RISING DIVIDENDS

Dividend Growth –
We believe it's the ultimate equity strategy.

WHAT DIFFERENCE DO DIVIDENDS MAKE?

In the 2016 *Financial Analysts Journal* (publication of the CFA Institute) article entitled, "The Surprising Power of Dividends", former Financial Times journalist, Phil Davis, writes, "portfolios of high-dividend paying stocks have the least risk yet return over 1.5% more per year than non-dividend paying stocks."

An important distinction Davis points out in his article, and that we have found to be true in our research, is that it's not all about value stocks either. While value stocks have largely been associated with dividend paying stocks, there are many growth stocks that also offer consistent and rising dividends where the ability to pay and increase dividends has been a sign of a strong and enduring company.

In this paper, we explore the research behind the notion of outperformance from companies whose management teams are able to run their respective companies in a way where profits can be allocated to dividends for shareholders, while still striking a balance on retaining profits to invest in the future growth and prosperity of the company.

WHY RISING DIVIDENDS MATTER

As the Baby Boom Generation, the largest ever to enter retirement, begins to enter the distribution phase of their lives, demand for income to supplement Social Security and other pension type income is becoming increasingly important. Currently about 60% of the wealth in the United States is owned by this generation.

Fortunately, there is a solution appropriate for most investors' portfolios. We believe using a rising dividend emphasis to identify companies that will produce attractive, perhaps above average, total returns over time. A key component of this total return is a rising income stream that should far outpace inflation over time, increasing an investor's spending power. We consider this approach to be the cornerstone of a long-term retirement income plan. In this whitepaper, we will examine the history and fundamentals of why rising dividend companies are a good place to focus a significant portion of a portfolio's equity allocation.

Investor and author of "The Theory of Investment Value," John Burr Williams, wrote in the 1930's…

... A stock is worth the present value of all the dividends ever to be paid upon it, no more, no less... Present earnings, outlook, financial condition, and capitalization should bear upon the price of a stock only as they assist buyers and sellers in estimating future dividends.

When Williams wrote this, investors were scrambling to find ways to avoid getting burned by faulty accounting and excessive speculation, which led to the stock market crash in 1929. Today, we remember two significant bear markets in 2000–2003 and 2008–2009 and the still unfolding market downturn in the spring of 2020 induced by the Coronavirus Pandemic. In addition, we now enter the second decade of very low interest rates and the challenges that presents for retirement income.

Market trends come and go; economies expand and contract, sometimes causing significant fluctuations in corporate earnings and in investor's confidence in the prospects for share prices. This is what creates bull and bear markets. Dividends however, have been vastly more predictable. Companies committed to a long-term plan of raising their dividend tend to do so for extended periods of time, in both good and bad markets.

The ideal equity investment strategy should have some combination of the following characteristics:

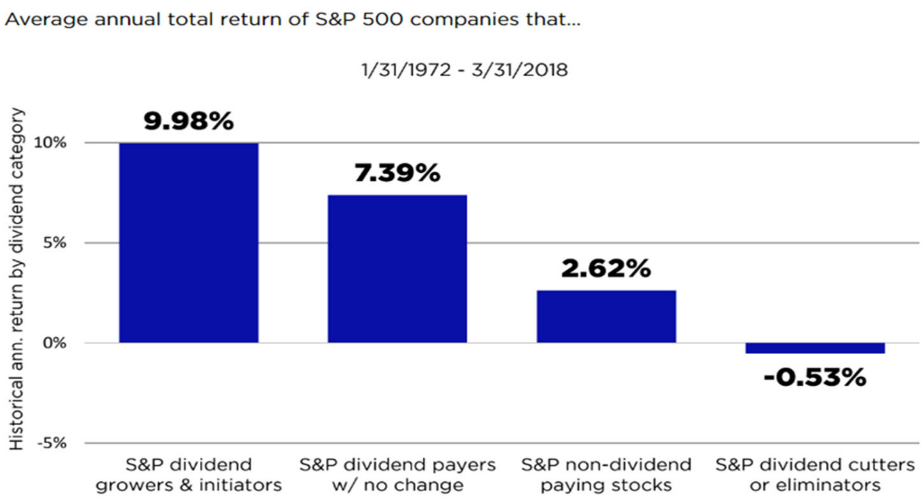
- Attractive total return over time to build wealth
- Lower than average risk
- A rising income stream for the retirement distribution phase
- A high-quality focus to minimize chance of permanent loss
- Low turnover for tax efficiency

