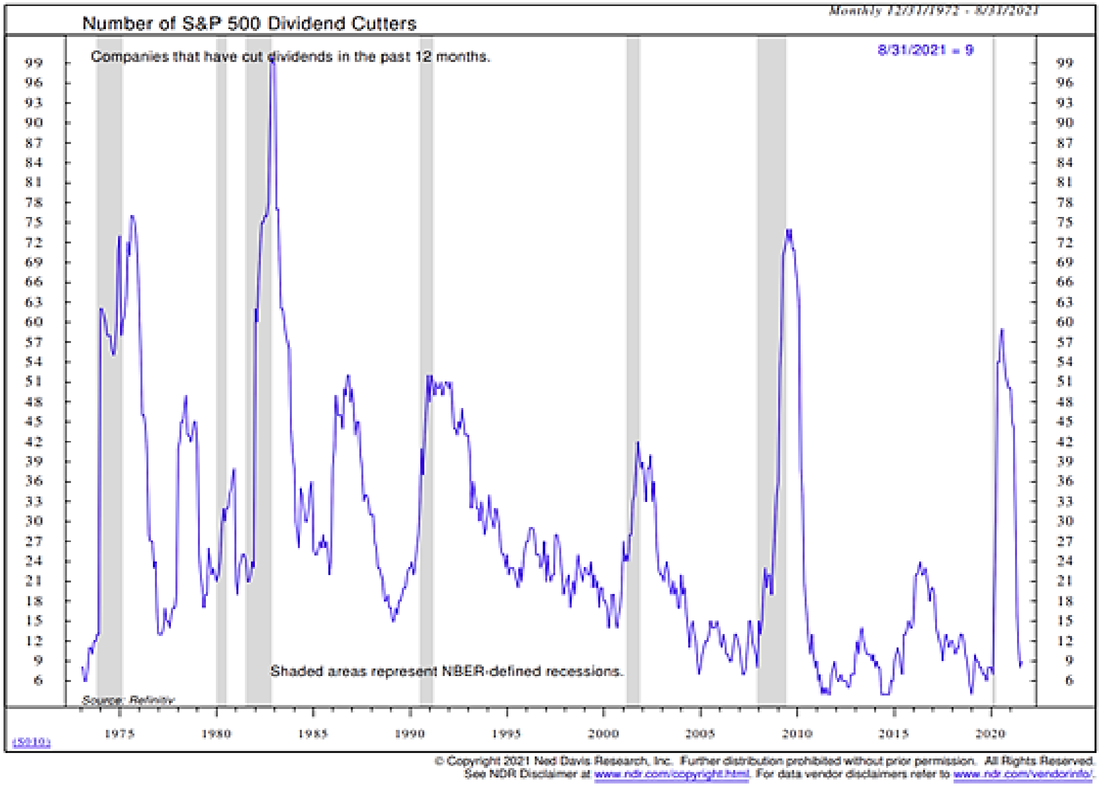
Dividends: Active Vigilance

The Lead | October 2021



Source: Ned Davis Research

The college football season started in September. One of our team's favorite sayings is that in investing, just like in football, “defense wins championships.” Our beloved Virginia Cavalier football team learned this firsthand during their last two home games, as their offense went from giving up zero quarterbacks sacks to six and, as you might expect, from winning to losing. Protecting the quarterback in football can be key to winning. In a dividend growth strategy, the key is protecting the overall dividend growth rate by reducing exposure to companies that cut or eliminate their dividend. We know that stocks with a history of growing their dividends can provide desired outcomes in the form of higher income, lower volatility, and compelling risk-adjusted returns, while potentially inflation protection during periods of rising prices. However, we note that naïve, backward-looking approaches based on passive or factor-based methods can lead to shortcomings. Dividend suspensions or cuts can happen quickly, and investing in stocks that slash their dividends can materially impact performance. Ned Davis Research notes that, from January 1973-August 2021, S&P 500® stocks that cut or eliminated their dividends both underperformed dividend growers by over 11% per year and actually generated a negative absolute return.

