Dividend Growth Investing: Addressing Both Sides of the Retirement Equation

Santa Barbara Asset Management

MARKET COMMENTARY

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AS INVESTORS APPROACH RETIREMENT, the goal is to transition an investment portfolio from compounding wealth to an ongoing source of income for balancing expenses and lifestyle preferences. However, solely focusing on income while overlooking growth may fail to generate the cash needed for retirement expenses – as well as erode the principal of a portfolio. Although the risks of investing apply to all investors, individuals preparing for (or presently in) retirement should evaluate and manage the associated risks.

Pertinent Retirement Investment Risks

- **Ignoring both components of total return:** Total return is broken down into two parts: changes in price (capital appreciation/depreciation) and dividend income. Given the risks to continued global growth - such as political, legislative and geopolitical events - investors may not be able to rely on equity market appreciation alone in order to achieve the required returns for retirement.
- **Loss of capital:** Mitigating capital loss is a key objective for all investors, especially retirees whose portfolios have lower downside tolerance due to having less time to recover from losses in a volatile equity market.
- **Inflation:** One of the biggest threats to retirement savings is the risk of inflation, which can significantly diminish the value of an investor's long-term purchasing power.

The purpose of this paper is to explore the empirical evidence of dividend growth investing for retirement. When planning for retirement, in our view, the favorable opportunity set of dividend growers allows for capital appreciation. Furthermore, companies with these attributes tend to be well-run, high-quality companies, which can make for an ideal core equity allocation. Companies exhibiting consistent dividend growth may help position a portfolio for total return by addressing both elements of total return: growing dividend income over time but also long-term capital appreciation. An actively managed portfolio with a dividend growth focus may offer the potential for a better

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risk-adjusted total return. We believe the results from this total return approach can lead to building wealth, increasing portfolio cash flow over time and offsetting any potential loss of purchasing power from the effects of inflation, thereby helping to address the risks that investors face as they plan for retirement.

Retirement Risk: Ignoring Both Components of Total Return

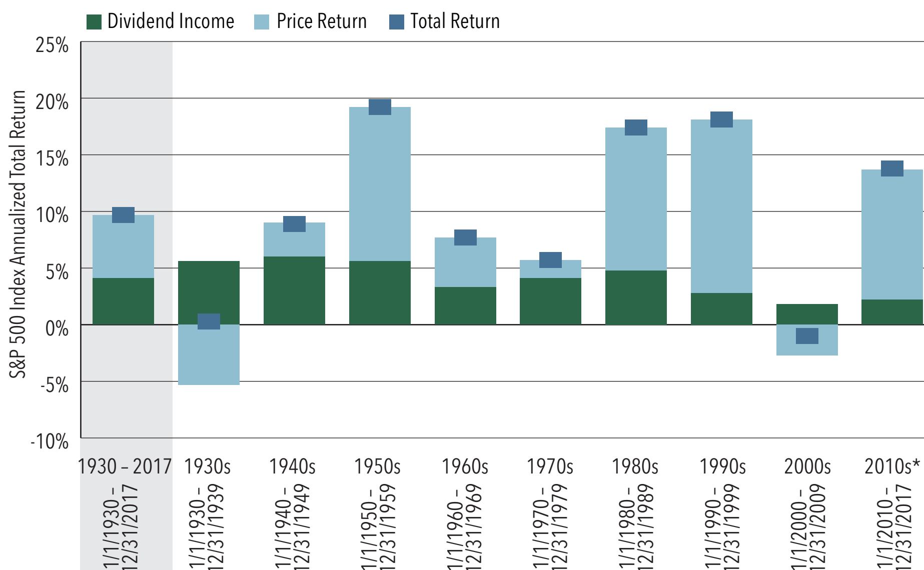
While the percentage has varied from decade to decade, the evidence has shown that dividends are a meaningful component of total return. Historically since 1930, dividend income has accounted for an average of 42% of the long term total return of equities, with capital appreciation contributing the rest.[1]

When looking at the components of total return, changes in both price (appreciation and depreciation) and dividend income, dividend income will always be positive, but price return may be positive or negative. For example, as illustrated in **Exhibit 1**, the 1980s and 1990s were especially friendly to non-dividend paying companies, with dividend income only contributing 28% and 15% of total return, respectively. During these same decades, equities averaged a total return of 17% and 18% respectively, a significant leap from the longer term average return of 10% since 1930. It was not until the 2000s that equity investors experienced a negative return, with dividend income representing the only positive component to total return. For example, in that decade, investors who opted for non-dividend paying equities appear to have placed their reliance for total return on only one component. The investor was hoping for positive changes in price (appreciation) only to experience a contraction (depreciation) of their capital due to negative price returns for that decade.

