Resilient Dividends

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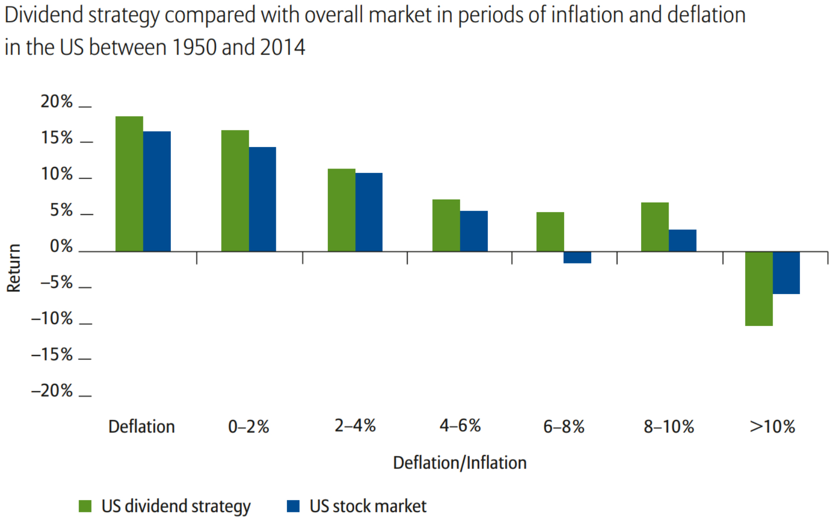
Performance of Dividend Strategies During Various Inflationary Periods



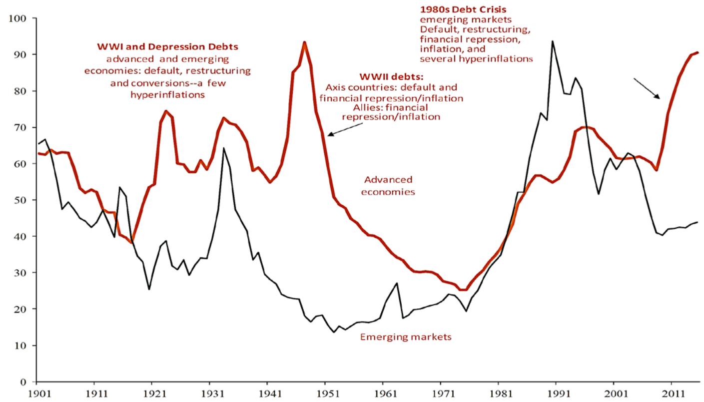
Sources: French, Allianz, Datastream, Allianz GI Capital Markets & Research.

Perhaps the word of the year for 2022 was inflation. According to Bloomberg, inflation was mentioned 14,200 times on S&P 500 earnings calls over the course of the year. While many Federal Reserve (Fed) observers were parsing Chairman Powell's words regarding when the latest rate hiking cycle may peak after the last meeting, we were focused on his response to a Wall Street Journal reporter's question on whether the Fed would change its 2% inflation target. After committing to the target, Powell added, "it may be a longer-run project at some point."

While the relative level of inflation and interest rates over the next three to five years can be debated, with an inflation rate of 7.1% and a fed funds rate range of 4.3% to 4.5%, the rate of inflation is clearly running ahead of the fed funds rate. Inflation is running ahead of the U.S. ten-year Treasury yield that stood at around 3.5% in mid-December. As a result, should one invest in a ten-year Treasury in the current environment, while they receive a 3.5% 'nominal' yield, after subtracting for inflation, they may earn a negative 'real' interest rate. For example, if an investor earns a 'nominal' yield of 3.5% but inflation runs at 6.0% over the course of the year, the 'real' yield an investor earns is calculated by taking the 3.5% and subtracting 6.0%, yielding a -2.5% return, taking inflation into account. In sum, if the rate of inflation is greater than 3.5% as in this case, at the end of the year, the investor's purchasing power is less than it was at the start of the year. In this context, we want to highlight the term 'financial repression' that has been studied by former World Bank Chief Economist and Harvard professor Carmen Reinhart, who researched the history of governments that let the inflation rate exceed nominal yields to extinguish high public debt levels over the years.

We provided a chart below that shows public debt levels to gross domestic product (GDP) for advanced economies, shown in orange. One can see that levels at the time of the paper were similar to post-World War II when 'financial repression' was employed to reduce public debt through what Reinhart calls "a tax on bondholders and savers via negative or below-market real interest rates."

