Allspring

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Dividend Growers: Distinctly Different

INVESTMENT PERSPECTIVES

Key takeaways

- Dividend growth strategies historically have delivered competitive returns and favorable risk ratios.
- In contrast to high absolute yield strategies, dividend growth strategies seek companies likely to increase per-share dividends.
- Dividends are just one component of a firm's resource-allocation strategy. Companies that grow dividends also tend to be prudent and productive allocators of company resources.

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Overview

In dividend growth strategies, portfolio managers strive to identify companies that will steadily increase their per-share dividend payments. These types of companies are often referred to as dividend growers. Has a dividend growth strategy historically outperformed other investment approaches over time? The answer is yes—and they potentially can add value as part of an investor's asset allocation.

We evaluated 30+ years of dividend growers' performance within the S&P 500 Index relative to the returns of other selected groups within the same universe. Our research clearly shows that dividend growers' strong performance has been driven mainly by two common characteristics:

01 A pattern of rising dividends distributed to investors over time

02 Prudent and productive allocation of a company's resources that are required to sustain those dividend increases

In essence, shareholders were rewarded for investing in high-quality businesses run by managers capable of making strategic investments while paying out higher dividends over time.

The double duty of dividends ... and then some

Dividends may assist investors in five main ways:

01 Dividend payouts to investors have contributed significantly to long-term total returns, particularly when reinvested.

02 When taken as income, cash payments can be used by investors to pay their retirement expenses and other longer-term liabilities, and they can fund philanthropic activities as well.

03 Regular dividend payments may help reduce investors' uncertainty and serve as a buffer during market drawdowns.

04 Management teams that consistently pay dividends demonstrate their confidence in the sustainability of the company's earnings and cash flows.

05 Dividends instill discipline in company management. Paying dividends reduces corporate resources available for projects, which forces thoughtful capital allocation that may ensure only the most productive opportunities will be funded.

Not all dividends are created equal

A dividend yield (dividend payment divided by stock price) alone doesn't qualify a stock for inclusion in a rising dividend portfolio. In fact, there is far less importance placed on what the level of the yield is than on why the yield is what it is. A dividend growth approach focuses on identifying companies with a high likelihood of steadily increasing their per-share payments to investors and places less emphasis on the absolute current yield.

Other types of dividend strategies take different approaches toward dividends. (Each dividend strategy referenced in this paper is defined in the endnote on page 6.) One heavily used strategy involves owning high dividend yield stocks and focusing on the regularity and size of a dividend rather than its growth rate. This potentially can be a shortsighted approach that sacrifices total return for current income, and here's why. Companies with limited growth prospects often pay out a higher percentage of income in the form of dividends. Over time, their management teams may have to choose between continuing to pay substantial dividend obligations and funding attractive projects. Reluctant to make tough choices, they may decide to add debt, possibly straining corporate balance sheets. Also, some companies have high yields because of low stock prices. In these instances, investors may be signaling they have little confidence in management's ability to maintain the current dividend.

Dividend growers versus high dividend yield: Where's the sweet spot?

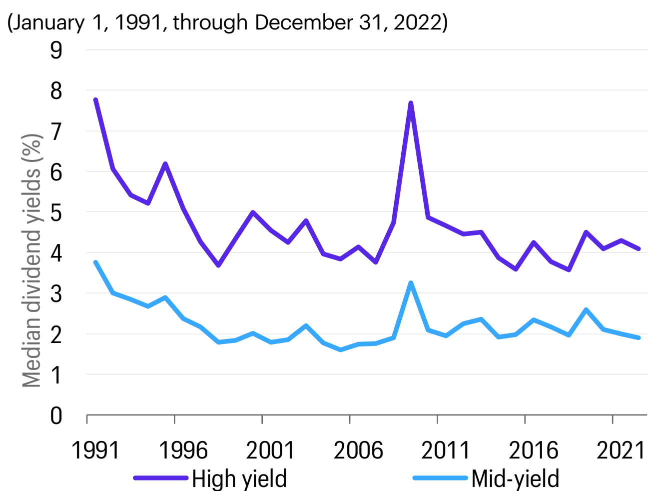
Historically, high dividend yield stocks have offered yields in the top quartile of all stocks. In contrast, dividend growers historically have sported dividend yields that have been below the top yielders but above the higher-growth, lower-yield crowd. Like Goldilocks: not too high and not too low, perhaps just right. We refer to this as the dividend sweet spot: a payout level set by managers that instills discipline by creating healthy competition between maintaining a growing dividend while at the same time investing in projects to grow the business.

