

MARKET COMMENTARY

WHEN GOING GETS TOUGH: QUALITY OR YIELD?



Where do you want to be invested when faced with the prospect of a bear market? Some say that high dividend yields provide protection when stocks fall. This implies that since the yield rises as the stock price declines, new buyers will be attracted as the price drops. Such buyers could help establish a “floor” below the stock. While this sounds good in theory, we find scant evidence that it actually works in practice.

This strategy fails when needed most because “high yielders” tend to be fundamentally weak. While some high-yielding stocks may be good bargains, most high yields reflect poor quality or poor growth prospects. We believe that owning the most flexible, durable, and predictable high-quality stocks during a downturn tends to be a better option.

HIGH YIELD TENDS TO BE LOW QUALITY

We crunched some data to test the idea that high-yielding stocks tend to be low-quality.

First, we categorized the 1,000 largest U.S. companies into “buckets” based on quality and yield. We assigned grades “A” through “F” for quality based on profitability, consistency, and indebtedness. We tracked the performance of each quality grade bucket. More profitable, more consistent, and lower debt companies earned higher marks, while less profitable, less consistent, higher debt companies earned lower marks.

Next, we ranked the same companies by dividend yield, placing higher yield stocks into a “High Yield” bucket and lower yield stocks into a “Low Yield” bucket. We excluded stocks without dividends and tracked the performance of each category grouped by dividend yield.

Lastly, we compared the composition of the quality buckets by dividend yield category. Chart A on page 3 shows that high-quality companies tend to carry lower yields, and low-quality companies have high yields. Within the “A” Quality bucket, 83% is low yield, and 17% is high yield. The “F” Quality bucket is made up overwhelmingly of “High Yield” stocks (79%) and only 21% “Low Yield.” Thus, the more companies a portfolio holds with high yields, the more likely it is that the portfolio also has a lower-quality (aka. “higher risk”) tilt.

As you are about to see, this low-quality tilt can increase risk in a market selloff.

WHEN GOING GETS TOUGH, GO WITH HIGH QUALITY

Pivoting away from high yield, which can lead to low quality and risk, is the first step in addressing the “high-yield is safe” error. With a focus now on fundamentals, we see that the nature of a business and how it is financed means far more than yield, especially during tough times. During the past three market crises, high quality has held up far better than both the market and low quality (Chart B, page 3).

LET’S WALK THROUGH EACH

The Technology Wreck (2000-2002)

This episode brought pain to the NASDAQ and the overall market. Before the slide, low-quality “F” stocks yielded 2.7%, versus 1.7% for high-quality “A” stocks. Yet, the higher-yielding low-quality “F” stocks fell by 43% from May 2001 through October 2002. By contrast, the lower-yielding “A” quality stocks fell by just 26%.

The Global Financial Crisis (2007-2009)

The Global Financial Crisis took the market down sharply again. When the market was down about 56% from July 2007 through March 2009, the lower quality higher-yielding “F” Quality stocks were down 70%. Over the same period, the “A” Quality stocks fell an average of 45%, resulting in a 25% outperformance versus “F” Quality. The fact that low-quality stocks’ average yield rose to 6.1% by 2008 was little recompense for the damage done.

The COVID-19 Pandemic (2020)

When the pandemic began in 2020, the market was again tested. Stock market averages fell more sharply than almost any other time in history. In days, the market (Russell 1000 Index) was down 39%, while “F” Quality stocks fell an average of 49%. Over the same period, “A” Quality stocks dropped an average of 32%, outperforming the overall market and lower-quality, higher-yielding stocks.

