ClearBridge Investments

Podcast: Why Dividend Growth Matters as Yields Fall

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With Dividend Strategy Portfolio Managers John Baldi (JB), Peter Vanderlee, CFA, (PV) and Investment Strategist Jeffrey Schulze, CFA (JS)

JS: Hello, and welcome to the latest ClearBridge podcast. This is Jeff Schulze, CFA, Investment Strategist at ClearBridge Investments. ClearBridge is a global equity manager with $146 billion in assets under management committed to delivering long-term results through authentic active management. ClearBridge tailors our strategies to meet three primary client objectives in our areas of proven expertise: high active share, income solutions and low volatility. We integrate ESG considerations into our fundamental research process across all strategies.

So, it's been a year since we last spoke about dividends on the podcast, and in that year, we've seen a monumental shift in U.S. monetary policy. The Fed has gone from raising interest rates to cutting rates for the first time since the financial crisis as trade tensions have threatened growth around the world. Even with the stock market near all-time highs, we've seen some meaningful drawdowns, and long-term interest rates have fallen dramatically. With the 10-year Treasury below the dividend yield of the S&P 500, it's a good time to look at what dividend-paying stocks have to offer.

So I'm excited to be joined in the podcast booth by Peter Vanderlee and John Baldi, portfolio managers for the ClearBridge Dividend Strategy. Peter and John are here to talk about how dividend stocks are positioned to provide both income and growth in a low-yield environment and what sort of qualities they look for in dividend payers across the sector spectrum. It's the first time for both of them in the ClearBridge podcast booth. Peter, John, welcome and thanks for joining us.

PV: Thanks for having me, Jeff.

JB: Thank you.

JS: And the topic of today's podcast is why dividend growth matters as yields fall. So we'd love to get your feedback about topics we cover and how we can make our podcast better. So you can contact us with questions, comments and suggestions by emailing us at podcast@ClearBridge.com.

So John, Peter, I can't believe summer is already over. It's already post-Labor Day. It's almost like the lights turned on here in New York City, my bus lines are longer. It takes me half hour now to get my salad.

But if you looked at the markets, the markets have had a very active summer, and that's not really surprising. If you look at volatility since it's been measured in 1990, July, August and September tend to be the highest volatility months. I guess the old adage of "sell in May and go away" actually really does make some sense, especially here in 2019. And a lot of that is due to recession fears. Is this a slowdown or is this a recession? And if you look at the 10-year Treasury and how much it fell in July and August, the summer bond markets are saying that this may be recessionary overall. The Fed obviously cut rates in July for the first time in a decade. The markets are pricing in the near certainty of

a cut in September. And I personally think that there's going to be a cut in the back half of this year, but are we looking at a prolonged period of low rates? I mean, you've seen them back up here over the last couple of days. Do you think rates are going to stay at these levels or move higher from here? And really what's causing this distortion? Peter, maybe I'll turn it over to you first.

PV: Yes, certainly, there are fears about the potential for a recession. The bond market has an inverted yield curve, and that's signaling, traditionally, that there is some stress, some issues to contend with, and these issues are also related with macroeconomic factors, such as the tariff war that we're having with China.

But if you cut through all of this and kind of look at it, well, how are stocks positioned in this environment, they're actually quite well positioned. Right now, we have over $15 trillion worth of debt that has a negative yield…

JS: Did you say 1-5, $15 trillion?

PV: Over $15 trillion…

JS: Wow.

PV: …worth of debt that has a negative yield. That's unprecedented. Bonds do not provide much in income, if any. Stocks do, though, and the dividend yield of the S&P 500 exceeds that of the 10-year Treasury note, as you mentioned earlier, Jeff.

JS: And I think right now, as of a couple of days ago, 60% of the S&P 500 has a dividend yield higher than the 10-year Treasury, 47% has a dividend yield higher than the 30-year Treasury, which is much higher than what you saw even in the financial crisis.

PV: That's right. This has not happened often at all. And, you know, with the costs of debt coming down, the overall weighted average cost of capital for corporations is diminishing, and, as a result, the future cash flows are being discounted at a lower discount rate, and that actually leads to higher prices. So, you know, viewed from that perspective, it also points to the scenario that stocks here are well positioned.

