



Dividend Growers Look Appealing as Market Headwinds Increase

Selectivity and diligence are keys to long-term compounding.

December 2021

KEY INSIGHTS

- Relatively attractive valuations and the appeal of dividend growth during periods of inflation and moderate equity market returns could be tailwinds.
- We seek high-quality names that we believe have the potential to compound returns over a full market cycle by growing their cash flow and dividend consistently.
- Our low-turnover style relies on rigorous due diligence that goes beyond the numbers to assess the potential sustainability of each holding's dividend growth.

Elevated equity valuations, persistent inflation, continued headwinds to containing the coronavirus pandemic, and the prospect of central banks adjusting their policies after a period of extraordinary support—macro-level controversies abound and have dominated the headlines.

These uncertainties create a challenging (and noisy) near-term environment for investors that could burnish the relative appeal of companies with a track record of consistent dividend growth. Our fund's value proposition is longer term in nature, as we strive to buy and hold names that we believe can compound value over an extended period by steadily increasing their cash flows and payouts to shareholders.

Rigorous due diligence is the bedrock of our low-turnover approach. We continually test our assumptions and

evaluate our existing and prospective holdings to ascertain whether we think their underlying business fundamentals can sustain a solid level of cash flow and dividend growth over the long haul.¹

A Near-Term Case for Dividend Growers

The setup for the broader U.S. equity market strikes us as increasingly challenging.

The forward price-to-earnings ratio for the S&P 500 Index appears elevated on a historical basis (Figure 1) and the Federal Reserve plans to start winding down its monthly asset purchases, suggesting that further upside in stock prices is likely to depend more heavily on earnings growth—as opposed to expansion in valuation multiples.

Meanwhile, net profit margins for the companies within the S&P 500 Index

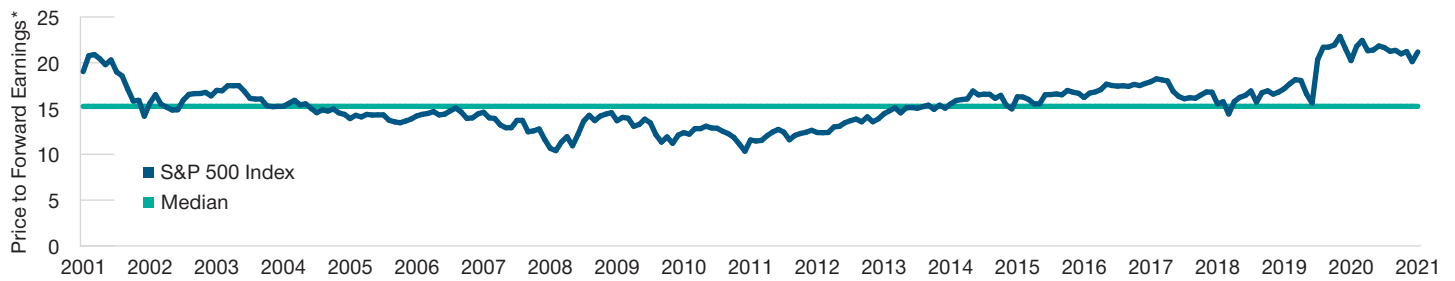


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¹ Dividends are not guaranteed and are subject to change.

U.S. Equity Market Valuations Look Elevated on Historical Basis

(Fig. 1) S&P 500 Index price to forward earnings*



Twenty years ended October 31, 2021.

* Next 12 months

Source: T. Rowe Price analysis using data and analytics provided by FactSet Research Systems, Inc. All Rights Reserved. See Additional Disclosures. Actual outcomes may differ materially from estimates.

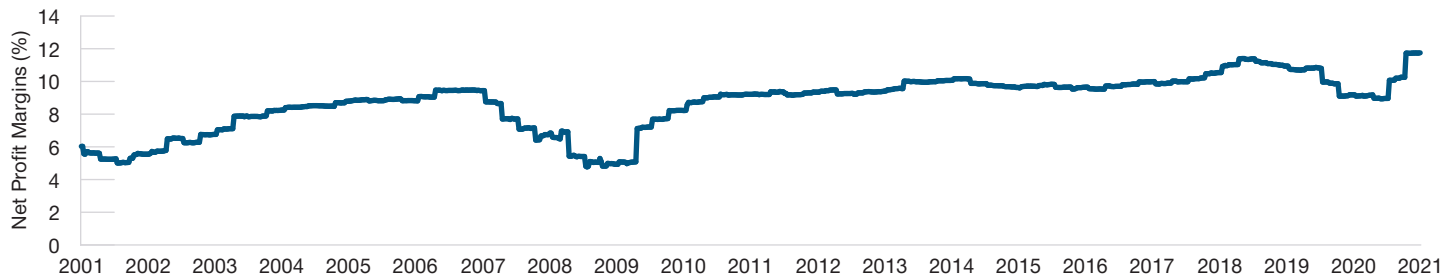
have surged beyond their 20-year high (Figure 2), lifted in part by the strength of the economic recovery and the cost-cutting measures that corporations have implemented during the pandemic. Sustaining such a high level of profitability and clearing the high bar of earnings expectations embedded in prevailing valuations could be a difficult proposition, even more so if recent inflationary pressures persist.

