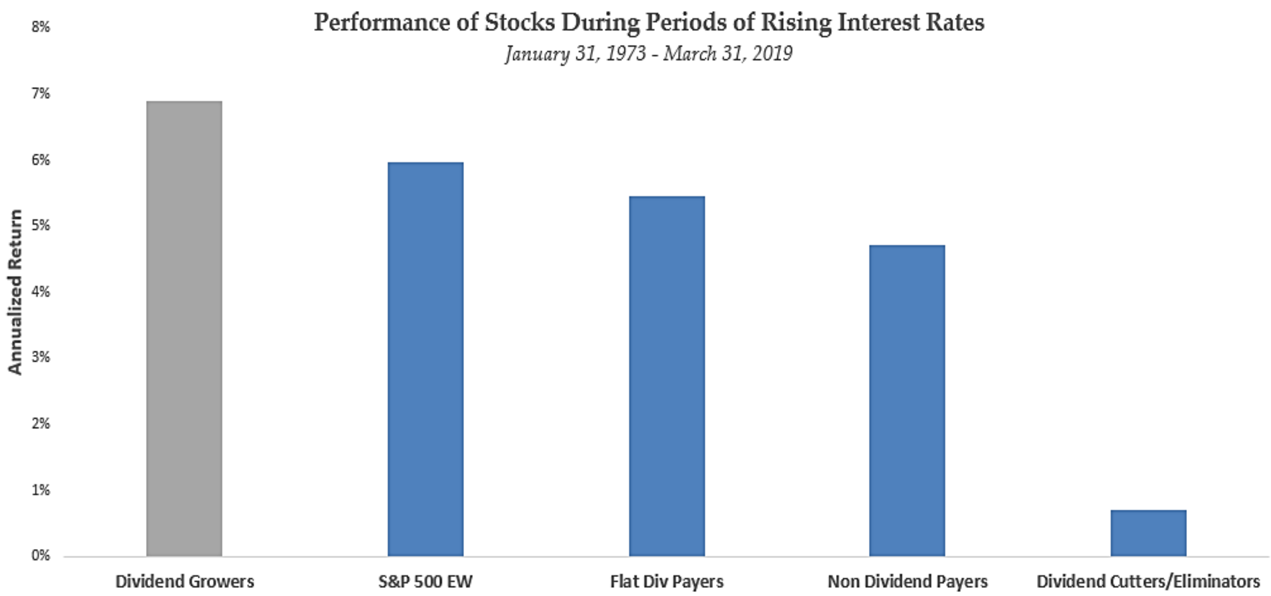
Dividend Growth and Rising Rates

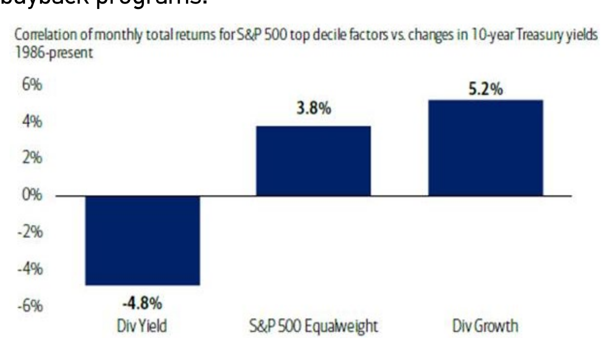


Source: Ned Davis Research. Returns average of annualized returns over time periods.