And then couple that with the fact that we're not in a recession at the moment. As a matter of fact, the growth rates are still fairly solid. Around 2% GDP growth for our economy is actually quite healthy. Corporate earnings are poised to grow over time, and, yes, there's risk to the growth rate, but there's still growth there and earnings multiples are not necessarily quite high.

So I think the environment we're in is conducive for being constructive on stocks. Notwithstanding the risks that have risen, I think overall we're still in a good position here from a stock perspective.

JB: I'd also add in, Jeff, the fact that if you look at any of the consumer metrics that are out there, and the fact that two-thirds of our domestic economy is consumer driven, if you look at…

JS: We love to spend here in the U.S.

JB: If you look at employment, if you look at wage growth, all these variables continue to be very strong. Now, I'm not necessarily saying that that's a leading indicator, but, nonetheless, from the standpoint of the health of the overall consumer, that would tend to be supportive of at least growth consistent with where we are today. The risks appear to be on the investment side with respect to businesses, as we weigh the uncertainties surrounding trade.

JS: Well, and you mentioned trade, right? The one thing that you've seen business confidence drop like a stone since the first tariffs were instituted back in 2018 with the steel and aluminum tariffs. But the one thing that's remained relatively bland is consumer confidence. This latest print that we saw from August, the UMICH survey came in below expectations, but consumer confidence has still hung in there. My one concern is that if you do see this last tranche of tariffs continue to get dialed up, it's all on consumer goods, everything people buy from clothes, toys to electronics. Maybe consumer confidence starts to come down and people stop spending, but you're just not seeing it with the data, especially with the labor market data that you mentioned before, John.

Now, thinking about the portfolio that you have, in this late-cycle environment…and I do believe that this is late-cycle…what sort of qualities do you look for for a typical holding in your portfolio? It usually has a kind of a defensive characteristic to it, if I may.

PV: Well, we certainly look for quality in the holdings that we have, and by that we mean market leadership typically. So we tend to own companies that are the number one or number two player in their space. We tend to not necessarily favor the number six player trying to become number five. We really go for the market leaders in their sector.

Also, from a financial standpoint, we look for quality, and by that we mean strong balance-sheet companies that generate a lot of free cash flow, companies that also have quality management teams in place, that have a proven track record of creating shareholder value over time.

And then obviously in this program we look for a very strong dividend profile, and that comes in the form of an attractive upfront current yield, but perhaps as importantly, if not more importantly, the ability to grow that dividend stream over time. And I think the portfolio has delivered on that. Since inception of the portfolio in 2003, we have annualized a compounded growth rate of around 9%.

JS: Wow.

PV: That is significant. And that growth rate actually has accelerated over the last two years as balance sheets are flush with cash, free cash flow is strong and payout ratios are still somewhat conservative. So all of this points to the way we look at holding a quality portfolio of names diversified with strong dividend profiles.

JS: Yes. If you think about dividend growers…right?…that's going to help sidestep the lower interest-rate environment that we're seeing with the Fed, right? It's a negative duration or a component to that, because you're getting a higher income stream, where most of the yields are coming down across a lot of different asset classes.

JB: Yes. I would echo Peter's points along the lines of the focus is on the growth profile and dividends secured by their position in their relative markets, the business model, which should result in favorable financial characteristics that come out.

I would also emphasize one point here. With respect to Dividend Strategy, we do not employ a dividend screen or have a minimum-yield threshold. We focus on a company's ability to grow over time and hence support a profile that would at least protect the dividend stream in an inflationary environment, in a deflationary environment. In a whole host of scenarios, we try to underwrite investments that we think are positioned to grow their dividends over time.

JS: And if you look at a lot of the research that's come out since 1990, dividend growers give you the best return profile and the lowest volatility profile versus companies that have not changed their dividend, they have no dividend at all or are dividend cutters. And you've obviously seen a lot of different investing environments over the last 30 years.

Now, you've talked to me a little bit about the qualities that you look for for a particular holding. What type of qualities do you shy away from? And what risks do you seek to avoid in the portfolio?

