KOVITZ INSIGHTS

Lower for Longer

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Interest rates aren't going up anytime soon. That was the Federal Reserve's guidance in August, which was confirmed with economic projections offered in mid-September. Fed Chair Jerome H. Powell and his colleagues on the Federal Open Market Committee (FOMC) indicated that their target for the fed funds rate likely will remain in the range of 0% to 0.25% through the end of 2023, as the pandemic is expected to keep inflation "well below" the Fed's 2% long-run target and the labor market below maximum employment. Mr. Powell said the Fed's stance will likely support a strong recovery and limit economic damage, but he conceded a full recovery would come only "when people are confident that it is safe to reengage in a broad range of activities."

No doubt, this should cheer those who are net borrowers, as an ultra-low cost of debt allows for increased spending, faster repayment of principal, equity market multiple expansion and inexpensive business growth. At the same time, net savers including retirees are likely to feel an income crunch once again, forcing expenses to be funded by principal withdrawals or the switching to higher-risk investments.

DWINDLING OPTIONS FOR INCOME

Cash is the best vehicle for those that can't stomach any volatility, but placing one's money into the modern-day equivalent of the mattress allows the chance to earn a whopping 0.10% yield for a 3-month Treasury Bill. And that assumes one opts to trade their own T-Bills, as yields on cash at most brokerages are closer to 0.01% in money market funds. Growth of capital obviously is not the objective, but at that 0.01% money market fund rate, cash will double in 6,932 years.

Others prefer longer-term U.S. Treasuries, where the yield on the 1-year note is currently hovering around 0.12%, the yield on the 10-year bond is near 0.68% and the yield on the 30-year bond is in the 1.45% range. Considering that inflation has averaged 3% per annum over the past eight decades and the Federal Reserve is targeting at least 2% in the nearer term, those willing

Global Government Bond Yields					
Country (Currency)	3-Month Government Yield	6-Month Government Yield	1-Year Government Yield	10-Year Government Yield	30-Year Government Yield
United States (USD)	**0.10%**	**0.11%**	**0.12%**	**0.68%**	**1.45%**
Australia (AUD)	0.14%	N/A	0.12%	0.79%	1.74%
Canada (CAD)	0.12%	0.16%	0.21%	0.56%	1.11%
China (CNY)	2.35%	2.65%	2.69%	3.18%	3.89%
Eurozone (EUR)	-0.64%	-0.60%	-0.60%	-0.52%	-0.09%
Germany (EUR)	-0.60%	-0.60%	-0.60%	-0.52%	-0.09%
Japan (JPY)	-0.12%	-0.10%	-0.13%	0.02%	0.60%
United Kingdom (GBP)	0.06%	0.04%	-0.01%	0.23%	0.78%

Figure 1: Global Interest Rates
As of 09.30.2020. Current bid yields on generic government bonds. Source: Kovitz using via Bloomberg Finance L.P.

to accept the current yields on 10-, 20- and 30-year Treasuries are likely to see a reduction in purchasing power and little in the way of real return if they hold to maturity, along with the risk of capital losses should the bonds be cashed out early.

Looking across the pond, government bonds throughout much of Europe have negative or near-zero yields, while yields across all major maturities of the German Bund are negative. Certainly, we understand that there are other factors at play in Europe as investors weather currency movements, deflation and deposit penalties. Plus, the European Central Bank boosted its bond buying program to 1.35 trillion euros in June as part of an effort to prop up the economy during the pandemic. On the plus side, we believe the fact that corporations can borrow at the lowest rates in history bolsters the appeal of stocks as they use the proceeds to invest in their businesses, make acquisitions, cut interest expense, buy back shares and pay dividends.

