



Citi Global Wealth Investments

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Learning to Appreciate Dividends Again

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Summary

- **The strongest annual returns for this new economic cycle may be behind us. This is in no way a bearish view on the future, but it does speak to a new reality for investors and their portfolios.**
- **We are returning rapidly to a new normal. We expect growth to moderate further as peaking demand for consumer goods and the end of inventory replenishment are upon us. We also remind readers that the pandemic is not over yet.**
- **We think that most investors and market prognosticators undervalue dividends and the role they play in determining total investor returns.**
- **Given that the 38% return for global equities is behind us, we have reduced weightings to some cyclical assets and are beginning to shift portfolios towards higher quality assets. One way to convince investors of a company's growth prospects is growth in cash distributions.**
- **Growth in dividends is consistent with management activities that are focused on the long-term health and competitive position of these companies. A firm's capacity to grow dividends demonstrates their fortitude and commitment to shareholders.**
- **Cash generators have beaten the S&P 500 return by 60 percentage points over the past 30 years.**

The New Normal Begins Now

As we have discussed in our Mid-Year Outlook, the strongest annual returns for this new economic cycle may be behind us. Expectations of a strong economic recovery have been priced into most financial markets. US economists are no longer raising forecasts given that 2021's GDP growth rate to June averages 7%. This is in no way a bearish view on the future, but it does speak to a new reality for investors and their portfolios. By our estimates, positive returns are earned in equities slightly more than 5 times more frequently than losses, matching the ratio of expansions/contractions. But where should one find those returns?

An Abundance of Anxiety

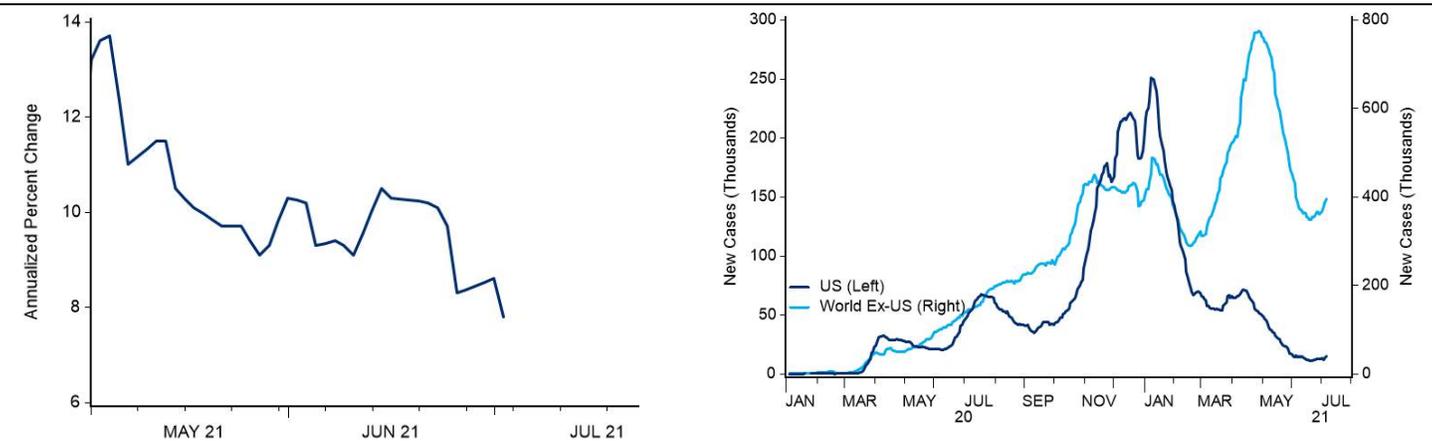
Global equities are just 1% below their record highs. Investors have shaken off fears that surging inflation and interest rates would crush the bull market and budding economic recovery. Their newest anxiety is reflected in a rallying bond market that expresses the exact opposite view, a fear that growth will slow quickly. The drop in 10-year US yields from 1.75% at the end of the first quarter to a low near 1.30% last week is indicative.