A portfolio of high-quality rising dividend companies has the potential to deliver these desirable characteristics given sufficient time. Let's take a closer look.

RETURN POTENTIAL

As investors, we should focus the foundation of our long-term investment plan in the areas where the wind is at our back. The chart below shows the S&P 500 Index broken into categories by dividend paying characteristics.

Total Return By Dividend Category

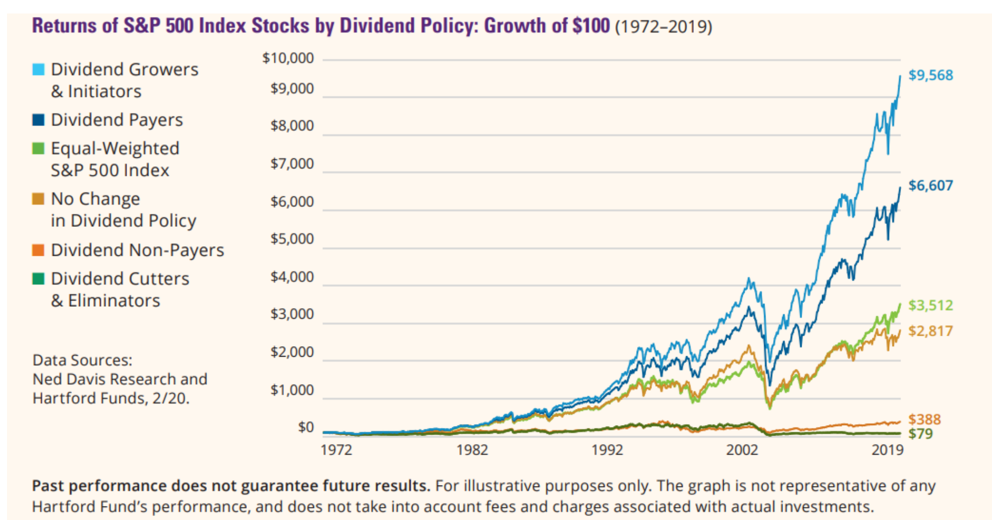


Source: Ned Davis Research

From January of 1972 to the spring of 2018, the total return offered by companies that initiated or raised their dividend payment out-performed those companies which had stagnant dividends by about 2.6% on an average annual basis. In addition, it was no contest when compared to companies which reduced their dividend (a negative return) and those companies which did not pay any dividend – a paltry 2.62% average annual return.

It makes perfect sense to focus our attention in the group where the chance for error is minimized and the chance for success maximized. The chart at right shows the growth of $100 invested in dividend growers compared to other categories of dividend payment status for the period from 1972 through 2019.

