

# Looking Backward and Forward at Dividend Growth

Compared with investing in the overall equity market, investing with a focus on dividend-paying stocks has historically delivered a number of desirable outcomes, namely higher income, lower volatility, compelling risk-adjusted returns, and inflation protection during periods of rapidly rising prices. Previous articles in the Leadership Series—including “Equity and Non-Bond Income: Opportunities and Investment Approach” and “The Merits of a Global Equity Income Approach”—demonstrate these benefits in both U.S. and international markets. This article concentrates on how to invest more effectively in dividend-paying equities by avoiding some possible shortcomings of simplistic approaches.

While there are several backward-looking income-oriented and valuation factors that have worked well historically, we will demonstrate that a combination of factors such as dividend yield, price-to-book, and leverage can be more successful than any one in isolation. The ability to forecast dividend growth can be even more powerful than backward-looking factors, suggesting that an active approach may offer some advantages. The insights derived from fundamental analysis to forecast positive dividend growth may also help investors avoid companies that cut or suspend dividends, thus mitigating one of the key risks of equity income investing.

## Historical measures of equity income

A backward-looking approach that isolates stocks using just a single relevant factor—such as high dividend yield or low leverage—would have produced reasonably attractive annualized active returns with at least average probabilities of portfolio outperformance. To demonstrate this, we construct hypothetical equal-weighted portfolios by factor-ranking stocks in the S&P 500 Index and sorting them into five quintiles during the past two decades from December 31, 1990 to June 30, 2011. We rebalance the quintiles quarterly and calculate the average 12-month forward return for each quintile. This type of analysis uses equal weighting to highlight factor-specific differences without the impact of stock-specific market capitalization.

For example, a hypothetical equal-weighted portfolio owning the top quintile of S&P 500 stocks ranked by dividend yield would have delivered 171 basis points (bps) of active return relative to the equal-weighted index, with a risk-adjusted return of 0.20.<sup>1</sup> This high-yield strategy would have outperformed the index 49% of the time, which is called the *success rate* (see Exhibit 1, page 2). Likewise, simply owning the equal-weighted top quintile of stocks with the lowest leverage—defined as net debt to equity—would have delivered 124 bps of annual outperformance relative to the equal-weighted S&P 500 Index, with a risk-adjusted return of 0.10 and a success rate of 52% (see Exhibit 2, page 2).

When we extend this backward-looking approach by blending dividend yield and leverage, the historical results improve further. A hypothetical portfolio combining high dividend yield with low leverage would have delivered 260 bps of annual outperformance, with a better risk-adjusted return of 0.27 and a higher success rate of 54% during the past two decades (see Exhibit 3, page 2). This improvement in return characteristics is driven in part by the low correlation among these factors, which allows each factor to be additive.

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## KEY TAKEAWAYS

- Equity portfolios constructed from backward-looking combinations of income-oriented and valuation factors have performed well historically, yet there are pitfalls to this approach.
- Sector imbalances and dividend cuts or suspensions can have negative consequences to a portfolio's total return.
- An active, forward-looking approach not only helps investors avoid the risk of the dividend cut, but also holds the prospect of forecasting positive dividend growth.
- Accurate estimates of dividend growth would have generated greater outperformance more consistently than most combinations of backward-looking factors.
- Investors who take an active approach to anticipating dividend growth may be able to reduce the risks and enhance the benefits of equity income.

### Hidden risks of naive, backward-looking approach

The above-average success rate of a simple combination of historical dividend yield and leverage might suggest that equity income investing is such a fundamentally attractive strategy that a naive, backward-looking approach would suffice. However, this approach has at least two notable shortcomings.