DIVIDEND YIELDS REMAIN FAVORABLE

The low or negative yield environment for global government bonds leaves investors who have a need for income with options that necessarily add risk to their portfolios. This is historically unusual. Equities usually offer lower yields than government bonds, as presented in Figure 2. However, large stimulus in 2008-2009's Great Recession, giant austerity packages in Europe and the global COVID-19 pandemic this year have flipped that on its head, with the S&P 500 yield presently well-above the risk-free 10-year Treasury yield. Value stocks (those trading for lower fundamental valuation metrics) currently provide even more generous income streams than the S&P 500's 1.6% forward yield. Breaking down the index into Core Value and Core Growth components, one finds the former with a forward yield of 2.8%, as of September 25, compared to 1.1% for the latter.

Of course, investors need to be willing and able to take on equity risk, and for those that can, we think the potential to benefit from both capital appreciation and income is highly attractive. Figure 3 on the subsequent page shows that more than 40% of the S&P 500's long-term return since December 1927 has come from income, while capital appreciation has been a larger portion of the total return in recent years as Growth stock gains have largely outpaced Value stocks.

HIGHER YIELD, NOT HIGHER RISK

Even more important to some, we also plotted the annualized standard deviation of the trailing 3-year returns, a common measure of risk, for the value-weighted Fama-French (combining the dividend payers) data sets to determine the spread of

Figure 2:
Long-Term Yields

From 07.31.1926 through 06.30.2020. S&P 500 trailing 12-month yield. SOURCE: Kovitz using data from Professor Robert Shiller

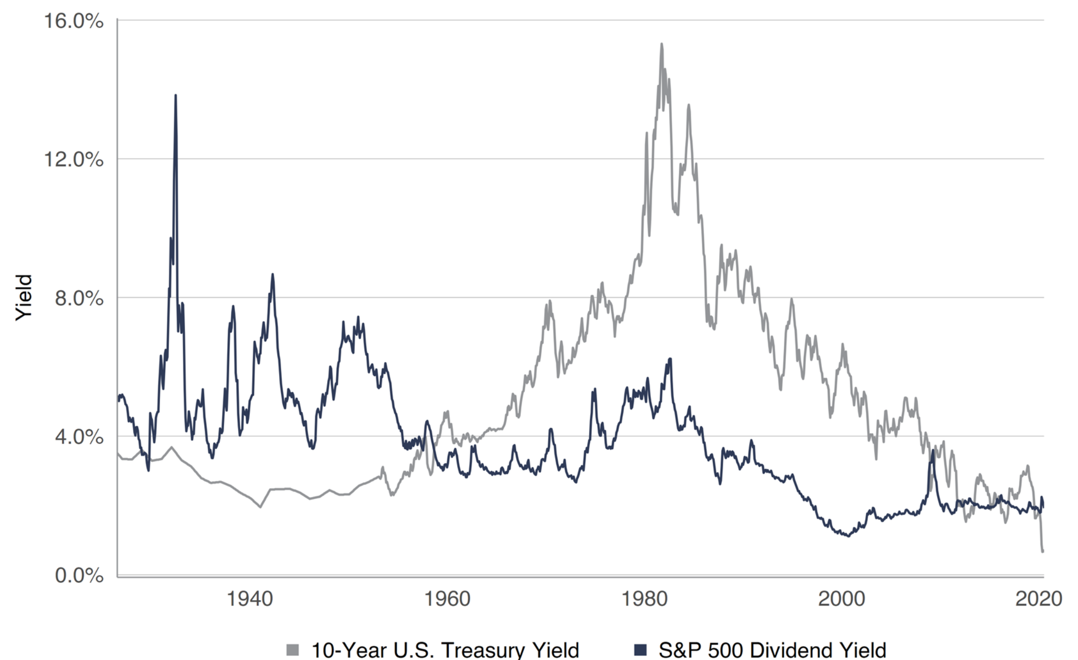
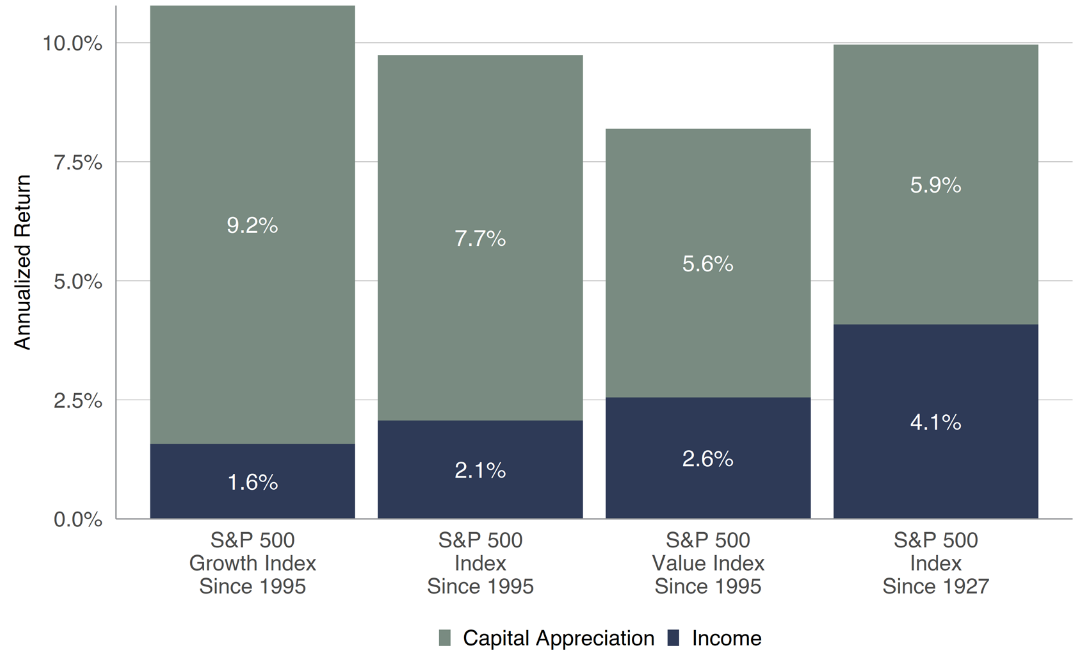


