Sustainable Dividends

The Lead | November 2021

Source: Bloomberg, S&P 500 Constituents, S&P Global. As of 09.30.2021 (Higher Better)

The CFA Institute's environmental, social, and corporate governance (ESG) certification process defines responsible investment as an investor's objective to keep "the long-term return of an investment portfolio in mind." However, as noted in our April report, the phrase "next quarter" was mentioned 150 times during 1Q2021 conference calls with S&P 500® Index members, while the phrase "next ten years" was mentioned just once. Finding companies with a long-term focus on sustainable growth appears rare in the current marketplace.

One of the most attractive features of finding companies with a stated goal of paying increased dividends over time is a long-term mindset aligned with that of investors seeking sustainable returns. A stated management objective of providing higher cash dividends over time can heighten the focus on capital allocation and long-range planning. Over the past several months, we've highlighted how sustainable dividend growth can enable investors to stay ahead of the market during times of inflation, how double-digit dividend growers appear to augment performance, and how avoiding dividend cutters can also improve returns.

Specifically, it appears stocks with dividend growth rates in the 10-15% range are in the "sweet spot" in terms of providing relative performance. This cohort is interesting because they appear consistent with relatively high ESG rankings using third-party assessments. In the chart above, we show S&P's ESG rankings for stocks with various five-year compound dividend growth rates by quintile (as of 09.30.2021). As seen in the chart, the quintile with the highest S&P ESG scores is comprised of stocks with five-year dividend growth rates of 9-15%, essentially in-line with the range of dividend growth that demonstrated relative outperformance within the Russell 1000® Value Index over the past ten years.

Why might stocks within this dividend growth rate range have attractive S&P ESG scores? Perhaps their solid management of environmental and social risks help companies to potentially reduce regulatory and litigation costs. Moreover, strong governance can reduce the risk of pursuing mergers that destroy shareholder value, enabling economic profits to be paid to shareholders through increasing dividends.

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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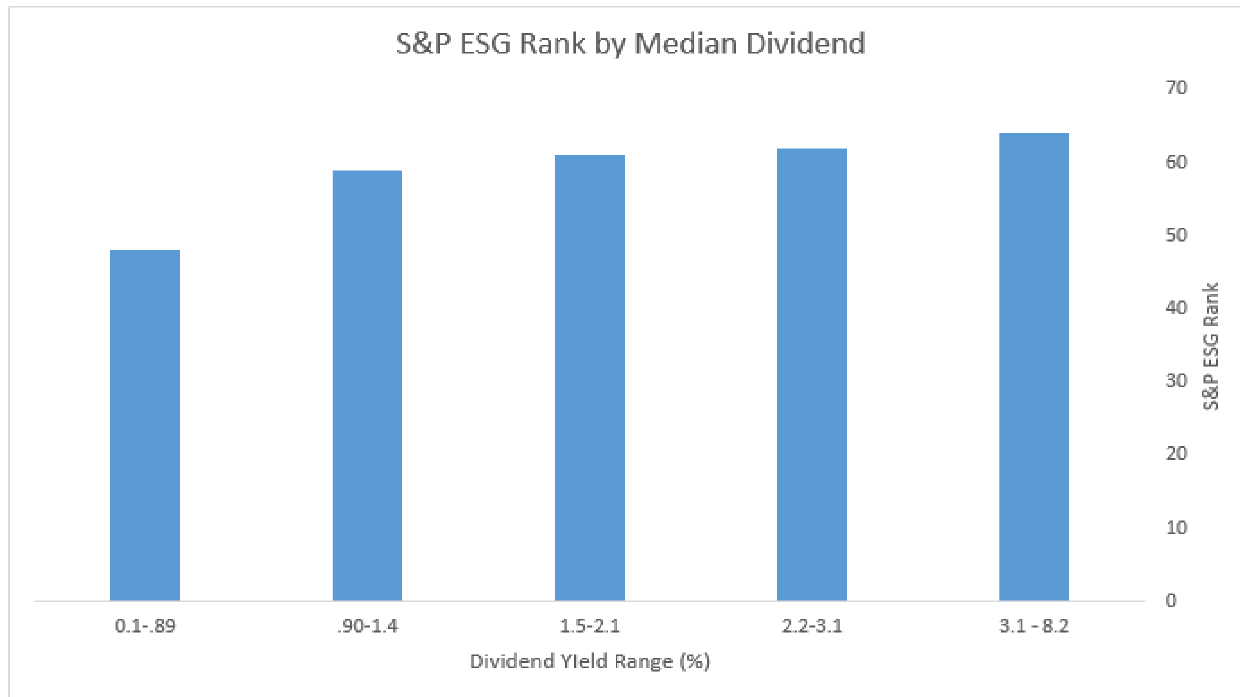

Source: Bloomberg, S&P Global. S&P Constituents paying dividends.

A good example of how the evolving ESG landscape impacts the ability to pay a sustainable dividend can be found in London-based BP plc shares. In August 2020, the CEO announced that its dividend “reset” was “deeply rooted in strategy” to become “an integrated energy company” with an increased investment in a low carbon strategy.

An investor may expect to receive a lower dividend yield to “pay up” for more sustainable companies, however this does not appear to be the case at present. As the chart above shows, in the current market, higher dividend yields are correlated with higher S&P ESG rankings. With the S&P 500 currently offering a dividend yield less than 1.3% and growing at 5.1% over the past five years, it appears investors can create portfolios with above-average dividend yields and growth that also offer attractive sustainability characteristics, given the alignment of managements and investors focused on the long term.

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.

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Important Information

Disclosures

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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.

The Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000® companies with lower price-to-book ratios and lower expected growth values. The Russell 1000® Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics.

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).

ESG Risk: The use of ESG factors could result in selling or avoiding investments that subsequently perform well or purchasing investments that subsequently underperform. As a result, strategies that take ESG factors into account could underperform similar strategies that do not take into account ESG factors.

Technical Terms: **ESG**: ESG is the acronym for Environmental, Social, and (Corporate) Governance, the three broad categories, or areas, of interest for what is termed "socially responsible investors." They are investors who consider it important to incorporate their values and concerns (such as environmental concerns) into their selection of investments – as opposed to simply considering the potential profitability and/or risk presented by an investment opportunity. **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.

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