HIGH DIVIDEND SECTORS ARE NOT "IN A BUBBLE"

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Recently there has been a lot of chatter about whether dividend-paying equities are becoming expensive or reaching a "bubble." Many point to high P/E ratios as evidence that dividend-payers, specifically in the S&P 500 Utilities (Utilities), Telecommunication Services (Telecom), Health Care (Health Care) and Consumer Staples (Consumer Staples) sector indexes, are getting expensive. In my opinion, price-to-earnings ratios may not be the best estimates of whether the stocks within these sectors are reaching a bubble or not. Consider that since these indexes contain dividend-paying stocks, a better gauge might be the trailing 12-month dividend yield, since it compares the prior 12-months' worth of dividend payments to the stock price. In addition to being a stand-alone metric, the trailing 12-month dividend yield of a stock, sector, or even index can be compared to that of the broader market, in this case the S&P 500 Index. On the basis of such a trailing 12-month yield spread,[1] only Utilities is more expensive than its average for the 20-year period from 8/31/1992 to 8/31/2012. We take the 20-year average trailing 12-month dividend yield spread in order to gain a better understanding of what an overall baseline might look like for each sector that has been observed over 20 years—a period that has included both bull and bear markets. What this 20-year average will allow us to do is to gauge the present levels in a greater historical context. The other three aforementioned sectors, besides Utilities, are actually relatively cheap compared to their historical averages over that period: • Telecom had a 20-year average trailing 12-month dividend yield spread of 1.54%, but as of August 31, 2012[2] this spread was 2.70%, the highest of any sector. One could thus argue that this particular value is one of the more attractive spreads that these stocks have displayed over the last 20 years. • Consumer Staples had a 20-year average trailing 12-month dividend yield spread of .32%. As of August 31, 2012, these stocks had a trailing 12-month dividend yield spread of .68%—again signaling a lower valuation than its historical average. • Health Care had a negative 20-year average trailing 12-month dividend yield spread to the S&P 500 Index. As of August 31, 2012, the sector exhibited a positive spread of .09%—another spread level higher than its historical average, which signals a potentially attractive current valuation level. One option for those concerned about potential valuation risk[3] in U.S. Utilities may be to consider foreign Utilities,[4] as they appear to be trading at discounts[5] to both U.S. Utilities[6] and their own histories. In my opinion, dividend stocks are not in, or near, a bubble. I am confident that there are still potential valuation opportunities in high-dividend sectors—even after their strong recent performance. *Read our commentary for more information. Use our dividend yield calculator.* [1]A comparison of the trailing 12-month dividend yield of a stock, sector or index to that of a broader index. Higher spreads indicate that prices are at lower levels relative to trailing 12-month dividends. [2]The large number of constituent firms within each index contribute to making observed levels stable over time, relative to that of a single company. [3]Specifically, that price levels of stocks within the S&P 500 Utilities Sector Index are high compared to trailing 12-month dividends, earnings, or any other financial metric. High current price levels may imply greater future risk. [4]As represented by the MSCI AC World ex-US Utilities Sector Index. [5]Specifically, foreign Utilities, as of 8/31/2012, have higher trailing 12-month dividend yields than U.S. Utilities and higher trailing 12-month dividend yield spreads relative to their own historical averages. Trailing 12-month dividend yield spreads of foreign Utilities are captured by subtracting the trailing 12-month dividend yield of the MSCI AC World ex-US Index from that of the MSCI AC World ex-US Utilities Sector Index.[6]Refers to fact that the trailing 12-month dividend yield spread between the MSCI AC World ex-U.S. Utilities Sector Index and the MSCI AC World ex-U.S. Index is larger than that between the S&P 500 Utilities Sector Index and the S&P 500 Index.

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