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Three ways growing dividends can add value for investors

From the Field

Key Insights

- The U.S. stock market's strong returns made dividends an afterthought in 2023 and 2024.
- Historically, dividend growers have outperformed in down and flat markets. They also have captured a good portion of the upside in hot markets.
- Sticking with a dividend growth strategy over a longer period may help to compound returns.

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Dividends were an afterthought in each of the past two years. A handful of popular stocks drove strong returns for the S&P 500 Index, reflecting the market's enthusiasm for companies offering exposure to artificial intelligence (AI). Stocks with high valuations and high betas, in particular, thrived last year.

But an emphasis on high dividend growth[1] can still help investors tap the power of compounding returns, especially over longer time horizons. And relative weakness in high-quality dividend growers may create opportunities.

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1. Beyond 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 potential for higher yields.

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

- 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.

2. 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 portion of upside in better times. However, as in 2023 and 2024, 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 2024, 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.

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.

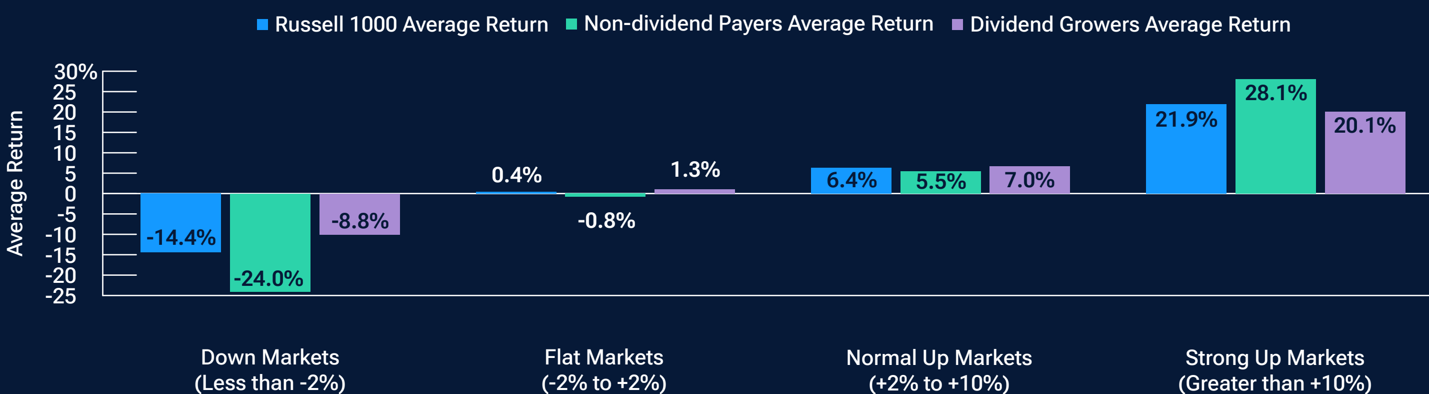
- **Free cash flow (FCF):** To pay a dividend regularly, a company must generate extra cash beyond what it needs to run and maintain the business. For this reason, dividend payers tend to be established operations that generate significant recurring revenue and ample amounts of this FCF.

- **Capital allocation:** 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.

[2] **Past performance is no guarantee or a reliable indicator of future results.**
The dividend growers in the Russell 1000 Index generated an annualized total return of 11.41% and posted an annualized standard deviation of 14.35%. The Russell 1000 Index generated a lower return of 11.07% and posted a higher standard deviation of 15.87%.
Sources: Compustat and FTSE/Russell. (See Additional Disclosure.) Analysis by T. Rowe Price.

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, 2024.
Past performance is no guarantee or a reliable indicator of future results.
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 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.

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.

3. 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 46.1% 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.

The value of a steady hand

Rules-based approaches to dividend growth investing can offer exposure to the power of long-term compounding.

But the stock market is rarely orderly and predictable.

Even thoughtfully designed guardrails for dividend growth investing may constrain or conflict with good decision-making.

Strict rules on a stock's dividend yield, increases, or payment history may limit a strategy's ability to invest in the earlier chapters of a company's growth story.

They can also result in forced sales when a company cuts its dividend—often a time when the share price is under significant pressure.

Actively managed strategies may be able to add value here. Given the flexibility and resources, an experienced portfolio manager can focus on seeking compelling setups in companies that have the potential to grow their dividends stronger for longer.

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.

Seeking dividend growth

Quality amid controversy

Sectors that have lagged, such as health care, could be fruitful hunting grounds for dividend growth. A deep understanding of individual companies and industry dynamics is critical amid accelerating innovation and potential shifts in government policy.

Plugging in

Power-hungry AI infrastructure, along with electrification and the push to onshore critical industries, could be a boon to dividend-paying utilities and parts of the natural gas supply chain. Not all companies will benefit equally, so selectivity is key.

46.1%

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

[3] **Past performance is no guarantee or a reliable indicator of future results. 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, 1994, to December 31, 2024.
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.

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