Dividend compounding has been a powerful driver of long-term equity total returns. Steady dividend growers have even outpaced markets over time.

We see above-trend inflation magnifying the importance of dividends and dividend growth. However, high but unsustainable dividend yields warrant caution.

We favor a multi-asset income strategy with a dividend growth-focused equity allocation as we pursue sustainable income, capital growth, and drawdown management.

Heightened inflation and market volatility have increased the challenges for investors seeking a reliable stream of income, whether for retirement or other needs. We see the complex environment calling for a flexible multi-asset investment approach to achieve sustainable income and capital growth, while managing downside risk.

But not all multi-asset income strategies are equal. Under the hood, the compositions of their equity, bond, and other asset class allocations can look distinctly different. We think an equity allocation focused on dividend growth can help in the pursuit of these goals.
Why Dividend Growth?

Dividends, especially reinvested dividends, have been a powerful driver of long-term equity total returns. In fact, the value of dividends to investors tends to increase when markets waver or decline. Since 1970, compounded dividends made up more than 65% of global equity total returns (Figure 1).

Moreover, we think dividend growth sends important signals about corporate health and governance. Broadly speaking, dividends reflect managements’ commitment to safeguard shareholder value. To ensure there is enough cash to pay dividends, managements will likely need to be disciplined in allocating capital and managing debt responsibly. Further, companies that grow their dividends are typically focused not only on returning capital to shareholders, but also investing productively to boost long-term earnings and cash flows.

The combination of returning capital to shareholders and growing earnings is an attractive value proposition for investors — the long-term outperformance of dividend growers versus their markets reflects this. U.S. dividend growers, represented by the S&P 500 Dividend Aristocrats Index, generally outran the S&P 500 Index since 1990 (Figure 2).

Admittedly, dividend growers have encountered hiccups in the past few years. Before resurgent inflation became a global concern, near-zero interest rates had fueled a rally in mega-cap technology stocks, which buoyed broader markets and left dividend growers behind. Investors were willing to reward companies displaying outsized future growth potential with increased valuations, even if they did not generate profits or dividends.

What Has Inflation Changed?

However, a new inflation regime has changed the market narrative. We expect above-trend inflation in the medium term to increase the appeal of dividends and dividend growth.

To be sure, inflation in the U.S. has started to ease recently amid a slower, though positive economic backdrop, and we see risks to cyclical growth in the next six to 12 months. Financial markets began to price in a possible approaching recession in the first quarter of 2023. In the real economy, goods demand slowed as businesses held back investments and consumers moderated COVID-related spending. Meanwhile, tighter monetary conditions hit the banking sector, contributing to stricter lending standards and bank failures. So far, forward-looking economic indicators have signaled an impending slowdown, along with a further drop in inflation in the coming months.

Nonetheless, taking a three to five-year view, we expect inflation to remain elevated relative to the pre-pandemic years, though lower than recent peaks. Market forecasts that see inflation coming close to the U.S. Federal Reserve’s 2% target by late 2024 require a rapid rate of disinflation that looks unrealistic to us. Even continuing the recent pace of decline would be a rare feat, comparable with what happened in the aftermath of steep interest rate hikes that quashed the Great Inflation in the early 1980s.

If the next recession arises from financing and destocking shocks, we think it may be short. This will likely leave the economy supply-constrained in the subsequent recovery and exposed to another inflation squeeze as demand returns. Already, we believe the real economy has sustained a lack of...
investment in the last two decades. For example, global mining and energy companies have only started recently to increase investments in ESG-critical metals.¹ A housing shortage also persists in the U.S.

Data points to the relative strength of dividend and dividend growth stocks when inflation is above trend. In periods when U.S. headline inflation exceeded the historical trend, dividends composed the bulk of global equities’ total return (Figure 3). There were three such occasions since 1970—the 1970s, the 2000s, and the period from April 2021.

In the 1970s, when inflation was above trend over 90% of the time, the MSCI World Index’s net total return was 74%. Of this, approximately 31% came from price gains and 43% came from dividends. This meant that dividends accounted for over half of the total return.

More recently, when inflation was above trend throughout the period from April 2021 to March 2023, the net total return was slightly above 2%. It would have dropped nearly 1% if not for a 3% return from dividends.

In another analysis, dividend growers mostly outshone their markets when inflation exceeded the historical trend (Figure 4). In the 2000s, U.S. dividend growers gained around 88%, whereas the S&P 500 fell 9%, translating to an outperformance of 97%. Between April 2021 and March 2023, U.S. dividend growers also fared better, albeit by a smaller 4%.

What might lie behind the general resilience of dividend stocks when inflation runs hotter than usual? We see market and corporate factors at work. Using a discounted cash flow model, a higher discount rate is typically warranted during periods of elevated inflation. All other things being equal, this will lower the accrued benefit of long-dated cash flows that characterize the valuations of many growth-oriented and non-dividend-paying companies. As a result, the valuations for these companies are likely to be materially lower than during a period of low inflation. By contrast, during periods of higher inflation, the valuations of companies with near-term cash flows, including those that pay dividends,

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¹ ESG: Environmental, social, and governance.
should be penalized less, causing these firms to outperform on a relative basis.

From a corporate perspective, the rates on loans used to finance new purchases are likely to increase in a higher inflation environment. This higher cost of capital can restrict the growth of younger companies that are just starting to build their capabilities. Comparatively, established companies that already have a strong asset base may be able to grow their earnings and increase investment without externally sourced capital. As a result, it will be harder for younger companies to compete against more mature firms. Ultimately, as the cost of capital increases due to inflationary pressures, the larger and more established firms may be in a place to continue to pay and increase dividends as their assets generate incrementally more positive cash flow.

**Beware High Dividend Yields?**

Some income investors may naturally gravitate toward stocks with the highest dividend yields. But we would be cautious about such an approach.

In the U.S., the highest yielding stocks have shown more volatility in periods of market stress, indicated by spikes in their beta (Figure 5). This may partly reflect concerns about dividend cuts or cancellations, especially by companies that prioritized dividend payouts at the expense of vital business investments. We see higher odds of such companies sacrificing their dividends in hard times, which may lead to unexpected share price declines.

By comparison, we prefer durable dividend growers. We think companies that can continue to raise their dividends even amid market challenges tend to be high-quality businesses with compounding earnings and free cash flow, healthy balance sheets,
strong growth prospects, and shareholder-oriented managements.

Importantly, we believe it takes discerning active investors to identify and avoid stocks with high but unviable yields, while leaning into those with the potential to grow their dividends.

How Does Dividend Growth Fit in a Multi-Asset Portfolio?

We think an actively managed multi-asset strategy can help investors seeking an enduring stream of income. Specifically, we designed our Multi-Asset Global Income (MAGI) strategy to pursue the goals of sustainable income, capital growth, and drawdown management.

The strategy’s main building blocks reflect our philosophy. The fixed income allocation of MAGI targets a stable income across a global investment opportunity set. The strategy also has an active overlay program to manage portfolio drawdown risk and implement specific multi-asset views.

“...The equity allocation is focused on both capital growth and modest dividend income through dividend growth names...”

—Richard Coghlan
Portfolio Manager,
Global Multi-Asset Team

The equity allocation is focused on both capital growth and modest dividend income through dividend growth names, given our belief in their potential to drive outperformance against the market across market cycles.

Further, given our assessment of a heightened inflation environment, we believe investors will be challenged to seek a reliable stream of income. Focusing on dividend growers instead of absolute dividend yield should help investors to push through the uncertainty with more attractive risk-adjusted returns potential.
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