A Growing Dividend Can Add Up

Don't overlook the long-term appeal of a rising dividend.

August 2023

Thomas Huber
Portfolio Manager, US Dividend Growth Equity Strategy

KEY INSIGHTS

- The stock market's strong returns and the competitive yields offered by bonds made dividends an afterthought in the first half of the year.
- Dividend growers have outperformed in down and flat markets. They also captured a good portion of the upside in all but the hottest markets.
- Sticking with a dividend growth strategy over a longer period may help to compound returns.

The dividends that some companies pay to shareholders were an afterthought in the first half of 2023. Seven popular growth stocks accounted for more than 70% of the S&P 500 Index's performance. Dividend payers in the S&P 500 gained about 12%, while non-dividend payers rallied 37%.[1]

Meanwhile, higher interest rates meant that money market funds and U.S. Treasuries offered their most competitive yields in more than a decade. Uncertainty about the economic outlook appeared to make the prospect of getting paid to wait in these traditional safe harbors even more appealing to those inclined to remain on the sidelines.

But an emphasis on high dividend growth can still help investors to tap the power of compounding returns, especially over longer time horizons. And relative weakness in high-quality dividend growers so far this year may create opportunities.

More Than Just Income: A Virtuous Circle of Growth

Dividend growth investing focuses on companies that have the potential to increase the cash payments that they make to shareholders. The prospect of a rising stream of dividends can offer benefits that may be hard to come by in other investment strategies, even if some asset classes offer the prospect of higher yields:

> "...relative weakness in high-quality dividend growers so far this year may create opportunities."

[1] **Dividends are not guaranteed and are subject to change. Past performance is not a reliable indicator of future performance.** 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. Source: financial data and analytics provider FactSet. Data analysis by T. Rowe Price. Copyright 2023 FactSet. All Rights Reserved. See Additional Disclosure.

- Strong dividend growth can improve returns and may help to blunt the bite of inflation by providing a rising income stream. Think of it like an annual raise.

- Dividend growers also offer the potential for price appreciation. That's because stocks tend to track increases in a company's earnings and dividends over time.

- Reinvesting rising dividends can accelerate the compounding of returns.

Bottom Line: Dividend growers may not always offer the most compelling yields. But dividend growth investing is more about tomorrow than today. Over time, buying and holding a stock with a rising dividend can translate into a higher yield *on cost*. Steady dividend increases also tend to drive share price appreciation.

A Combination of Defense and Offense

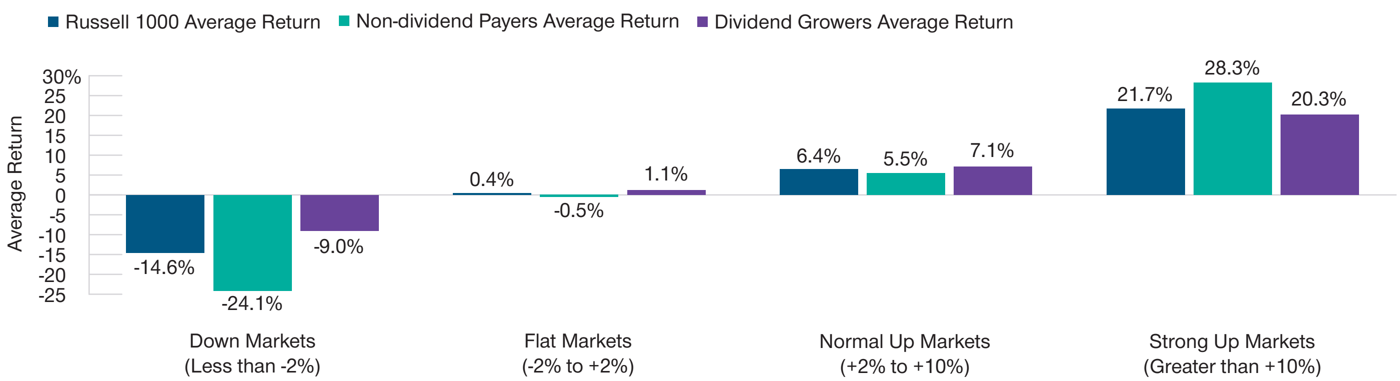
Large-cap dividend growers historically have given up less ground in down markets and outperformed when the market was flat. They've also captured a good chunk of upside in better times. However, this group has lagged non-dividend payers by a wider margin in stronger up markets (Figure 1).

