New normal, new opportunities

RBC Wealth Management

The importance of resilient companies in portfolio construction

This report is part of the "New normal, new opportunities" series, in which we examine secular trends in a post-COVID-19 world. The series will cover a range of themes that are emerging as a result of social distancing, the work-from-home imperative, health care developments, corporate implications, and broader societal change. We believe identifying these trends and understanding their investment implications will be critical to navigating the road ahead. Additional reports will be released over the following weeks.

The global pandemic has challenged management teams in unprecedented ways. The sudden, forced retrenchment of economic activity has impacted companies differently—the ones that were resilient to these unexpected changes have seen their stocks outperform those of companies that were less able to successfully react to these changes. This discussion will study the characteristics of resilient companies and examine the importance of selecting these types of companies for investment portfolios.

Corporate resilience is a characteristic that enables a business to tolerate, overcome, and be strengthened by adverse events and experiences. This aspect of a company can be expressed across multiple facets: operational resilience, financial resilience, and even resilience of employees can play a part in ensuring corporations thrive during periods of adversity.

The global management consultancy firm McKinsey & Co. analyzed the top ten percent of companies to emerge from the global financial crisis in 2009 to find common threads that contributed to their resilience during the last recession.

The clearest marker of resilience was profitability. McKinsey found that as the economy started to contract, almost all companies suffered declining revenues to similar degrees. But as the economy bottomed out, the cash earnings of "resilient" companies were already up by ten percent from their low point, while the earnings of their industry peers continued to shrink.

What were the factors behind this divergence? In general terms, resilient companies made efforts to clean up their balance sheets and ensure cash flow flexibility *before* the recession arrived. This doesn't mean these companies' management teams were particularly good at anticipating recessions. Rather, it means they were cautious as the economy slowed. They divested noncore assets early, while they could still get a good price for them.

They also implemented far-sighted operational changes, such as variable pricing contracts, diverse and flexible supply chains, and dynamic resource reallocation. This focus on flexibility and balance sheet strength paid dividends after the recession too, as it gave them more firepower to acquire growth assets as the economy took off again.

Many of the more resilient companies were also proactively investing in digital platforms at a time when this was a relatively radical approach to operations management and customer engagement.

Supply chains

The supply chain flexibility factor of resilient companies was particularly important in the run-up to the COVID-19 pandemic. The proactive management teams of resilient companies had already moved to diversify supply chains as trade war rhetoric heated up in the years before the recession. The pandemic underlined the vulnerability other companies faced as several links in the global supply chains broke at the same time.

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Identifying resilient companies in investment portfolios

The easiest way to ensure we invest in resilient companies may be to avoid the companies that clearly aren't resilient. Using the metric of balance sheet strength is likely a good place to start, specifically by studying dividend payments.

According to the fund firm Janus Henderson, global dividend payments fell by 22 percent to $382 billion in Q2 2020 as the recession forced companies to address their dividends to preserve their balance sheets. Most sectors were impacted, although Energy and Consumer Discretionary companies were the hardest hit.

We believe the stocks of those companies that were forced to cut dividends to preserve cash may be laggards until the economy regains its original growth trend. And we note that the stocks that offer relatively high dividend yields may need some time to regain investors' trust.

If we look at the year-to-date stock performance of companies grouped by their dividend yields, we note that those with the lowest yields have performed the best this year. This is partly due to the success of technology companies as work-from-home practices took hold, because these growth companies typically pay low or no dividends. But we also believe that significantly higher dividend yields tend to indicate higher-than-average risks to cash flows.

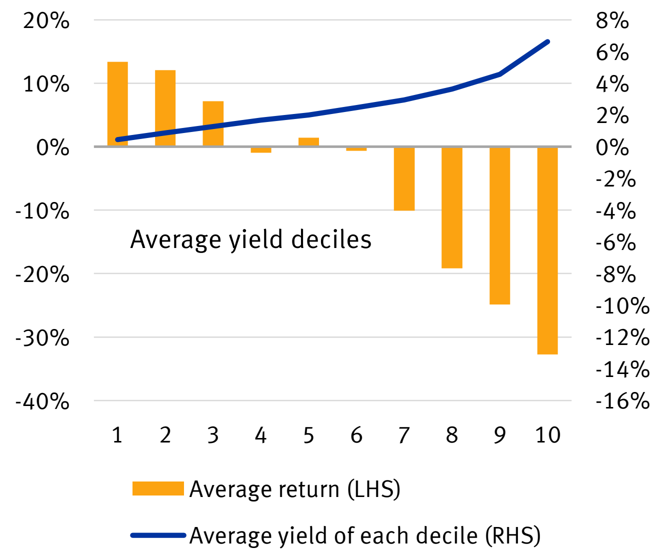
We grouped all the S&P 500 stocks that pay dividends into ten deciles based on their current yield (see top chart). The lowest-yielding decile performed the best, on average, so far this year. And the performance of the remaining deciles declined as average yields increased, with the highest-yielding decile (average yield of nearly seven percent) posting significant underperformance. While dividend-paying companies are an important source of income, we should be wary of the signaling provided by excessively high yields.

Last word

For long-term investors, resilient companies should constitute a significant share of portfolios. Less resilient companies can work well too when the economy is firing on all cylinders, but in periods of economic stress or slow growth, the resilient companies tend to shine.

Higher-yielding dividend stocks have performed poorly in 2020

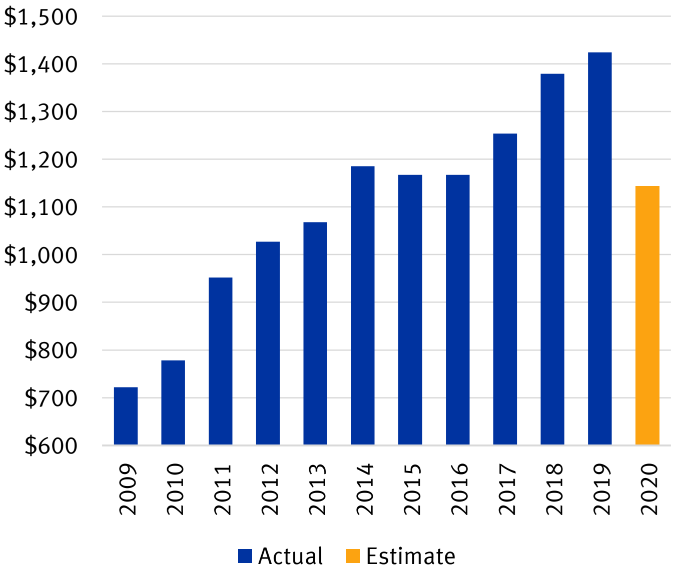
YTD returns of each yield decile of the S&P 500



Source - Refinitiv, RBC Wealth Management; bars indicate price returns from 12/31/19 to 8/26/20

Annual global dividends

Total global dividends (U.S. $ billions)



Source - Janus Henderson, RBC Wealth Management estimate

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As of June 30, 2020

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