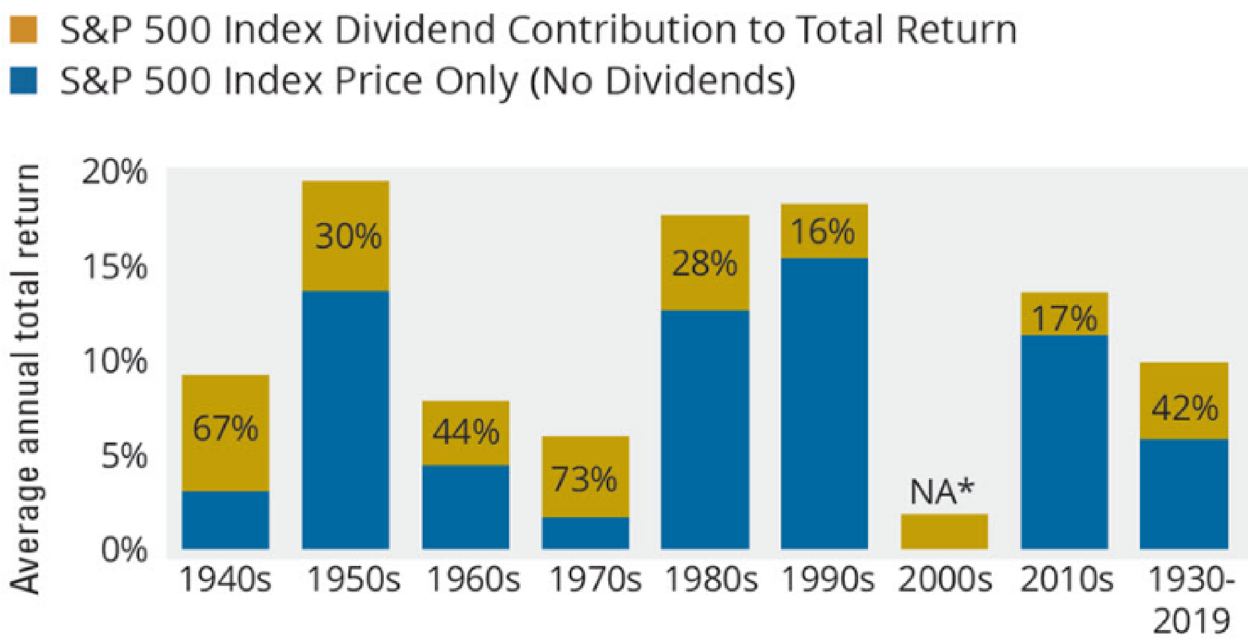
U.S. Dividend Growers Outperformed



Source: Hartford Funds

Many investors turn away from dividend paying stocks because they seek "growth" companies. We believe the rising dividend group of companies are among the best growth stocks to own for a balance of growth potential with lower than average risk. The chart on the next page shares a clue as to why. While varying from decade to decade, dividends provide well over 40% of the total return achieved by common stocks. During particularly poor periods of stock performance, like the 1930s and early 2000s, dividends may just save the day.

Dividends' Contribution to Total Return Varies By Decade



Data Sources: Morningstar and Hartford Funds, 2/20. *Total return for the S&P 500 Index was negative for the 2000s. Dividends provided a 1.8% annualized return over the decade.

The first desired portfolio characteristic is that rising dividend companies tend to be high-quality growth companies offering the potential to accumulate more wealth and income over time.

KEEP RISK IN CHECK

Controlling risk is important for all investors, not just retirees. Contrary to popular opinion, risk control is a tool to enhance returns. There are two main reasons a low-risk approach may help to improve returns.

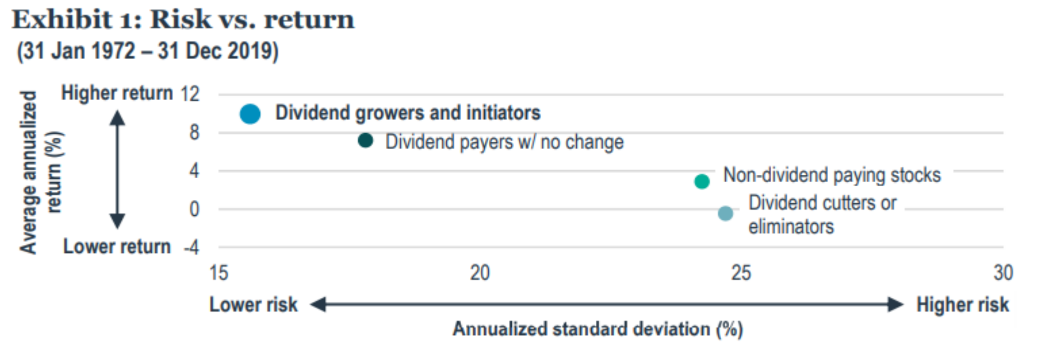
First, when portfolio declines occur, it takes a larger percentage of recovery just to get back to break even. This becomes more important when declines move beyond normal correction territory and into full bear market mode.

