ARGUS®

WEEKLY ECONOMIC COMMENTARY

March 27, 2017

Focus on Dividend Growth in a Rising Rate Environment

As expected, the Federal Reserve raised the fed funds rate by 25 basis points on 3/15/17, its third rate hike in the current cycle and third since the financial crisis. Though the mid-March hike was the first of this year, it was the second hike in three months; the prior one coming in December 2016. The fed fund target range is now 0.75%-1.00%.

Since the inauguration, Washington and Wall Street have rejoiced at a renewed growth outlook for the economy, based on prospects for tax cuts and infrastrucure investment. The Federal Reserve deals with the here and now, not future stimulus drivers. In announcing the more restictive monentary policy, Fed Chair Yellen's language was little changed from past FOMC meeting commentary, in which she both supported the need for higher rates while indicating continued plans for a go-slow approach amid uneven economic indicators.

The Fed, late in 2016, indicated that it was targeting three rate hikes in 2017, and the central bank appears on track for that cadence in 2017. Chair Yellen stated that the "the data have not notably strengthened," giving the Fed no reason to change its course. The chair also suggested that the Fed would have sufficient time to adjust its plans should Congress and the President get to the point where they are ready to proceed with tax reform or infrastucure investment.

Last week we detailed that the stock market has shown the ability to continue moving higher in the early phases of the rate cycle, while finding the path more challenging as the rate cycle matures. Currently, nominal short-term interest rates are below the rate of inflation, which means that real interest rates are negative. When the Fed hikes four or more times, likely by early 2018, the economy will have to contend with positive real rates. That could create new challenges for the stock market.

DIVIDEND GROWTH OVER HIGH-YIELD

So far in 2017, sectors perceived as sensitive to rising rates are already under-performing. These include high-yield sectors such as real estate (REIT) and telecom services, both of which are close to break-even for the year (in a market that is up about 6%). The utility sector has done slightly better than other high-income sectors, but is still toward the bottom among all sectors in year-to-date performance.

Dividend income is an important element of total return. Between 1930 and 2012, dividend income accounted for 42% of total return on the S&P 500 (source: Morgan Stanley). Equally important are reinvested dividends. One study suggested that for a hypothetical $100 invested in 1940, the position would have been worth approximately $174,000 as of year-end 2011 if dividends were reinvested, but only $12,000 if dividends were not reinvested (source: Bloomberg; Guinness Atkinson Asset Management).

Still, not all dividends are created equal. It is important to understand the difference between high-yield stocks and dividend-growth stocks, particularly in a rising-rate environment. With the Federal Reserve poised to raise rates several more times this year, the differences between the two dividend categories are more important than ever.

High-yield stocks typically have dividends that pay out in the 4%-8% range. Though the income appears attrac-

(continued on next page)

tive, the share prices of high-yield stocks are perceived as being at risk in a rising-rate environment. This is because at the margin, as interest rates are moving higher, risk-averse equity investors could be drawn to the relative safety of bonds and may sell their high-yield stocks. In addition, it is worth noting that a yield in the 7%-10% range could signal a company is struggling and the dividend is at risk.

Dividend-growth stocks typically have lower yields, often in the 1.5%-2.5% range. But while the yields are not as high, management teams are more likely to boost the payouts at an aggressive rate over time. These above-average dividend hikes give off several positive signals. For one, the company has the financial strength to boost the payout. Two, management is focused on shareholder returns and understands that dividends are a big part of those returns. And three, the company is confident enough about its outlook to boost the dividend.

On average, the dividends of the companies in the S&P 500 have grown 6.1% per year since 1973. Only rarely has the dividend growth rate been negative — during the bear markets of 2000, 2008 and 2009. At the other side of the spectrum, only in 11 of the past 43 years has the average dividend growth rate been 10% or above.

At this stage of the economic and market cycles, Argus recommends focusing on dividend growth instead of dividend yield. Specifically, we would focus on persistent dividend growers — companies that have boosted their dividend for many years consecutively — and companies that have an above-average rate of dividend growth. We would scour for dividend growth in sectors outside the traditional equity-income areas of utilities, REITs, and MLPs. And for all names, we would track some measure of dividend safety; our favorite is cash flow coverage or free cash flow coverage of dividends.