Figure 3:
Contribution to Return by Source for S&P Indexes

From 12.31.1927 through 08.31.2020. Total return. The Value and Growth indexes were not available at the S&P's inception and begin on 06.30.1995. The long-term S&P series begins in 1927. SOURCE: Kovitz using data from Morningstar, Professors Eugene F. Fama and Kenneth R. French



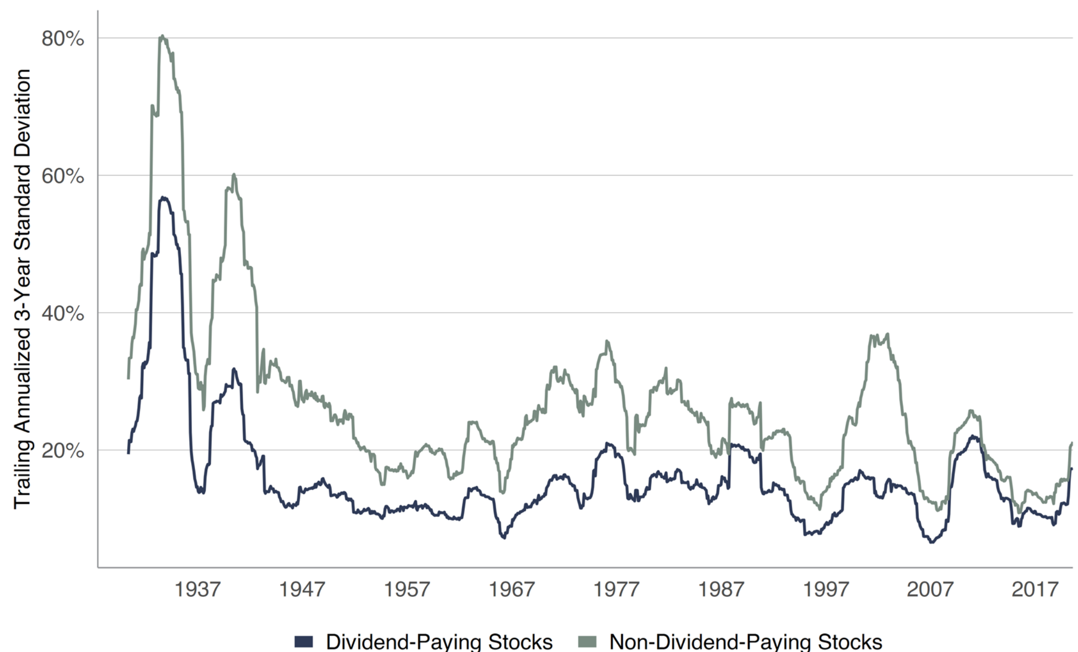
the series since 1927. The greater the standard deviation, the more volatile the return and the higher the risk that the return will deviate from the norm. As shown in Figure 4, dividend payers, in addition to their strong long-term return characteristics, have had meaningfully lower standard deviation than non-payers.

