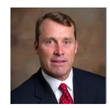
The Appeal of a Dividend Strategy Amid Chaotic Markets

Companies with a record of rising dividends have advantages.

May 2020



Thomas Huber
Portfolio Manager, US Dividend Growth Equity Strategy

KEY INSIGHTS

- Investors with reasonable time horizons should consider taking advantage of opportunities created by recent market volatility despite greater uncertainty.
- With the economy in recession, some cyclical sectors such as industrials and financials offer attractive values and upside potential.
- Although more companies are cutting dividends, a dividend growth strategy remains viable, particularly for income-oriented investors.

Uncertainty and volatility remain high as the new coronavirus has caused massive disruption to economies around the world. Tom Huber, who recently marked his 20th anniversary managing the US Dividend Growth Equity Strategy, discusses the current investment environment, his investment strategy amid a growing number of dividend cuts, and some useful insights he has gained over the past two decades. The strategy is focused on dividend-paying stocks that have the potential to increase dividends over time.

Q. How do you view the current market environment and outlook?

We are experiencing a truly unique market environment, but the significant fiscal and monetary response to the economic upheaval is buying us some room. The underlying carnage is even worse than it looks because the five largest companies account for about a fifth of the S&P 500's market capitalization and have significantly outperformed. The direction of the market in the near term will depend on the progress we make in reopening the United States and other countries at an acceptable pace and without a resurgence in the pandemic. How successful we are in developing treatments for COVID-19, the disease caused by the coronavirus, until a vaccine is discovered will also be crucial.

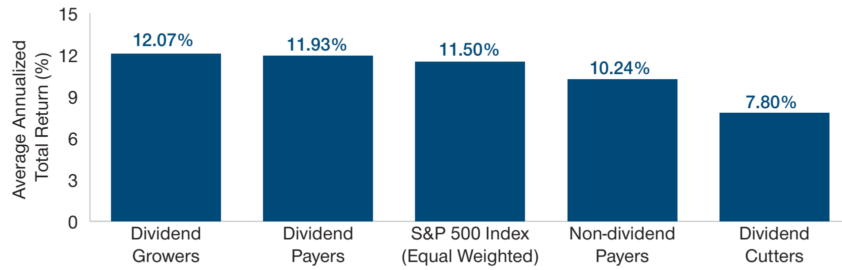
In the meantime, volatility will persist. What's unusual about the sell-off is that companies that would be expected to offer some defensiveness just haven't. Ross Stores, for example, has typically done well in recessions but now their entire fleet of stores is closed. However, periods of severe market volatility and dislocation have historically shown to be good times to invest in high-quality companies—and we don't believe this time is different.

Q. How do you assess earnings prospects and valuations now?

You really have to look at earnings on a case-by-case and industry-by-industry basis. For industries that have been in

Dividend Growers Have Outperformed

(Fig. 1) S&P 500 Index: returns and volatility



	Dividend Growers	Dividend Payers	S&P 500 Index (Equal Weighted)	Non-dividend Payers	Dividend Cutters
Average Annualized Standard Deviation	*15.88%*	*16.66%*	*17.22%*	*24.17%*	*24.54%*

March 31, 1972, to March 31, 2020.
Past performance is not a reliable indicator of future performance. For illustrative purposes only. It is not possible to invest directly in an index.
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the eye of the storm—such as travel, retail, and airlines—you can't focus on the near term. We are looking out to 2021 and 2022 and making investment decisions based on some reasonable level of potential earnings over that time frame. If you are looking out several years, there is still good value in the market, assuming that this pandemic is eventually behind us. Even looking out a year, we see there are attractive opportunities in some cyclicals, particularly industrials and financials, that have underperformed and should have upside potential.

Q. Companies in the S&P 500 Index and more broadly have been cutting or suspending dividends at the fastest pace since the global financial crisis. Do you expect this trend to continue?

Yes. So far, it's been concentrated in those industries most directly affected by the pandemic, including travel-related sectors, some retailers, and energy, which also had an oil supply shock. While we have had a few companies in the portfolio cut their dividends, we do not expect any impairment in our ability to find attractive stocks.