There are many reasons for the anxiety. One is the instability of consumer prices. Seasonal travel budgets will be sorely stretched as the hospitality sector reopens with a surge in demand. A second is the increase in equity market volatility around the early July US holiday and bond-bearish positioning that have exaggerated the US rate moves.

Yet, the truth is that we are returning rapidly to a new normal. The post-pandemic “rocket” recovery (hat tip to Richard Branson here) is coming back to Earth. Estimates for US economic growth are slowing. Over the past two weeks, the Atlanta’s Fed’s tracking estimate for 2Q real GDP fell from a previously *unprecedented* +10.2% to +7.8% (**see figure 1**).

We expect growth to moderate further as peaking demand for consumer goods and the end of inventory replenishment are upon us. We also remind readers that the pandemic is not over yet. As **figure 2** shows, new infections in the US are lower, but the disease remains prevalent. Among the willing adult population, it is no longer easy to find unvaccinated arms to jab. Outside the US, infections are rising again due to slow vaccination rates and the fast spreading Delta variant. Stark actions in Japan and other Asian economies limit social interactions and a return to full economic activity. We therefore expect US growth to moderate to 4%-5% level even as service activity booms.

Figure 1: Tracking Estimate for 2Q Real US GDP Growth: Atlanta Fed **Figure 2: New COVID Infections: US vs World Ex-US**



Source: Haver Analytics as of July 9, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

We Do Expect Rates to Rise From Here, But Modestly

From an investor point of view, bond market valuations are atrocious. It is possible that US investors will earn real negative rates of return for several years to come. We do think rates are too low given our economic growth expectations. Yet, looking at precedent, treasury yields haven’t moved up more than 50 basis points in the second year of an economic recovery since 1981. Signs that economic growth and inflation are now at peak rates has historically checked a material rise in yields. And the quiet, steady drumbeats of a gradual move by the Fed to a more conventional monetary policy approach in coming years has calmed inflation concerns.

A Shift in Portfolios toward Dividends and “Quality” Growers

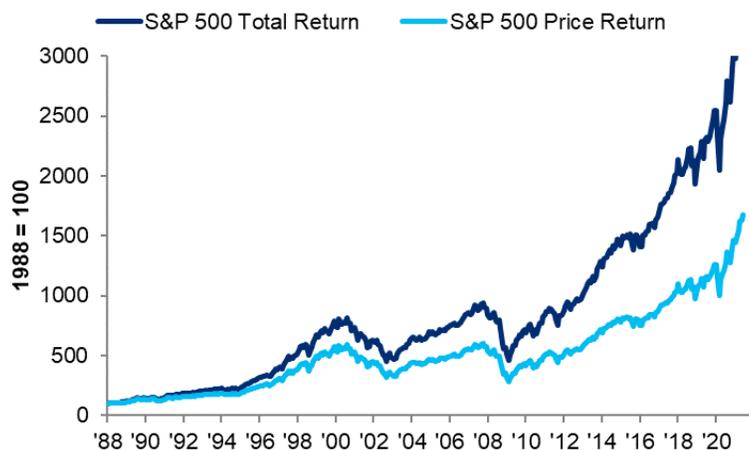
Given that the 38% return for global equities is behind us, we have reduced weightings to some cyclical assets that have priced in most of the current economic recovery. And we also beginning to shift portfolios towards higher quality assets with the most convincing growth prospects beyond the COVID rebound.

One way to convince investors of a company’s growth prospects is growth in cash distributions. While some firms have internal growth opportunities in which to reinvest, a firm’s capacity to grow dividends (and cut if absolutely necessary) demonstrates their fortitude and commitment to shareholders.

We think that most investors and market prognosticators undervalue dividends and the role they play in determining total investor returns. As figure 3 shows, a whopping 52% of the total return in the S&P 500 has been earned by receiving and reinvesting dividends, even over the tech-dominated past three decades.

If that result isn't convincing enough, the vast difference in total return for US and European shares over the past 20 years largely is largely explained by their differences in payout growth rates. US dividends compounded at a 6% growth rate, Europe's is just 3% (see figures 4-5).

