DIVIDEND GROWTH: 
THE KEY TO “REAL” 
INVESTMENT SUCCESS 

KLEINWORT BENSON INVESTORS WHITE PAPER
Dividend Growth - The Key to “Real” Investment Success

Many of our clients, particularly those in the US, have become increasingly concerned over the prospects for inflation and are looking at specific ways to increase the level of inflation protection in their portfolios.

They also feel there is an apparent shortage of assets to provide this hedge against inflation over the short to medium term. While there are investment products specifically designed to match short term movements in inflation (TIPS/Inflation Linked Bonds or synthetic derivative products) and investments that are very responsive to price movements (commodities), one of the biggest drawbacks is that they can offer very poor investment returns if the inflation risk you are hedging against fails to materialise. Also, for various reasons, these approaches all tend to remain on the fringes of most investors’ portfolios and so fail to make a meaningful impact in the context of the total fund.

Most investors accept that equities have an important role to play in the fight against inflation over the long term. Indeed this is one of the key reasons that they retain a central place in most portfolios. However, it is usually accepted that the time lags involved for the “Real” results to materialise are too long for them to be specifically labelled as inflation hedging assets. Depending on the type of equities in question, we think that there is a strong argument for disagreement. To show what we mean we will examine the component parts of equity returns where we will see that while there is typically a negative relationship between capital gains and inflation, there is a positive one between dividends and inflation.

Indeed, one of the reasons that payout levels have been so low for so long is that inflation levels have been so low for so long. Yet this never got a mention in all the analysis of “disappearing dividends” in the early 2000s. Furthermore, equity portfolios that are specifically designed to have high dividend yields and dividend growth rates that are above the inflation rate can provide excellent hedging characteristics even over relatively short time periods.

There are three dynamics that contribute to this:

**Dividend Yield:** A high absolute level of yield provides a buffer against price rises and helps protect the real value of your assets.

**Dividend Growth:** Dividends are not as sticky as you think. Dividend growth measures the increase in the amount of dividends being paid out to shareholders and can be very responsive to inflation.

**Dividend Premium:** Equities tend to be de-rated in periods of inflation. This means the price that investors pay per unit of earnings goes down. But companies that pay high and increasing dividends perform better. (Think “Gordon’s Growth Model” but with inflation as the driver of dividend growth rather than GDP).
Equities and inflation

The majority of studies of equity market behaviour conclude that while equities as an asset class deliver very good protection against inflation over the long term, they are a poor match for price changes over the short or even medium term. However, it’s very important to examine carefully the data that is used in long term studies and whether it reflects the actual financial dynamics that a shareholder who was invested over the period would have experienced. Dimpson Staunton and Marsh of the London Business School have long been evangelists on this matter, and the data provided by Robert Schiller and his team at Yale, along with the annual Barclays Equity Gilt Study, are real eye openers in this regard.

The first problem that investors face is one of accurate data. Many of the long term equity studies which examine the relationship between equities and inflation focus only on the price to price response of equities at an index level and don’t include the income component. This is not unusual as modern equity investors are trained to focus on a specific part of the equity transaction and as a result often miss the bigger picture. Driven by the prospect of quick price appreciation, investors tend to overlook the importance of the dividend component. As we will see this is a very big omission. Not just because it overlooks two of the component parts of equity returns – Dividend Yield and Dividend Growth – but because it overlooks THE component parts which are the most effective against inflation.

Dividends and inflation over the long term

First let’s look at long term research from one of the most respected databases that actually does record the behaviour of equities from a total return perspective: the Barclays Capital Equity Gilt Study. It shows that dividends account for 90% of the total equity return ABOVE inflation. Their research on UK equities shows that over the last 110 years, equities have produced a total real return (i.e. above inflation) of 5.0% p.a. Capital appreciation contributed only 0.5% p.a. in real terms (or 10% of the excess return), while the dividends contribute 4.5% (or 90% of the excess return). Most investors who have grown up with the cult of the equity throughout the eighties and nineties find this astonishing, but it makes perfect sense, when you understand that both dividends and inflation are nominal (whereas bond coupons are fixed for example) and dividends tend to increase over time.

