Why Dividend Growth Investing Has Staying Power

Owning quality dividend growers can put compounding on your side.

February 2021

KEY INSIGHTS

- The unusual underperformance of dividend growth stocks during the market sell-off last year was due to entire industries going offline and is unlikely to repeat.
- Low interest rates and easier earnings comparisons could act as tailwinds for dividend growth stocks, although periods of volatility are likely to persist.
- We are finding potential compounders in utilities and financials, areas where we believe the market does not appreciate companies' long-term growth prospects.

Thomas Huber
Portfolio Manager, U.S. Dividend Growth Equity Strategy

Last year was indeed different. Stocks with track records of consistent dividend growth underperformed the broader U.S. equity market in 2020, somewhat uncharacteristically providing less downside mitigation during the sharp sell-off that occurred in the first quarter and then lagging during the subsequent recovery rally.

However, we do not regard this breakdown—the product of a highly atypical economic downturn stemming from the coronavirus pandemic—as a structural shift that would require us to rethink our investment strategy of buying and holding stocks that we believe can compound in value over the long haul by steadily growing their cash flow and dividends.

What's more, the setup for the high-quality dividend growers strikes us as more favorable this year, thanks to low interest rates and the potential for last year's excesses to unwind. An improving economy and possible inflationary pressures could also act as tailwinds. At the same time, delays to the rollout of vaccination programs and the emergence of more contagious coronavirus strains could lead to additional market volatility. We believe that the defensive qualities that dividend growers traditionally have offered may have a better chance of asserting themselves this time around.

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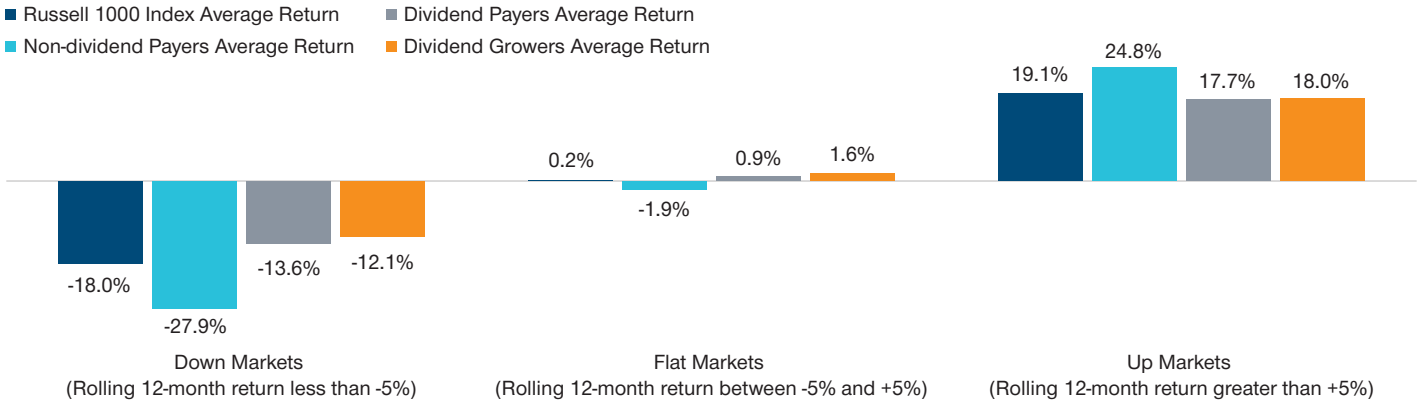
Confident in the Long Term

A T. Rowe Price analysis shows that dividend growth stocks in the Russell 1000 Index outperformed the index by an average of 5.88 percentage points during down markets over the 35 years ended December 31, 2020. This resilience contributed meaningfully to dividend growers' strong historical performance. Over this 35-year period, the dividend growth stocks in the Russell 1000

Dividend Growers Have Outperformed in Down Markets

(Fig. 1) Performance in various market environments by dividend policy[1]



As of December 31, 2020.

Past performance is not a reliable indicator of future performance.

[1] Based on rolling 12-month returns, measured monthly, from December 31, 1985, to December 31, 2020. 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.

Sources: Data provided by Compustat (see Additional Disclosure); data analysis by T. Rowe Price.

posted an annualized return of 11.4%—compared with 10.9% for the broader Russell 1000.