We were willing to give companies such as a Hilton or Marriott a little more leash since this situation was not of their making; there was no big strategic mistake. We expect many companies that are suspending dividends will reinstate them at some point. On the brighter side, the two biggest dividend-paying sectors are technology, where companies tend to have high cash flow, and financials, which tend to have lower payout ratios and are well capitalized. At this point, we think bank dividends are safe, but that could change if this recession lasts more than two or three quarters. However, regulators could require banks to temporarily suspend dividends to preserve capital, as they have already done with share repurchases.

I think the demand for yield will be stronger on the other side of this pandemic than it was going in. Companies with strong balance sheets and durable business models that can maintain and grow their dividends should be attractive for yield-oriented investors as rates and returns on fixed income securities are likely to remain relatively low. The trend over recent years of companies returning cash to shareholders should continue. A dividend yield of 2% to 3% with dividend growth will be valuable. It's also

> If you are looking out several years, there is still good value in the market, assuming that this pandemic is eventually behind us.

worth remembering that paid dividends are the only portion of stock return that is always positive—earnings growth and share price appreciation certainly are not.

Q. How have you reacted to the market volatility in your investment strategy?

We try to balance our risk-aware approach to stock selection against the need to move quickly and efficiently as attractive opportunities arise. The indiscriminate sell-off in March provided the opportunity to buy high-quality cyclicals with attractive risk/reward characteristics over the intermediate to longer term, especially information technology and industrial companies developing innovative products.

We used periods like this to add some new companies to the portfolio that we have been interested in but where the valuations had not been that attractive. We also look to increase some existing positions at better prices. At the same time, we sold some positions due to concerns about their balance sheets, which are critical when times get tough. So, overall, we were able to upgrade quality at more reasonable valuations.

We have long been overweight health care, our second-largest allocation. Among the defensive sectors of the market, it appears to offer the best combination of fundamentals and valuation. In an election year, there is political risk, particularly for drug companies and managed care. Health care companies are proving their value in the pandemic, however, so the political pressure may ease. We have added to several positions, favoring biotechnology and health care equipment and supplies.

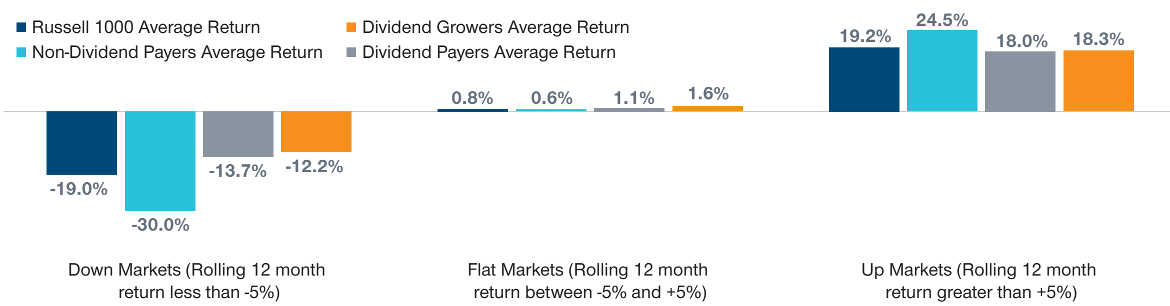
We remain overweight industrials and financials—cyclical sectors that have underperformed through this crisis. Within financials, we like insurance and insurance brokers, which have held up reasonably well. The rate environment has hurt the banks' business models, but valuation is on your side. If we get back on the road to recovery this year, we see there are good opportunities in both these sectors for investors with reasonable time horizons.

Information technology is our largest underweight position but remains one of our top absolute weights. Some companies are poised for strong secular growth. Our holdings are largely focused on IT services and software companies that should benefit from increasing demand for business technology solutions. We also own some quality semiconductor companies.