Figure 3: S&P 500 Total Return Index and Price-Only Return



Source: Bloomberg as of July 9, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Figure 4: S&P 500 Index and S&P 500 Dividends Per Share: Compounded Dividend Growth Rate 6%

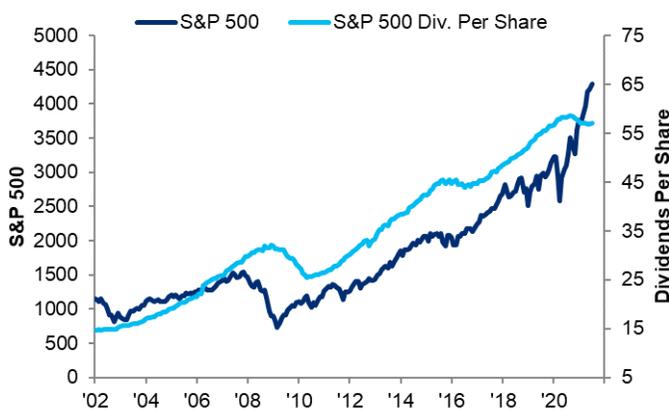


Figure 5: MSCI Europe Index and MSCI Europe Dividends Per Share: Compounded Dividend Growth Rate 3%



Source: Bloomberg as of July 9, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Aristocracy in Action

If we define Dividend Aristocrats as an index of US equities that has grown dividends consistently for 25 years, we can see why they deserve their lofty status in markets. As figure 6 shows, these cash generators have beaten the S&P 500 return by 60 percentage points over the past 30 years. They have done so with less downside over each of the five calendar years when broader US equities posted a drop. In fact, consistent dividend growers have beaten both a "growth basket" tilt and a value basket with a long enough investment horizon (see Figure 7). Finally, these Dividend Aristocrats have higher than market-average credit ratings (please see [Stocks for Bond People](#)).

Figure 6: US Dividend Aristocrats Total Return vs S&P 500 Total Return

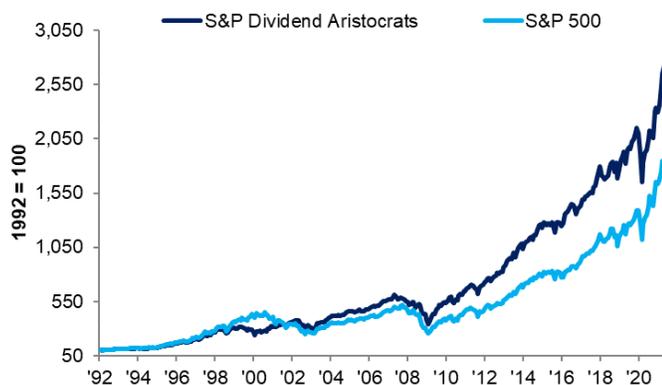
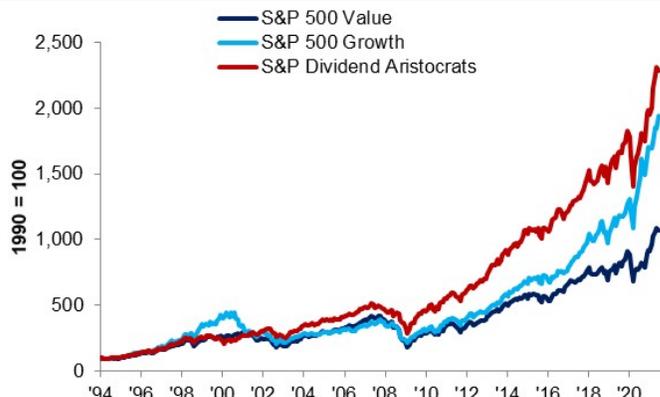


Figure 7: US Dividend Aristocrats vs “Growth Style” index and “Value Style” index



Source: Bloomberg as of July 9, 2021. Note: S&P Dividend Aristocrats Index identifies companies that have consistently grown dividend payouts for at least 25 consecutive years. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

It is our view that across *all* regions of the world, market leading firms that demonstrate their growth through increased dividends are likely to follow the US precedent of outperformance. In Europe, where we expect a reversal of the austerity and disunity of the past decade, it is possible that dividend growth will resume. And European shares begin with a dividend yield roughly twice the global bond yield (see **Figures 8-9** and our [European Strategy Monthly](#)).