Figure 1 displays two levels of yield. The violet line shows the median yield of companies that ranked in the highest yield quartile within the S&P 500 Index during the 32-year period measured. The blue line shows the combined median yield of companies that were in the second and third yield quartiles of the index during that period. The results displayed show the obvious and consistently significant yield advantage of the highest dividend-yielding stocks over the 32 years shown.

FIGURE 1

Median dividend yields of S&P 500 Index holdings: Top quartile and second/third quartiles

(January 1, 1991, through December 31, 2022)



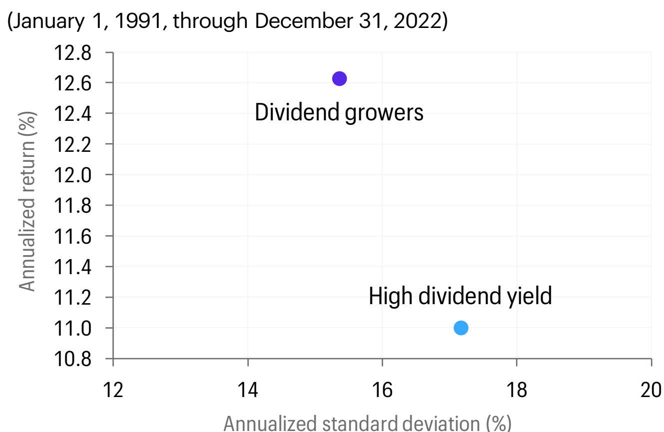
Past performance does not guarantee future results.
Sources: Allspring and Bloomberg

But yield is only part of the total return equation. Figure 2 shows the total returns (dividends plus price appreciation) of two hypothetical investments in equally weighted but different portfolios of stocks within the S&P 500 Index from 1991 through 2022. The first group contains stocks in the highest yield quartile. The second group is composed of dividend growers. The graph plots the average annual return and volatility (as measured by standard deviation) of each portfolio for the entire period. The results show that dividend growers offered a higher average return with less volatility.

FIGURE 2

Dividend growers and high dividend yield: Return versus risk

(January 1, 1991, through December 31, 2022)



Past performance does not guarantee future results.
Sources: Allspring and Bloomberg
Investment performance of hypothetical portfolios composed of dividend growers and high dividend yield. The portfolios are equally weighted and derived from the universe of S&P 500 Index constituents as of the beginning of each year. See endnote for portfolio definitions.

Figure 3 compares annualized total returns for the dividend growers and high dividend yield groups over a range of time frames within the 30-year period. For all of these periods, dividend growers consistently delivered better results than the high dividend yield group did.

FIGURE 3

Dividend growers versus high dividend yield: Annualized total returns and relative performance (%)

As of December 31, 2022

	DIVIDEND GROWERS	HIGH DIVIDEND YIELD	DIVIDEND GROWERS +/–
1 year	-5.3%	-8.8%	3.5%
3 year	10.3%	4.9%	5.4%
5 year	9.7%	6.2%	3.5%
7 year	12.1%	8.6%	3.5%
10 year	13.1%	10.0%	3.0%
15 year	10.5%	8.1%	2.4%
20 year	11.7%	9.5%	2.2%
25 year	10.4%	8.3%	2.1%
30 year	11.7%	10.0%	1.8%

Past performance does not guarantee future results.
Sources: Allspring and Bloomberg
See endnote for portfolio and standard deviation definitions.

The bottom line is clear: Although dividend growers lacked an absolute dividend yield advantage, as a group they still outperformed with less risk relative to the high dividend yield group for the entire period. Selecting stocks for the sake of yield is not a substitute for holding strong, growing companies in the dividend yield sweet spot. A high dividend yield may signal limited growth or potential business challenges. In contrast, quality companies with the ability to maintain and grow their dividends as well as realize higher stock prices have been able to produce not only attractive risk-adjusted results but also better total returns. Investors with income needs may want to consider systematically liquidating a portion of a portfolio of dividend growers to meet cash flow needs rather than depending on the income of a higher-yielding portfolio of companies that may not be as fundamentally strong.

There's a symbiotic relationship between dividend growers and ROIC

Why does the dividend yield sweet spot exist? In our experience, many dividend growers have proven to be well-managed companies with strong fundamentals and effective in turning investments into sustainable profits.