The nature of last year's downturn, which stemmed from the almost complete shutdown of some industries to curb the spread of the coronavirus, explains the break in this pattern relative to past economic slowdowns. These massive economic disruptions translated into severe market dislocations, as investors first herded into business models that stood to benefit from pandemic-driven behavioral changes and then into higher-beta cyclicals that were perceived as offering significant leverage to improvements in the economy. In this momentum-driven environment, dividend growers found themselves among the excluded middle.

Dividend growth investing is not broken. Amid the upheaval of last year, the portfolio's holdings still managed to increase their investment-weighted median payouts by a healthy annual rate.

We believe that the relative rewards of this potential resilience are best measured over full market cycles, especially if these high-quality companies can steadily grow their cash flows and dividends over time.

Cause for Cautious Optimism

We see the potential for dividend growers to enjoy a more supportive market environment in 2021, thanks to low interest rates and the potential for some of last year's excesses in U.S. equities to unwind.

Much of the market's returns in 2020 came from multiple expansion, elevating the bar of expectations for many of the high-flying stocks that investors piled into seemingly without regard to valuation. Against this backdrop, the relatively easier year-over-year earnings comparisons for dividend growers and other names that lagged during last year's runup could appeal to investors on a relative basis.

> ...our portfolio historically has exhibited a negligible negative correlation to rising interest rates...

If fundamentals return to the fore and the broader market generates only moderate returns, equities offering an implied dividend yield of 2% to 3%[1] and the prospect of consistent dividend growth—a potential sweet spot for our strategy—could find themselves in favor. The possible persistence of low interest rates could also make these potential compounders a compelling alternative to the yields offered by fixed income securities.

What should we make of concerns that fiscal stimulus and progress in vaccinating the population against the coronavirus could spur inflationary pressures and higher interest rates? These developments might present challenges for some equities where an above-average yield typically has accounted for the bulk of their total returns. However, our portfolio historically has exhibited a negligible negative correlation to rising interest rates, in part because the stocks in which we invest have tended to grow their cash flows and dividends over time. We run our portfolio as a high dividend *growth* strategy, as opposed to one that focuses on stocks sporting high dividend yields.

We believe our bottom-up approach to buying and holding quality dividend growers has resulted in a diversified portfolio, parts of which could benefit from rising interest rates and an acceleration in economic growth. That said, we make our bottom-up investment decisions based on our ongoing assessment of an individual company's potential to compound value over time by generating more cash flow to support a growing payout. We tend not to buy cyclical stocks purely for exposure to a near-term economic recovery. Instead, we favor business models that we believe can grow through the economic cycle and strive to avoid those whose profit pools could be threatened by disruption.

This commitment to quality business models explains the portfolio's limited exposure to energy—a sector where disruption has continued to lower the cost of producing oil and natural gas—and our reluctance to invest in airlines, cruise lines, and other business models where we believe eliminated dividends are less likely to return anytime soon. And when we took advantage of weakness to establish or add to positions in the consumer discretionary, industrials and business services, and financials sectors last year, these moves were made with a multiyear view regarding each holding's earnings outlook and potential tenure in the portfolio.

Opportunities in Potential Long-Term Compounders

Although some segments of the market have run up sharply, we are finding opportunities in utilities, a traditionally defensive sector that has lagged during the risk-on recovery. Not only do we appreciate high-quality utilities for their potentially resilient cash flows and appealing dividend yields, but we also value their opportunities to grow their rate bases in the coming years through capital investments related to the clean-energy transition and efforts to reduce downtime by hardening critical infrastructure against disasters. We find this combination of current dividend yield and potential growth to be a compelling proposition.

The financials sector is another area where we are finding potential compounders that trade at reasonable valuations. Although the banks that we favor would benefit from an expected increase in lending activity as the economy recovers and improved net interest margins if interest rates increase, we tend to focus on company-specific drivers and characteristics that we believe can help to position a financial institution for an extended period of sustained growth.

[1] **Dividends are not guaranteed and are subject to change.**

We are cautiously optimistic about the near-term outlook for U.S. equities while acknowledging that earnings are likely to be the main upside drive after a period of multiple expansion. At the same time, we recognize that elevated valuations and the potential for headline risk related to the rollout of coronavirus vaccines and the spread of resistant strains could lead to bouts of market volatility.

Given the stress that the severe economic downturn put our portfolio holdings through last year, we generally feel comfortable with the durability of their underlying businesses and potential to compound value over the long term. As always, we would tend to view any broad-based market dislocations as an opportunity to build our positions in high-quality dividend growers.

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