Dividends have historically contributed **42% OF EQUITY RETURNS** over the long term.

Exhibit 1: Dividend Income as Percentage of Total Return

(January 1, 1930 – December 31, 2017)



Data source: Ned Davis Research, Inc. from 1/1/30 – 12/31/17. Further distribution prohibited without prior permission. Copyright 2018 © Ned Davis Research, Inc. All rights reserved. **Past performance is no guarantee of future results**. For a description of the S&P 500 Index and methodology, see Endnotes for Exhibit 1 on the last page.

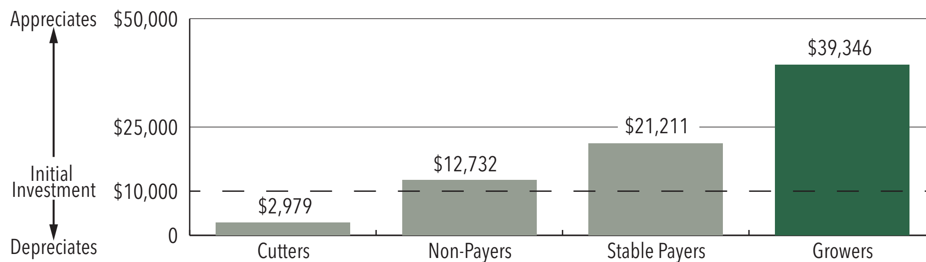
* Represents a partial period and not a full decade.

1 Data source: Ned Davis Research, Inc. from 1/1/30 – 12/31/17. Further distribution prohibited without prior permission. Copyright 2018 © Ned Davis Research, Inc. All rights reserved. Dividend income return is based on the return percentage of all dividend-paying companies in the S&P 500.

The returns over the past 20 years show the additional benefits of dividend investing (**Exhibit 2**). Companies with growing dividends have provided growth of income and capital appreciation. Long-term dividend growth cannot consistently re-occur without the underlying fundamental growth of the business. Companies with consistent dividend growth tend to have strong fundamentals, consistency of revenues and reliable earnings streams, all of which we believe make up the ideal company traits for long-term ownership.

Exhibit 2: Dividend Growers Long Term Total Return of Income and Capital Appreciation

S&P 500 Index Cohorts: Growth of $10,000 (December 31, 1997 – December 31, 2017)



Dividend growers have provided more than **THREE TIMES THE TOTAL RETURN** of non-dividend payers.*

Data source: Ned Davis Research, Inc. from 12/31/97 – 12/31/17. Further distribution prohibited without prior permission. Copyright 2018 © Ned Davis Research, Inc. All rights reserved. **Past results are no guarantee of future results.** The performance shown is for illustrative purposes only and does not predict the future performance of these groups. Performance returns may have been negative during this time period.

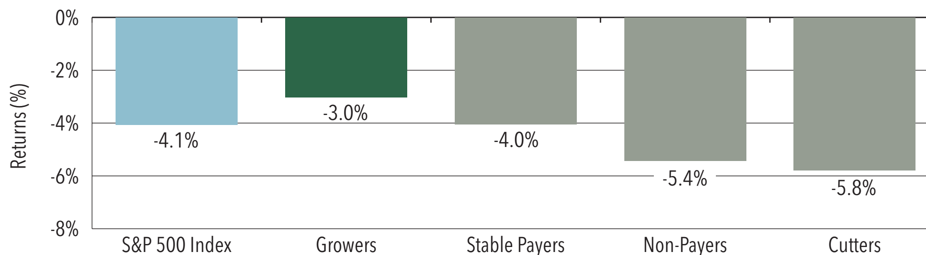
*The periods shown do not represent the full history of the S&P 500 Index. For a description of how each stock is grouped by dividend policy, please refer to the Dividend Policy Description on the last page.

Retirement Risk: Loss of Capital

One of the top concerns of an investor planning for retirement is the risk of broad market declines. As illustrated in **Exhibit 3**, dividend paying stocks, specifically those that have consistently grown their dividend, have been able to defend against market declines.

Exhibit 3: Defense During Down Months

Average Monthly Performance During Months When the S&P 500 is Negative (December 31, 1997 – December 31, 2017)



Dividend growers have helped to **PRESERVE CAPITAL DURING DOWN MARKETS.**

Data source: Ned Davis Research, Inc. from 12/31/97 – 12/31/17. Further distribution prohibited without prior permission. Copyright 2018 © Ned Davis Research, Inc. All rights reserved. **Past results are no guarantee of future results.** The performance shown is for illustrative purposes only and does not predict the future performance of these groups. The periods shown do not represent the full history of the S&P 500 Index. For a description of how each stock is grouped by dividend policy, please refer to the Dividend Policy Description on the last page.