Figure 8: S&P 500, US Dividend Aristocrats and Non-US “Dividend Achievers”

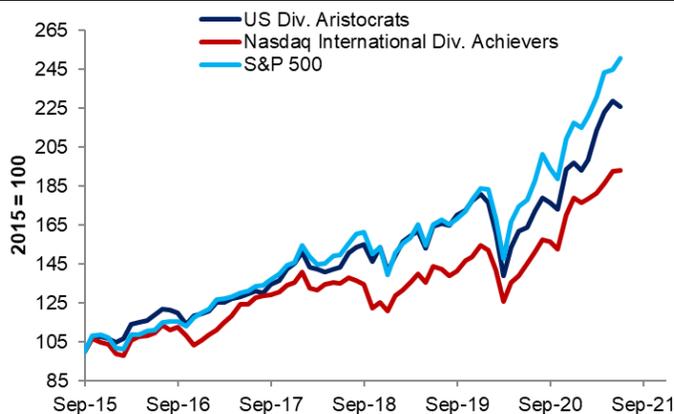


Figure 9: 10-Year US Treasury and German Bund Yield (%)



Source: Bloomberg as of July 9, 2021. Note: Dividend Aristocrats defined above. Nasdaq International Dividend Achievers Index identifies non-US companies that have consistently grown dividend payouts for at least 7 consecutive years. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Focus on Dividend Growth *not* High Dividend Yield

Companies that are able to consistently grow dividends tend to outperform those delivering unsustainable payouts. There is a demonstrable, significant performance gap between companies that *grow* their dividend consistently versus those that cut or suspend their dividends. Over the last 47 years, this outperformance of dividend growers relative to dividend “cutters” is over 3% *per year*, with 30% lower volatility.

Growth in dividends is consistent with management activities that are focused on the long-term health and competitive position of these companies. Dividend growth investing amounts to more of a “goldilocks” strategy, with moderate payout ratios, leverage, and yield delivering stronger long-run performance than both higher and lower yielding alternatives (see **Figure 10**).

By contract, high yielding dividend strategies tempt investors with indicative yields more than twice that of the broader market. Looking more closely, these higher payouts come with additional risks worth noting. The highest “yielding”

companies actually deliver lower cash flow generation and lower ROEs with higher leverage, and often unsustainably high payout ratios.

Using the Dow Jones Select Dividend index (the top 20% of dividend yielders in the S&P 500) as a proxy, we note that this index has underperformed the Dividend Aristocrats index by more than 3% per year and the broader market by 2% per year over the past 16+ years. As it turns out, their payout ratios of around 82% of annual net income on average don't allow for dividend growth. Thus, when the business environment changes, the top dividend yielders are often the first to make dividend cuts. This leads to lower total returns and more volatility, too. We should also point out that dividend growth strategies have outperformed high dividend yield strategies in both rising and falling real interest rate environments (see **Figure 11**).

Figure 10: Dividend index payout ratio, leverage and performance

	High Dividend Payers	Dividend Aristocrats	S&P 500
Dividend Yield	3.9%	2.4%	1.4%
Payout Ratio (% of Net Income)	82%	66%	55%
Leverage (Net Debt to EBITDA)	3.3x	2.4x	1.3x
Annualized Performance since 1995	11.7%	12.5%	10.9%

Figure 11: Dividend index performance during periods of rising and falling real interest rates

	Average 12m Return since 1995 During Periods of...	
	Rising real rates	Falling real rates
High Dividend Payers	6.7%	12.2%
Dividend Aristocrats	8.9%	12.5%
S&P 500	8.5%	5.6%

Source: Bloomberg as of July 9, 2021. Note: Return history analysis generated since 1995 per index data source availability. High Dividend Payers are proxied using Dow Jones Select Dividend Index. Dividend Aristocrats proxied using S&P 500 Dividend Aristocrats Index. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

The Dividend Metrics We Prefer

When identifying compelling dividend paying investment opportunities, it is essential to understand the underlying business fundamentals. Our focus is to find companies that have the ability to potentially generate returns in excess of their cost of capital. Key metrics we identify include: **dividend growth** – companies that consistently grow their dividend have historically outperformed; **free cash flow** – needed to pay the dividend and reinvest for future growth; **high Return on Invested Capital (ROIC)/ Return on equity (ROE)** – a “good quality” barometer as companies generate higher returns due to their competitive advantages; **payout ratio, debt levels** – these need to be well-managed for a company to maintain dividend payouts in more challenging times, and; **attractive valuations** – to provide both downside protection and an upside kicker when a company executes well.

