A Growing Dividend Can Add Up

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

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KEY INSIGHTS

- The stock market's strong returns 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.

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The dividends that some companies pay to shareholders were an afterthought in the first half of 2023. Dividend payers in the S&P 500 gained about 12%, while non-dividend payers rallied 37%.[1]

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.

Higher interest rates mean that bonds also offer yields[2] that are more competitive.

However, the prospect of a rising stream of dividends can offer benefits that may be hard to come by in other investment strategies:

- 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.

> ...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. Dividend yield is the yield a company pays out to shareholders in the form of dividends. It is calculated by taking the amount of dividends paid per share over the course of a year and dividing by the stock's price.
Source: financial data and analytics provider FactSet. Data analysis by T. Rowe Price. Copyright 2023 FactSet. All Rights Reserved. See Additional Disclosure.
[2] A bond's yield is the implied return, at the current market price, that would come solely from the next 12 months of interest payments. Bond prices and yields move in opposite directions.

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.

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 for dividend growth stocks. 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.[3]

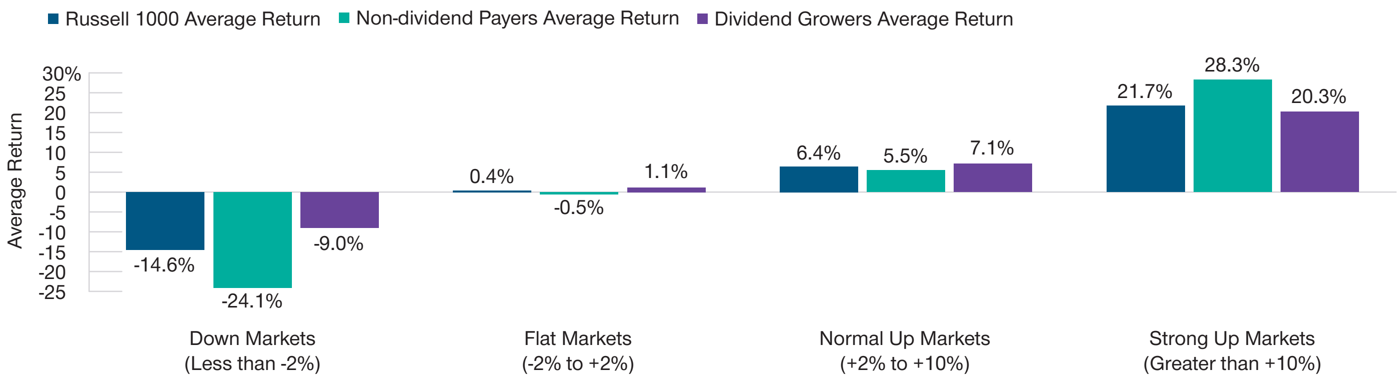
Some of this historical resilience reflects the value of dividends in difficult markets. Dividends paid to shareholders are the only portion of a stock's return that is always positive, so they can act as a bit of a shock absorber when the market is flat or down.

And the discipline involved in paying a dividend—especially one that grows consistently—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 have generated significant recurring revenue and ample amounts of this free cash flow.

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.

[3] **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%. Standard deviation is a measure of the amount of variation or dispersion of a set of values. A low standard deviation indicates that the values tend to be close to the mean of the set, while a high standard deviation indicates that the values are spread out over a wider range. 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.[4]

- Management teams at companies that have grown their dividend consistently are usually focused on returning cash 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 period 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.[4]

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 fund 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.

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.

[4] **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.

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