Clearly, some stocks can exacerbate losses while others may help play defense when the market declines. And while all dividend paying companies provide income, those that consistently grow their dividend have demonstrated limited downside volatility. During

periods of uncertainty, companies with capital strength, high-quality earnings consistency and free-cash flow generation tend to perform well on a relative basis versus other equities. Market volatility can cause swings in the price return of a portfolio, but dividend growth companies may help smooth out this volatility.

The Volatility Index (VIX), also known as the "fear index", tends to spike higher when investors are reacting to uncertainty, hence triggering a rise of concern or "fear". As illustrated in **Exhibit 4**, companies with persistent dividend growth have provided excess returns during these rising VIX periods. We believe active investment managers that focus on fundamentally sound dividend growth companies have the potential to provide lower volatility.

Exhibit 4: Dividend Growers Have Historically Outperformed During Heightened Volatility

S&P 500 Index Dividend Growers vs. Non-Payers

CBOE (**VIX**®) Monthly Increase (12/31/97 – 12/31/17)	Dividend Growers Average Excess Return
>40%	2.2%
20-40%	3.8%
10-20%	2.1%
<10%	0.5%
Average (Across All Months When VIX® Increased)	1.8%

Data sources: FactSet and Ned Davis Research, Inc. from 12/31/97 – 12/31/17. Further distribution prohibited without prior permission. Copyright 2018 © Ned Davis Research, Inc. All rights reserved. **Past results are no guarantee of future results.** This chart illustrates the average historical performance of S&P 500 stocks, grouped as shown according to their dividend policies. Periods greater than one year have been annualized. The returns do not reflect the deduction of any fees, expenses or taxes. Returns for stocks that paid dividends assume reinvestment of all income. Performance returns may have been negative during this time period. Investors cannot invest in an index. The periods shown do not represent the full history of the S&P 500 Index; it is the history maintained by the source. For a description of how each stock is grouped by dividend policy, please refer to the Dividend Policy Description on the last page. For a description of the **CBOE (Chicago Board of Exchange) Volatility Index® (VIX®)**, please refer to the Glossary on the last page.

Companies with sustainable dividend growth have historically generated **EXCESS RETURNS** during periods of market volatility.

Retirement Risk: Inflation

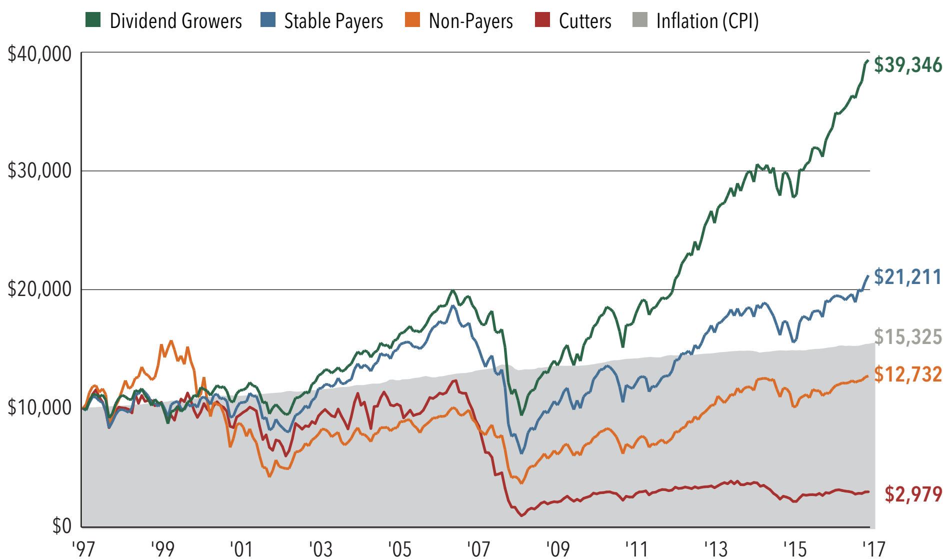
When comparing investment choices, an investor planning for retirement might frequently use current yield as a guide. This measurement allows investors to compare yields across a wide range of asset classes, however, yield must be translated into real dollars and the income for retirement has to account for more than just the current year, but for all of retirement. Due to the effects of inflation, annual retirement expenses have the potential to rise each year. We believe this is where dividend growth can play a pivotal role in an investor's retirement portfolio, helping to preserve purchasing power and grow a portfolio faster than inflation.

