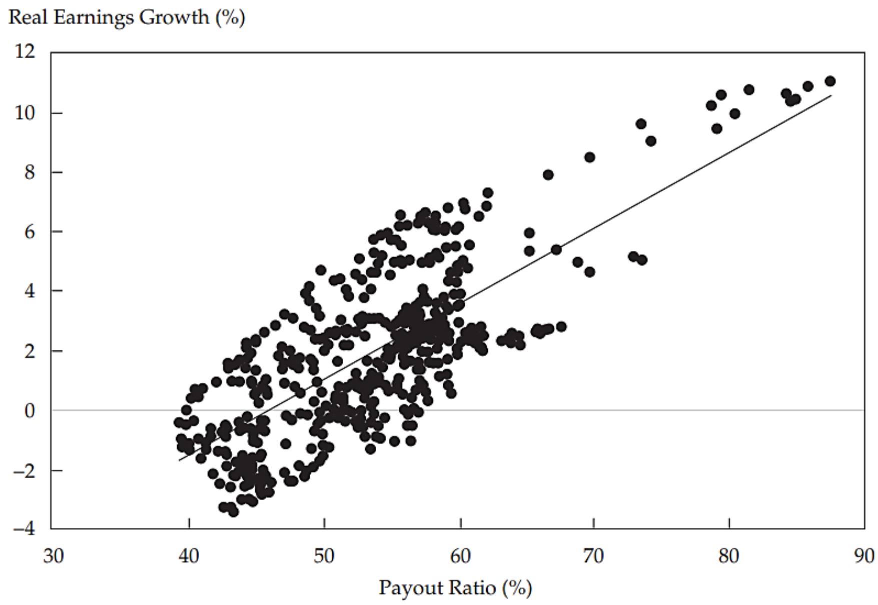
Dividend Investors Having Their Cake and Eating It, Too

The Lead | March 2023

Scattergram of Payout Ratio versus Subsequent Ten-Year Real Earnings Growth, 1946-2001 Data



Source: Arnott RD and Asness CS. *Surprise! Higher Dividends = Higher Earnings Growth* Financial Analysts Journal, Volume 59, Issue 1 (2003).

On February 18, 2023, the cover of The Economist Magazine titled *Why Inflation Will Be Hard to Bring Down* encapsulates what appears to be investors' top concern this year: inflation. Will inflation be brought under control and get back to the 2% level, and if so, when? Will inflation continue to run hot as recent economic datapoints have hinted?

We are not here to predict the future, but to shine light on a potential solution amidst the uncertainty. First, we want to define the concept of real earnings growth in the chart above. Real earnings growth is the difference between nominal growth and the rate of inflation. For example, if a company generates a nominal earnings growth of 5.0% but inflation runs at 6.0% over the course of the year, the real earnings growth of the company is calculated by taking the 5.0% and subtracting 6.0%, yielding a -1.0% growth rate. In this example, even if a company states it grew 5.0%, after inflation, it actually posted negative growth.

For dividend-paying stocks, there is a second concept that needs to be defined. This is the amount of a company's earnings that they pay out in dividends versus retain for themselves to invest in the business. Regarding the payout ratios of our companies, the belief is that a company that pays out less of its earnings should be able to grow faster since it has more money to reinvest in the business.

Interestingly, there is a 2003 study in the Financial Analysts Journal that shows companies that pay out more of their earnings grow their earnings faster. The chart above from that study shows the relationship between paying out more in dividends and generating a higher earnings growth, expressed as a percentage of the company's total earnings. The study's authors point to empirical facts that "managers possess private information that causes them to pay out a large share of earnings when they are optimistic that dividend cuts will not be necessary."

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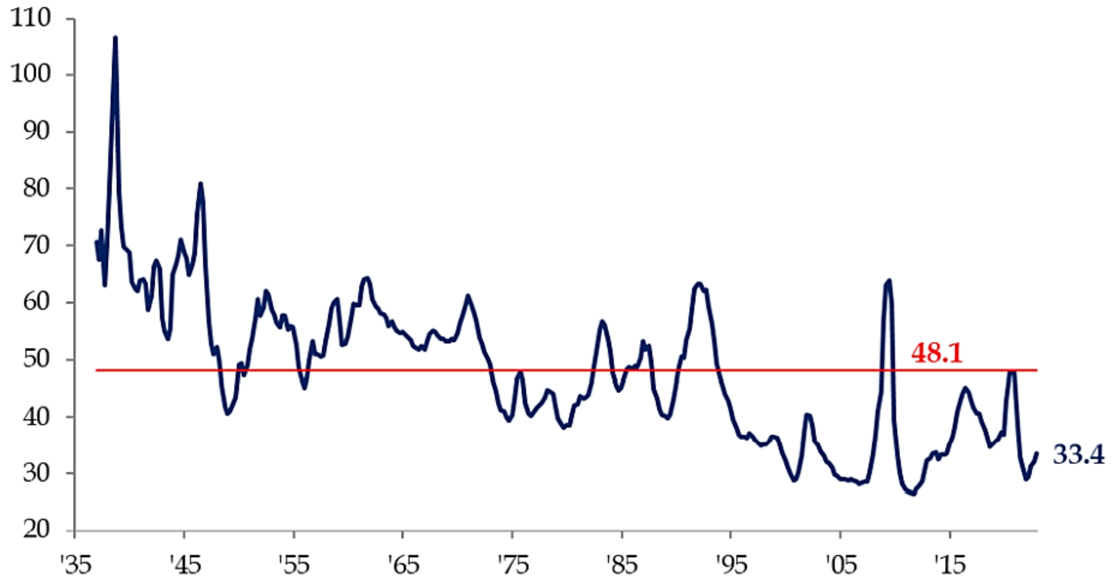
S&P 500 Dividend Payout Ratio



Source: Strategas Research.

In addition, they note that low payout ratios can lead to inefficient empire building and investing in less-than-optimal capital projects. As the chart on the first page notes, this discipline applies to real earnings growth. We've noted in the past that paying dividends, especially ones that increase annually, is a sign of quality, in our view. As seen in the chart above, companies that adhere to the discipline of rewarding their shareholders with dividends represent a minority in the stock market. In the Sterling Capital Equity Income strategy, our most recent payout ratio was 67% according to Bloomberg, aligning the strategy well toward this higher growth orientation. Attractive earnings growth and strong balance sheets that help ensure dividend payout ratios are funded by operations, not debt, and are core investment pillars of our strategy.

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.

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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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