The benefit of an active, forward-looking investment approach based on analyzing a company’s cash flows, balance sheet, and business model is the prospect of anticipating risk to ongoing dividend payment growth. As highlighted in the chart above, a high number of dividend cuts in the market tend to be rare but severe, and the challenge for long-term investors is that threats to ongoing dividend payment capacity can change. For example, from 2009-2010, 40% of dividend cuts came from the financial sector, according to Bloomberg. However, the sectors in the S&P 500 most exposed to dividend reductions, during 2020 and throughout the COVID-19 pandemic, were industrials and consumer discretionary stocks (over 40% combined). We provide a chart detailing dividend cuts and eliminations by sectors over the past twenty years on the next page. Note that while all sectors experience dividend cuts and eliminations, it appears sectors such as healthcare and technology experience fewer cuts given their sector weights over the time period, while financials and materials experience more given their average weights.

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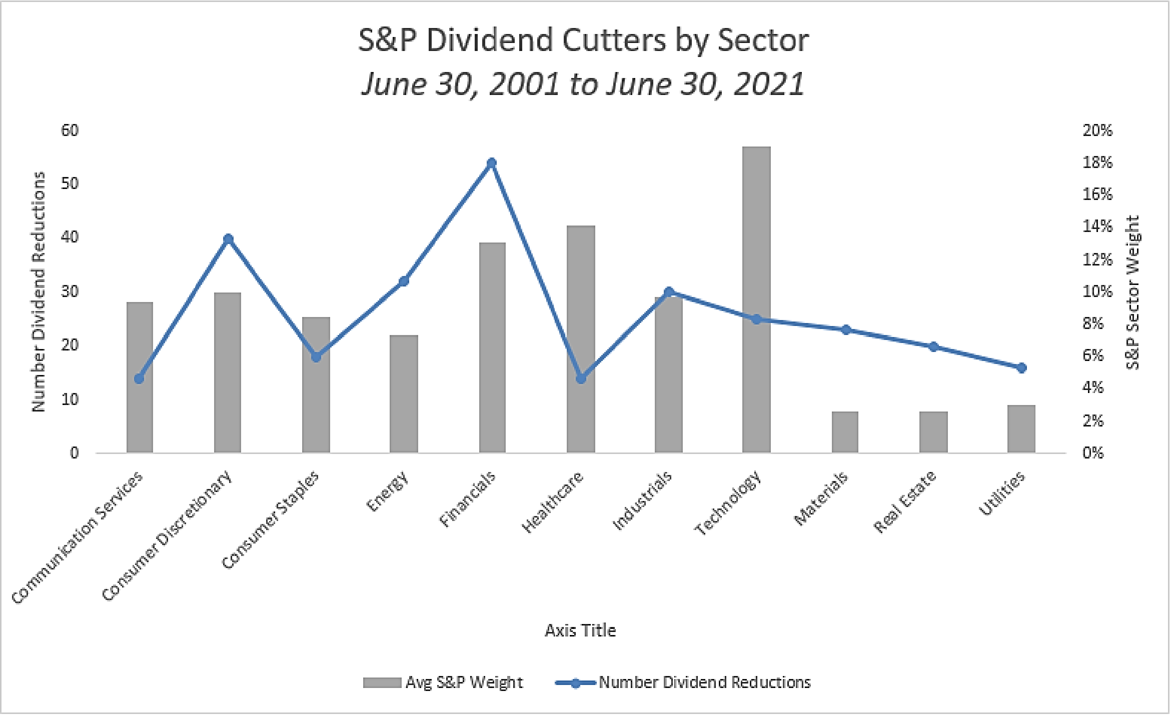

Source: Bloomberg

It may not be possible to precisely predict every company that will cut or eliminate their dividend, as dividend growth declarations are not only a function of an ability to pay but also a willingness to do so. Nonetheless minimizing exposure to these names can make a big difference in overall performance. We would note that seven stocks we sold in our dividend growth strategy over the past seven years subsequently cut or eliminated their dividends, leading to underperformance versus the benchmark and, similar to the Ned Davis research above, they are currently trading below our exit price. Through our team-based quintiles process and playbook with sustainable dividend growth in mind, we understand sometimes the best offense is a good defense.

