

Equity as a Bond Substitute

June 2015

It is quite understandable, in the world of low interest rates, that income-dependent investors would be open to bond alternatives as a means of generating income. One such popular alternative is income-producing common stocks as, for instance, those held in the iShares Core High Dividend ETF (HDV). This fund has \$4.7 billion in assets under management, a very reasonable 12-basis-point fee, and a trailing 12-month yield of 3.4%¹.

In early June, the 10-year Treasury bond was yielding 2.19%; hence, it is not difficult to see the allure. HDV has produced more than a 13% compound annual rate of return in the three years ended 03/31/2015, and an 8.6% rate of return in the last year. In contrast, in the three years ended March 31, 2015, the iShares 7-10 Year Treasury Bond ETF (IEF) produced an annual rate of return of about 3.5% (though the 1-year return of 8.8% is comparable to that of HDV).

How much does this return data really inform you? Are these statistics sufficient, in the absence of any qualitative information, to suggest that the future returns will reprise those of the past? It is important to consider the HDV holdings. There are 74, many of which are important positions in the S&P 500, as is evident in Table 1. Consequently, the performance of this fund has relevance to the performance of the S&P 500 Index.

Since the index is not very different from the S&P 500, the concept of income stocks as a bond substitute is not very different from the concept that stocks can be used interchangeably with bonds. In this framework, ExxonMobil, often the largest position in HDV, is a bond substitute. By contrast, using this logic, British Petroleum (BP), which is a European company belonging in the asset class of European equities, is not a bond substitute. In fact, British Petroleum, despite a dividend yield twice that of ExxonMobil, is not even a member of the iShares International Select Dividend ETF (IDV).

HDV is considered a relatively low-risk investment. This is simply because its equity beta is 0.80, that is, its share price has varied about 80% as much as the stock market during some measurement period. The dividend yield is 3.4% and its trailing 12-month P/E ratio is 17.87x, according to iShares. Consider, however, that 24.5% of the fund is invested in the energy sector, and that the price of oil declined by approximately 25% in the six months ended May 31, 2015—it is no surprise that the energy companies reported lower earnings in the first quarter of 2015, which lower earnings may well persist for the remainder of 2015. Consequently, HDV is at least potentially composed of fairly high-P/E stocks, depending on what happens to the price of oil. In any case, the ultimate P/E may well be substantially more than the current measure of 17.87x trailing earnings, unless the energy companies are somehow able to revert to their 2014 profit levels despite far lower oil prices. The energy companies, in aggregate, reported earnings above analyst estimates, but below earnings last year.

Of course, the most important question pertaining to index-trackers such as HDV relates to the risk relative to that of owning bonds. The index that HDV tracks, after all, was created as a bond substitute even though a stock, unlike a bond, has no maturity date and is, in fact, a long-duration asset.

An investor who thinks of the iShares Core High Dividend Index as a long-term bond might consider several factors. The iShares 20-Plus Year Treasury ETF (TLT) has produced a total return in the last 36 months of

¹ <http://www.ishares.com/us/products/239563/ishares-high-dividend-etf>, as of June 10, 2015

slightly more than 8% on a compound annual basis. By contrast, HDV has produced a return roughly 1.6 times that amount. That performance might tempt one to assert that the companies comprising HDV have been growing their businesses significantly during those 36 months, with this growth accounting for the substantial rate of return. However, the revenue growth for the year ended December 31, 2014 was a modest 2.7%. If oil prices don't increase substantially, we know what's going to happen in 2015. The three-year rate of revenue growth of the 50 companies is, cumulatively, 9.7%, on average, or 2.1% annualized.

