

The Appeal of Dividend Growth for Income-Oriented Investors

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In its review of the 1981 “political-romantic thriller” *Rollover*, *Variety* magazine found the film “fundamentally disappointing.”¹ The plot revolved around an heiress (Jane Fonda) and a banker (Kris Kristofferson) who fall in love while becoming ensnared in a web of international monetary intrigue. Many of the themes explored in the film will sound familiar to today’s investors – the collapse of a major bank, a loss of faith in paper currencies, rising gold prices, global political turmoil, and economic uncertainty. It should come as no surprise that the movie was produced at the conclusion of a turbulent decade when the U.S. economy experienced extended periods of high unemployment and rapid inflation.

We disagree fundamentally with *Rollover*’s rather dark conclusions. Although we cannot recommend the film, which, incidentally, lacked commercial or critical success, we can recommend a framework for investing in turbulent times – specifically, we continue to find dividend-paying equities attractive.

As was the case in the early 1980s, today’s environment marks a period of attractive equity valuations, particularly dividend paying stocks. This article discusses the philosophy and construction of our Equity Income Strategy, used as an equity model for selected client portfolios. The Equity Income Strategy is designed as a comprehensive equity portfolio, offering exposure

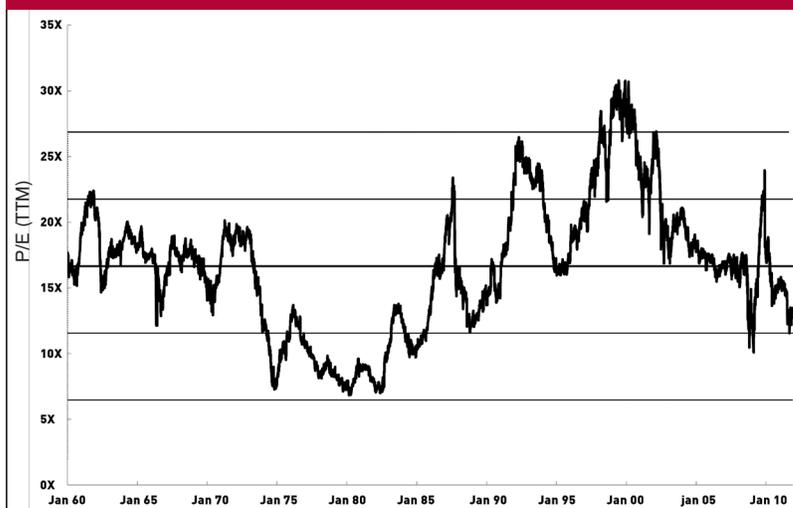
to stocks with less volatility and more current income, while still capturing the long-term capital appreciation and inflation protection that equities provide.

Equity Valuations are Reasonably Attractive

We think that equity valuations are currently attractive, both in absolute terms and relative to fixed income securities. The S&P 500 Index is currently trading about one standard deviation below its average P/E ratio since 1960 and, excluding a brief period in early 2009, is the cheapest the S&P 500 has been on this metric since the 1980s (see chart below).

In addition, comparisons with fixed income investments remain attractive, with the yield on the S&P

S&P 500 Price-to-Earnings (P/E) Ratio, 1960-2011



Sources: Cambridge Trust Company, Bloomberg. (trailing 12 months)

The Appeal of Dividend Growth for Income-Oriented Investors *Continued*

500 nearly equal to the yield on 10-year U.S. Treasury Bonds. Many stocks with consistently growing dividends are at the top of our list of attractive valuations. Historically, these stocks have exhibited less volatility than the broader market (as represented by the S&P 500). In addition, larger capitalization multinationals – a group that has been out of favor for some time – constitute a large portion of the universe of dividend-paying stocks. The largest stocks have lagged the market since the late 1990s and may be due for a period of stronger relative performance.²

