FINDING OPPORTUNITIES IN THE PROS WHILE MITIGATING THE CONS OF HIGH-YIELDING EQUITIES

by Isaac Braley, President and Co-Portfolio Manager, BTS Asset Management

Warren Buffett once said, "We all hope for capital gains, but the only thing we can really count on is the dividend." This is a very true statement until it is not, as not all companies can hold this maxim true. Many companies paying very high yields may be at risk of cutting these dividends and seeing further price declines. There are numerous Pros and Cons of investing in high-yielding equities.

Find Opportunity

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High-yielding equities certainly have a place in most investor portfolios, but managing the risks these securities may bring to a portfolio is essential. Warren Buffett once said, "We all hope for capital gains, but the only thing we can really count on is the dividend." This is a very true statement until it is not, as not all companies can hold this maxim true. Many companies paying very high yields may be at risk of cutting these dividends and seeing further price declines. There are numerous Pros and Cons of investing in high-yielding equities. Some of those are outlined in the table below:

1. Steady Income
2. Inflation Hedge
3. Historical Stability
4. Attractive Total Returns
5. Tax Advantages
6. Share Accumulation Tool
7. Diversification
8. Compounding Returns

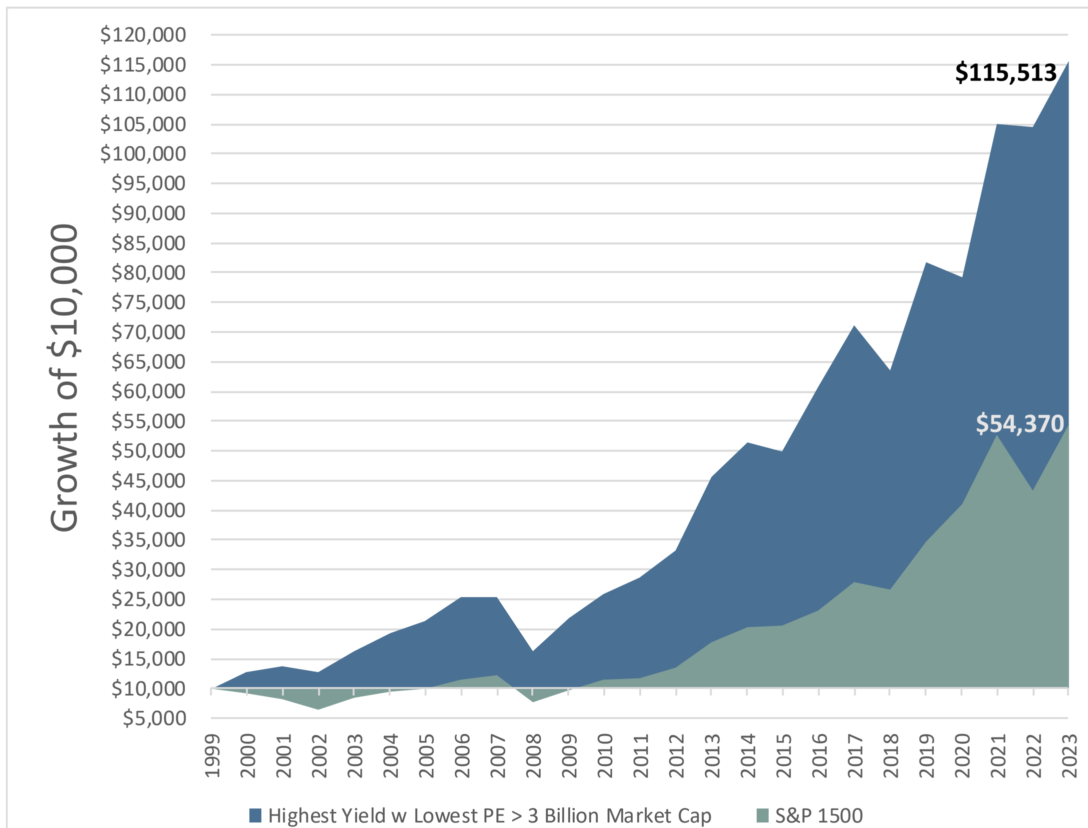
1. Risk of Dividend Cuts
2. Interest Rate Sensitivity
3. Price Declines
4. Growth Potential Limitation
5. Organizational Health
6. Opportunity Costs
7. Mindlessly Purchasing for Yield
8. Liquidity Risks

Based on these pros and cons, it is paramount that we balance our search for Yield with strong diversification and strong fundamental analysis. As investors look to generate regular cash flow, high-yielding equities can be an excellent diversification tool to introduce to the portfolio. Risk mitigation needs to be a heavy part of the analysis to reduce the risk of investors catching a falling knife. Understanding the importance of analyzing certain vital areas can significantly improve a portfolio's risk/return impact. The primary focus on security selection should be centered around some critical considerations.

1. Financial Health of the Corporations
2. Dividend History
3. Industry Stability
4. Industry Diversification
5. Company Size

Analyzing the four types of financial ratios, Profitability, Leverage, Liquidity, and Efficiency, can help us assess the financial health, long-term viability, and, most notably, the early warning signs (both good and bad) of potential companies to invest in. It can be pretty surprising how adding a couple of simple measures like P/E (Price-to-Earnings) and Market Cap rules to your search for Yield can help increase the value of a portfolio. In this approach, you would filter all the securities in the S&P 1500 at the end of the year, buy the top quartile of securities, and hold them for the next twelve months. You would then repeat the process each year for 23 years. This simple approach generates a return more than 2.3X greater than the S&P 1500. It does this while creating a standard deviation of 7% lower than the S&P 1500.

