

Why dividend growth investing has staying power

From the Field



Key Insights

- A top-heavy U.S. equity market and the drift toward a narrower approach to growth investing may not reflect the widening range of long-term outcomes.
- History underscores the value that diversification can add when extremely crowded markets eventually disperse.
- Dividend growers have posted solid returns in bad and good markets, potentially providing useful ballast while compounding long-term value.
- A strategy focused on dividend growers can allow for more balanced exposure to a greater variety of growth stories, even in a highly concentrated market.



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Popular U.S. large-cap core and growth indexes have become more top heavy and skewed toward high-growth stocks. So have the passive strategies that track these benchmarks and the actively managed ones that aim to beat them.

This rising concentration has been a boon for U.S. equities over the past decade. Strong business fundamentals for the giants of the digital age and the companies supplying the artificial intelligence (AI) boom have driven robust market returns.

But can an investment portfolio contain too much of a good thing?

Risks have increased in a narrowly focused market

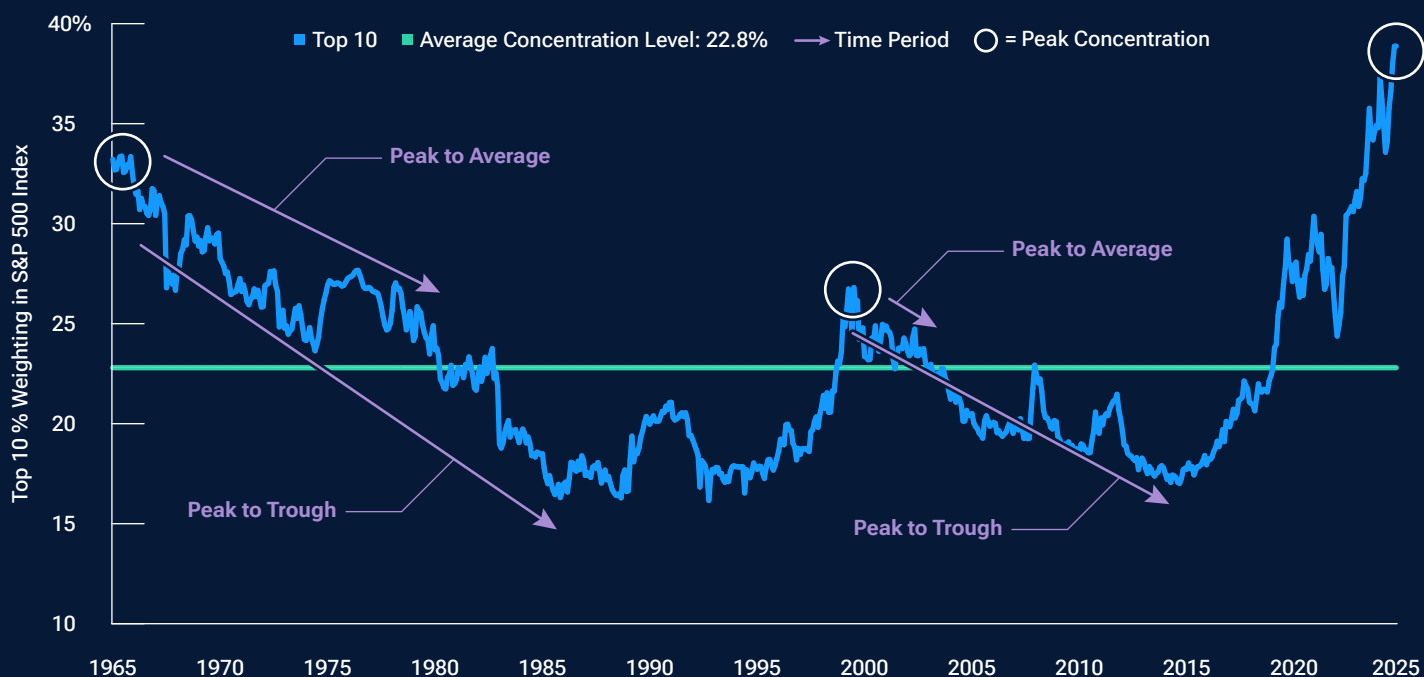
The 10 largest companies represented more than 38% of the S&P 500 Index at the end of the third quarter—an unprecedented level. We don't know when this overexposure will shift from a tailwind to a headwind. However, history underscores the value that diversification can add when extremely crowded markets eventually disperse (Figures 1A and 1B).

A top-heavy U.S. equity market and the drift toward an increasingly narrow approach to growth investing may not reflect the widening range of long-term outcomes that typify major innovation waves, such as the rise of AI.