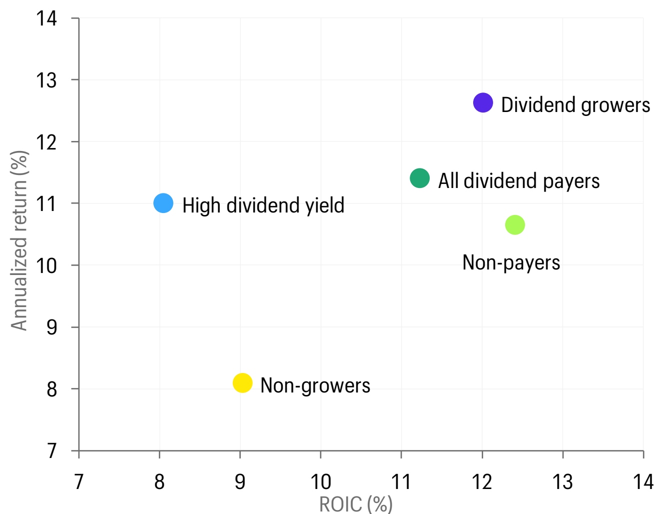
We believe a company's return on invested capital (ROIC) reflects its resource-allocation efficiency. The ratio (percentage) conveys the level of earnings that can be expected from every dollar of company investment. The higher the number, the more productive the company's capital is in operating the business. Whether the firm is building an additional manufacturing plant, installing new software, or hiring new salespeople, investors should see the results in the ROIC.

Plotting the total return of hypothetical portfolios against ROIC reveals an interesting relationship. In Figure 4, dividend growers produced strong operating results (high ROICs) and delivered the best total returns to shareholders over the period measured. High dividend yield companies and non-growers generally delivered lower returns on capital and total returns.

FIGURE 4

Operating performance: Five groups of companies within the S&P 500 Index

(January 1, 1991, through December 31, 2022)



Past performance does not guarantee future results.
Sources: Allspring and Bloomberg
Investment performance of hypothetical portfolios composed of dividend growers, all dividend payers, non-growers, high dividend yield, and non-payers. The portfolios are equally weighted and derived from the universe of S&P 500 Index constituents as of the beginning of each year. See endnote for portfolio definitions.

Why do dividend growers often achieve high ROICs? We believe it's the symbiotic relationship between the dividend-growing company's disciplined dividend and capital allocation practices.

The dividend commitment reduces company coffers. As a result, company management can afford to fund only projects deemed to have the highest projected returns. This disciplined reinvestment creates a self-reinforcing cycle that likely may lead to higher ROICs.

These companies establish formidable economic moats, potentially resulting in fewer investment dollars being required to maintain a targeted earnings growth rate and a competitive advantage. Excess capital generated may be used to increase dividends, buy back shares, or pursue strategic acquisitions—all actions with the potential to create shareholder value and lead to higher stock prices.

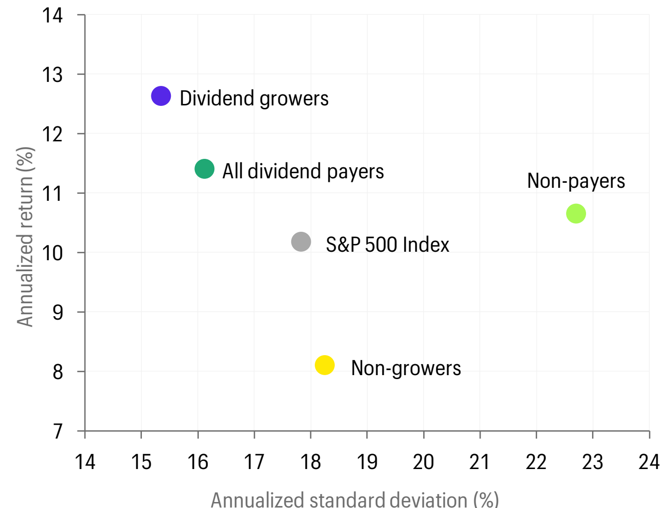
Higher returns with lower volatility

Not only did dividend growers generate higher total returns with more productive use of capital over the 32-year period evaluated, they did so with less realized volatility. Figure 5 compares the hypothetical portfolios of dividend growers, non-growers, non-payers, all dividend payers, and the broad S&P 500 Index in terms of return and volatility (as measured by standard deviation). Among all of these groups, dividend growers offered the best combination of return and risk for the 32-year period.