CHART A | HIGH DIVIDEND YIELD TENDS TO BE LOW QUALITY

Source: WCA, Bloomberg

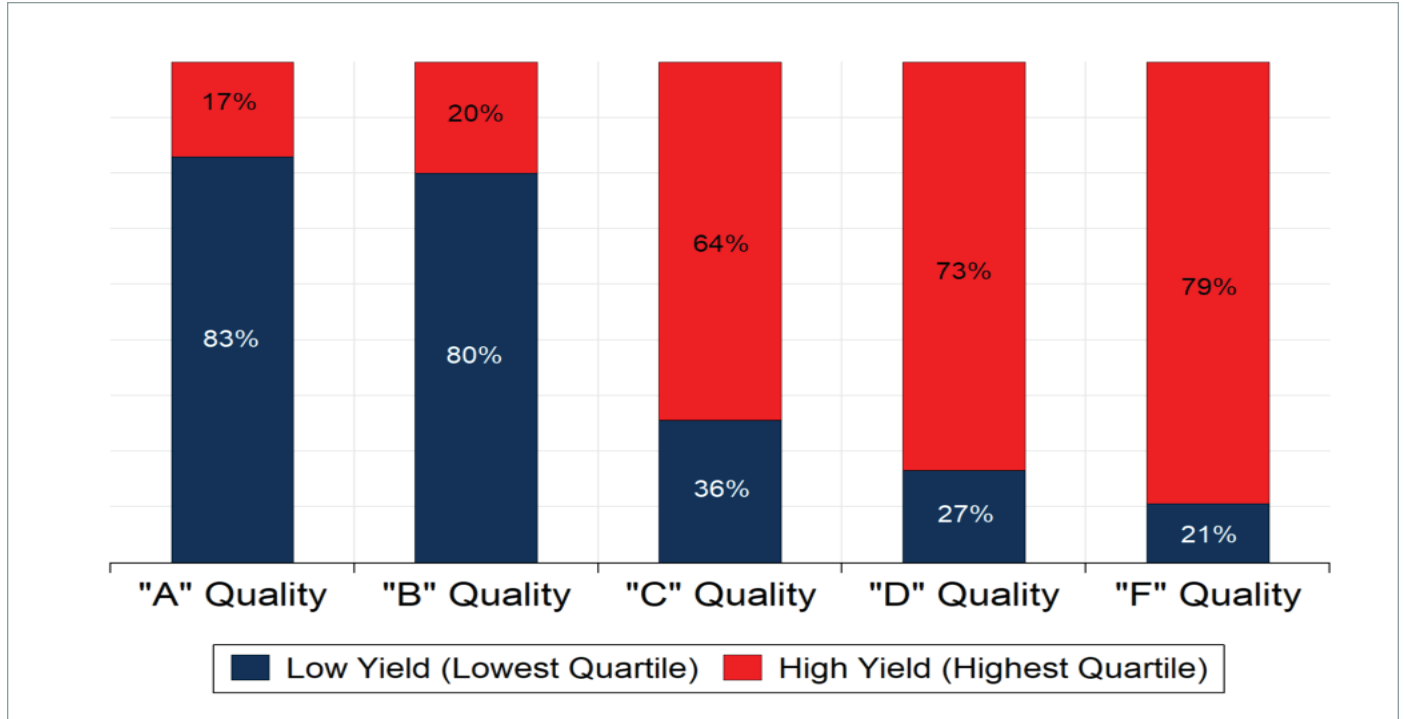
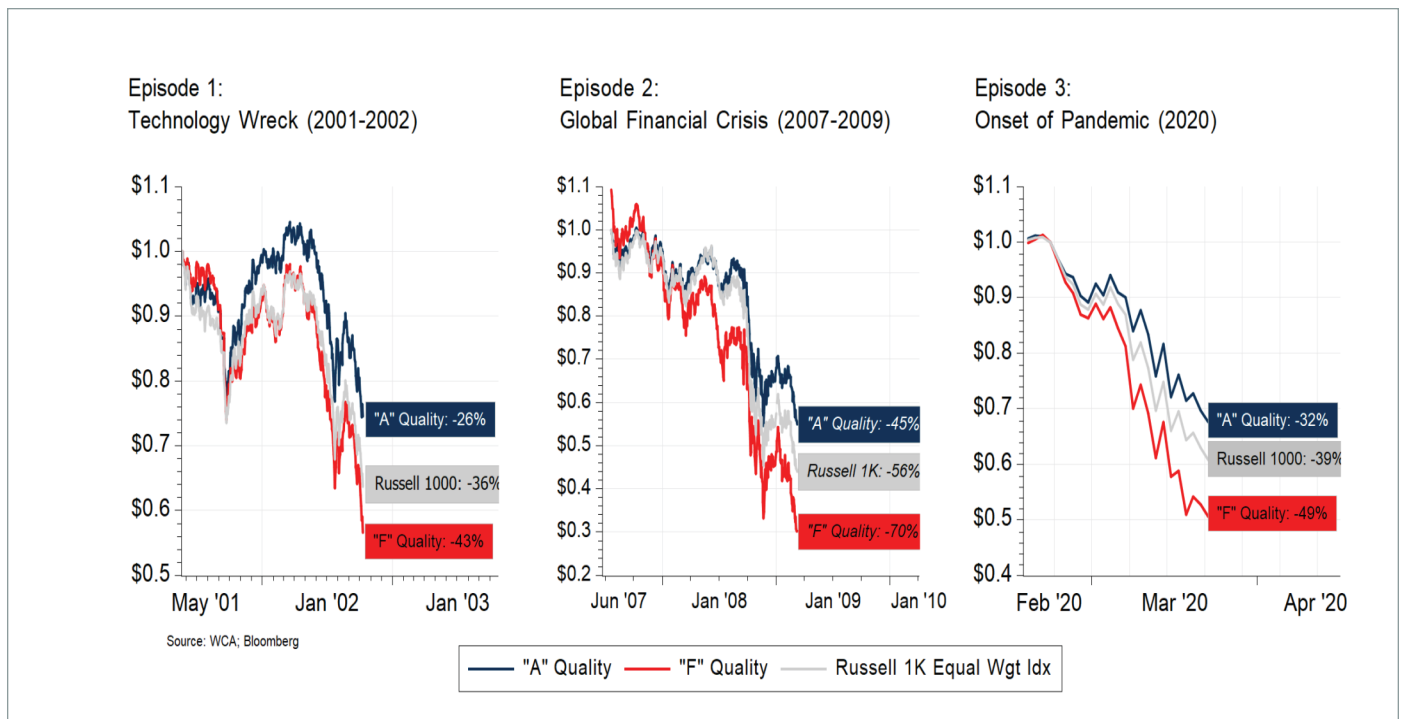



