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Equitile Investments

Depressed lobsters & the dividend yield trap

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Is it better to invest for dividend income or capital gains? This is one of the perennial questions asked by equity investors. It's a perennial because there is no clear answer. Returns delivered via dividends can be reinvested to generate capital gains, and capital gains can be realised to deliver income. So, provided you are getting one or the other, it makes little difference. At least that's the theory, but, when it comes to financial markets, and economics for that matter, reality rarely matches theory.

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At Equitile we are open minded about how companies choose to deploy their returns. Provided they are producing healthy returns we are happy for our investors to get the benefit through dividend distributions, share buybacks, organic investment or external acquisitions. Used appropriately the mathematics of all these mechanisms can benefit shareholders more or less equally. That said, when we see an unusually high dividend yield we become wary.

Companies are willing to adapt their share-repurchases and investment spending plans, from year to year, to fit their changing economic circumstances. But dividends are a different story. Once declared, senior management often see it as a point of pride to either maintain or increase the dividend year-on-year. If the underlying business does not support these payments the company becomes over-leveraged and financially fragile.

Often the stock market senses when a company's dividend has become unsustainable. The stock price begins to slide, temporarily driving the dividend yield higher, sometimes much higher. Shortly thereafter, the management capitulates, and the yield-trap is sprung when the dividend is cut, eliminated' or even replaced with call to return the previous dividends in the form of a rights issue.

Biased to back losers

There are at least two powerful reasons why investors often fall into these yield traps. One is behavioural the other educational. The behavioural issue is known as the anchoring bias. This is our inbuilt tendency to assume that some previous asset price is the correct price and today's deviation from that price is just a temporary aberration. This bias means, when we see a sharply falling stock price we tend to expect it to recover back to its earlier higher price. And, when we see a sharply rising price we expect it to fall back to its earlier lower price. We humans appear to be pre-programmed to expect a return to the status-quo.

The educational issue is known as the 'random walk hypothesis' or the 'efficient market hypothesis'. This is the idea that asset price movements are entirely random. According to this hypothesis we can learn nothing about the future behaviour of a stock price from its previous behaviour; regardless of what has gone before, the next price movement may as well be decided randomly by the flip of a coin – heads the price rises, tails it falls.

The random walk hypothesis tells us to ignore recent stock price movements in our investment decisions. According to the theory, a stock is as good an investment today, when it is trading at 50 as it was yesterday when it was trading at 100. If true, and the dividend remains unchanged, there is every reason to believe the stock is now a high-yield bargain.

So the anchoring bias works on our instinctive right brain telling us to buy into companies with falling share prices and the random walk hypothesis works on our logical left brain telling us there's no reason to expect the downtrend to continue. As a result, we interpret the combination of 'high-yields and falling-prices as an opportunity and not the threat it often is.

Fighting Lobsters

Jordan Peterson recently burst into the public consciousness with his bestselling book, [12 Rules for Life: An Antidote to Chaos], and a recent [television interview with Cathy Newman], which went viral on the internet.

"It's winner-take-all in the lobster world, just as it is in human societies."

Peterson is a shock-jock self-help philosopher, offering a mix of tough-love advice with a hefty dose of personal anecdote. He deliberately sets out to make his readers face some unpalatable hard truths. I say this as a compliment not a criticism – as Keynes said, "words ought to be a little wild, for they are the assaults on the thoughts of the unthinking." Much of what Peterson says needs to be said.

One of Peterson's messages is profoundly important for both investors, when they are choosing companies to invest in, and for economists when they are trying to make sense of the economy.

Peterson makes the obvious, irrefutable, observation that nature is dominated by brutal competitive forces, and that those forces require members of a species to compete amongst themselves for resources.

Peterson illustrates his point with a discussion of the territorial behaviour of two diverse species – Wrens and Lobsters:

"Now, Wrens and lobsters are very different. Lobsters do not fly, sing or perch in trees. Wrens have feathers, not hard shells. Wrens can't breathe underwater, and are seldom served with butter. However, they are also similar in important ways. Both are obsessed with status and position…"

He continues…

"The wiliest, strongest, healthiest and most fortunate birds occupy prime territory, and defend it. Because of this, they are more likely to attract high-quality mates, and to hatch chicks who survive and thrive… Territory matters, and there is little difference between territorial rights and social status. It is often a matter of life and death."

The point being, past-performance does predict future-performance, an idea explicitly denied by the efficient market hypothesis.

Where he courts controversy is in his willingness to extent this discussion of what he calls dominance hierarchies into our own human behaviour.

"This is equally true of human neighbourhoods, when bird flu viruses and other illnesses sweep across the planet. The poor and stressed always die first, and in greater numbers. They are also more susceptible to non-infectious diseases, such as cancer, diabetes and heart disease. When the aristocracy catches a cold, as it is said, the working class dies of pneumonia."

Peterson describes an elaborate series of lobster conflict rituals starting with aggressive posturing, escalating to spraying with chemical signals, before moving on to outright physical conflict, culminating in lobsters tearing each other limb from limb.

As Peterson observes, this final stage of conflict resolution risks delivering a Pyrrhic victory in which both sides are left mortally wounded. Therefore, lobsters and other species have evolved sensible behavioural traits designed to de-escalate a conflict once the likely winner has become apparent. These traits tell the loser when to give up and not to pick another fight.

