Dividend Payers and Growers: Smart Options in a Rising Rate Environment

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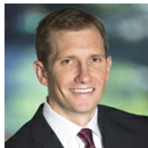
As bond yields begin to compete with equities, we recommend an ecumenical approach to equity income and growth in dividends.



We spent a good part of 2016 discussing the somewhat rare opportunity to buy stocks at better yields than those offered by the 10-year U.S. Treasury.

As of November 25, with the 10-year Treasury[1] down 4.5% since November 8, and the broad equity index, as represented by the S&P 500® Index, up 4.5%, the market is catching up to the opportunity we highlighted. As of November 25, just 36% of stocks out-yield the 10-year Treasury, and the 10-year yield of 2.35% is now 0.25% higher than the yield of the S&P 500, according to FactSet. So is that it, then, for the opportunity in dividend-paying stocks? Not in our opinion.

One of the major impediments to using stocks for yield has been the earnings recession over the last five quarters. The continuation of that trend would have undermined the stability of the dividend payout. The market, however, has now withstood the effects of a stronger dollar on multinational earnings and withstood the energy sector's adjustment to oil at $50 per barrel, and the S&P 500 is finally growing earnings again, year over year. For the third quarter 2016, FactSet reported a blended earnings growth rate for the S&P 500 of 2.9%—the first time the index has seen year-over-year growth in earnings since first quarter 2015.

Further, many market participants now see the potential for substantial earnings growth. With the new administration and a Republican majority in both the House and the Senate, corporate tax cuts become a very real possibility. A 25% effective tax rate falling to 15% could mean an additional $10 per year or more in earnings. At a 17x multiple, this could mean more than 170 points on the S&P 500. In addition, the Trump administration is suggesting $550 billion in infrastructure spending. Digging into the numbers, *The Wall Street Journal* estimates, admittedly optimistically, that extra spending will come to about $100 billion each year, which amounts to 0.50% of gross domestic product. This isn't the answer to all growth problems in the world, but it's also not an insignificant figure that can be summarily dismissed.

The result of all this is that investors are less likely to look at dividends as a static or possibly declining number. While absolute dividend payout was a dominant factor in stock returns in 2016—an equal-weighted portfolio of the top 10% of dividend payers, for example, outperformed the S&P 500 by 21% over the first six months of the year, according to Bloomberg—research shows that the highest dividend payers don't typically reward

investors over the long term because the highest-dividend payers are often stretched in their ability to maintain high payouts. Higher interest rates also can decrease the real value of the often fixed payouts of the highest-dividend payers. As such, the returns to these companies generally decline when interest rates increase. We may be seeing the long-term dynamics play out as those companies have been essentially flat since June 20, 2016 (through November 25).

We have been warning about the **pitfalls of investing in the highest-yield stocks**, preferring instead more balanced approaches to finding yield among a variety of sectors and business models. In addition, we believe a focus on the fundamental strength of companies and the value the stocks potentially offer should lead to better long-term prospects than a myopic focus on current yield.

This search for diversity and value has been aided by the changing nature of the dividend-paying universe over the last decade. More industrials and information-technology stocks now pay a dividend, which in turn decreases the importance of traditional income-paying stocks such as utilities. Growth companies also are more likely to pay a dividend now than in years past. This increase in diversity in the equity-income universe is a welcome development for investors seeking balanced portfolios of dividend-paying stocks that offer more long-term growth potential and less sensitivity to rates.

We continue to believe that investors will be well served to focus on dividend growth, both historical dividend growers and companies with the potential to keep growing dividends. The rising payouts and strong business models of these dividend growers can help tremendously in the effort to combat the inflation that can come with increased economic growth and the volatility that can come with political and economic uncertainty. Inflation is an increasingly relevant concern: In the brief period of November 7–25, for example, five-year inflation expectations rose, from 1.64% annually to 1.92%, according to the U.S. Federal Reserve. Companies with strong business models and defensible competitive positions usually have the ability to pass along price increases to their end customers, which is a major reason these stocks have shown little to no correlation to the fluctuation in interest rates in the past. Finally, consistent dividend growers have shown the resilience of their businesses and capital structures through business cycles and have the potential to outperform when uncertainty increases and equity markets decline.

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[1]As measured by the BofA Merrill Lynch Current 10-Year U.S. Treasury Index (11/8/2016 – 11/25/2016).

[2]Data sourced from CNBC.

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