Surges in Central Government Public Debts and their Resolution: Advanced Economies and Emerging Markets, 1900-2012

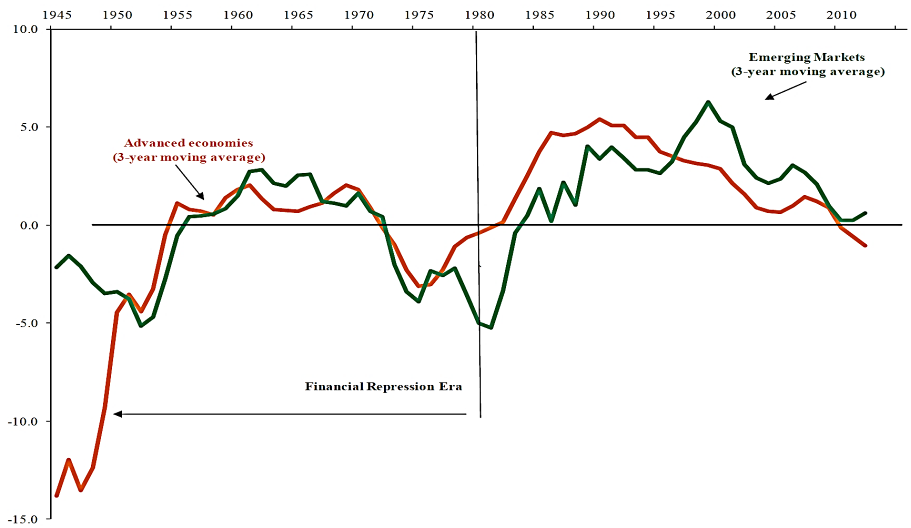


Left axis is percent. Sources: The Liquidation of Government Debt, Reinhart, Sbrancia. Advanced economies include: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom and United States.

Past performance is not indicative of future results. Any type of investing involves risk and there are no guarantees that these methods will be successful. Charts are for illustrative purposes only.

Average Ex-post Real Rate on Treasury Bills: Advanced Economies and Emerging Markets, 1945-2012 (three-year moving averages, in percent)

Figure 3: Average Ex-post Real Rate on Treasury Bills: Advanced Economies and Emerging Markets, 1945–2012 (3-year moving averages, in percent)



Sources: International Financial Statistics, International Monetary Fund, various sources listed in the Data Appendix, and authors' calculations. *Notes:* The advanced economy aggregate comprises: Australia, Belgium, Canada, France, Germany, Greece, Ireland, Italy, Japan, New Zealand, Sweden, the United States, and the United Kingdom. The emerging market group consists of: Brazil, Egypt, India, Korea, Malaysia, Mexico, Philippines, South Africa, Turkey and Venezuela. The average is unweighted and the country coverage is somewhat spotty prior for emerging markets to 1960.

Sources: The Liquidation of Government Debt, Reinhart, Sbrancia.

The chart on this page is from the same International Monetary Fund working paper and shows the real rate for Treasury bills over roughly the same time period.

We said over the course of 2022 that we want our clients to "stay ahead of the game," and for our Sterling Capital Equity Income strategy, that means not only striving to provide clients with an attractive dividend yield for the strategy, but also seeking to craft a portfolio with double-digit dividend growth ahead of the rate of inflation. The chart on the first page goes back to 1950 and shows how dividend strategies outperformed 'the market' with inflation rates up to 10% and periods where 'financial repression' was an effective means of reducing large public debt levels.

As always, thank you for your interest and trust 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 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

Past performance is not indicative of future results. Any type of investing involves risk and there are no guarantees that these methods will be successful.

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

Dividend-focused strategies may underperform strategies that do not limit their investment to dividend-paying stocks. Stocks held strategy may reduce or stop paying dividends, affecting the strategy's ability to generate income.

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. (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.

Since we began publishing The Lead in 2015, our primary purpose has been to communicate our investment philosophy and process as an investment advisor in the context of changing markets. In creating portfolios that differ from our benchmarks by focusing on characteristics that have a long term history of attractive relative returns according to Ned Davis Research, the portfolios are different from the benchmarks and as a result there can be periods where results differ including below benchmark performance. Since strategies are oriented toward the long term characteristics, if those characteristics are out of favor over a period of time, the given strategy's performance could be challenged in terms of relative performance. While Sterling believes active professional investment management that employs a consistent process with a long term orientation and aligned with client interests offers benefits, management fees to support the active approach can be higher than certain alternatives. When hiring an investment manager we believe it is important to monitor the investment risks taken including sector concentrations, portfolio turnover, and the impacts of dividend policy changes.

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