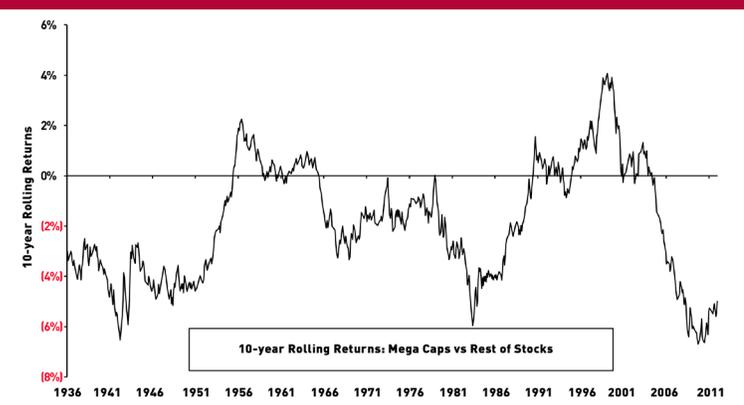
Identifying Sustainable Dividend Growth

Sources of strong earnings and dividend growth are many and varied. However, at the core, the companies that we select for the Equity Income Strategy exhibit sustainable, defensible business models with high barriers to entry and one or more of the following characteristics: strong secular growth trends, flexibility to raise prices to offset inflation, increased sales to emerging economies, unique industry characteristics, or simply a renewed emphasis on returning cash to shareholders. Illustrative examples include: Union Pacific and Praxair, which have high barriers to entry; IBM and Schlumberger, which are increasing very modest payout ratios; McCormick, Coca-Cola, and Pepsi with high market share and a good degree of pricing power; and Travelers, which participates in a largely overcapitalized property and casualty insurance industry. Many companies in our Equity Income Strategy have increased their dividends in 2011- Microsoft (+25%), Target (+20%), Schlumberger (+19%), Travelers (+14%), Praxair (+11%), Procter & Gamble (+9%), ExxonMobil (+7%), and Pepsi (+7%).

For much of the past twenty years, dividends were seen as the purview of mature companies and slow-growth enterprises such as electric utilities. Investors regarded dividend payers with a skeptical eye – after all, how will a company grow if it is returning its excess capital to shareholders, rather than investing in new projects? We believe that earnings growth and dividend income are not mutually exclusive, and our approach seeks to identify companies with rising earnings and a commitment to growing the dividend.

The seemingly innocuous statement that investors should seek robust earnings growth from equity income investments is often met with surprise. Yet, earnings are the raw material from which dividend growth is possible. A commitment to a growing dividend can play a role in protecting shareholders against potentially negative outcomes associated with a buildup of large cash balances: self-inflicted damage (large mergers, share repurchases at high prices); management complacency in the face of technological change and/or competitive threats; or simply sub-par return on capital (excess cash on the balance sheet). In our view, earnings growth provides the fundamental

Relative Returns: Mega Cap Stocks Versus Rest of Stocks



"Mega" is defined as the largest 50 stocks by market capitalization, "Rest" as stocks 51-1500. Source: Bernstein Research.

The Appeal of Dividend Growth for Income-Oriented Investors *Continued*

basis for equity income investing. We believe that, over time, this approach should provide a stronger growth profile and better downside protection (against a potential decline in earnings) than a strategy that owns only the highest-yielding securities.

As evidence that dividend growth and earnings growth are not mutually exclusive, a number of companies in the Equity Income Strategy posted strong earnings and dividend growth over the past five years, despite an unusually deep and prolonged recession (see table on adjacent page). In fact, there are fourteen companies in our Equity Income Strategy that delivered annualized earnings growth in excess of 10% over the past five years, while seven of those fourteen delivered annualized earnings growth in excess of 15%. In addition, twelve of the fourteen companies mentioned above grew their dividends at least 9% annually over the past five years. In comparison, the S&P 500 experienced annualized earnings and dividend growth of 1.8% and 1.6% respectively over the same period. The unfavorable comparisons for the S&P 500 are largely the result of reported losses and dividend reductions by banks and other financial companies. That dividends should rise more slowly than earnings is somewhat intuitive as earnings tend to be more volatile than dividends; dividends are viewed as long-term commitments that companies are often reluctant to cut.

One measure of dividend sustainability is the dividend payout ratio, which divides the current dividend by the level earnings. Dividend payout ratios remain modest and, in many cases, below historical levels. For example, the S&P 500 dividend payout ratio is currently 28%, well below the average of 51% since 1960.³ This ratio indicates room for further increases in the dividend and/or a substantial cushion to continue

paying the dividend in times of earnings duress.

Many income-oriented equity investors focus on understanding if the current payout is sustainable. We try to set a higher bar – our research seeks to identify currently attractive payouts that can grow over time. Not surprisingly then, the weighted average payout ratio for our Equity Income Strategy is just 38%.

