Dividend Growth: Investing for Changing Market Conditions

Since the start of 2022, growing inflation and rising interest rates have contributed to a marked increase in market volatility. On top of that, the global economy is facing supply chain disruptions and geopolitical and macroeconomic uncertainty, which will likely remain part of the near-term environment. All of this has led to earnings multiple compression, which has contributed to some of the most significant declines for growth stocks seen in recent history.

With such a backdrop, how can investors immunize their portfolios against the challenges of the current environment?

We believe that investing in companies with consistent and growing dividends can provide core building blocks to grow your capital while managing risk in the current environment and over the long term, regardless of changing market conditions.

1. Higher historical returns with less risk

Dividends are payments made by a company on a regular, often quarterly, basis to return some of its profits to shareholders. However, dividends can do more than provide a stream of income. Investing in companies that can persistently grow free cash flow and raise dividends can also help reduce volatility and drive total returns while delivering sustainable income over the long term.

Companies that can grow dividends have historically led in performance…

![Graph showing growth of dividend-paying stocks compared to non-dividend-paying stocks over time.]
…with lower volatility

A look at the returns of S&P 500 Index stocks sorted by dividend policy over the past 50 years shows that companies with growing free cash flow and dividends have outperformed over the long term with lower volatility relative to non-dividend payers or dividend cutters.

2. Buffer against market volatility

Dividend-paying stocks’ regular payments may help support returns when stock prices struggle and reduce the volatility of a stock's total return. Dividends provide current income to investors and, during periods of volatility, this may provide a cash flow return to investors that offsets falling share prices. Think of it as a rent collection from companies in the form of dividends. In the 1930s and 2000s the S&P 500 Index price returns were negative, but returns from income almost completely offset the price decline.

In addition, companies with the financial strength necessary to support dividend growth tend to experience less volatility in stock prices and have outperformed during volatile markets.

**Dividend growers vs. non-payers: Excess returns during months when volatility increased**

<table>
<thead>
<tr>
<th>VIX* monthly increase</th>
<th>Average out/under performance of dividend growers vs. non-dividend payers</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt;20%</td>
<td>2.06%</td>
</tr>
<tr>
<td>10 to 20%</td>
<td>1.09%</td>
</tr>
<tr>
<td>&lt;10%</td>
<td>0.21%</td>
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<tr>
<td>Average (all months when VIX increased)</td>
<td>1.05%</td>
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</tbody>
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* VIX refers to the Chicago Board Options Exchange’s CBOE Volatility Index

Source: Ned Davis Research, Bloomberg, Guardian Capital, from January 31, 1990 to April 30, 2022. In USD. Dividend growers vs. non-payers performance during months when the CBOE Volatility Index (VIX) increased. Chart illustrates the average historical performance of S&P 500 Index component stocks based on their dividend policies. The various dividend policy categories are subsets of stocks within the S&P 500 Index, as defined by Ned Davis Research. Past performance is not a guarantee of future results. For illustrative purposes only.

A steadily growing dividend is often a sign of a company's durability, stability, and confidence in its underlying business. The mere fact that a company pays a dividend typically means it is profitable and has excess free cash flow, qualities that may help to bolster its stock during challenging times. This is especially important today when the market has many unprofitable or marginally profitable companies.

**Hallmarks of dividend growth and resilience**

A company’s dividend policy can be one of the clearest indicators of a management team’s confidence in the future growth prospects of their business. In order to continuously pay a dividend, a company must generate profits above and beyond the operating needs of the business. They are also incentivized to be more careful with their use of cash. Because of this, companies with a commitment to dividends often also demonstrate traits that make them more resilient in challenging macro environments, such as:

- **Durable competitive advantages and diversified revenues that allow them to grow earnings even in difficult periods**
- **Stable earnings, ample cash flows and strong balance sheets indicative of company health**
- **Well-managed companies committed to return cash to shareholders**
3. Resilience during periods of high inflation and rising interest rates

Dividend growers and payers have historically outperformed relative to non-dividend payers and dividend cutters during periods of high inflation and rising interest rates.

Source: Goldman Sachs Global Investment Research. In USD. Performance is calculated using 12-month median returns. Highest quintile of dividend growth is based on trailing 12-month dividend growth. Reproduced with permission of Goldman Sachs. Past performance is not a guarantee of future results. For illustrative purposes only.

Performance by dividend policy after rate hikes
S&P 500 Index

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Source: Ned Davis Research, Guardian Capital LP. In USD. Data is the average monthly performance in the months following the first Fed rate hike of a tightening cycle. Includes rate hike cycles starting May 1983; March 1988; February 1994; June 1999; June 2004; and December 2015. Past performance is not a guarantee of future results. For illustrative purposes only.
We believe a company’s ability to provide sustainable dividend growth is one of the cornerstones of wealth building, and it becomes even more important during inflationary periods. As inflation erodes the value of a dollar, growing dividends can help to maintain purchasing power.

With high inflation and interest rates on the rise, cash flow visibility has become very important, and companies that can continue to grow their earnings and dividends in this environment may be more resilient against inflationary concerns. These high-quality companies generally have well-established competitive advantages and pricing power that enable them to adapt and grow their income to keep up with inflation.

Also, with rising interest rates in mind, dividend-growers are generally less sensitive to changes in the cost of capital and interest rates.

**Not all dividends are created equal**

For many investors, the search for dividend income might start with companies that pay the highest yields. Rather than investing based on yield alone, we believe the focus should be on companies with strong dividend growth, a sustainable payout ratio and persistent earnings and free cash flow growth. As we have noted above, the charts on pages 1 and 2 illustrate that dividend growers have a history of being rewarded by the market over time. But these charts also show that, in addition to identifying dividend growers, it is equally essential to avoid companies that are cutting or eliminating their dividends.

It is important to employ an investment discipline that is able to identify companies with consistent earnings growth and rising cash flows, that are likely to increase their dividends in any market environment. Doing so should provide the benefit of long-term growth coupled with an attractive and growing income stream regardless of market conditions.
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