JB: I think one of the avenues that we tend to focus on is avoiding stuff with any material binary risk on an outcome, such as, for example, a biotechnology company whose future hinges upon the successful FDA approval of a certain drug or we also try from a holistic standpoint with respect to the portfolio to minimize sector weightings that are reliant upon a single factor risk. For example, the exploration and production sector within energy and its reliance on the price of the commodity of oil.

So we take those factors all into account, and the one…I should have started with this earlier…the one overarching thing that we avoid from the start is any company with a high payout ratio and with a high level of leverage. You can have one or the other, but, in most circumstances, you cannot have both.

JS: Right. So once you start seeing cracks in the foundation, it's hard to keep that payout ratio up there.

Well, we're talking a little bit about qualities that you shy away from. Talk a little bit about your sell philosophy. I know there's probably been names that have made it into the portfolio, but something has changed at the margin where that thesis did not play out. Do you have a recent example of a stock that fits this description?

PV: In a way, the sell decision is the inverse of the buy decision. So situations where we can sell a stock include a changing thesis, which could, for example, have been created by transformative acquisition. Another example would be a deterioration in the balance sheet and the free cash flow profile, where the leverage has become too high and the dividend may be at risk. Also, if our investment thesis has played out and the stock has risen substantially, we may trim or sell because the risk reward on a forward-looking basis may have become poor. In other words, there's nothing wrong against taking some profits at times. So those are some overarching principles that we put forth in the sell philosophy.

An example of a sale that we did was in the beginning of 2017, we decided to part with GE. That turned out to be, in retrospect, a good decision. We got roughly…

JS: I would say so.

PV: …$30 for it. You know, the reason…There were quite a few reasons, but one was that we did see a discrepancy between the amount of free cash flow that was being generated by the underlying businesses versus the earnings growth trajectory that the company was on, and that gave us some pause. And we got a little bit more uncomfortable with the balance sheet after doing additional due diligence and decided it was a prudent course of action just to part with it.

JS: Now, I know that there are some signals of a recession on the horizon. I feel like the word "recession" is coming up more and more often. Our Anatomy of a Recession Dashboard that we have at ClearBridge has moved from green to yellow, but we're not quite at red yet.

What besides dividend income do the dividend stocks you prefer offer in the way of defensive characteristics? Because, again, as I mentioned before, I do think we're moving closer to late cycle.

JB: I think it starts with the underlying strength of the balance sheet and your ability to weather a downturn. You know, if you have a strong balance sheet heading into a downturn, we've actually seen some of the best transactions taking place within those downturns and driving considerable growth for the coming years.

One transaction that comes to mind is when BlackRock bought Barclays in the midst of the global financial crisis. And if you think about BlackRock today, it's paying more out in dividends than the company was earning…

JS: Wow.

JB: …post the crisis.

JS: Ten years.

JB: So it's just been a phenomenal story of having a balance sheet and dry powder to invest when things are a little bit murky out there and then driving growth forward, that strategic vision on behalf of management, the capital allocation decisions that management makes in points of stress to drive future value.

PV: I would add that the portfolio does offer a lot of defensive characteristics, and, as John mentioned, part of that is the investment process where we favor quality and market leadership with strong balance sheets, and those companies typically fared better during downturns. Also, I should mention that we strive to diversify the portfolio across sectors in order to minimize risk and we will not bet the ranch on any given sector and individual stock, no matter how much we like it.

And then third, let's not forget that our companies are solid dividend payers and that those dividends continue to be paid even during downturns, and we have a total return approach consisting of dividends and capital appreciation. But in case of downturns, the capital depreciation funds an offset in

these dividends that we collect, and that cushions the blow and that's another measure of downside protection.

JS: Yes, if you look at dividend contribution to total return, if you look at the market over time, dividends, when you have rough market environments, like the 1930s, the 2000s, they made up over 100% of the contribution to the markets during those timeframes. And a lot of these dividend growers give you much better downside capture, right?

PV: That's one of the key reasons why.

JS: Yes, the team put out a really good white paper in May of 2019 called the Low Downside Capture from Dividends Adds Up. I encourage everybody listening to read that. It's a really interesting read that talks about the power of dividend growth investing.

Let's move over to opportunities. Were you finding some opportunities now in dividend stocks? Are there any values in some unconventional areas?