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Higher market concentration heightens risks

(Fig. 1A) The S&P 500 Index has reached unprecedented concentration levels



Index heavyweights have lagged when market concentration has unwound

(Fig. 1B) Cumulative total returns for the top 10 and the rest of the S&P 500 Index after past concentration peaks

	Top 10	Rest of S&P 500		Top 10	Rest of S&P 500
Peak-to-Trough Concentration			Peak-to-Trough Concentration		
Dec. 1965–Mar. 1986	284%	601%	Jun. 2000–Aug. 2015	-11%	122%
Peak-to-Avg. Concentration			Peak-to-Avg. Concentration		
Dec. 1965–Mar. 1981	107%	190%	Jun. 2000–Feb. 2004	-38%	-8%

December 31, 1965, to September 30, 2025.

Past performance is not a guarantee or a reliable indicator of future results.

Source: T. Rowe Price calculations using data from FactSet Research Systems Inc. All rights reserved.

The 10 largest weightings in the S&P 500 Index and the rest of the index are reconstituted monthly. Total returns are capitalization weighted.

Mega-cap risk: Competition after a decade of dominance

The mega-cap technology companies that have an outsized influence on the U.S. stock market's fortunes appear well positioned to benefit from the AI revolution. These behemoths boast massive user bases, troves of valuable data, computing power, and abundant financial resources.

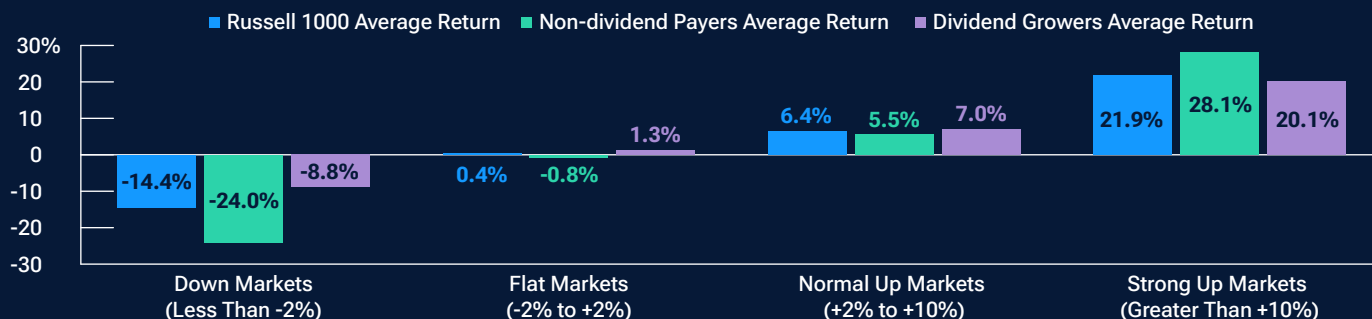
However, AI competition could create real challenges for some of the mega-caps' core business models, from online search and advertising to enterprise software and cloud computing. Worries about this risk—and the pursuit of potentially compelling growth opportunities—are fueling massive spending on AI infrastructure and capabilities.

The urgency and magnitude of these AI-related investments could pressure some of the mega-caps' free cash flow (FCF) and profitability in the near term, particularly if sufficient returns on investment take time to materialize.

How the AI revolution will play out is uncertain. But for the first time in a long time, the heavyweights at the top of the index are showing signs of potential vulnerability.

Dividend growers have delivered solid performance in bad and good markets

(Fig. 2) Historical returns by dividend policy¹



December 31, 1985, to December 31, 2024.

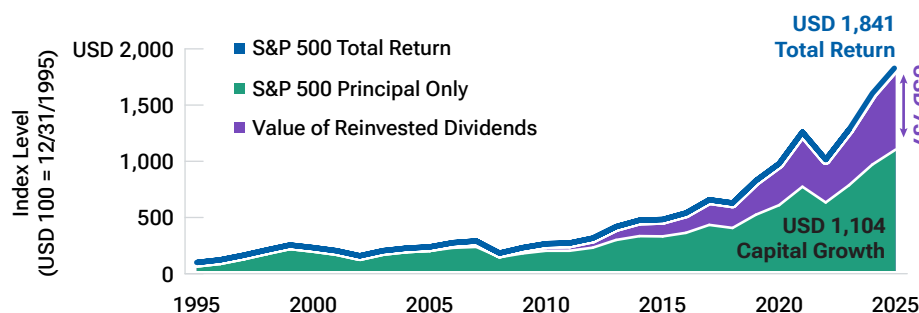
Past performance is not a guarantee or a reliable indicator of future results.

Sources: Compustat and FTSE/Russell. Analysis by T. Rowe Price.

¹ The market environments reflect the Russell 1000 Index's rolling 12-month returns, measured monthly. At the start of every month, T. Rowe Price sorts 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.

The power of dividend reinvestment

(Fig. 3) Reinvested dividends have boosted long-run returns



December 31, 1995, to September 30, 2025.

Past performance is no guarantee or a reliable indicator of future results.

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. Analysis by T. Rowe Price.

