclusions for investors who embrace quarterly distributions: Dividends will likely play an outsized role in returns for several years.

Dividend stocks have been performing well since interest rates bottomed out during COVID-19 lockdowns in 2020.

As the economy recovered, inflation took hold and bond yields rose to multi-year highs, the strategy of holding the shares of stable companies that paid large distributions – including stocks known as “bond proxies,” because of their steady growth and regular payments – have outperformed other strategies.

“Dividend yield has been one of the more powerful quantitative factors since the trough in U.S. 10-year rates in August, 2020. This fits with our fundamental work which argues for stocks with high and stable dividends, despite rising interest rates,” Ian de Verteuil, an analyst at CIBC World Markets, said in the note.

This outperformance resembles the 1970s, he added, when dividends accounted for 72.7 per cent of annual equity returns, as represented by the total return of the S&P 500.

Despite the strong allure of dividends since then, their importance has often been far lower in terms of their contribution to total returns since the end of the 2007 to 2008 financial crisis.

According to Mr. de Verteuil’s figures, dividends have accounted for just 17.9 per cent of total equity returns for the S&P 500 since the end of 2009. Though the differences between these two periods are far less extreme for Canadian stocks, the role of dividends has also been decreasing since 2009.

“For most of the past half century, and certainly since the financial crisis, equity investors have been ‘trained’ to focus mainly on capital appreciation. After all, strong price returns have made dividend yield a ‘nice-to-have’ but a non-crucial element in terms of investment returns,” he said in his note.

This perspective needs to change, he believes.

That’s because today’s environment of high inflation and rising interest rates is reminiscent of the late 1960s and early 1970s, when oil price shocks fed a turbulent decade with sparse equity returns (after factoring in inflation).

“We are already seeing fiscal and monetary policy acting in opposition, and this has the potential to make inflation more difficult to control,” Mr. de Verteuil said.

In Britain, for example, proposed [tax cuts](https://www.theglobeandmail.com/world/article-britain-backs-down-from-controversial-tax-break-for-the-rich/)will likely entrench deficits. Last week’s dramatic response to the proposals sent British borrowing costs soaring and [undermined the pound](https://www.theglobeandmail.com/world/article-liz-truss-britain-tax-cuts-bonds-pound/), before the Bank of England intervened.

In an environment of sustained rising interest rates, the natural concern is that dividend yields will also rise, weighing on the performance of dividend stocks.

Indeed, Mr. de Verteuil noted that – over the past 25 years – typical bond-proxy sectors such as utilities, telecommunications, financials and real estate have lagged the broader market when interest rates rose.

But these past periods of rising interest rates coincided with accelerating economic activity.

Not so today, as economists grow increasingly concerned about the threat of a global recession, which brings back the comparison to the 1970s when dividend stocks played an outsized role in equity returns.

“The higher rates may affect asset allocation with higher fixed-income allocations,” Mr. de Verteuil said. “But within equities, higher yielding stocks can retain their appeal.”

For investors who want to outperform the broader market, even as interest rates rise, dividend stocks look like a sound approach.