Percent Price Decline	Percent Recovery Needed to Break-even
10%	11%
20%	25%
30%	43%
50%	100%

The second reason for avoiding large losses relates to investor psychology. We all think we can handle bear markets without flinching, but history tells us differently. The biggest reason most investors underperform is the pattern of abandoning asset classes or strategies after large declines. Eventually, when things look good again, investors move out of safe investments and re-enter riskier ones. However, this usually happens after the markets have recovered substantially. This process of selling low and buying higher locks in losses and forces missed opportunity.

Investors are far more likely to stick with a strategy if it doesn't drive them crazy with volatility and the fear of losing all their money. That is where a dividend growth strategy may help. High-quality rising dividend companies will fluctuate in value, but historically the price action is more muted than the stock market in general. The chart below compares the returns of stocks grouped by dividend status against their volatility.

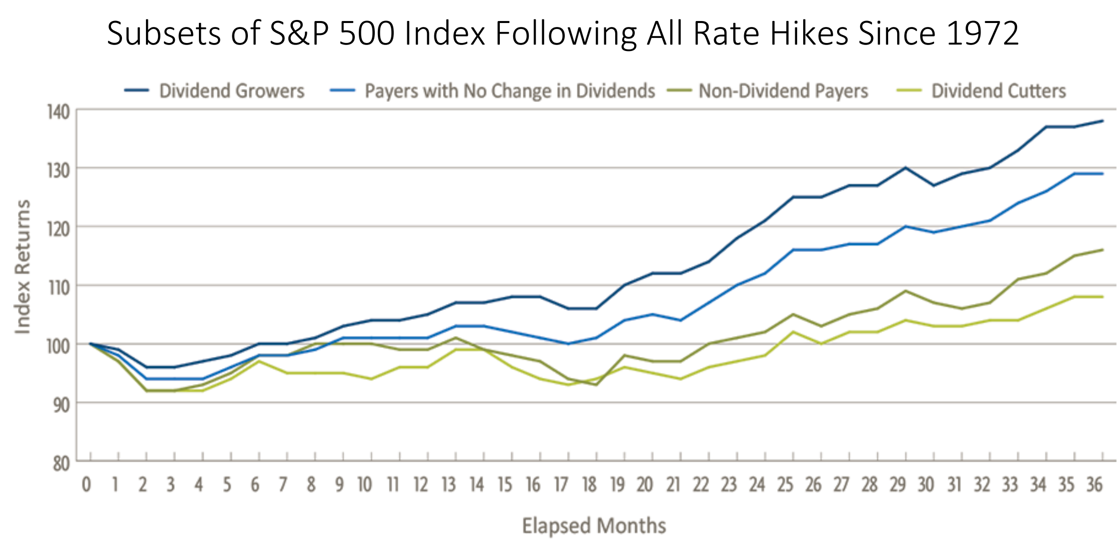
On this chart, being in the upper left portion is desirable because it indicates higher return with lower volatility as measured by standard deviation. Once again, we can see the superior group over time has been companies that initiate and grow dividends.



Source: Ned Davis Research. Inc. data from 1/31/1972 to 12/31/2019

Why are dividend growers and initiators less volatile and generally less risky that the other groups of stocks categorized by their dividend paying characteristics? During market declines, investors tend to not sell these companies to the extent they sell other, lower quality companies, because they are more confident in the firm's ability to weather tough times. This provides a buffer against price declines.