JB: I think one of the spaces that we find attractive at current prices would be the alternative asset management universe. And this is a space that is experiencing strong secular growth in assets, and it's mostly driven by the environment that we talked about to date, one of low yields throughout the world has put a lot of pressure on pensions and insurance companies that they need to generate returns to satisfy their client obligations. And they're more and more turning to the alternative asset management universe to provide those returns.

And if you think about the space, it's a broad array of asset classes like private equity, credit, real estate, infrastructure investing. It's all these less-trodden paths, if you will, that they have the opportunity to deploy capital at favorable rates of return. The one thing from an investment perspective that we like when we talk about downside risk and protecting is that the capital that gets committed to these alternative asset managers is permanent capital. It's long-duration capital. It's tied up for seven years, five years, 10 years. Sometimes it's infinity. And if you think about what this does for a Blackstone, for example, it provides a high degree of visibility into what is called "fee-related earnings" in the industry. And when you have a high degree of visibility on earnings, you think you should be able to support multiples that are elevated relative to where these stocks trade today.

The only other piece that I would add to this conversation on alternative asset managers is that over the past, I would say 18 months now, we have witnessed effectively all of them convert from partnerships where they were issuing K-1s, to C-corps, where there is no longer K-1 issuance associated with these names, so the universe of people that can buy these stocks, the indexes, every retail who has largely been cut out from the investor base of these companies, that dramatically has changed over the course of the past 18 months.

JS: Don't need a special tax advisor to file your taxes anymore.

JB: And we think that could be a driver of performance in rerating over time as people get more and more comfortable with the underlying strong sector trends that we see.

JS: How about you, Peter? Any opportunities?

PV: Yes. I see some opportunities on the pipelines in the energy infrastructure space. These companies also were MLPs and were K-1 issuers. And K-1s are about as popular as colonoscopy procedures in the investment world. (Laughter) And many investors…

JS: So not popular. Just for the record.

PV: Yes. Many investors shy away from them. So a few years ago, these energy infrastructure companies, at least quite a few of them, decided to convert to C-corps status and began issuing a 1099 form and no longer this dreaded K-1. And in the process, as John also alluded to, these companies can now be owned more widely and the stocks are also being included in various indices, and that increases passive demand for the share.

So we like pipeline companies, such as Kinder Morgan and the Williams Companies. Both are high-quality infrastructure players with an asset footprint that includes long-haul pipelines. These pipelines are attractive from a cash-flow standpoint, as they are typically contracted on a long-term basis with quality counterparties, and the cash flows are contracted and not depending on the on-the-line price of the commodities, such as crude oil and natural gas.

Both companies have strong investment-grade balance sheets and have attractive dividends, Kinder Morgan around 5% and Williams around 6%. We expect that to grow over time. So we believe it is prudent to obtain energy exposure through these infrastructure names and that's where we are positioned in terms of our energy exposure, away from more of the traditional method of getting energy exposure in the exploration and production companies, but towards more of the predictability of the cash-flow streams in the energy-infrastructure names.

JS: Not as much tethered to the price of oil or natural gas, but just the production, which we're close to record production here in the U.S., and it appears that that's not going away any time soon.

JB: Right. One other element of that story that's also interesting to note, just to add on to Peter, is that the capital structures today, given their payout ratios, they can finance internal growth with earnings. Previously, these companies were relying upon the capital markets for financing growth, and the market always got nervous about that in dips, would the financing be available.

That is no longer the case today. The payout ratios, I think, are down to about 65% or so, and with that remaining 35% of capital, these guys are financing new pipes and that's driving growth for the future.

JS: That means, importantly, that if you have another situation like 2015 and 2016, that these providers don't have to rely on capital markets and they can fund their growth even if oil does move back down to the 30s or even the 20s, which is a big difference than where we were just a couple of years ago.

So we talked a little bit about the defensive quality of dividend stocks. I want to talk a little bit more about the growth quality of dividend stocks specifically, and how do you both balance the need for current income with the need for dividend growth?