### Sector imbalances

A backward-looking approach that focuses on dividend-oriented metrics may periodically expose an investor to large sector tilts. The following analysis uses capitalization weighting, which better represents sector allocation differences in the equity market.<sup>2</sup>

To highlight the risk of sector imbalances, we look at the financials sector, which has long been a staple of income-oriented strategies because financial companies have a history of paying relatively high dividends. During the past two decades, a backward-looking strategy focusing on the top quintile of S&P 500 stocks ranked by dividend yield would have had an average exposure of 22% to the financials sector, which compares with the broad market's average of 16%. This overweight of the financials sector introduces degrees of portfolio imbalance and risk that may not be fully appreciated until an event such as the global financial crisis of 2008–2009. Heading into the crisis in the third quarter of 2008, this strategy and the S&P 500 respectively would have had 37% and 14% exposures to financials. In 2008, financials qualified as the worst-performing sector of the S&P 500, returning –56% versus the broad market's –38%.

Among dividend-oriented exchange traded funds (ETFs), the exposure to the financials sector can be even more magnified. For example, across a sample of the five largest dividend ETFs by assets, the average fund invested 35% in financials as of June 30, 2008, just prior to the turbulent third quarter.<sup>3</sup> Among the outliers was an ETF with more than 65% of its total assets invested in just the financials sector (see Exhibit 4, page 3). Not surprisingly, these ETFs meaningfully underperformed the broad market with highly volatile performance during and after the tumultuous 2008–2009 period.

### Dividend cuts and suspensions

The same dividend yield that attracts investors to a stock may also result in that stock's rapid undoing. Dividend cuts and suspensions can happen quickly. On average during the past two decades, 10% of stocks with the highest dividend yields suspended or cut their dividends within one year of joining the top quintile (see Exhibit 5, page 3). In 2009, this percentage spiked to 40%!

Investing in a stock that cuts or suspends its dividend is not a trivial matter. Based on our analysis, the average security that cut or suspended its dividend underperformed the market by more than 23% during the 12 months preceding the official announcement of the dividend cut or suspension (see Exhibit 6, page 3). Put another way, the market often anticipates a dividend cut or suspension well before it is announced. In the world of equity income investing,

EXHIBIT 1: Hypothetical portfolios with high dividend yield would have produced attractive active returns.

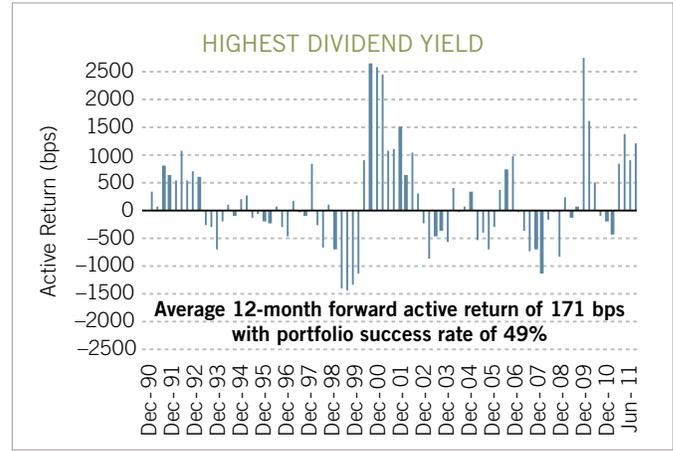


EXHIBIT 2: Hypothetical portfolios with low leverage would have generated active returns during the past two decades.