Growth of $10,000 Selecting the Top Quartile of Stocks at Year End and Holding for One Year Based on Yield with the Lowest P/E Companies with Market Cap Greater Than $3 Billion vs. S&P 1500 1999-2023



For informational purposes only. The performance shown above is not a recreation of any BTS Portfolios or Products. Yield with the Lowest P/E performance constitutes backtested hypothetical performance formulated by selecting the top quartile of stocks in the S&P 1500 with market capitalization greater than 3 Billion based on Yield with the Lowest P/E at the end of each year with data available as of 12/31 of each year and holding those securities until the end of the following year. The S&P 1500 index is the benchmark for comparison. An investment cannot be made directly in an index. Internal Analysis.

You can see that the basic approach on the previous page can potentially impact an investor's portfolio in a significantly positive way. The return of this approach looks attractive, but what about the Yield? Adding a few simple layers of analysis generated an average 24-year yield of 3.93%, compared to 1.97% for the S&P 1500.

To potentially take advantage of the pros and limit the cons mentioned earlier in this paper, we must deploy additional layers of analysis. The approach above may leave investors concentrated in too few sectors, thereby increasing the risk and potentially lowering the portfolio's overall return. We should broaden our rule set to require better diversification. Diversifying between multiple industries can possibly help take advantage of the cyclical nature of industries. When looking at each sector, we must also understand that some types of financial ratio analysis may work better in one industry than another. Capital-intensive companies like manufacturing may need to focus more heavily on ratios like debt-to-equity than less capital-intensive industries like technology. High-growth industries may prioritize different ratios than stable or mature industries. For instance, a technology startup may focus more on return on equity and revenue growth, while a utility company may prioritize stability and dividend yield. So, once you have established high-yielding companies from each industry, you must compare the right corporate health metrics for each.

When the right metrics have been applied, you can attempt to remove or reduce the most considerable risk of a high-yield company. That is the risk of catching a fallen knife. It is excellent if the Yield is big, but you are probably losing significant principle if it gets even bigger. If a company is not increasing its dividend payment and instead, the Yield is growing because the security price is declining, we have not improved the portfolio. It is essential to look for companies that have a high yield. Still, you are actually hoping that the Yield slowly comes down due to investors bidding the security price up because of the improvements in a company's underlying health.

Searching for Yield in the equity markets can bring additional sources of income to an investor wishing to create a distribution strategy or for an investor looking to grow a portfolio through further share accumulation by reinvesting dividends. No matter why you are looking to add these highly valuable securities, we must add fundamental analysis to make sure that we are giving ourselves the best opportunity to create an attractive sequence of returns.

About BTS Asset Management

Founded in 1979, BTS Asset Management is one of the oldest risk managers, managing traditional assets with a nontraditional approach. BTS has a multi-year track record in tactical fixed income and equity management. Our goal is to find opportunities with the potential to take advantage of rising markets while working to manage losses during downturns.

BTS:

- ❑ Seeks to preserve capital
- ❑ Aims to offer downside protection and upside potential
- ❑ Strives to reduce volatility while delivering consistent long-term returns

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S&P 1500 is an index of US stocks made by Standard & Poor's. It includes all stocks in the S&P 500, S&P 400, and S&P 600. This index covers approximately 90% of the market capitalization of U.S. stocks.

Price-To-Earnings (P/E) Ratio is the ratio for valuing a company that measures its current share price relative to its earnings per share (EPS).

Debt-to-Equity (D/E) Ratio is used to evaluate a company's financial leverage and is calculated by dividing a company's total liabilities by its shareholder equity. D/E ratio is an important metric in corporate finance. It is a measure of the degree to which a company is financing its operations with debt rather than its own resources.

Dividend Yield is expressed as a percentage, is a financial ratio (dividend/price) that shows how much a company pays out in dividends each year relative to its stock price.

Return On Equity Ratio is expressed as a percentage and can be calculated for any company if net income and equity are both positive numbers. Net income is calculated before dividends paid to common shareholders and after dividends to preferred shareholders and interest to lenders. A measure of financial performance calculated by dividing net income by shareholders' equity.

Profitability Ratio are financial metrics used by analysts and investors to measure and evaluate the ability of a company to generate income (profit) relative to revenue, balance sheet assets, operating costs, and shareholders' equity during a specific period of time. They show how well a company utilizes its assets to produce profit and value to shareholders.

Liquidity Ratios are used by financial analysts to evaluate the financial soundness of a company. These ratios measure a company's ability to repay both short-term and long-term debt obligations. Liquidity ratios are often used to determine the riskiness of a firm to decide whether to extend credit to the firm.

Leverage Ratios are any kind of financial ratio that indicates the level of debt incurred by a business entity against several other accounts in its balance sheet, income statement, or cash flow statement. These ratios provide an indication of how the company's assets and business operations are financed (using debt or equity).

Efficiency Ratios are used to measure how well a company is utilizing its assets and resources. These ratios generally examine how many times a business can accomplish a metric within a certain period of time, or how long it takes for a business to fulfill segments of its operations.

Fundamental Ratios are quantitative measures that are used to assess businesses.

Market Capitalization refers to the total dollar market value of a company's outstanding shares of stock.

Standard Deviation measures the degree of variation of returns around the average return, the higher the volatility, the higher the standard deviation. It considers monthly returns.

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