AI beneficiaries could broaden over time

Many early AI winners have been the companies providing critical components to the infrastructure boom that has emerged as a key growth engine for the otherwise lackluster U.S. economy.¹ As value creation gradually shifts from AI enablers to AI adopters, the market leadership baton could change hands.

AI's broad applicability also suggests that, over a longer time frame, the

potential productivity and earnings benefits from this technology could accrue to a broader range of industries than during the buildout phase. In a data-intensive industry like insurance, for example, game-changing productivity benefits could reinforce the competitive advantages of scaled players that are leading the way on AI adoption.

Bottom line: A market environment where the biggest winners keep winning by such a large margin isn't necessarily a given over the long run.

Smart diversification: Defense and offense with dividend growth

How can investors position a U.S. equity portfolio for a wider range of outcomes without diluting their growth exposure and giving up too much potential upside participation?

Consider the diversification benefits of a strategy that applies a different lens to growth investing.

Dividend growers² can offer a combination of defense and offense that may be hard to come by in other strategies.

- **Resilient performance:** Dividend growers historically have posted solid relative returns in most environments, holding up better in difficult markets and capturing a good portion of the upside in better times (Figure 2).
- **Compounding value:** Reinvested dividends accounted for more than 40% of the S&P 500 Index's gains over the past three decades (Figure 3). The effects could be even more compelling for a portfolio of high-quality companies that can grow their dividends at an above-market rate.

¹ See Tim Murray's T. Rowe Price white paper, "Have U.S. Stocks Become Too Expensive?"

² Dividends are not guaranteed and are subject to change.

This past resilience reflects the value of dividends in tough markets. Dividends paid to shareholders are the only portion of a stock's return that is always positive, providing a bit of shock absorption when the market is flat or down.

The discipline involved in paying a regularly scheduled dividend—especially one that has risen steadily over time—means that these companies have characteristics that are appealing in any market environment.

- **Free cash flow:** To support a dividend, a company must generate extra cash beyond what it needs to maintain and grow the business. Dividend payers tend to generate significant recurring revenue and ample FCF.
- **Capital allocation:** Management teams at companies that have grown their dividend consistently tend to be focused on returning capital to shareholders and aim to invest in ways that can boost long-term earnings.

These qualities and historical return profile suggest that a dividend growth strategy could be easier to hold through the market's ups and downs. Timing may also be less of a concern versus other investment approaches.

A balanced approach to growth investing in a narrow market

Playing a different game can also allow for more balanced exposure to a greater variety of growth stories, even in a highly concentrated market. Focusing on stronger-for-longer dividend growth usually leads to quality companies that have the potential to increase their top and bottom lines consistently and exhibit less earnings variability across the economic cycle.

Such an approach, in other words, favors companies that can provide what resembles a regular paycheck which increases over time. Of course, no dividend payment is guaranteed. Selectivity and a deep understanding of individual companies are critical to identifying potential durable growers.

An investment strategy seeking consistent dividend growth also tends to limit exposure to lottery ticket-like stocks associated with popular themes. These companies haven't necessarily generated earnings but do generate a lot of speculation about their future growth prospects. Gains in these sentiment-driven stocks can reverse quickly if the narrative shifts.

But a dividend growth strategy does not mean forgoing secular growth stories, even if many of the companies at the top of the market don't prioritize more than a token payout.

A disciplined focus on dividend growers can lead to differentiated exposure to promising themes, which can be attractive at a time when so much of the market is piling into so many of the same popular stocks.

- **Digital ubiquity:** The digitalization of everything looks set to continue, with benefits likely to accrue to established cloud providers and the companies that supply the equipment and components used to make the chips that process all this data. Increasing adoption of digital payments is another structural trend creating opportunities for dividend growth investors.
- **Building AI:** Potential dividend growers range from companies involved in custom AI chips and high-speed networking to those that help to ensure that power-hungry data centers receive

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...a dividend growth strategy does not mean forgoing secular growth stories....

enough electricity. Scaled-up companies that specialize in electrical connectors also stand to benefit as AI requires interlinking increasing numbers of high-performance chips.

- **Health care innovation:** The sector is an attractive hunting ground, thanks to attractive valuations and the potential for underappreciated earnings and dividend growth. Scientific advances are accelerating drug discovery.³ Along with a flood of low-cost biosimilars as branded biologic drugs come off patent, this innovation wave creates a compelling tailwind for high-quality life science tools companies involved in producing and distributing these medicines.

Playing the long game

Dividend growers may lag during market rallies when investor sentiment and a stock's momentum take precedence over fundamentals, such as valuation and business quality.

Sticking with a dividend growth strategy can provide useful diversification while creating an opportunity to compound returns over the long term.

³ See John Hall's T. Rowe Price white paper, "Drugging the Undruggable: How Biotech Innovation is Creating Opportunity for Investors."

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