Another aspect of risk is how rising dividend companies perform during periods of rising interest rates. Fortunately, this is another area where dividend growers excel. The chart below shows how rising dividend companies perform compared to non-dividend paying companies in time-periods following Federal Reserve rate increases. Once again, companies that grew their dividends outperformed. This characteristic may be of particular importance with rates still near all-time lows, and likely to rise in the future.



Source: Ned Davis Research, Inc. data from 1/31/1972 to 12/31/2019

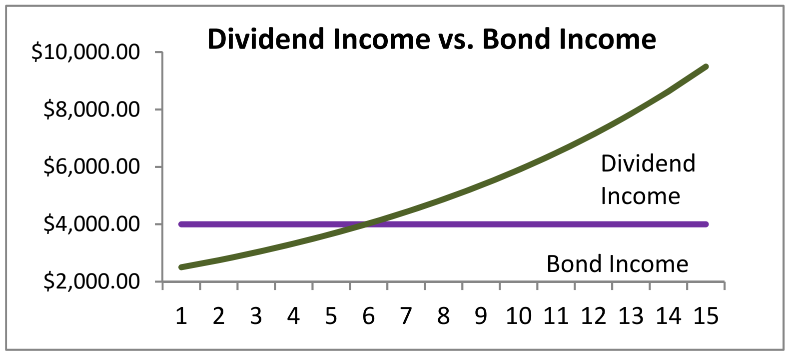
Dividend growers have historically provided a lower volatility path, while achieving above average returns. We believe this will help keep investors away from the sell low - buy high cycle of failure, and better positioned to realize the long-term benefits of owning high-quality companies with increasing income, even during periods of rising rates.

MORE INCOME EACH YEAR

One of the most important characteristics of an ideal equity strategy is a rising income stream. Many of the vehicles investors use as default income generators tend to provide a flat income stream or one with small increases. The classic example is a high-quality government, municipal or corporate bond. (Note that there are some exceptions like floating rate bonds and inflation protected bonds, which may increase or decrease interest payments based on the formula to which the bonds yield is tied.)

Hypothetical Example:
Investor A purchases $100,000 face value of a 15 year corporate bond yielding 4% and collects $4,000 per year in interest payments, totaling $60,000 total income. At maturity, the investor will receive back the $100,000 initial investment.

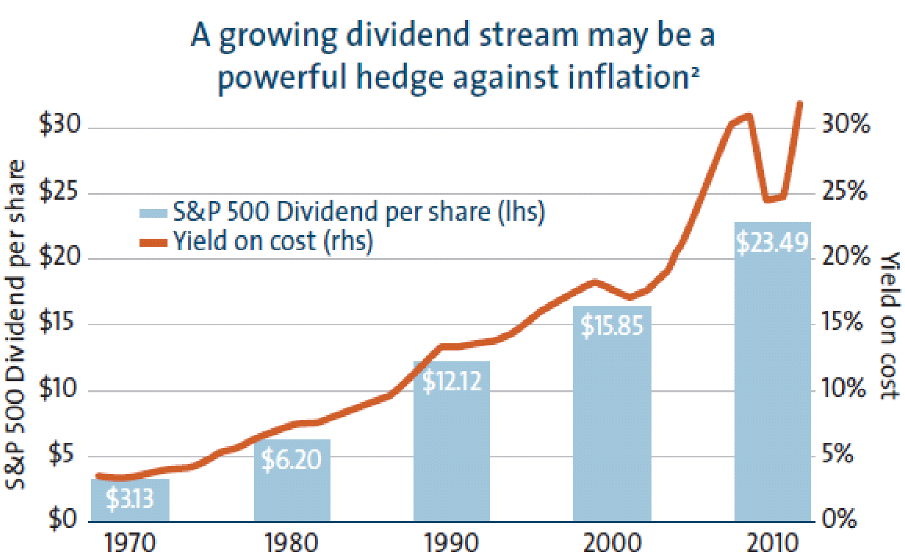
Investor B puts $100,000 into a portfolio of companies that have exhibited strong rising dividend characteristics currently yielding 2.5%, he or she would receive $2,500 in dividend income in the first year. It would not be unreasonable to expect a 10% annual increase in dividend income on an average annual basis (The average rate of dividend increase for the entire S&P 500 Index since 1940 has been 6.4% per year).



