Are Dividend Paying Stocks Expensive?

Barron's over this past weekend included an article warning that dividend paying stocks were getting expensive. Author Michael Santoli cited recent work from Vadim Zlotnikov at Bernstein Research comparing price/book valuations on low beta and high beta stocks. On this basis low beta stocks are at the 99th percentile of valuation (i.e. expensive) over the past 50 years, whereas high beta stocks are at the 6th percentile. Low beta stocks don't have to be the same as high dividend yield stocks, although there tends to be a good deal of overlap. The kind of business that can pay a reliable dividend that grows predictably tends also to have less volatile earnings, so it makes sense for the two categories to overlap. Pro-cyclical businesses with high earnings volatility pay low (or no) dividends, conserving cash for less certain times.

Companies that we include in our Hedged Dividend Capture Strategy include boringly predictable names like Chubb Corporation (CB),Kraft (KFT), Procter and Gamble (PG) and AT&T (T). Annual dividend increases of 6% or more are not uncommon among names like these over many years, and they all offer dividend yields that are competitive with high grade bonds (and much more attractive than treasuries). As the future increasingly looks as if it will not provide a fair return to traditional investors in fixed income, investors have been finding other sources of income and dividend paying stocks have been a beneficiary. BernsteinResearch invariably produces high quality work that is supported with reams of data. The increasing price/book multiple paid by investors for such names could indicate that they're becoming relatively expensive, although the wide equity risk premium suggests that stocks are not that expensive compared with bonds using 40 years of data. If you go back a really long way however, Vadim

Zlotnikov notes that over 140 years it’s not quite so compelling.

But the performance of dividend paying stocks has coincided with falling interest rates, and bond yields are similarly at or close to their 99th percentile of overvaluation by any measure this side of World War II. Such names can be owned as a long-only portfolio or with a market hedge so as to be beta neutral, but the possibility of getting yield with an “equity kicker” appears increasingly compelling.