The Dividend

TANDEM
INVESTMENT ADVISORS®

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Dividends can be quite impactful on total return. In fact, from World War II through 2019, roughly 40% of the S&P 500's total return can be attributed to dividends. They are clearly an important component of total return. Some investors value dividends chiefly for the income they produce. Dividend yield is what they seek and growth would just be icing on the cake. Others believe that dividend growth is the Holy Grail and the surest way to produce consistent and superior returns. Tandem falls in the growth camp, not the income camp.

Tandem pays little attention to dividend yield. In fact, we find that many (though certainly not all) high dividend stocks pay such a high dividend for one of two unfortunate reasons: either they choose not to reinvest enough earnings to provide for future growth, or the dividend is potentially in danger of being reduced.

The dividend growth investors we know of value dividend growth so much so that they make it their primary objective in screening stocks. There is even an index called Dividend Aristocrats that includes all S&P 500 companies that have paid and grown their dividend annually for at least 10 years.

Tandem takes a considerably different view of dividend growth. While we require dividend growth for any company we own that pays a dividend, we do not seek dividend growth. We seek companies that consistently grow earnings, revenues and cash flow through any economic environment. For these companies, dividend growth is a by-product of good corporate management. Unlike most dividend growth investors, we do not seek dividend growth, we require it. More importantly, we seek companies that grow and reinvest in future growth. This makes dividend growth sustainable.

It is our belief that companies producing the results that we demand will produce a more consistent, repeatable investment experience for our clients. It is our opinion that if a company can increase the cash flow it pays to investors in the form of dividends, the value of that company is likely to grow. And if that company can repeat this growth in dividends year after year, it is even more likely that the value of the company will increase. Will it increase at a rate faster than the broader market for any given period of time? Who knows? That is not our objective. Our objective is to provide a smoother, less volatile, more repeatable experience that will likely outperform the market over a complete cycle.

> We seek companies that *consistently* grow earnings, revenues and cash flow through any economic environment.

Sometimes examples work better than words. So let us study 3 hypothetical companies that we will call Company A, Company B and Company C. All are profitable and pay a dividend. In our example, we will purchase 1 share of each of these for $20.

Company A pays out as much of its earnings as it can, reinvesting little for future growth. It pays a $1/share dividend that never grows. The initial hypothetical dividend yield is 5%.

Company B pays a dividend of $0.42/ share for a yield of 2.12% at the time of hypothetical purchase, and has a dividend growth rate of 8.55%.

Company C pays a $0.35 dividend for a yield of 1.75% at the time of hypothetical purchase, and has a dividend growth rate of 11.26%

We will compare these companies as if we were conducting an experiment in the lab (which of course is not possible in the real world, unfortunately). In the first example we hold all things constant including dividend yields. In other words, over the 10 years of this hypothetical study, the dividend yield for all 3 companies never changes. The result of the first experiment is simply that the company with the greatest dividend growth will produce the greatest total return.

Dividend yield = dividend amount/price per share

If dividend yield and amount never change, price won't either. So Company A pays a nice dividend, but that is all. Companies B and C pay more modest dividends that become larger each year. If yield stays the same and dividend amount grows, price must grow as well. So B and C produce a greater total return than A, with C producing the best result when dividend yields remain constant.

In the second example we assume dividend yields increase by 0.10% each year. When yields rise, prices fall. A stock that pays a dividend of $1/share yields 5% when the price is $20. If the dividend yield increases to 5.1% but the dividend is still $1/share, the price has to fall to $19.61 to reflect the rising yield. Without

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dividend growth to offset the uptick in rates, Company A consistently declines in value. It had the highest yield of the 3 at time of hypothetical purchase (5%), and ends with the highest yield as well (5.9%). It also experiences a price decline in this example, while B and C grow their dividends and share prices, although by less than in the first example. Once again, C produces the best total return.

Lastly, we explore the impact on the total return of these companies when dividend yields decline by 0.1% each year. All 3 companies produce their best total returns in the third example, as we should expect. If prices fall when rates rise, they logically rise when rates fall. But dividend growth wins the day, and Company C's superior dividend growth makes it 3-for-3 on a total return basis.

Of course, there are other elements to consider when investing. Earnings growth typically impacts share price even more dramatically than dividend growth. We will not conduct a similar experiment for earnings growth, but consider this: if earnings don't grow, dividend growth isn't sustainable.

There are ways to grow dividends that do not require the consistent growth in earnings, revenues and cash flow we require. A company can buy back shares and have the effect of increasing dividends on a per share basis. A company can borrow money to increase its dividend. A company could even sell an asset. But the only sustainable way to grow a dividend over time is to grow a business over time as well.

And this is the beauty of Tandem's approach to dividend growth. We don't seek it. We don't try to identify it. We simply demand it of any company that grows earnings, revenues and cash flow over any economic cycle. Without all these qualities, a company cannot be in our portfolio. We believe it produces a more consistent, repeatable and less volatile experience, no matter what the market may be doing.

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There are many ways to invest successfully. Dividend growth strategies have proven over time to be one such way. We believe that Tandem's unique approach to dividend growth – identifying growing companies rather than growing dividends, and then demanding dividend growth – produces a consistent, repeatable and less volatile experience for our clients. Less volatility means clients are more likely to stay invested, even in the most volatile times. Some may enjoy the excitement of being the hare, but we all know that the tortoise wins the race.

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