CHART B | WHEN GOING GETS TOUGH, GO WITH HIGH QUALITY

Source: WCA, Bloomberg



CONCLUSION



As you can see, while a high dividend yield may occasionally point to value, it usually means low-quality fundamentals and more risk. Thus, we caution against over-emphasizing high dividend yield and focusing instead on quality.

Given the years of run-up from the Global Financial Crisis through today, now may be the right time to emphasize high quality for its better defensive characteristics.

Important Disclosures

WCA Barometer: We regularly assess changes in fundamental conditions to help guide near-term asset allocation decisions. Analysis incorporates approximately 30 forward-looking indicators in categories ranging from Credit and Capital Markets to U.S. Economic Conditions and Foreign Conditions. From each category of data, we create three diffusion-style sub-indices that measure the trends in the underlying data. Sustained improvement that is spread across a wide variety of observations will produce index readings above 50 (potentially favoring stocks), while readings below 50 would indicate potential deterioration (potentially favoring bonds). The WCA Fundamental Conditions Index combines the three underlying categories into a single summary measure. This measure can be thought of as a “barometer” for changes in fundamental conditions.

Standard & Poor’s 500 Index (S&P 500) is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market.

The S&P 500 Equal Weight Index is the equal-weight version of the widely regarded Standard & Poor’s 500 Index, which is generally considered representative of the U.S. large capitalization market. The index has the same constituents as the capitalization-weighted S&P 500, but each company in the index is allocated a fixed weight of 0.20% at each quarterly rebalancing.

The Washington Crossing Advisors’ High Quality Index and Low Quality Index are objective, quantitative measures designed to identify quality in the top 1,000 U.S. companies. Ranked by fundamental factors, WCA grades companies from “A” (top quintile) to “F” (bottom quintile). Factors include debt relative to equity, asset profitability, and consistency in performance. Companies with lower debt, higher profitability, and greater consistency earn higher grades. These indices are reconstituted annually and rebalanced daily. For informational purposes only, and WCA Quality Grade indices do not reflect the performance of any WCA investment strategy.

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