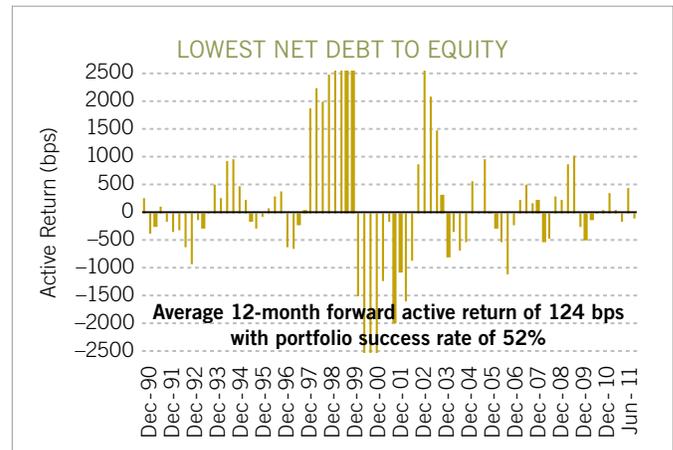
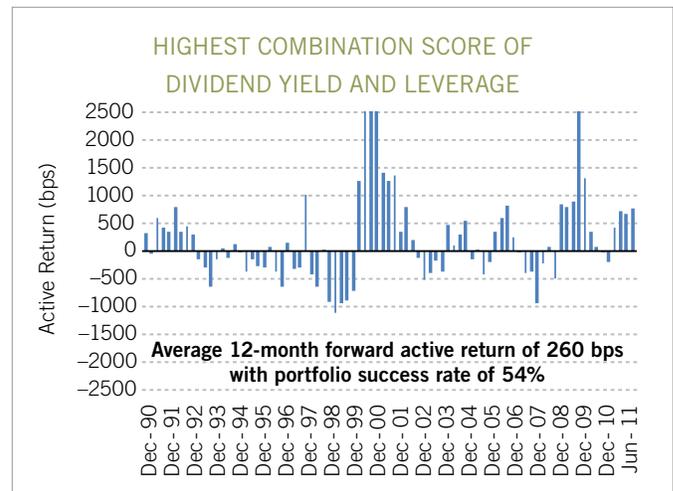
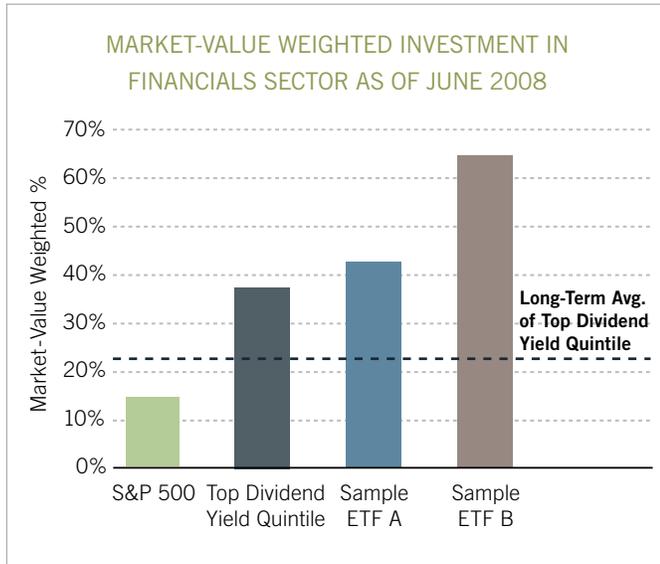


EXHIBIT 3: Hypothetical portfolios with high dividend yield and low leverage would have delivered even better active returns.



Active return = portfolio return – benchmark return. Source: FactSet, Fidelity Investments as of Jun. 29, 2012.

EXHIBIT 4: An unconstrained focus on dividend yield tends to tilt portfolios toward the financials sector.