Dividends Have Been a Stable Source of Income

As Jeremy Siegel and Jeremy Schwartz point out in their opinion piece in the August 22, 2011 Wall Street Journal, “Per share dividends of the S&P 500 firms have grown at 5% per year over the last half-century, which

Dividend and Earnings Growth Through the Business Cycle

	Company	Dividend		Annualized Growth Rate, 5 Years	
		Payout Ratio	Yield	Earnings	Dividends
1	BlackRock Inc.	38%	2.95%	24.7%	27.2%
2	Union Pacific Corp.	24%	2.19%	23.5%	16.9%
3	Coca-Cola Co.	35%	2.81%	19.9%	9.5%
4	International Business Machines Corp.	22%	1.67%	18.6%	26.2%
5	Microsoft Corp.	23%	2.83%	17.5%	10.2%
6	Travelers Cos. Inc.	21%	2.76%	17.5%	9.2%
7	NextEra Energy Inc	42%	3.72%	15.7%	7.1%
8	Schlumberger Ltd.	25%	1.47%	13.3%	14.9%
9	Ecolab Inc.	29%	1.34%	12.6%	12.0%
10	McCormick & Co. Inc.	38%	2.42%	12.0%	10.2%
11	Johnson Controls Inc.	27%	2.05%	12.1%	9.3%
12	Praxair Inc.	47%	1.84%	11.6%	20.1%
13	JPMorgan Chase & Co.	22%	2.78%	10.7%	-31.8%
14	PepsiCo Inc.	48%	3.20%	10.3%	13.4%

Source: FactSet.

The Appeal of Dividend Growth for Income-Oriented Investors *Continued*

handily beat the average rate of inflation of 4% during the period. In fact, dividend growth has beat inflation both during the low inflation periods of the 1960s, 1990s and 2000s, and the high inflation periods of the 1970s and early 1980s.” Siegel and Schwartz further point out that the “entire decline in dividends of U.S. stocks during the [2007-2009] recession was due to the fall of the financial sector. The sum of the dividends paid by firms in the other nine sectors of the U.S. equity markets was actually higher in 2009—at the bottom of the worst recession and bear market in the past 75 years—than it was in 2007, when stocks and the economy were at their peak.”

Dividend sustainability has been further enhanced by the benefits of global diversification. Many of the companies represented in the Equity Income Strategy derive a large portion of their revenue from outside the United States. They provide additional diversification and stability, as large U.S.-domiciled companies are major participants in global GDP growth. Companies such as 3M (66% non-U.S. revenue, almost half of which is emerging markets) and IBM (55% non-U.S. revenue) derive a significant portion of revenue from emerging economies with significantly higher growth rates than developed markets and operating margins that are often on par with or better than domestic markets.

Attractive Opportunities in a Low-Rate World

Finally, it is worth reiterating our framework for choosing stocks for the Equity Income Strategy (originally described in our Summer 2010 TrustLetter). When evaluating potential additions to this model portfolio, our goal is to focus on well run companies that we regard as offering an attractive mix of current income and opportunity for capital appreciation, and not the highest yield per se. Our criteria for dividend-growth stocks represent a framework that attempts to capture dividend sustainability, dividend growth potential, and yield.

With interest rates near their lowest levels in decades, dividend-based investing approaches are gaining attention.⁴ For many investors approaching or in retirement, the security of a growing dividend stream can be very appealing. Our Equity Income Strategy is designed to meet the needs of clients who require more current income, lower volatility, or both objectives.

1 Variety, December 31, 1980. <http://www.variety.com/review/VE1117794542?refcatid=31>.

The New York Times concurred noting in the December 11, 1981 issue, “Is the Arab Euro-dollar really a good subject for movie banter?” and “The dramatic possibilities of the material are weak at best, and its satirical underpinnings are nowhere to be found.” The passage of time has not been particularly kind to the movie either, as Internet Movie Data Base (IMDB) users rate Rollover a mere 5.3 stars out of a possible ten (534 users).

2 Bernstein Research, “Quantitative Research: Prospects for a Large Cap Comeback,” June 10, 2011. Exhibit 5: Returns in the last decade have been the worst for the largest 50 stocks in nearly seventy years.

3 Sources: Current level, FactSet. Average since 1960, calculation is Cambridge Trust Company from data compiled by Prof. Robert Shiller. <http://www.econ.yale.edu/~shiller/data.htm>

4 Levisohn, Ben. Wall Street Journal, “It’s Payback Time! The Markets are Rewarding Companies That Pay Dividends,” August 27, 2011.

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