FIGURE 5

Annualized risk and return for four groups and the S&P 500 Index

(January 1, 1991, through December 31, 2022)



Past performance does not guarantee future results.
Sources: Allspring and Bloomberg
See endnote for portfolio definitions.

Dividend growers also exhibited the lowest beta (least sensitivity to market moves) and the highest Sharpe ratio (highest return per unit of volatility) of all of the groups evaluated, including the broad S&P 500 Index. Figure 6 shows the beta and Sharpe ratios for all of these groups for the 32-year period.

FIGURE 6

Beta and Sharpe ratios for the groups compared in Figure 5

(January 1, 1991, through December 31, 2022)

	DIVIDEND GROWERS	ALL DIVIDEND PAYERS	NON-GROWERS	NON-PAYERS	S&P 500 INDEX
Beta	0.74	0.79	0.85	1.16	1.00
Sharpe ratio	0.74	0.64	0.41	0.47	0.53

Past performance does not guarantee future results.
Sources: Allspring and Bloomberg
See endnote for portfolio definitions.

Beta measures fund volatility relative to general market movements. It is a standardized measure of systematic risk in comparison with a specified index. The benchmark beta is 1.00 by definition. Beta is based on historical performance and does not represent future results.

Sharpe ratio measures the potential reward offered by a mutual fund relative to its risk level. The ratio uses a fund's standard deviation and its excess return to determine reward per unit of risk. The higher the Sharpe ratio, the better the fund's historical risk-adjusted performance.

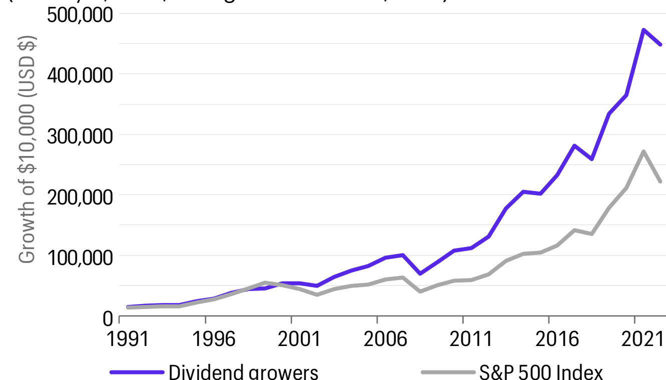
Over the long haul, dividend growth frequently has led the pack

As with any investment strategy, it's important to evaluate the strategy's efficacy across a long-term horizon. Over shorter periods when market movements are dominated by price momentum and higher-beta stocks, dividend growth strategies can be challenged and underperform the S&P 500 Index. This type of environment occurred, for example, during the late 1990s (as seen in Figure 7A). However, this period was temporary. Longer-term returns have favored the disciplined capital approach common to dividend growers (as seen in Figure 7B).

FIGURE 7A

Dividend growers and the S&P 500 Index: Growth of $10,000

(January 1, 1991, through December 31, 2022)



Past performance does not guarantee future results.
Sources: Allspring and Bloomberg
See endnote for portfolio definitions.

FIGURE 7B

Dividend growers versus S&P 500 Index: Annualized total returns and relative performance (%)

(As of December 31, 2022)

	DIVIDEND GROWERS	S&P 500 INDEX	DIVIDEND GROWERS +/–
1 year	-5.3%	-18.1%	12.8%
3 year	10.3%	7.7%	2.7%
5 year	9.7%	9.4%	0.3%
7 year	12.1%	11.5%	0.6%
10 year	13.1%	12.6%	0.5%
15 year	10.5%	8.8%	1.7%
20 year	11.7%	9.8%	1.9%
25 year	10.4%	7.6%	2.8%
30 year	11.7%	9.6%	2.1%

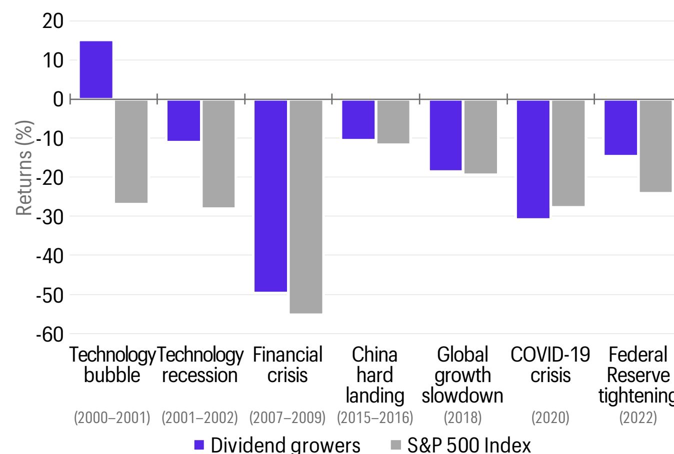
Past performance does not guarantee future results.
Sources: Allspring and Bloomberg
See endnote for portfolio definitions.