Table 1: Revenue Growth for iShares Core High Dividend ETF (HDV) constituents

		Year-over-Year	3-year cumulative			Year-over-Year	3-year cumulative		
1	XOM	Exxon Mobil Corp.	-6.35%	-15.61%	41	AEE	Ameren Corp.	3.68%	-1.55%
2	T	AT&T Inc.	2.87%	4.52%	42	WEC	Wisconsin Energy Corp.	2.78%	5.92%
3	GE	General Electric	1.74%	1.40%	43	COH	Coach Inc.	-9.77%	0.28%
4	VZ	Verizon Communications Inc.	5.42%	14.61%	44	MXIM	Maxim Integrated Products Inc.	-0.96%	-2.66%
5	CVX	Chevron Corp.	-7.38%	-16.45%	45	CA	CA Inc.	-3.31%	-9.07%
6	PFE	Pfizer Inc.	-3.84%	-18.73%	46	SCG	Scana Corp.	10.14%	12.29%
7	PG	Procter & Gamble	-2.50%	-3.90%	47	RSG	Republic Services Inc.	4.41%	7.26%
8	PM	Philip Morris International Inc.	0.10%	4.92%	48	POM	PEPCO Holdings Inc.	4.54%	-1.73%
9	MO	Altria Group Inc.	0.23%	3.03%	49	MCHP	Microchip Technology Inc.	12.27%	47.24%
10	COP	ConocoPhillips	-4.69%	-15.97%	50	HAS	HASBRO Inc.	4.78%	-0.21%
11	MCD	McDonalds Corp.	-2.37%	1.61%	51	CINF	Cincinnati Financial Corp.	9.14%	30.03%
12	KMI	Kinder Morgan Inc.	15.32%	104.28%	52	PNW	Pinnacle West Corp.	1.07%	7.71%
13	LLY	Eli Lilly	-15.13%	-19.23%	53	LNT	Alliant Energy Corp.	2.23%	4.00%
14	OXY	Occidental Petroleum Corp.	-4.25%	-3.44%	54	LEG	Leggett & Platt Inc.	8.77%	14.50%
15	DUK	Duke Energy Corp.	5.14%	92.76%	55	ORI	Old Republic International Corp.	-0.67%	16.08%
16	SO	Southern	8.08%	4.59%	56	OGE	OGE Energy Corp.	-14.47%	-37.36%
17	KRFT	Kraft Foods Group Inc.	-0.07%	-2.00%	57	WR	Westar Energy Corp.	9.70%	19.81%
18	LMT	Lockheed Martin Corp.	0.53%	-1.93%	58	WDR	Waddell & Reed Financial Corp.	16.64%	42.30%
19	D	Dominion Resources Inc.	-5.21%	-9.65%	59	STR	Questar Corp.	-2.54%	-0.42%
20	EMR	Emerson Electric	-0.83%	2.19%	60	FMER	FirstMerit Corp.	8.62%	54.65%
21	NEE	Nextera Energy Inc	12.45%	10.95%	61	VR	Validus Holdings Ltd.	-3.29%	9.33%
22	KMB	Kimberly Clark Corp.	0.83%	2.37%	62	PNY	Piedmont Natural Gas Co.	14.95%	2.44%
23	CTL	CenturyLink Inc.	-0.35%	17.46%	63	FII	Federated Investors Inc.	-2.16%	-4.02%
24	BAX	Baxter International Inc.	11.39%	22.24%	64	CBRL	Cracker Barrel Old Country Store	4.26%	12.50%
25	GIS	General Mills Inc.	-2.49%	12.01%	65	TRMK	TrustMark Corp.	2.85%	13.56%
26	AEP	American Electric Power Inc.	10.83%	12.60%	66	SJI	South Jersey Industries Inc.	21.34%	7.00%
27	SE	Spectra Energy Corp.	6.98%	10.32%	67	NWN	Northwest Natural Gas Co.	-0.66%	-8.94%
28	PPL	PPL Corp.	-1.89%	-8.59%	68	GHL	Greenhill & Co.	-4.18%	-6.46%
29	RAI	Reynolds American Inc.	2.85%	-0.82%	69	FI	Frank S International NV	6.96%	60.36%
30	NOV	National Oilwell Varco Inc.	11.54%	59.11%	70	EE	El Paso Electric Co.	3.15%	0.00%
31	IP	International Paper	0.57%	21.34%	71	IPHS	Innophus Holdings Inc.	-0.59%	3.58%
32	WM	Waste Management Inc.	0.09%	4.62%	72	CCOI	Cogent Communications Holdings Inc.	9.20%	24.59%
33	XEL	Xcel Energy Inc.	7.06%	9.68%	73	AVX	AVX Corp.	-4.34%	-13.31%
34	MAT	Mattel Inc.	-7.11%	-3.86%	74	OB	OneBeacon Insurance Group Ltd.	1.85%	16.91%
35	NYCB	New York Community Bancorp Inc.	-2.31%	-5.00%			<i>Average</i>	2.69%	9.72%
36	NUE	Nucor Corp.	10.78%	5.40%			<i>Annualized</i>		2.13%
37	K	Kellogg	-1.45%	10.49%					
38	PAYX	Paychex Inc.	9.33%	41.84%					
39	DTE	DTE Energy	27.33%	38.87%					
40	CLX	Clorox	-0.66%	4.93%					

Source: iShares, Company reports, Bloomberg. As of December 2014 (or closest month for companies with a different reporting cycle)

There seems to be little doubt that HDV, essentially, is populated with mature firms that dominate their industries yet collectively have little prospect of expanding their businesses much beyond the rate of inflation. Of course, these businesses are subject to cyclical forces, such as changes in the price of oil. They are also potentially subject to permanently disruptive forces, such as the growing impact of solar energy on electric utilities.

In summary, then, viewed as a bond substitute, the companies that comprise HDV are subject to various business risks. Furthermore, the ETF as a whole is subject to the valuation risk that inures to any perpetuity when interest rates rise, as eventually will be the case. As a bond substitute, HDV is, in effect, a super-convexity index. Its historical volatility characteristics—upon which investors have in large measure based their investment decisions—do not yet include periods of rising interest rates. (Indeed, there was no such index in the 1970s.) HDV’s standard labeling statistics—the equity beta of 0.80 and its standard deviation of 9.1%—upon which buyers rely, do not reflect the risk characteristics of the index.

Moreover, since the firms held in HDV account for a substantial portion of the S&P 500, it follows that the potential volatility characteristics of even that index are poorly understood. The basic idea of asset allocation is that there are three basic asset classes—bonds, equities, and cash-equivalents—that have different levels of risk and return, meaning that they should behave differently over time. The creation of equity bond substitutes, and the manner in which these are valued of late, runs contrary to the historical practice.

Indexation is said to be based on modern portfolio theory. But the providers of these products don’t follow modern portfolio theory. They simply say that they do.

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