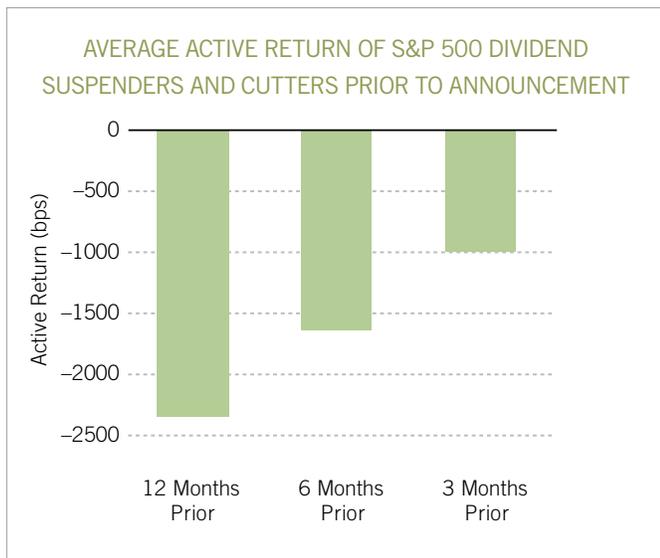


Source: FactSet, Morningstar Direct, Fidelity Investments as of June 2008.

a handful of securities with double-digit negative relative returns can materially dampen portfolio returns and amplify volatility.

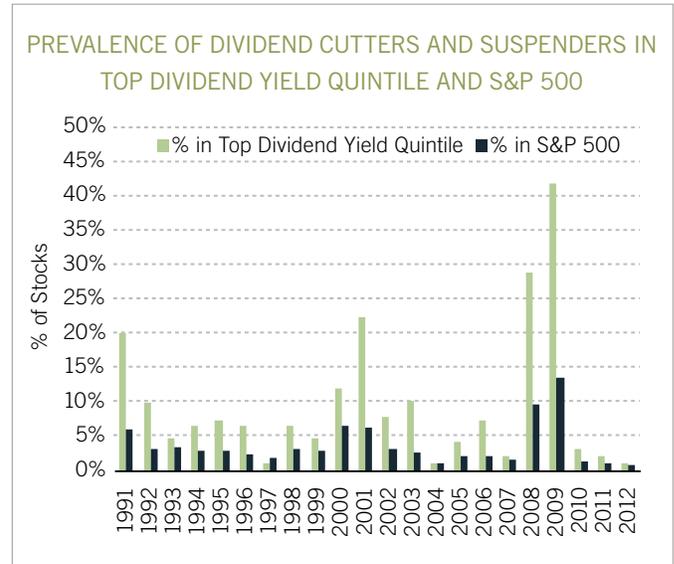
While the returns in advance of the average dividend cut or suspension are damaging enough, the story can occasionally be much worse. Consider supermarket chain SUPERVALU, which suspended its dividend on July 11, 2012.<sup>4</sup> During the six months

EXHIBIT 6: The market on average anticipates a dividend cut or suspension months before the announcement.



Active return = portfolio return – benchmark return. Source: FactSet, Bloomberg, Fidelity Investments as of Jul. 25, 2012.

EXHIBIT 5: Dividend cuts and suspensions are prevalent among the highest yielding stocks.



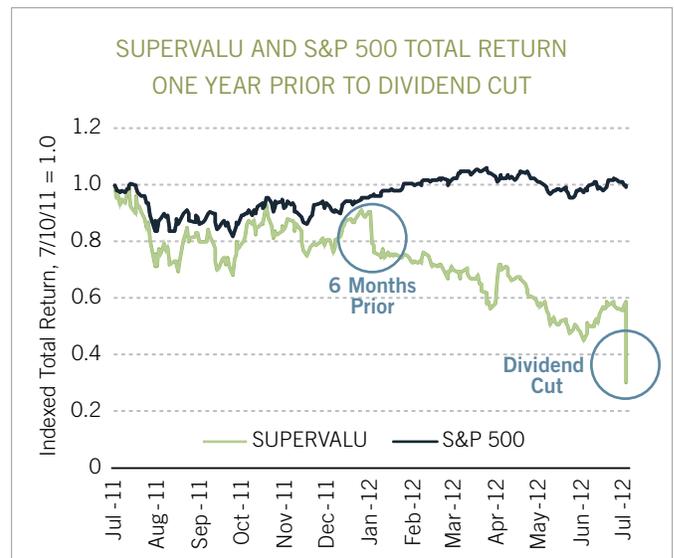
Source: FactSet, Bloomberg, Fidelity Investments as of Jul. 25, 2012.

leading up to the announced dividend cut, the stock price fell 25%. And on the day of the announcement, SUPERVALU plunged another 50% (see Exhibit 7, below).