In tough markets, less bruising with less beta

Figure 8A displays seven of the more recent market downturns. In six of them, the dividend growers component of the S&P 500 Index performed better than the index itself.

FIGURE 8A

Dividend growers versus the S&P 500 Index during recent downturns



Past performance does not guarantee future results.
Sources: Allspring and Bloomberg
See endnote for portfolio definitions.

Despite underperforming the index during the COVID-19 pandemic, Figure 8B shows that dividend growers still outperformed the S&P 500 Index over the entire 23-year period that ended December 31, 2022.

FIGURE 8B

Returns over period covering seven recent downturns

(January 1, 2000, through December 31, 2022)

	DIVIDEND GROWERS	S&P 500 INDEX	DIVIDEND GROWERS +/−
Cumulative	903.6%	304.6%	599.0%
Annualized	9.6%	6.0%	3.5%

Past performance does not guarantee future results.
Sources: Allspring and Bloomberg
See endnote for portfolio definitions.

These most recent periods also reflect what largely drove longer-term outperformance of dividend growers: winning by losing less. Investors may be comforted to know that possibly losing less in tough markets means they don't have to earn as much back during the recovery to get back to even. The potential for compounding returns prevails.

Conclusion

A dividend growth strategy may offer a compelling allocation opportunity for investors. Many companies with a history of increasing their dividends have delivered favorable total returns over full market cycles while providing a buffer during market drawdowns. These companies have established wide economic moats through productive and disciplined uses of capital—the foundation for potentially higher dividends and strong total returns. Although high dividend yield may be most important to some, a company's ability to sustainably grow its dividend—with yields in the sweet spot—may generate better results over time.

INDEX DEFINITION

S&P 500 Index: The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock's weight in the index proportionate to its market value. You cannot invest directly in an index.

ENDNOTE

Figures 2, 4, 5, 6, and 7A compare results that include hypothetical portfolios constructed as of January 1, 1991, using companies within the S&P 500 Index.

Each portfolio's total return is the equally weighted average of all of the total annual returns of securities within that hypothetical portfolio. Each portfolio's composition was revised at the end of every calendar year to reflect additions to and deletions from the S&P 500 Index and changes in the dividend behavior of each firm as described above within the S&P 500 Index. Portfolio returns were computed for each year from 1991 through 2020. The geometric average return and the standard deviation of return for each portfolio was computed for the entire 30-year period.

All dividend payers: Firms that paid a dividend during each of the prior calendar years in which performance was calculated. As an example, the first calendar year of performance was 1991 for those companies that paid dividends in 1990. The second calendar year of performance was 1992 for those companies that paid dividends in 1991, and so on for the remaining years.

High dividend yield: Firms that ranked in the top quartile of dividend payers at the beginning of each of the calendar years in which performance was calculated. As an example, the top quartile of dividend payers on January 1, 1991, were used to calculate the performance for 1991. The top quartile of the dividend payers on January 1, 1992, were used to calculate the performance for 1992, and so on for the remaining years.

Non-payers: Firms that did not pay dividends during each of the prior calendar years in which performance was calculated. As an example, the first calendar year of performance was 1991 for those companies that did not pay dividends in 1990. The second calendar year of performance was 1992 for those companies that did not pay dividends in 1991, and so on for the remaining years.

Dividend growers: The subset of firms that grew their dividends during each of the calendar years in which performance was calculated. As an example, the first calendar year of performance was 1991 for those companies that increased their dividends in 1991. The second calendar year of performance was 1992 for those companies that increased their dividends in 1992, and so on for the remaining years.

Non-growers: The subset of firms that did not increase their dividends during each of the calendar years in which performance was calculated. As an example, if the firm did not increase their dividends in 1991, they were classified as a non-grower. If the firm did not increase their dividends in 1992, they were classified as a non-grower, and so on for the remaining years.

Standard deviation: The square root of the sum of squared deviations from the mean. It is often used as a measure of volatility, variability, or risk. Standard deviation is based on historical performance and does not represent future results.

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