To quote directly from the study, "reinvested dividends are effectively real in nature as dividends paid out are assumed to have been invested at the current nominal rate, one that reflects the prevailing inflationary environment. Thus dividends should act as an effective hedge against inflation – evidenced by the figure below, with the reinvested dividend index consistently providing returns well above inflation."

UK Equity Returns: price changes, dividends and inflation

Since 1899, dividends provide an annual return of 4.5%, well above inflation

Source: Barclays Capital
While this data shows us that dividends are responsive to inflation and the combined dynamics of dividend yield, dividend growth and dividend premium are very effective in conquering inflation, the main drawback is that the time horizon being covered in the study is a bit longer than most of us are prepared to wait! But there is also a second key message from this data: an equity strategy that focuses on dividends and dividend growth provides an effective hedge against inflation over much shorter periods than a strategy that focuses on capital appreciation. Let’s look at this more closely.

### Dividend growth and inflation

The 1970s are the period most referred to when looking at the damage that inflation can inflict. If you spent $100 in your grocery store in 1970, by 1980 the exact same bill at the exact same store would now cost you $200. To paraphrase Einstein, “compounding is the most powerful force in the universe”. But this is true for dividends as well as price increases. In early 1970 the average S&P 500 company had a dividend yield of 3.4%. This means that an investment of just under $3,000 invested with a dividend yield of 3.4% would have provided enough dividend income to cover your $100 tab in 1970. Throughout the decade that followed companies raised their nominal rate of dividend payments in line with inflation. So by 1980 the same investment now provided $200 in dividend income – still covering your expenses tab after a decade of inflation. Note that this does not take into account the price change of your investment which would now have been worth approximately $5,715 at the end of the period.
Dividends tend to grow faster than inflation over the long term (3.5% dividend growth for S&P 500 stocks versus 2.2% inflation over the past 139 years annually). Further, when inflation “heats up” so does dividend growth. Take, for example, US stocks in the 1970s: inflation and dividend growth were both above 6%.

While broad market equity prices fell throughout the 1970s, stocks with high dividend yields that were also increasing their dividend payments did much better. Part of the reason for this is that equities go through different periods when their price multiples get de-rated or re-rated. The price that investors are prepared to pay for a given level of earnings (or more accurately expected earnings) changes through time. This is independent of the actual changes to earnings themselves. Generally equity multiples get de-rated during inflationary times, but higher dividend payers fare better. The extreme example of this is the UK in the 1970s. From 1969 to 1980, P/E ratios on UK equities contracted from 22.1 to 6.5, while dividends grew at an annualised rate of almost 6%.

In the 1980s, inflation cooled off (averaging 5%), while dividends kept growing at a rate of 7% in the US and 4.5% in the UK.

Because the historical data is only available on an aggregated index or market level, rather than for all the underlying stock listings, disentangling the different performance elements of high dividend stocks is impossible. However, what we can examine clearly is the dividend growth component at a broad market level. While this doesn’t reveal the full effects of how dividends benefit equity investors in times of inflation it does tell us a lot about how responsive dividends can be to inflation.

Dividend growth tends to beat inflation for two reasons:

1: Earnings growth tends to beat inflation (but this may take some time)

2: The payout component rises with inflation (this is usually adjusted annually)

While the first of these facts is a staple of any equity textbook, the second is missed by most investors (who tend to be more influenced by recent experience rather than anticipating the future or looking at the long term history). Dividend growth is not just a function of profit growth, it’s also a function of payout decisions.

Ultimately dividends get paid from earnings. Studies of payout policy show that company management won’t authorise dividend increases unless they anticipate their earnings growth will be strong enough to cover the increased obligations to shareholders. Companies that declare dividends tend to increase the dividend over time, and avoid cutting their dividend if at all possible. This story plays out consistently throughout history.