Three Sectors with Sustainable Dividend Growth

Health Care, (Pharma, in particular)

Pharmaceutical companies, currently yield 2x the market average (2.70% vs. 1.35%), have a higher ROE (15.3% vs. 14.0%), higher operating margins (13.4% vs. 9.5%), higher trailing 5 year dividend growth (6.3% vs. 4.5%), and trade at a 38% discount based on free cash flow to enterprise value. We also believe that secular growth tailwinds will drive attractive top-line growth for many companies across the industry. Valuations appear to reflect material drug price reform in the United States given that the sector trades at a meaningful discount to the broader market. Though our “base case” remains that we will likely see drug price reform passed over the next 12 months, we expect a fairly modest impact on most companies' earnings. And with the lifting of this regulatory cloud, we might see a substantial upgrade in valuation for the group.

Biopharma companies also generate free cash flow and this is often underappreciated by investors. The cash generation of biopharma companies allows them to methodically reinvest in their pipelines via increased R&D spending and bolt-on M&A. These investments will drive the next leg of growth and innovation.

The biopharma industry's recent successes with COVID-19 vaccines and Alzheimer's therapy approvals have showcased that it can drive scientific breakthroughs.

In addition to investing in their pipelines, pharma and biopharma companies return cash to shareholders and many support dividend yields north of 3%. We expect many of these companies will grow their dividends by at least mid-single digits in the years ahead.

Finally, the near-term outlook for health care companies tied to utilization is also quite attractive. Patients postponed elective procedures and wellness visits throughout 2020. This dynamic creates "easy comps" for health care companies as utilization continues to normalize in the quarters ahead.

Select consumer staples with strong pricing power

Consumer staples companies historically have delivered more than twice the market dividend yield (2.76% vs. 1.35%), have much higher ROEs (25.5% vs. 14.0%), higher 5-year dividend growth (6.6% vs. 4.5%), reasonable payouts (58%), and are trading at a 28% discount based on free cash flow to enterprise value. In addition, high quality consumer staples companies have been able to grow topline organically in excess of inflation due to their strong brands, pricing power, relatively inelastic demand and strength over private label (store brands).

We have also seen a bottoms-up focus on restructuring consumer staple business leaders. Using Zero Based Budgeting (a combination of product and SKU rationalization, cost controls, more efficient marketing spend, lower central and procurement costs (scale benefits) and a pivot to ecommerce) leaders have driven much better results leading to greater free cash flow generation. After the necessary reinvestment in technology and growth strategies, boards of these companies have elected to return the excess FCF to shareholders in the form of share repurchases and dividends.

Semiconductors that power an increasingly digitized world

Semiconductors are an underappreciated dividend growth sector that historically have 4 times the 5 year dividend growth (20.8% vs. 4.5%), significantly higher ROEs (25.5% vs. 14.0%), double the operating margins (20.5% vs. 9.5%) and trades are at a 15% discount based on free cash flow to enterprise value. The Semiconductor industry has attractive fundamental characteristics driven by unstoppable trends including data growth and demographics (see our [Outlook publications](#) regarding Unstoppable Trends). Demand drivers across the semiconductor industry include growth in Artificial Intelligence, Big Data/Cloud Computing, Electric Vehicle (EV) and autonomous driving, sensors and robotics. All of this is leading to demand for smaller, more power efficient, and ultimately more complex semiconductors. We expect that the industry will consolidate due to the increasing complexity of semiconductors and the associated cost in developing and producing such chips at scale. Thus, the management of leaders in this sectors will, in our view, become more comfortable committing to a regular, higher dividend pay-outs.

Citi Global Wealth Investments

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