**Fundamental analysis of cash flows to forecast dividend growth**

An active management approach that can help to mitigate the twin pitfalls of outside sector imbalances and potential dividend cuts

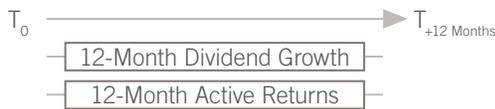
EXHIBIT 7: Even though the consensus expects a dividend cut, it can still be damaging when it occurs.



Total return = price appreciation + dividends, indexed to 1.0 on Jul. 1, 2011. Source: FactSet, Bloomberg, Fidelity Investments as of Jul. 12, 2012.

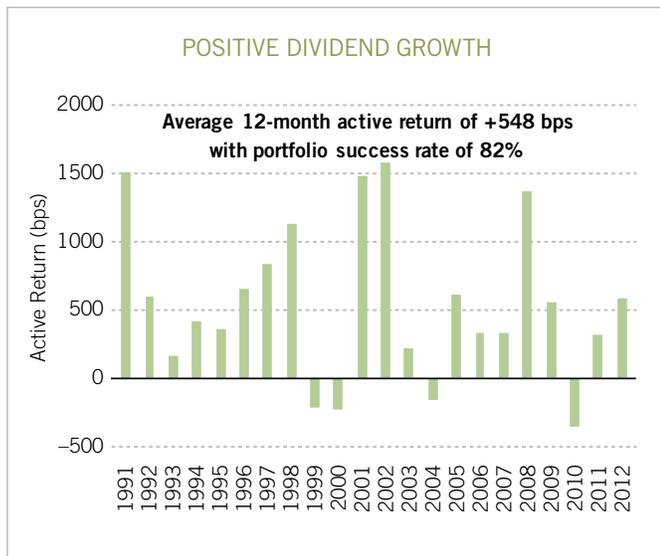
should hold up well against a simple, backward-looking strategy. Beyond risk mitigation, an active, forward-looking approach may hold the prospect of forecasting positive dividend growth. By carefully examining a company's cash flows and identifying all claims on cash—such as capital expenditures, taxes, corporate debt maturities, and so on—an active approach may more reliably predict future cash flows. Understanding future cash flows is a critical precursor to predicting dividend growth, and to the extent that an investor may be able to anticipate future dividend growth, portfolio performance may be enhanced.

While the previous analyses examine the forward returns associated with hypothetical portfolios categorized by trailing data, our next analysis measures forward returns of stocks grouped by forward, actual data, as illustrated below. If an investor could accurately predict and hold the S&P 500 stocks that would have positive dividend growth after 12 months, what would be the active returns of this hypothetical portfolio over that period?



We find that correctly forecasting next year's positive dividend growers one year in advance of the announcement would have the potential to generate substantially higher active returns and odds of outperformance than the backward-looking strategies described above. During the past two decades, hypothetical portfolios with positive dividend growth would have delivered

**EXHIBIT 8: Accurately forecasting dividend growth would result in consistently strong active returns.**



Active return = portfolio return – benchmark return. Source: FactSet, Bloomberg, Fidelity Investments as of Aug. 8, 2012.