PV: It's a balancing act. Our research has shown, and as you have alluded to, Jeff, that dividend growths tend to outperform over time. And we see dividend growth as very important as it signals that free cash flow is growing, which is ultimately how a company creates wealth for shareholders over time. Now, since inception of the program, we have compounded dividend growth rate at around 9%, as I mentioned earlier, which is very strong. And perhaps more importantly, the prospects for dividend growth also remain strong as payout ratios are still modest by historical standards and balance sheets are in very good shape.

So we also look for attractive current income as the balancing part of that, and, typically, we strive for a portfolio yield that is 50 to 100 basis points above our benchmark, the S&P 500, and, as such, the portfolio does offer both attractive income and a prospect for income growth over time.

Now, we also own a number of names that have a rich history of increasing the dividend, such as Procter and Gamble, which has increased the dividend for 63 years in a row. Now, there are no guarantees, but that is a trend. And others include 3M at 60 years of consecutive dividend increases; Johnson & Johnson's 57 years; Coca Cola, 55 years, just to name a few.

And then further, we own a number of names that are part of the next generation of dividend aristocrats, and Microsoft is such an example as the company has now increased its dividends for 15 years in a row, and we like the company as it's a leader in its space. It generates about $3 billion of free cash flow every month and has almost $150 billion in cash and investments on the balance sheet and is rapidly growing its dividend. Its five-year dividend compounded annual growth rate is 11%. It's one of only two companies left with a AAA-rated balance sheet and it's firing on all cylinders. So that's a good example of the kind of companies that we look for in terms of current yield and also the ability to grow that over time.

JB: And I would also, just to add on to Peter's commentary, this is not a targeted strategy going in in terms of barbelling our approach to dividends, but we do have companies with high current coupons

with still the prospects for growth, like alternative asset management, like energy infrastructure. But there are also companies that we own that we think have a great trajectory for dividend growth over a long period of time, even though their current yields may not be that high.

So I would point out companies like Visa and Mastercard, which have been wonderful investments for the portfolio. The current coupons aren't that great, but payout ratios are about 20%. There's strong secular growth. So we think that even if earnings get blunted by a recession or something along those lines that slows the growth trajectory of these companies, there is a long runway for dividend growth. Payout ratios can easily be supported for these companies well into the 40%, 50% range, because there's no leverage at the (inaudible) and other financial characteristics that we like to look for.

This all goes back to the strategy not employing a dividend screen, because we think that, unfortunately, that would cut us off from a large swath of the universe that has the ability to grow and compound over time.

JS: Now, the last question I want to bring and get both of your perspectives on is the idea of buybacks versus dividends. Obviously, 2018 saw record buybacks. I believe there was over $800 billion worth of buybacks last year, which is a 50% increase versus 2017. We're not on quite that pace in 2019, but it's still a healthy run rate of buybacks.

If you look at buybacks, it was essentially considered a form of market manipulation before 1982, and, in that year, the SEC came out with a safe harbor for companies to buy back shares under Rule 10-B-18. Maybe to give a little bit more context, between 1927 and 1981, dividend income accounted for 60% of the overall annualized returns of common stocks. Since 1982, and the introduction of that rule, it's only about 25% of the annualized rate.

So do you think that this is a good use of shareholder capital or do you think that dividends will come back into vogue once we get to the next recession?

PV: In a capital allocation framework there can be room for both. Buybacks make sense when the stock price is depressed, but make less sense when the stock price is particularly compelling. And what we have observed is that the pace of buybacks is high during periods of strong stock market performance, but less so during downturns.

JS: So the exact opposite of what you're supposed to do.

PV: Exactly. That's akin to buying high and not buying low, which is not particularly helpful. Dividends, on the other hand, are much more stable and companies are loath to cut them as it signals stress in the business. Shareholders depend on dividends being steady, so cutting them is disappointing and companies don't like to disappoint.

Also I would point out that buybacks can be announced, but not necessarily be executed. So there is no real commitment in announcing a buyback to follow through. And what we've seen happening also in quite a few cases is that buybacks are not necessarily all what they're cracked up to be from that perspective.

And then, lastly, oftentimes, buybacks are also used to offset dilution from, say, stock option exercises and stock compensation, which is essentially a disguised form of paying employees and management and it's more of a compensation expense and is not necessarily reducing shares outstanding to the degree you would expect. So all that, you know, you can sum it up differently saying, buybacks is more like dating and dividends is more like marriage.