Dividend-oriented stocks are not necessarily insulated from the challenges the broader market faces.

However, in our view, valuations for the established, free cash flow²-generating names that we gravitate toward generally appear less demanding on a relative basis—especially when compared with many of the high-flying stocks that investors bid up during a period of extraordinarily accommodative policies from the Fed and other central banks. Some speculation likely stemmed in part from the low risk-free rate of return³, as measured by U.S. Treasury yields, which can encourage investors to pay higher near-term valuation multiples for expected earnings that are further and further out

Corporate Profitability Above Historical Peaks

(Fig. 2) S&P 500 Index company net profit margins (trailing 12 months)



Twenty years ended October 31, 2021.

Source: Financial data and analytics provider FactSet. Copyright 2021 FactSet. All Rights Reserved. See Additional Disclosures.

² Cash that is left over after the expenditures needed to run and maintain a company's existing business.

³ Risk-free rate of return is a theoretical return of an investment with zero risk and the measure is used as a rate against which other returns are measured. Treasuries are backed by the full faith and credit of the U.S. government, but no investment involves zero risk.

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into the future. As the Fed begins to wind down its stimulative policies, the potential for the market to refocus on business fundamentals could favor high-quality companies that are viewed as assets that are more likely to deliver shareholder returns in the near term because they have generated meaningful cash flows, have a record of paying healthy dividends historically, and exhibit the potential for steady growth.

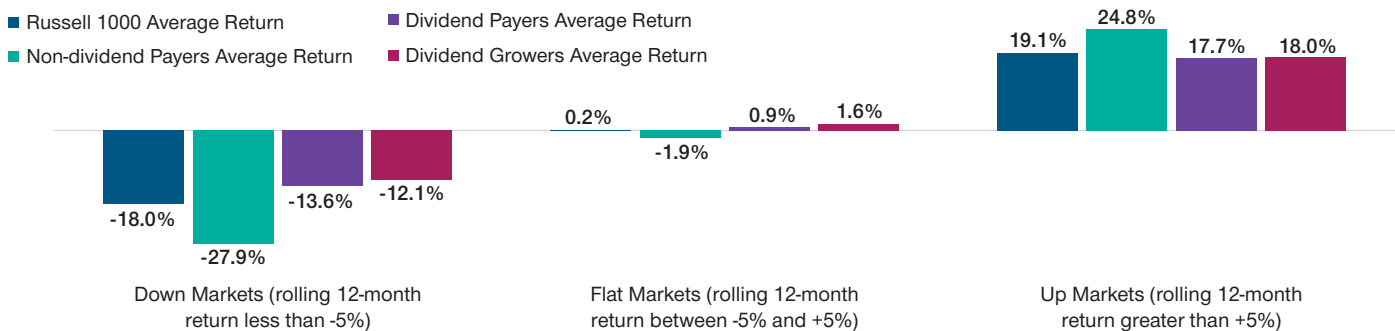
A lower-return environment for equities could also boost the relative appeal of stocks that offer the prospect of a market-like dividend yield and the potential for an extended run of above-average dividend growth. Past is not always prologue, as demonstrated by the atypical market action that occurred during and after the unprecedented pandemic-driven contraction. But we believe historical market data offer some evidence of dividend growers' relative resilience in difficult markets. An analysis conducted by T. Rowe Price shows that dividend growth stocks in the large-capitalization Russell 1000 Index outperformed the benchmark during down and flat markets over the 35 years ended December 31, 2020 (Figure 3).

And unlike securities that are expected to generate the bulk of their total return from an above-average yield, companies that have the potential to grow their cash flows and dividends through the cycle may be able to offset at least some of the erosive effects that inflation and higher interest rates can have on the value of future cash flows. We run our fund as a high dividend *growth* strategy, as opposed to one that focuses on stocks sporting high dividend yields.