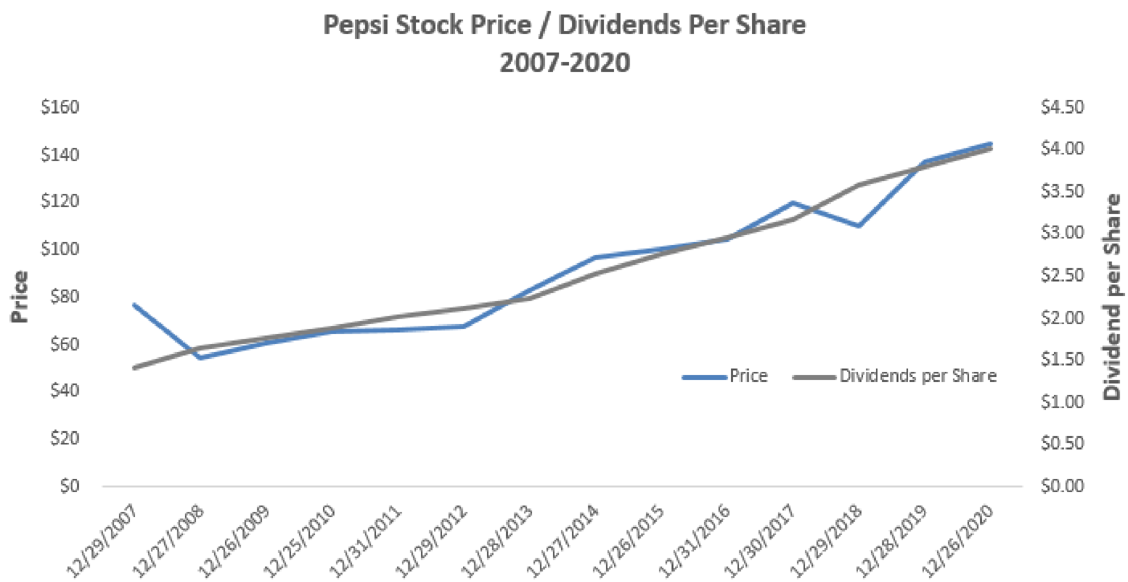
With the robust economic recovery underway and the potential for further interest rate increases, we wanted to examine how dividend growth stocks fared in previous periods of rising interest rate environments. Drawing from the same data set that we use to assess returns for S&P 500® Index stocks according to dividend policy, we carved out time periods with rising federal funds rates. As illustrated in the chart above, dividend growers outpaced the return of "the market" as well as other dividend philosophies during periods of rising interest rates.

How can dividend growers outperform when interest rates are on the rise? Perhaps it begins with the foundational aspects of dividend growth investing. One beautiful aspect of dividend growers is that committing to dividend growth is not a casual exercise. Companies with increasing dividends demonstrate confidence in their potential for dividend growth in both the present and the future. By providing tangible growth rates to investors, management is "putting their money where their mouth is" in terms of the prospects for the business. Moreover, by articulating a dividend growth philosophy, investors arguably have a safety net, as there should be less risk of management using their authority to benefit themselves rather than their shareholders. The embedded expectations of the rate of future dividend growth should heighten management's focus on capital allocation, and the implicit signal regarding the potential rate of future growth in the business should be awarded a premium.

During periods of rising interest rates, the benefit of the safety net, as well as dividend growers' exposure to an improving macroeconomic environment, can be an added benefit. This is especially true for high-dividend yielders, as shown in the BofA illustration below. High yielders tend to experience inferior growth rates in a world where growth is a decisive factor – their dividend yields compete with both the broader market's free cash flow yield, and with companies with robust stock buyback programs.



Source: BofA Global Research, BofA U.S. Equity & U.S. Quant Strategy, Bloomberg



Source: Bloomberg

A case study on the power of dividend growth over time can be seen in our ownership of Pepsi shares, in our Equity Income strategy. In the chart above, we show the relationship between Pepsi's stock price and its dividend growth since our November 2006 purchase. We paid attention to Pepsi's signals and safety net at time of purchase, noting: "the company has a long track record of disciplined stewardship of stockholders' money, returning nearly $5 billion to stockholders in 2006 – $3 billion via share repurchases and nearly $2 billion more in cash dividends. In fact, the company has doubled doubled its dividend rate since late 2002, extending a 34-year streak of consecutive increases." During rising interest rate environments, as well as for the long term, companies that employ a dividend growth strategy show their confidence in their own future prospects. This signals to us that their intentional capital allocation has the potential to generate outperformance for our clients.

As always, thank you for your interest and trust in managing your investments.

Charles J. Wittmann, CFA®, Executive Director, joined Sterling Capital Management in 2014 and has investment experience since 1995. Chip is an equity portfolio manager. Prior to joining Sterling, he worked for Thompson Siegel & Walmsley as a portfolio manager and (generalist) analyst. Prior to TS&W, he was a founding portfolio manager and analyst with Shockoe Capital, an equity long/short hedge fund. Chip received his B.A. in Economics from Davidson College and his M.B.A. from Duke University's Fuqua School of Business. He holds the Chartered Financial Analyst® designation.

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***The S&P 500® Index** is a readily available, carefully constructed, market-value-weighted benchmark of common stock performance. Currently, the S&P 500 Composite includes 500 of the largest stocks (in terms of stock market value) in the United States and covers approximately 80% of available market capitalization.*

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