INCOME WITH UPSIDE

We do our own homework and crunch our own numbers to ensure that what we believe philosophically actually corresponds to what has proven to be successful from a historical perspective. While past performance can never predict future results, our long-time emphasis on undervalued dividend-paying stocks is validated by more than nine decades of market history. It's not quite the Holy Grail of investing, but it is nice to see that over the long term, dividend-paying stocks on average historically have outperformed non-paying stocks and they have done so with lower volatility.

Figure 4:
Historical Risk and Dividend Payment

From 06.30.1927 through 07.31.2020. Trailing annualized 3-year standard deviation using monthly returns. SOURCE: Kovitz using data from Professors Eugene F. Fama and Kenneth R. French



For more information on working with our financial professionals contact us at wealth@kovitz.com or 312.334.7300.

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All returns are geometric average unless otherwise stated. The geometric average is calculated using the mean of a set of products that takes into account the effects of compounding.

The federal funds rate is the rate banks charge on loans to each other.

The quoted forward yield for the S&P 500 uses the iShares S&P 500 ETF (ticker: SPY) as a proxy. The quoted forward yield for the S&P Core Value uses iShares Core S&P U.S. Value ETF (ticker: IUSV) as a proxy. The quoted forward yield for the S&P Core Growth uses iShares Core S&P U.S. Growth ETF (ticker: IUSG) as a proxy.

The factor-based (book value-to-price) portfolio data is from Eugene F. Fama and Kenneth R. French. The dataset is broken into four groups: large value, large growth, small value and small growth. The aggregate Value and Growth portfolios are monthly averages of the two returns.

The Standard & Poors 500 index (S&P 500) is a broad stock market index based on the market capitalizations of the largest 500 companies listed in the U.S. Small company stocks, via Ibbotson Associates, are the bottom twenty percent of the New York Stock Exchange. Large company stocks, via Ibbotson Associates, are represented by the S&P 500 index. The S&P 500 Growth Index is a market capitalization weighted index. All the stocks in the underlying parent index are allocated into value or growth. Stocks that do not have pure value or pure growth characteristics have their market caps distributed between the value & growth indices. Prior to 12/19/2005 this index represented the S&P 500/Barra Growth Index. The S&P 500 Value Index is a market capitalization weighted index. All the stocks in the underlying parent index are allocated into value or growth. Stocks that do not have pure value or pure growth characteristics have their market caps distributed between the value & growth indices. Prior to 12/19/2005 this index represented the S&P 500/Barra Value Index.

To perform the portion of the study from 1927 to present, we utilized the dividend-weighted portfolio data from Eugene F. Fama and Kenneth R. French. The dataset is broken into five groups: non-dividend paying, top 30% of dividend payers, middle 40% of dividend payers, bottom 30% of dividend payers and all dividend payers (weighted 30% of top dividend payers, 40% of middle dividend payers and 30% of low dividend payers).

Figure 3 is calculated by subtracting the annualized price return from annualized total return for each index. The Value and Growth indexes were not available at the S&P's inception and begin on 06.30.1995. The long-term S&P series begins on 12.31.1927.

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