Dividends are nominal by nature and therefore tend to track any changes in the general level of prices. In practice average growth in dividends has tracked inflation well, even during the high inflation period of the 1970s. Again studies of payout policy show that company managements are aware of the competitive forces at play in broader financial markets when it comes to attracting investors to buy their debt or equity. The prevailing level of yields and interest rates are an important part of these competitive forces and they increase when inflation increases. Also shareholder behaviour changes in line with the overall economic experience they are living through. Return expectations and risk tolerances are variable. Investors are more likely to “shop for yield” in cautious markets or as real earnings growth expectations fall. As a result, companies are motivated to increase dividends to draw investors to their stock.

Similarly when inflation and yields decline so too does the imperative to increase payout levels.
Sceptics may feel that the timeframes we have examined are still too long. While we believe that those investors with long term mindsets will always prevail over the masses, we accept that non-investment issues can force investors to have shorter time horizons. However, we would be loath to encourage investors to look at anything shorter than 5 year periods. The charts below look at the rate of change of dividend payments over rolling 5 year periods for the UK and US. While dividends are typically described as “sticky” the results show they are a lot more dynamic than you think.

**UK Dividend growth rates and inflation**

Dividends provide protection against rising inflation over the medium term

FTSE All Share Realised Dividend Growth vs. UK RPI Growth, smoothed over 5 years

Source: Morgan Stanley Equity Research, Factset

**US Dividend growth rates and inflation**

Dividends provide protection against any big rise in inflation over the medium-term: US DPS Growth vs. Inflation (5 year CAGR)

Source: Ibbotson, GF Data, Morgan Stanley Research

Again even an analysis which limits itself to five year periods clearly displays that dividend growth is very responsive to inflation. There is some volatility in the relationship however. Is there anything we can do to make the relationship more stable?
Inflation conscious investors should target high dividend growth. Other benefits will follow.

Well, all the data and charts we have presented so far refer only to the dividend growth component that equity investors receive passively through generic broad market exposure. This assumes of course that they are invested in total return indices and not passive vehicles that give only price to price exposure (and there are more of these about than you think). It is of course possible, and definitely advisable, for equity investors with inflation concerns to specifically target a higher level of dividend yield and dividend growth than is available from a broad market strategy.

Specifically, before inflation picks up, you should start out with a dividend yield that is higher than the inflation rate and ensure that the annualised dividend growth rate you are receiving is also higher than the inflation rate. From an income perspective this clearly and simply solves the inflation hedging requirement as the amount of income growth being generated is higher than the prevailing rate of inflation.

From a total return perspective stocks generating such a rate of growth in dividends should also receive a premium from investors. This should lead to relative outperformance against the broad equity market.

When making a portfolio with inflation hedging in mind investors should also recognise that dividend growth rates are significantly higher in emerging markets than they are in the developed world. Any portfolio designed to combat inflation should not only be globally diversified, it should include a healthy allocation to dividend payers from emerging regions. Many commentators also point to the inflation hedging properties that come with exposure to emerging market currencies. Countries with high inflation tend to have depreciating currencies and therefore benefit from foreign currency exposure. Emerging markets are especially interesting, though, because inflation is usually accompanied by a rise in commodity prices, and emerging markets tend to be large commodity exporters. They also tend to deliver higher interest rates because of perceived risks about their broader economic governance and political stability, which enables investors to benefit from the carry trade.

### The KBI Portfolios

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<th>KBI Global Strategy</th>
<th>MSCI Global Index</th>
<th>KBI Emerging Markets Strategy</th>
<th>MSCI Emerging Markets Index</th>
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Source: Kleinwort Benson Investors, Datastream, 30/09/2011
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"We would like to thank Barclays Capital for the production of these charts from their Equity Gilt Database.

If you would like to find out further information please refer to www.kleinwortbensoninvestors.com

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