We believe picking stocks for their dividend yield is a strategy likely to suffer adverse selection bias.

"In the aftermath of a losing battle, regardless of how aggressively a lobster has behaved, it becomes unwilling to fight further, even against another, previously defeated opponent. A vanquished competitor loses confidence, sometimes for days…

…If a dominant lobster is badly defeated, its brain basically dissolves. Then it grows a new, subordinate's brain – one more appropriate to its new, lowly position."

The losing lobster is literally a different animal after the fight. Peterson, also dares to make the all too obvious connection to our own behaviour:

"Anyone who has experienced a painful transformation after a serious defeat in romance or career may feel some sense of kinship with the once successful crustacean."

In other words, in the face of defeat both humans and lobsters lose their mojo. They become depressed and are, as a result, less successful competitors. Which brings us to the crux of Peterson's point:

"When a defeated lobster regains its courage and dares to fight again it is more likely to lose again than you would predict, statistically, form a tally of its previous fights. Its victorious opponent, on the other hand, is more likely to win. It's winner-take-all in the lobster world, just as it is in human societies, where the top 1 percent have as much loot as the bottom 50 percent and where the richest eighty-five people have as much as the bottom three and a half billion."

The point being, success breeds success and failure breeds failure. There is persistence in the outcome of conflicts between animals. The winners tend to stay on the top and the losers stay on the bottom. This is not a process that can be appropriately modelled with the mathematics of a random walk.

Winners win, losers lose

Peterson's hard truths about the reality of animal behaviour and his honest recognition of its applicably to our own behaviour is important for our understanding of both the economy and financial markets.

Left-leaning, Marxist economists yearn for an egalitarian society with a flat social pyramid, free of any dominance hierarchy. Right-leaning, libertarian economists yearn for a society where everyone strives only for their own betterment, never interfering with their neighbours. Neither of these models, or rather ideals, of human behaviour is compatible with real human behaviour. As Peterson points out, we are pre-programmed to form a social pyramid and to compete for dominance within that hierarchy. I believe, economics would be a whole lot more useful if it were to incorporate Peterson's version of reality into its models.

The implications for our understanding of financial markets are equally profound. A victorious lobster gains confidence and likely goes on to greater victories. A defeated lobster becomes timid, and likely goes on to greater defeats. The point being, past-performance does predict future-performance, an idea explicitly denied by the efficient market hypothesis.

Consider a hypothetical pair of almost identical companies. Each is populated by almost equally talented individuals, is equally profitable, equally valuable, pays an equal dividend and, like lobsters, operates in a competitive ecosystem. Imagine what happens to the psychology of the work-forces of these two companies when one of them wins that large tender they have both been competing for.

As with the lobsters, the victors will gain confidence and the losers lose confidence. There may even be some migration of talent between teams as the winning company cherry picks the best talent form the losing team, obliging the loser to fill its vacancies with its competitor's cast-offs.

When those two companies go head-to-head again the previous winner will have more confidence and more resources. In all likelihood the outcome will be the same, the winner will win, and the loser will lose.

We see this dynamic in team sports. Today it's easier for Manchester City to attract talented players than it is for West Brom. Man City has more confidence and more resources. The outcome of the next Manchester City West Brom clash is not a forgone conclusion, but it's a long way from the coin flip probability of the random walk model, as taught to almost all financial professionals.

We look for companies at the top of their respective dominance hierarchies, those with the financial resources and confidence to defend and extend their territory.

The stock market is a scorecard of past corporate victories and defeats. If a stock is on an uptrend it is likely the company has had a series of success. It's likely to have a confident management and a happy workforce. If the stock price is on a downtrend the company has likely had a string of defeats. Its management is likely timid, and its workforce depressed, and both are likely spending at least some of their time looking for opportunities to join the opposition's winning team. The winning company will likely keep winning and the losing company keep losing.

The dividends paid by a company are also a scorecard of past corporate victories. But, as discussed, company managers are often reluctant to cut dividends once they have been declared.

Returning to our two hypothetical companies. Once the result of the competitive tender is announced it's likely the stock price of the victorious company will rise and that of the defeated company will fall. The winner will, initially at least, have a lower dividend yield than the loser. But If the loser keeps losing that higher yield will become unsustainable.

Chasing dividend yield is chasing losers

If the random walk theory is correct, limiting yourself to high dividend stocks may be a reasonable strategy. But, if Peterson is correct, and there is persistence in both success and failure, then selecting stocks based on dividend yield risks producing a portfolio of yesterday's losers and tomorrows failures. The technical term for this effect is an 'adverse selection bias'. We believe picking stocks for their dividend yield is a strategy likely to suffer adverse selection bias.

Occasionally Leicester City wins the Premier League. Occasionally corporate failures recover. Occasionally a losing lobster pulls off a surprise victory. More often than not the Premier League is won by a recent champion, corporate losers become corporate failures and the losing lobster ends up as lunch. Betting on the underdog can be exhilarating, occasionally very profitable but, in our view, it's not a viable long-term investment strategy.

We buy Peterson's theory of persistence in the winning and losing behaviour of individuals and we would extend this idea to the persistence of success and failure at the group level – successful sports teams tend to stay successful and successful companies tend to stay successful.

For these reasons, we do not chase dividends. Rather we aim to invest in the winning corporate lobsters. We look for companies at the top of their respective dominance hierarchies, those with the financial resources and confidence to defend and extend their territory. ■