Our investment approach hasn't changed in 20 years. We try to identify high-quality companies with reasonable valuations,

Performance in Different Market Environments by Dividend Policy

(Fig. 2) Dividend growers have outperformed in down markets



Past performance is not a reliable indicator of future performance.
Based on rolling 12 month returns, measured monthly, from 12/31/85 to 12/31/19.
Sources: Data provided by Compustat (see Additional Disclosures); data analysis by T. Rowe Price. Non Dividend Payers, Dividend Growers and Dividend Payers are subsets of the Russell 1000 Index (see Additional Disclosures).

Dividend growers have historically outperformed the market over the long term with less volatility.

a defendable business model not subject to disruption, and consistent cash flow that enables management to invest in the business and pay a dividend that grows over time. And we have low turnover; we want these investments to compound for us over at least three to five years.

We are confident that our strategy can continue generating superior risk-adjusted returns potential, especially when measured over complete market cycles.

Q. In such a tough operating environment, what's the case for a dividend growth strategy?

Dividend growers have historically outperformed the market over the long term with less volatility. A T. Rowe Price analysis shows that dividend growth stocks in the Russell 1000 Index achieved an annualized total return of 11.3% from the end of 1985 through 2019 compared with 10.8% for dividend payers and 10.5% for the index overall. Also, companies with both a high dividend yield and high dividend growth, on average, significantly outperformed the dividend payers overall in the index over that period.[1]

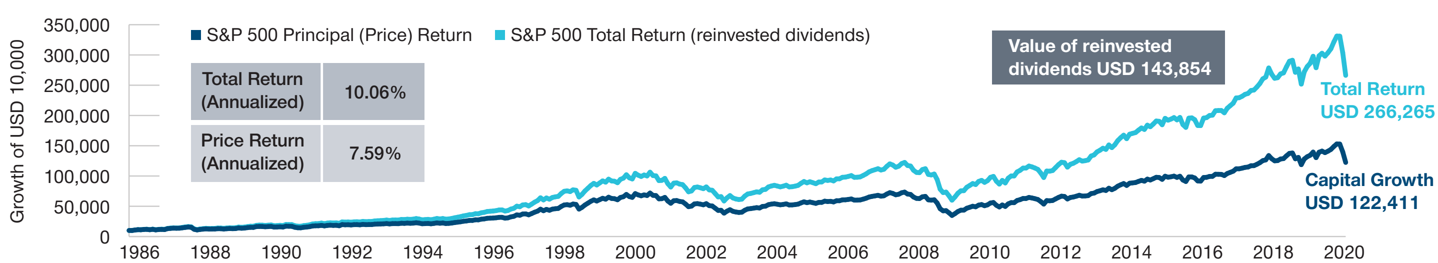
Reinvested dividends accounted for nearly half the S&P 500 Index's total return over the past 30 years. If we go back to an environment of moderate growth and high debt levels around the world, it's reasonable to assume equity returns may be less than the long-term average for some time. In that environment, dividends will be a more important component of the return.

The strategy should work because companies that have a strong record of dividend growth tend to have strong balance sheets and generate consistent cash flow and earnings. They also generally held up better in down markets, although that has not been the case recently. With the entire economy being shut down, yield-oriented sectors such as industrials, consumer discretionary, financials, and energy were hit relatively harder than they might have been in a normal recession.

There is no such thing as a safe equity strategy, but we believe this approach does usually provide some cushion and level of comfort just in terms of the quality of the businesses you own. A dividend-oriented strategy really should be looked at over full market cycles.

Dividends Are Large Portion of Total Returns

(Fig. 3) S&P 500 Index: principal versus total return



Past performance is not a reliable indicator of future performance.
As of March 31, 2020.
Source: Standard & Poor's (see Additional Disclosures). Data analysis by T. Rowe Price.
Since 1986 over 54% of the total return of the S&P 500 Index came from the reinvestment of dividends.

[1] **Past performance is not a reliable indicator of future performance.** For illustrative purposes only. It is not possible to invest directly in an index. Dividend payers and dividend growers are subsets of the Russell 1000 Index (see Additional Disclosures).

Q. What are some of the investment insights you have gained over 20 years managing the U.S. Dividend Growth Equity Strategy?