The dividend income in the 15th year will be about $9,493 in this example. Total income from the rising dividend strategy over the 15 year period would be $79,427 ($19,427 more than the bond strategy). Furthermore, Investor B would have started receiving more income than Investor A in year 6. Extending these projections out to 20, 25 and 30 years make it look even better.

Additionally, Investor B would realize a 9.5% yield on their original $100,000 investment in year 15. Investor B did not reinvest dividends in this example. Reinvestment of dividends would make these results even more attractive.

As previously referenced, the S&P 500's average rate of dividend increase has been 6.4% annually since 1940. The chart below shows the yield on the original cost of an investment in the S&P 500 in 1970 due to average dividend growth. Even if dividends only grew at the average rate, like illustrated below, the results would likely still be very good and would outpace the rate of inflation.



Investing in companies that regularly raise their dividends will, over time, provide more income than traditional fixed income investments, and likely outpace inflation.

A FOCUS ON QUALITY

In the previous example, we picked a 15 year time-frame because history shows there are no 15 year periods where U.S. stocks didn't at least break even on a total return basis. Furthermore, the average annual return across all rolling 15 year periods since 1926 is approximately 8%. If the investor can be patient for 15 years or longer, time has historically reduced risk to a low level.

We believe this is especially true for high-quality companies. Our definition of a high-quality company is one that can sustain or grow their revenue, earnings and dividends through good times and bad. These firms tend to be healthier and more stable business models with superior management. The financial strength of the dividend growers group minimizes the likelihood of a corporate bankruptcy or other form of failure and translates into a higher level of trust and confidence with investors.

Firms that consistently grow profits over time and share those profits with shareholders are at the least risk of failing and causing a permanent loss of capital for shareholders. This fact should boost investor confidence

OWNING BUSINESSES vs. TRADING STOCKS

The views expressed above begin to form a philosophy that begs the question – Does price really matter if income rises each year? We believe investors should focus more on owning great businesses for the long-term, ignoring short-term price fluctuations. If the investor can "buy in" to the stocks, some additional benefits become possible.

Investing as an owner provides the chance to enjoy the rising income from growing business ventures. Making correct buying and selling decisions is difficult. Making these decisions more often certainly isn't any easier. The longer-term high-quality focus minimizes the need to be right every few days or weeks.

A less active approach also results in lower portfolio turnover. Lower turnover provides a distinct advantage – lower capital gains taxes. In more active strategies, smaller gains are taken more frequently, subjecting the gains to taxation. In addition, many of the gains may be short-term in nature (assets held for less than one year), which are taxed at higher rates than long-term gains.

Of course, the tax issue is a moot point in IRAs and other tax qualified accounts. Regardless, the attractive long-term capital appreciation and income potential of the rising dividend stock universe works well in both tax-qualified and non-qualified accounts.

SUMMARY

A portfolio strategy consisting of companies which regularly raise their dividend payment leads to a high-quality growth stock portfolio, which historically has delivered above-average returns in a lower than average risk, tax efficient manner. While some may perceive the approach as boring, we will happily accept that criticism in exchange for peace of mind and what we believe will be superior performance and risk characteristics.

DISCLOSURES

About Integra Capital Management

Integra Capital Management is a fee-only registered investment advisor founded in 1992. We manage the Elite Dividend Portfolio, a rising dividend strategy and the Liquid Alternatives High Yield Portfolio strategy, an alternative asset income strategy. To learn more about these strategies call us at 941-778-1900, or visit our website at www.integrcapitalmanagement.com

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