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 co-portfolio manager of the Global Leaders strategy and associate portfolio manager of the Equity Income strategy. 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. Chip earned the Certificate in ESG Investing, which is developed, administered and awarded by the CFA Society of the United Kingdom. He holds the Chartered Financial Analyst® designation.

Important Information

Disclosures

The securities described are neither a recommendation nor a solicitation. Security information is being obtained from resources the firm believes to be accurate, but no warrant is made as to the accuracy or completeness of the information.

The volatility of an index varies greatly. All indices are unmanaged and investments cannot be made directly in an index.

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.

Dividend Policies: Dividend Paying vs. Non-Paying: Each stock's dividend policy is determined by its indicated annual dividend. We classify a stock as a dividend-paying stock if the company indicates that it is going to be paying a dividend within the year. A stock is classified as a non-payer if the stock's indicated annual dividend is zero. Prior to July 2000, the indicated annual dividends were updated on a quarterly basis. Since July 2000, the indicated annual dividends are updated on a daily basis, so the most up-to-date information is used. The index returns are calculated using monthly equal-weighted averages of the total returns of all dividend-paying (or non-paying) stocks. A stock's return is only included during the period it is a component of the underlying index. The dividend figure used to categorize the stock is the company's indicated annual dividend, which may be different from the actual dividends paid in a particular month. **Dividend Growing, No-Change-in-Dividend, and Dividend Cutting:** Each dividend-paying stock is further classified into one of the three categories based on changes to their dividend policy over the previous 12 months. Dividend Growers and Initiators include stocks that increased their dividend anytime in the last 12 months. Once an increase occurs, it remains classified as a grower for 12 months or until another change in dividend policy. No-Change stocks are those that maintained their existing indicated annual dividend for the last 12 months (i.e., companies that have a static, non-zero dividend). Dividend Cutters and Eliminators are companies that have lowered or eliminated their dividend anytime in the last 12 months. Once a decrease occurs, it remains classified as a cutter for 12 months or until another change in dividend policy. (Source: Ned Davis Research).

Technical Terms: **Dividend Risk:** Dividend yield is one component of performance and should not be the only consideration for investment. Dividends are not guaranteed and will fluctuate. This report should not be regarded by the recipients as a substitute for the exercise of their own judgment. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager. **Dividend Yield**: a financial ratio that measures the annual value of dividends received relative to the market value per share of a security. In other words, the dividend yield formula calculates the percentage of a company's market price of a share that is paid to shareholders in the form of dividends. **S&P 500 Dividend Aristocrats**: also known as the Dividend Aristocrats, is an exclusive index within the Standard and Poor's 500 that was launched in 2005. It contains companies that increased their dividend payouts for over 25 consecutive years. It is a high-performance index and consists of approximately 60 large-cap stocks over a wide variety of sectors and is often considered an attractive index to invest in, as it includes many stable growth-oriented stocks. (Technical definitions are sourced from Corporate Finance Institute and Investopedia.)

The **Chartered Financial Analyst® (CFA)** charter is a graduate-level investment credential awarded by CFA Institute — the largest global association of investment professionals. To earn the CFA charter, candidates must: 1) pass three sequential, six-hour examinations; 2) have at least four years of qualified professional investment experience; 3) join CFA Institute as members; and 4) commit to abide by, and annually reaffirm, their adherence to the CFA Institute Code of Ethics and Standards of Professional Conduct.

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