Our experience shows that successful long-term investing requires disciplined adherence to an investment philosophy and process, as well as the ability to look past short-term market swings to focus on the underlying fundamentals.

When you find a solid business run by a competent management team, let it potentially compound for you over time. Time and time again, you learn the lesson that in periods of crisis, a solid balance sheet can pay a strong dividend in terms of comfort and performance. Stick to your strategy, try not to be emotional about your holdings, and take a long-term view.

WHAT WE'RE WATCHING NEXT

We are closely following the reopening of the U.S. economy and whether that ignites a second wave of the coronavirus outbreak. That is key to ascertaining how markets respond. Also, we'll monitor progress on the development of a coronavirus treatment or vaccine. Success on either front would be a major positive. A rise in tensions between the U.S. and China could destabilize markets, in our view. In the second half of the year, investors will focus more on the U.S. elections. A Democratic sweep could heighten concerns about potential increases in regulation and taxes.

Key Risks—The following risks are materially relevant to the strategy highlighted in this material:

Equity General Portfolio Risk

General Portfolio Risks

Capital risk - the value of your investment will vary and is not guaranteed. It will be affected by changes in the exchange rate between the base currency of the portfolio and the currency in which you subscribed, if different.

Equity risk—in general, equities involve higher risks than bonds or money market instruments.

Geographic concentration risk—to the extent that a portfolio invests a large portion of its assets in a particular geographic area, its performance will be more strongly affected by events within that area.

Hedging risk—a portfolio's attempts to reduce or eliminate certain risks through hedging may not work as intended.

Investment portfolio risk—investing in portfolios involves certain risks an investor would not face if investing in markets directly.

Management risk—the investment manager or its designees may at times find their obligations to a portfolio to be in conflict with their obligations to other investment portfolios they manage (although in such cases, all portfolios will be dealt with equitably).

Operational risk—operational failures could lead to disruptions of portfolio operations or financial losses.

The specific securities identified and described do not represent all of the securities purchased, sold, or recommended for the portfolio, and no assumptions should be made that the securities identified and discussed were or will be profitable.

Additional Disclosures

Figure 1 shows the historical total returns of S&P 500 component stocks based on their dividend policies. Each stock's dividend policy is determined by its indicated annual dividend. Ned Davis Research classifies a stock as a dividend-paying stock if the company indicates that it is going to be paying a dividend within the year. This is determined programmatically using indicated annual dividend data. A stock is classified as a non-payer if the stock's indicated annual dividend is zero. Prior to July 2000, the indicated annual dividends were updated on a quarterly basis. Since July 2000, the indicated annual dividends are updated on a daily basis, so the most up-to-date information is used.

The index returns are calculated using monthly equal-weighted geometric averages of the total returns of all dividend-paying (or non-paying) stocks. A stock's return is only included during the period if it is a component of the S&P 500 index. The dividend figure used to categorize the stock is the company's indicated annual dividend, which may be different from the actual dividends paid in a particular month.

Each dividend-paying stock is further classified based on changes to their dividend policy over the previous 12 months. Dividend Growers and Initiators include stocks that increased their dividend anytime in the last 12 months. Once an increase occurs, it remains classified as a grower for 12 months or until another change in dividend policy. Dividend Cutters and Eliminators are companies that have lowered or eliminated their dividend anytime in the last 12 months. Once a decrease occurs, it remains classified as a cutter for 12 months or until another change in dividend policy.

The indices are equal-weighted geometric indices based on monthly total returns, with the constituents of each index reconstituted monthly. **This chart thus offers historical perspective on how stock returns and company dividend policy have been related over time. The chart is for perspective purposes only.**

At the start of every month, T. Rowe Price categorizes the Russell 1000 index into various categories depending on dividend policy. We then calculate that month's market-cap weighted returns for each category. We accumulate the returns during the full periods and calculate the annualized total returns for each category. Dividend growers consist of companies whose dividend growth over the prior 12 months was greater than zero. Dividend payers consist of companies whose current dividend yield is greater than zero. Non-dividend payers consist of companies whose current dividend yield equals zero.

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ID0003303 (05/2020)
202005-1187642