ClearBridge Investments

Embracing Dividend Opportunities in 2024

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Key Takeaways

- Amid higher interest rates, it is important to consider a spectrum of dividend-paying companies, some with higher current yield and some with higher growth potential and the ability to compound dividend yield over time.
- The utilities sector, a poor performer in 2023 due largely to interest rate pressure, has likely already priced in higher-for-longer interest rates, is attractively valued, and should continue to be defensive in a slowing macro environment.
- The rate-sensitive real estate sector has also likely already priced in a regime of higher interest rates, creating some price dislocations for companies supported by strong balance sheets and offering an attractive combination of upfront yield and growth.

A Conversation with Jeff Schulze, John Baldi and Tatiana Eades

Yields rose stiffly in 2023, driven by the Federal Reserve's rate-hike regime, but with expectations increasing for a pause in hikes or a potential cut in 2024, the outlook for income investing looks poised to change. ClearBridge's Head of Economic and Market Strategy Jeff Schulze, CFA, sat down on November 15th with John Baldi, Portfolio Manager for the ClearBridge Dividend Strategy, and Tatiana Eades, Senior Analyst for Renewables/Utilities, to discuss how income-oriented sectors are positioned going forward.

Jeff Schulze (JS): How are you thinking about dividend-paying stocks in a world of higher interest rates?

John Baldi (JB): As a general overall market observation, the macro is highly unpredictable. We entered 2023 with expectations for a recession that was going to start in the back half of this year. We've just reported one of the strongest quarters of growth in the recent past. With highly unpredictable macro as a backdrop, I think it's important to maintain equity exposure. One of the better ways to maintain equity exposure, in our opinion, is a simple framework of investing in dividend-paying stocks.

We own dividend-paying stocks across the spectrum. Some of them have lower upfront yields and higher growth potential on the backend with respect to their income. Others have higher yields upfront and more modest growth expectations on the backend.

Two examples of stocks on the wide ends of that spectrum are Visa and Williams. Visa has compounded earnings tremendously over time. It currently yields about 1% — not very high in the grand scheme of interest rates today. But that income stream has compounded at something like high teens in the past five years. So, as the earnings growth of the company has materialized, shareholders have enjoyed higher income from dividends.

In the energy space, Williams yields north of 5% today, but that 5% is not going to grow at a Visa-like rate, though it should still grow at a very respectable 5% over the course of the next five years.

We feel it is important to maintain equity exposure when we don't necessarily know what the macro environment is going to do, and there are many ways to achieve it. With the ClearBridge Dividend Strategy we try to find the right balance between getting that upfront yield and getting the growth of the compounding of that yield over time.

JS: What has been behind the underperformance of utilities in 2023?

Tatiana Eades (TE): There are several factors. Given the bond-like characteristics of the utility sector, a rapid rise in interest rates creates a competitive income option for investors. Also, the sector has generally higher dependency on debt financing. Typically, utilities' debt-to-capitalization ratio is around 60%. So high interest rates create some temporary pressure on the companies' profitability. Also, utilities tend to underperform in a rising inflation environment, because rising inflation negatively impacts the underlying value of the utility asset base.

JS: Are utilities attractively valued now?

TE: The short answer is yes. Regulated utilities have been one of the worst-performing sectors year to date, and we'll likely see some tax-related selling into the year end. But looking at the longer-term history, this magnitude of underperformance of about 32% in November is quite extreme, the second worst, in fact, in 40 years. That means that valuations are very attractive right now. Today, the sector is trading in line with the previous troughs in 2009 and during the pandemic. It is trading at an 18% discount to the market on next year's earnings. From that perspective, it already reflects a very weak macro environment. That 18% discount compares to a long-term 10% premium to the market. So, this is an extremely low valuation for my sector.

From a macro standpoint, historically, the sector has outperformed the broader market toward the end of the Fed tightening cycle. So, if we think that we are approaching that period, then just looking back at history, the sector should start performing better going forward.

JS: John, how are you thinking about your utilities allocation and the ClearBridge Dividend Strategy?

JB: Utilities are probably close to pricing in the reality of higher interest rates for a longer period of time. Within utilities, we currently own two stocks: Sempra and Edison International. Sempra is mostly a regulated utility out of California and Texas, Edison a pure-play on California. We see a pretty decent outlook for earnings growth over the next few years, driven by spending to electrify and prepare for a greener, less carbon-intensive future. Also to harden the system and protect from future wildfires (particularly with respect to California).

JS: What kind of companies are you finding attractive in other income-oriented sectors beyond utilities, such as energy and real estate?

JB: We are currently overweight energy. But it's important to note that most of our energy position is based on infrastructure companies whose pipes move oil and gas throughout the country: some down from Canada, through our ownership of Enbridge, and some along the East Coast, mostly natural gas, with Williams. For those business models, while the stocks can trade sensitive to the underlying commodity, their revenue streams are mostly durable and protected through long-dated take-or-pay contracts. So they're classified as energy, but we think about them more as infrastructure companies with very durable revenue streams. They also offer a good upfront yield, around 5%, and a pretty good growth outlook, with mid-single-digit dividend growth over the foreseeable future.

Real estate, like utilities, most likely reflects higher-for-longer interest rates. Those stocks have underperformed dramatically in 2023 as the real estate investor base is sensitive to interest rates because they dictate the price of land. Recently, we've tried to take advantage of some dislocation in the space with a new position in AvalonBay, a bi-coastal apartment company. We started that position late in 2022, and in 2023 we bought Public Storage.

The common theme here is phenomenal balance sheets. Both companies are run exceptionally well with respect to their debt structures and terming out their debt structure in the low interest rate environment of the past. Public Storage effectively has for the most part funded itself with preferred equity over a long time. The other common theme is they both trade at discounts to net asset value (NAV). If we mark to market their real estate portfolio based on recent private transactions, we feel that they're both near a 20% discount to NAV. They are also poised to grow mid-single digits. The combination of upfront yield and growth, the steadiness provided to them by their balance sheets, and how they are funded make real estate attractive for us.

JS: If a recession materializes, will utilities be able to offer their historically defensive characteristics?

TE: Utilities should continue to be defensive, for several reasons. The growth outlook today for the sector is quite good. Typically utilities offer a 5% to 6% earnings growth rate over the next several years, plus a 4% dividend yield that will continue to grow in line with earnings, and a very low beta. So a very attractive overall return. Also, weather has not been a utility friend in 2023, with a mild winter and a cool summer. Yet despite that, the results were very strong.

Meanwhile, power demand growth continues to hold up quite well. The sector is an indirect beneficiary from AI and data center growth, as those facilities tend to be very power-intensive. There is also growing electric vehicle penetration, which helps demand and also requires more electric infrastructure. The companies also continue to see manufacturing onshoring or reshoring in their jurisdictions.

Spending drivers also include grid resiliency amid climate change and incentives for renewables in the Inflation Reduction Act. Importantly, since these are regulated utilities, state regulators are broadly more receptive to the companies' big investment programs to reduce carbon emissions, and to make the local grids more weather resilient and efficient.

About the Authors

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