How are we viewing the business risks that may accompany rising interest rates? Consider our bottom-up investment decisions in materials and industrials and business services, sectors that usually exhibit higher levels of sensitivity to economic conditions and rising input costs. Here, we focus on high-quality names that we believe should experience less volatility in cash flows and profit margins and have the potential to grow through the cycle. Possible near-term cost headwinds aside, we feel good about the pricing power and longer-run growth prospects of our specialty chemical, industrial gas, and railroad holdings.

Dividend Growers Have Outperformed in Down and Flat Markets

(Fig. 3) Performance in various market environments by dividend policy¹



As of December 31, 2020.

Past performance is not a reliable indicator of future performance.

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

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.

“...our mandate does not preclude us from investing behind some of the well-known tailwinds that have provided fundamental and narrative support for high-growth stocks.

Focused on the Long Haul

By design, our patient approach takes a long view as we seek to tap the power of compounding. We work closely with our global team of research analysts to build a deep understanding of each company in which we invest, assess the potential durability of its growth prospects, and analyze how competitive dynamics in its industry might evolve.

The search for potential dividend growers typically leads us to companies that have generated meaningful free cash. But free cash flow can be a blessing or a curse, depending on how intelligently a company's management team chooses to allocate this capital. Bad acquisitions or other strategic missteps can be costly from both a financial and a reputational perspective, even for resilient business models that might be able to absorb some unforced errors.

For this reason, we spend a great deal of time delving into management's motivations and decision-making to gauge whether we believe they have the potential to be good stewards of capital and create value for shareholders. We also evaluate each company's systems and culture, which can play an important role in the consistency and repeatability of the internal factors driving cash flow generation. These intangibles, in our experience, can provide useful insights into the potential sustainability of a company's growth story.

An acceleration in the innovation-driven disruption of many legacy business models over the past decade has made the market quick to discount any potential secular risk that might be on the horizon. Even if a company's earnings and cash flow appear to be stable and its dividend is still increasing, fears of future disruption can compress a stock's valuation multiple to the point that it can be a significant performance headwind. Accordingly, differentiating between cyclical and secular risk is critical.

To aid our risk management efforts, we spend a good deal of time working with our analysts who cover the technology-driven disruptors seeking to siphon off cash flows from established businesses. We may not be able to invest in the dominant U.S. online media and e-commerce platforms that do not pay a dividend; however, understanding their business models and strategies continues to inform how we invest in traditional retail, media, and telecommunication companies. In the consumer discretionary sector, for instance, we focus on retailers, such as Home Depot, that we believe have defensible business models and appealing growth potential, thanks to a strong online presence for ordering and/or differentiated in-store shopping experiences.

At the same time, our mandate does not preclude us from investing behind some of the well-known tailwinds that have provided fundamental and narrative support for high-growth stocks. We seek potential dividend growers whose business models could offer the durable growth and reasonable valuations that we prize while also standing to benefit, in our view, from powerful secular trends. Key transformations where we are finding opportunities include the wave of innovation-fueled capital investment taking place in drug development as well as accelerating adoption of cloud computing, digital payments, clean energy, and electric vehicles.

We believe that longtime holding Microsoft, for instance, offers exposure to accelerating adoption of cloud-based software and services by enterprise—a powerful secular trend that appears to have significant room to run. We do not own the stock because of inertia or its large enterprise value and prominent weighting in the S&P 500 Index; rather, we appreciate the potential durability of the technology giant's growth story, management's commitment to returning capital to shareholders, and a valuation that does not seem overly expensive relative to its multiyear business prospects.

We also see opportunity in utilities, a traditional dividend-paying sector where we believe that the market does not fully appreciate the potential cash flow growth from investments in renewable energy and modernizing the transmission grid. For example, Florida-based NextEra Energy strikes us as potentially well positioned to try to take advantage of these trends.

In these uncertain times, we remain committed to our long-standing process and the ongoing due diligence needed to determine whether we believe our holdings have the potential to sustain above-average dividend growth over a longer time frame.



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 quality and potential sustainability. Of particular interest are instances where near-term fears of inflationary pressure may have caused the market to lose sight of a company's longer-run growth story and the potential catalysts that could help to shift the narrative and unlock value for shareholders.

Securities mentioned in this material have the following weightings in the Dividend Growth Fund as of September 30, 2021: Home Depot 1.29%, Microsoft 6.09%, and NextEra Energy 1.04%.

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