A growing dividend means the cash flow an investor receives this year will be greater than it was last year. Ideally, a company that is organically growing its dividend will do so out of the growth of its earnings, as opposed to being driven by increasing debt, reducing its cash, or solely increasing its payout ratio. In this way, a company's dividend growth has a greater potential to be understandable, repeatable and consistent.

Perhaps the most important potential benefit of dividend growth is its impact on the real income a portfolio can generate, and because of this dynamic, a growing dividend can be a powerful hedge against inflation (**Exhibit 5**).

Exhibit 5: Outpace Inflation Long Term

Growth of Hypothetical $10,000 Investment (December 31, 1997 – December 31, 2017)



Dividend growers have helped provide **2.5 TIMES MORE PURCHASING POWER THAN INFLATION**.

Data sources: U.S. Bureau of Labor Statistics, FRED, Federal Reserve Bank of St. Louis and Ned Davis Research, Inc. from 12/31/97 – 12/31/17. Further distribution prohibited without prior permission. Copyright 2018 © Ned Davis Research, Inc. All rights reserved. **Past results are no guarantee of future results.** Chart illustrates the hypothetical growth of a $10,000 investment with income reinvested and no transactions costs or taxes. **Inflation:** Consumer Price Index for All Urban Consumers: All Items (CPIAUCSL). The periods shown do not represent the full history of the S&P 500 Index. Different benchmarks, economic periods, methodologies and market conditions will produce different results. For a description of how each stock is grouped by dividend policy, please refer to the Dividend Policy Description on the last page.

Investment Implications: Balancing Risk and Return

Investors saving for retirement and those already dependent on their retirement savings likely can benefit from equity investments for the potential long term returns they can provide, but we believe they should also demand an investment approach that provides a way to manage the inherent risks. Specifically, risks to continued global growth, increased equity market volatility, and the long-term effect from inflation need to be considered for ideal retirement investments. An actively managed investment strategy focused on dividend growth may help investors generate attractive long term total return with lower volatility while also growing income for retirement. ■

For more information, please contact your financial advisor and visit nuveen.com or contact Santa Barbara by visiting sbasset.com.

ENDNOTES

Exhibit 1 Periods greater than one year are annualized. **The S&P 500 Index** is a widely used gauge of large-cap U.S. equities. The S&P 500 Index includes 500 leading companies and captures approximately 80% coverage of available market capitalization. Return performance is based on equal-weighted geometric average, computed monthly. Dividend income return is based on the return percentage of all dividend-paying companies in the S&P 500. The returns do not reflect the deduction of any fees, expenses or taxes, and assume reinvestment of all income.

DIVIDEND POLICY DESCRIPTION

Dividend Growers: Dividend Growers & Initiators; **Stable Payers:** Dividend Payers with No Change in Dividend; **Non-Payers:** Non-Dividend Paying Stocks; **Cutters:** Dividend Cutters or Eliminators.

The performance is based on the equal-weighted geometric average, rebalanced monthly, grouped as shown according to their dividend policies based on the historical performance of S&P 500 stocks. Each stock's dividend policy is determined on a rolling 12-month basis. For example, a stock is classified as dividend-paying if it paid a cash dividend at any time during the previous 12 months. A stock is reclassified only if its dividend payments change. Dividend growers and initiators include stocks that raised their existing dividend or initiated a new dividend during the preceding 12 months. Dividend cutters or eliminators include stocks that lowered their existing dividend or stopped paying regular dividends during the preceding 12 months. The returns do not reflect the deduction of any fees, expenses or taxes that would reduce performance in an actual client portfolio. Returns for stocks that paid dividends assume reinvestment of all income. These groups have been determined by Ned Davis Research, Inc. Further distribution of this information is prohibited without prior permission. Copyright 2018 © Ned Davis Research, Inc. All rights reserved.

GLOSSARY

The **CBOE (Chicago Board of Exchange) Volatility Index® (VIX®):** is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. Since its introduction in 1993, VIX has been considered by many to be the world's premier barometer of investor sentiment and market volatility (www.cboe.com).

Consumer Price Index (CPI): is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care.

Dividend yield: For a company's stock, the ratio of the dividends paid out by the company each year per share to the share's current market price.

Purchasing Power: of the dollar measures the amount of goods and services that a dollar can buy in a particular market, as compared with prior periods, assuming always an inflation or a deflation factor and using an index of consumer prices. For instance, $1 in 1982-1984 may have had 46 cents of purchasing power in 2010 because of the erosion caused by inflation.

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