JS: Now, how much room do you think there is for dividend growth at the moment? You know, if you think about payout ratios, it was 90% back in the 1930s. Currently, it's around 35%. I mean, do you think once we get through the next downturn, buybacks get a little bit more of a bad name that that payout ratio could potentially go up with rates being where they are?

PV: Well, payout ratios can go up for the wrong reason, which is the earnings decline, and, obviously, you need a cushion, which is why having a conservative payout ratio is particularly helpful during downturns, because the dividend, as a result, is not necessarily at risk. So we do look for that. We do

look at that carefully. We don't want to have scenarios, as John mentioned earlier, where payout ratios are very, very high because precisely during a downturn when earnings perhaps take a hit, payout ratios may become unsustainably high, which can lead to a dividend cut, which is something we like to avoid like the plague.

But having said all that, if you look at our scenario here for the S&P 500 as a proxy for the market, at 35%, mid-30s payout ratios, that is not historically a very high number. Historically, it's more in the mid-40s to high-40s. So we're well below historical levels here in terms of payout ratios. And combine that with overall healthy balance sheets in corporate America. Free cash flows are also abundant, and corporations are still growing their cash flow streams as well. So all that tells me that the prospects for continued dividend increases is strong.

And let's not forget that the demand for dividends are going up. The demand is going up because it is so difficult to get any kind of income stream…I mentioned over $15 trillion of negative yields in bonds. It's very difficult to get income, and dividends are a good place to go for folks that are seeking income. And let's also not forget that you have 76 million baby boomers that are in need of, you know, somewhat recreating a paycheck in retirement, and these dividends can help them, but they also need inflation protection, even though inflation is benign at the moment, still it does erode the principal of what you have. And, as a result, you do need something that has a growing stream of income over time to offset the pressure from inflation, and that's exactly what these dividend growers provide. They provide you much more than just an offset to inflation. They provide you with a rising stream of income that is far superior than what you pretty much can get anywhere else.

So the demand for this kind of story will stay high. The demand for these kind of stocks, in my view, is only going to grow. It's going to increase, not decrease, and, as a result, we feel pretty good about where we are positioned.

JB: I would also add, Peter and Jeff, just, I mean, it just popped into my head as we were going through this conversation, there are certain sectors where the amount of not only investor scrutiny on the sustainability of payout ratios, but the amount of regulatory scrutiny on the amount of payout ratios has come full circle since the financial crisis.

And, you know, I think about the banking industry as a whole, these companies go through annual stress tests where the Federal Reserve shocks unemployment, shocks economic growth, shocks trading losses and judges these companies' ability to maintain payout ratios at current levels. So there's a ton of different bodies looking at where payout ratios are today, the sustainability of those payout ratios. And, you know, I think our job incorporates examining the ability to grow from these ratios. But it's being looked at all over the place. It was one of the lessons of the crisis that I think is, from a regulatory standpoint, comes out to be very beneficial from an investing standpoint.

JS: Well, John, Peter, thanks for joining me in the booth today. I think that's all the time we have.

JB: Appreciate it.

PV: Yes. Thanks for having us. This was great.

JS: And I just want to leave the listeners with one quick statistic that I did on the podcast about a year ago is that if you look at the Dow Jones over the last 90 years, so since August of 1929 through August of 2019, if you look at the annualized returns of the Dow Jones in that timeframe, it was 4.85%. If you included reinvested dividends, that jumps all the way up to 9.07%, so almost a doubling of your returns. And I will probably misquote this, but I think it was Albert Einstein that said compounding interest is the eighth wonder of the world. Is that an accurate attribution? (Laughs)

PV: It certainly is an eighth wonder of the world.

JS: And, obviously, given the late-cycle dynamics that we're having, dividend growers give you the greatest return and lowest volatility versus other types of companies and seem to be well-positioned.

So, again, thank you both for joining me in the booth here. And thank you, everybody, for listening in to this version of ClearBridge's podcast. We hope you'll continue to join us throughout 2019 and

welcome any questions, comments and suggestions, which you can email us at podcast@ClearBridge.com.

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