These solid returns in a variety of market environments have added up. From the end of 1985 to the end of 2022, the dividend growers in the Russell 1000 Index outperformed this broader benchmark. They also exhibited less volatility.[2]

Some of this historical resilience reflects the value of dividends in difficult markets. Dividends paid to shareholders are the only portion of a stock's return that is always positive, so they can act as a bit of a shock absorber when the market is flat or down.

Dividend Growers Have Outperformed in All But the Strongest Up Markets

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



December 31, 1985, to December 31, 2022.

Past performance is not a reliable indicator of future performance.

Sources: Compustat and FTSE/Russell. (See Additional Disclosure.) Analysis by T. Rowe Price.

*The market environments reflect the Russell 1000 Index's rolling 12-month returns, measured monthly. 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. Non-dividend payers consist of companies whose current dividend yield equals zero.

[2] **Past performance is not a reliable indicator of future performance.**
The dividend growers in the Russell 1000 Index generated an annualized total return of 11.14% and posted an annualized standard deviation of 14.45%. The Russell 1000 Index generated a lower return of 10.31% and posted a higher standard deviation of 16.00%.
Sources: Compustat and FTSE/Russell. (See Additional Disclosure.) Analysis by T. Rowe Price.

42.5%

What reinvested dividends contributed to the S&P 500 Index's total return over the three decades ended last year.[3]

And the discipline involved in paying a dividend—especially one that grows regularly—means that these companies have characteristics that can be appealing in bad and good markets:

- To pay a dividend regularly, a company must generate extra cash beyond what it needs to run and maintain the business. For this reason, dividend payers tend to be established operations that generate significant recurring revenue and ample amounts of this free cash flow.
- Management teams at companies that have grown their dividend consistently are usually focused on returning capital to shareholders and aim to invest in ways that can boost long-term earnings.

Still, no dividend payment is guaranteed. Investors need to be vigilant and understand that a company's circumstances and strategic priorities can change over time, causing a formerly growing dividend to stagnate or, even worse, shrink.

The Power of Dividend Reinvestment

Sticking with a dividend growth strategy over a longer time horizon, instead of trying to time the market, creates an opportunity to compound returns.

Dividends accounted for a significant portion of the S&P 500 Index's total returns over the past three decades, with the reinvestment of these payments accounting for a little more than 42% of its gains.[3]

The effects could be even more compelling for a portfolio of high-quality companies growing their dividends at an above-market rate. Here's why: The more often a rising dividend is reinvested, the greater the potential effect on longer-term returns.

An experienced portfolio manager, supported by all the resources of a large investment firm, can add value by pursuing the special companies that have the potential to grow their dividends consistently and strongly over an extended period.

Taking the Long View

Dividend growers may lag during market rallies when investor sentiment and a stock's momentum seem to take precedence over fundamentals, such as valuation and business quality. But the benefits of focusing on the long term and staying the course with a dividend growth strategy can add up, one payout increase at a time.

That's why an approach focused on dividend growers, with their history of resilience in volatile markets and solid upside participation in all but the most speculative markets, can play an important role in a risk-managed portfolio.

[3] **Past performance is not a reliable indicator of future performance. Not representative of an actual investment and does not reflect transaction fees and other costs that may be associated with an actual investment.**
December 31, 1992, to December 31, 2022.
Index performance is for illustrative purposes only and is not indicative of any specific investment. Investors cannot invest directly in an index.
Source: Standard & Poor's. (See Additional Disclosure.) Analysis by T. Rowe Price.

WHAT WE'RE WATCHING NEXT

We are always on the lookout for any near-term dislocations, broad-based or company-specific, that could create a compelling opportunity in dividend growers that meet our criteria for business quality, earnings sustainability, and free cash flow generation.

Shares of managed care companies that provide health insurance, pharmacy benefits, and health care services came under pressure after their strong performance last year. We believe that our favorites can manage through near-term cost pressures from higher-than-expected demand for medical procedures. They should be well positioned for the long term as they use their scale and innovation to reduce health care costs and improve patients' outcomes.

Risks: All investments are subject to risks, including possible loss of principal. Dividend-paying stocks may lag shares of smaller, faster-growing companies. Also, stocks that appear temporarily out of favor may remain out of favor for a long time.

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.

Environmental, social, and governance (ESG) and sustainability risk—These risks result in a material negative impact on the value of an investment and performance of the portfolio.

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.

INVEST WITH CONFIDENCE℠

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

T. Rowe Price®

ID0006236 (08/2023)
202308-3069519