Dividend growers correlate well with positive long-term total return. Looking at historical return of stocks within the S&P 500 between 1972 and 2010, average annual return was 7.3%; but average annual return for companies that initiate or grow their dividends was 9.6% (source: Ned David Research).

Argus analysis also supports the view that dividend-growth stocks hold their value better in periods of rising rates and deliver solid total returns in all markets. To test this hypothesis, we examined the recent performance of the Argus coverage universe. We first started by excluding stocks that have not paid dividends over the past five years, leaving us with approximately 280 companies. We then cut the list into four different tranches, based on average rates of dividend growth over the five-year period.

We found that the top two tranches — which each averaged double-digit dividend growth — delivered solid double-digit returns even though they did not have the highest average yields. Moreover, they had the highest cash-flow coverage ratios — a key financial strength measure. By contrast, the bottom tranche for dividend growth was also the bottom-performing tranche on a total-return basis. Tranche four had the highest yields, along with a history of dividend reductions and a low FCF coverage ratio (source: Argus Research).

CONCLUSION

No investing style is completely weather-proof across an entire economic cycle, but we regard dividend growth as "weather-resistant." This style holds value even in defensive phases, while delivering superior returns in periods of economic expansion and stock market growth.

We believe investors' portfolios should strike a balance between dividend growth and pure income. As noted, we would be wary of the highest-yielding stocks, as these are often companies in distress.

As the Fed continues on its hiking cycle and market rates of interest move higher, we would shade our income-producing holdings more toward dividend growth and less toward high income. And we would be mindful of the multiplier effect of plowing all dividends back into investment portoflios in order to optimize total return.

Jim Kelleher,
Director of Research

Argus Research Co. (ARC) is an independent investment research provider whose parent company, Argus Investors' Counsel, Inc. (AIC), is registered with the U.S. Securities and Exchange Commission. Argus Investors' Counsel is a subsidiary of The Argus Research Group, Inc. Neither The Argus Research Group nor any affiliate is a member of the FINRA or the SIPC. Argus Research is not a registered broker dealer and does not have investment banking operations. The Argus trademark, service mark and logo are the intellectual property of The Argus Research Group, Inc. The information contained in this research report is produced and copyrighted by Argus Research Co., and any unauthorized use, duplication, redistribution or disclosure is prohibited by law and can result in prosecution. The content of this report may be derived from Argus research reports, notes, or analyses. The opinions and information contained herein have been obtained or derived from sources believed to be reliable, but Argus makes no representation as to their timeliness, accuracy or completeness or for their fitness for any particular purpose. This report is not an offer to sell or a solicitation of an offer to buy any security. The information and material presented in this report are for general information only and do not specifically address individual investment objectives, financial situations or the particular needs of any specific person who may receive this report. Investing in any security or investment strategies discussed may not be suitable for you and it is recommended that you consult an independent investment advisor. Nothing in this report constitutes individual investment, legal or tax advice. Argus may issue or may have issued other reports that are inconsistent with or may reach different conclusions than those represented in this report, and all opinions are reflective of judgments made on the original date of publication. Argus is under no obligation to ensure that other reports are brought to the attention of any recipient of this report. Argus shall accept no liability for any loss arising from the use of this report, nor shall Argus treat all recipients of this report as customers simply by virtue of their receipt of this material. Investments involve risk and an investor may incur either profits or losses. Past performance should not be taken as an indication or guarantee of future performance. Argus has provided independent research since 1934. Argus officers, employees, agents and/or affiliates may have positions in stocks discussed in this report. No Argus officers, employees, agents and/or affiliates may serve as officers or directors of covered companies, or may own more than one percent of a covered company's stock. Argus Investors' Counsel (AIC), a portfolio management business based in Stamford, Connecticut, is a customer of Argus Research Co. (ARC), based in New York. Argus Investors' Counsel pays Argus Research Co. for research used in the management of the AIC core equity strategy and model portfolio and UIT products, and has the same access to Argus Research Co. reports as other customers. However, clients and prospective clients should note that Argus Investors' Counsel and Argus Research Co., as units of The Argus Research Group, have certain employees in common, including those with both research and portfolio management responsibilities, and that Argus Research Co. employees participate in the management and marketing of the AIC core equity strategy and UIT and model portfolio products.

Investors