CREDO WEALTH

Trees do not grow to the sky

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Investing in any single company is an inherently uncertain process, the outcome of which can be influenced by a wide range of factors - some relatively easily foreseeable and others less so. Add to that the fact that the most successful of investors will be wrong from time to time, and it's not surprising that a level of diversification in any portfolio of equities is always a prudent strategy.

Recognising this underlying uncertainty, our investment process at Credo revolves around identifying the key factors that are likely to drive the outcome for any potential investment, and we seek to invest only when we believe those factors to be biased in our favour on balance of probabilities. Sometimes these factors are company specific, whilst at other times they relate more to industry dynamics or the macro environment.

Crucial to being a successful investor is the ability to recognise one's own weaknesses. As fundamental bottom-up investors, we are generally cautious when we identify key factors of a top-down nature that could play a dominant role in the outcome of any potential investment. While our long-term investment horizon often provides us with the opportunity to take a constructive view on such factors, we always have to consider also: what if we are wrong?

This leads us to the Credo Dividend Growth Portfolio (DGP), consisting of companies that pay a sustainable and growing dividend. Whilst we are pleased to report that DGP has performed strongly since inception, we also have to acknowledge that at least a portion of this outperformance can be linked to the structurally low interest rate environment which has prevailed over this period.

In general terms, investors who choose to invest in dividend paying companies specifically for their income are foregoing the opportunity to invest in alternative income producing products (such as bank accounts or bonds), the income of which is directionally linked to interest rates. All else being equal, the higher the level of interest rates, the greater the income available on such products, and thus the higher the dividend income required from a company in order for it to be considered as a similarly attractive alternative. The opposite is of course also true at lower interest rate levels, and it can therefore quite readily be accepted that interest rates and dividend yields are inversely correlated.

Interest rates around the world have been on a downward trajectory for the past three decades, and developed markets have seen levels at or near zero for a number of years now. As a consequence, investors faced with low yields on fixed income products have sought income elsewhere, in particular in dividend paying companies. This has driven valuations of many dividend paying companies upwards, at least in relative terms (i.e. as compared to the universe of companies which do not pay dividends). As a result, valuations of dividend paying companies in aggregate now appear to be extended by historical standards.

However, if interest rates were to start rising, there appears to be no reason why not to expect exactly the opposite of what we have seen in recent years, leading to an environment in which (relatively expensive) dividend paying companies could start to underperform.

Holders of fixed income products may of course first switch into equities in the face of rising interest rates in order to avoid a decrease in the capital value of their investments (and we have already seen some such behaviour since the US election of Trump). Over the longer term, however, investors are likely to be less reliant on dividend paying companies for income, which should lead to a reduction in demand for those (pushing valuations down).

No-one knows precisely what will happen to interest rates over the next few years. (For what it's worth, Credo has maintained a "lower for longer" stance ever since the global financial crisis and only time will tell exactly how this plays out over time). Where we may differ from some market participants, however, is that we know that we do not know. Having said that, with rates starting to rise in certain developed markets such as the USA, it seems trite to suggest that the interest rate environment is likely to be less favourable going forward than it has been for the past number of years.

There may of course be sceptics (not to mention proponents of dividend paying companies) who will contend that rates might in fact not rise meaningfully or quickly from current levels. Such a situation is also not without precedent: one only has to look at the situation in Japan ever since the late eighties. Whilst this could turn out to be correct, we believe it is incumbent to examine the whole range of outcomes.

With interest rates still at or close to historically low levels, it stands to reason that there is a lot more scope for them to rise than to fall. But even if rates persist at a structurally-low level for much longer, the shares of such dividend paying companies will clearly not continue to benefit from the tailwind of incrementally lower rates. Trees do not grow to the sky.

Applying this to the DGP, we are therefore mindful of the fact that future performance (as measured against the global index) could be subdued due to a potential increase in interest rates. Whilst we will always strive to continue adding value to client portfolios by looking for stocks that outperform the broader market, we have to acknowledge that this may become increasingly difficult to achieve if and when interest rates eventually do start to rise.

Please contact your Credo Relationship Manager if you have any questions.

Important Notice