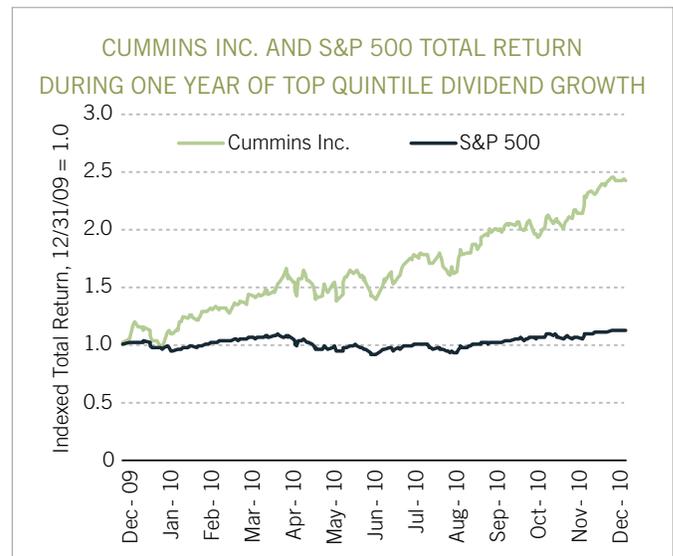
548 bps of annual active return on average, with a success rate of 82% (see Exhibit 8, below).

Just as an active approach can harness research to predict the deteriorating fundamentals that presage dividend cuts or suspensions, such an approach may also be able to uncover the best candidates with improving fundamentals for dividend growth, which is essentially the mirror image of avoiding dividend cuts and suspensions. For example, engine builder Cummins Inc. grew its dividend 25% in 2010.<sup>4</sup> During that year, the stock delivered a 143% total return, while the S&P 500's total return was 15% (see Exhibit 9, below).

### Investment implications

It is widely recognized that investing for equity income can provide advantages such as reduced volatility, above-average returns, and the potential for capital appreciation as well as current income. Less well documented is the role that attempting to forecast dividend growth can play in an investing strategy. We have demonstrated that although equity portfolios constructed with backward-looking income-oriented factors would have performed well historically, these portfolios may be prone to sector imbalances and dividend cuts or suspensions. As we have shown, determining which companies have the potential to grow their dividends requires a nuanced combination of the science of backward-looking analysis with the art of forward-looking fundamental analysis of each company's cash flows. By helping to avoid companies at risk of cutting or suspending dividends, and identifying those with the ability to grow dividends, such an approach has the potential to yield considerable benefits for an active equity income investment strategy.

**EXHIBIT 9: Raising the dividend can provide a boost to stock performance.**



Total return = price appreciation + dividends, indexed to 1.0 on Dec. 31, 2009. Source: FactSet, Bloomberg, Fidelity Investments as of Dec. 31, 2010.

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## References

Dirk Hofschire and James Morrow, "Equity and Non-Bond Income: Opportunities and Investment Approach." Fidelity Investments Leadership Series, August 2011.

Ramona Persaud, Naveed Rahman, and Srinivas Vemparala, "The Merits of a Global Equity Income Approach." Fidelity Investments Leadership Series, April 2012.

## Endnotes

<sup>1</sup> It is not possible to invest directly in a hypothetical portfolio. A basis point is equal to one hundredth of a percentage point. Active return is the portfolio return minus the benchmark return. Risk-adjusted return is the average active return divided by the standard deviation of active return over the period. Standard deviation shows how much variation there is from the average (mean or expected value), with a low standard deviation indicating that the data points tend to be very close to the mean, while a high standard deviation indicates that the data points are spread out over a large range of values.

<sup>2</sup> Another reason the sector-imbalance analysis reports capitalization-weighted results is that investors are more familiar with sector return data from 2008 on a market-capitalization basis.

<sup>3</sup> This represents the average weight of the financials sector in the five largest dividend-oriented ETFs based on public disclosure as of June 2008.

<sup>4</sup> References to specific companies are for illustrative purposes only and are not intended as recommendations for or against investment in these securities.

## Other important information

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**Past performance is no guarantee of future results. It is inherently difficult to make accurate dividend growth forecasts and the outcomes from those forecasts are not guaranteed.**

Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk. Diversification does not ensure a profit or guarantee against a loss.

## Investing involves risk, including risk of loss.

Stock markets are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Investing in equities involves risk, including the risk of the loss of principal.

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