Investment intelligence

Insights for the growth investor

Dividends – the long run drivers of equity investing

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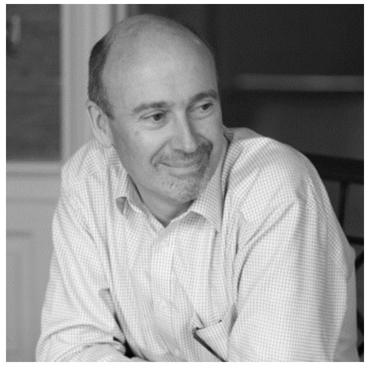
DUNDAS GLOBAL INVESTORS

Author

Russell Hogan
Investment Manager



Russell has been part of Dundas since its inception in 2010. Prior to that, he spent 17 years at Aegon Asset Management, latterly in the role of CEO with responsibility for £33 billion.

He is involved in all discussions and decisions about stocks in the Strategy.

Russell oversees the Dundas portfolios and makes regular visits to meet with existing and potential clients.

Investing for growth

Since launch in 2010, Dundas has pursued a single, clear investment strategy - to invest in global companies that offer the best opportunities for long-term capital and dividend growth.

Our philosophy centres on the principle that the best prospects for superior returns lie in companies that are able to grow their dividends faster than the market during good times, while not cutting them in the bad. We take the view that, as dividends are delivered, the market will reward those companies with higher share prices.

The universal challenge

Amidst the economic turbulence of the 21st century so far, one thing has become crystal clear - saving for our future has become an increasingly personal responsibility. Investors face daunting financial challenges and share the need to plan carefully for a lifelong income. Yet, when we decide to forego some of today's income and invest it to fund future expenditure, those savings set sail on an uncertain sea. We hope that they will be returned to us enhanced and trust that today's sacrifice will pay off in later life.

In reality, those savings are set adrift, vulnerable to every flurry of market fluctuation and fancy. Take the example of a university graduate who entered gainful employment in 1975. Over the subsequent 40 years, his pension savings would have had quite a journey, surviving five bear markets in the USA alone.

What was required back then – and what we all desire today – was a lifeboat. At Dundas, we believe that safe and sustainable growth is most readily found in dividend growth stocks.

Allow us to explain.

The case for dividends

The investment aims of Dundas are simple - to build a portfolio consisting of companies with superior growth and faster growing dividends.

In 2010, MSCI produced an in-depth analysis of the drivers of real equity returns from 1975-2009.

The study demonstrated that global equities returned 11.1% over the 40 year period**. Adjusted for inflation, this translates into a total return of 7.1%.

Delving deeper, the dominant components of long term returns were dividend income and book value growth, providing returns of 2.9% and 2.1% respectively – over 70% of the total real return. The study also showed that these are, by a long way, the least volatile components of return.

***MSCI World returns USD % p.a.**

	1975 - 2014	**2015**
Total gross return	11.1	-1.8
Inflation	3.9	1.0
less		
Total real return	**7.1**	**-2.8**
Valuation change	1.7	-3.0
Book value growth	**2.1**	**-2.0**
Dividend income	**2.9**	**2.5**

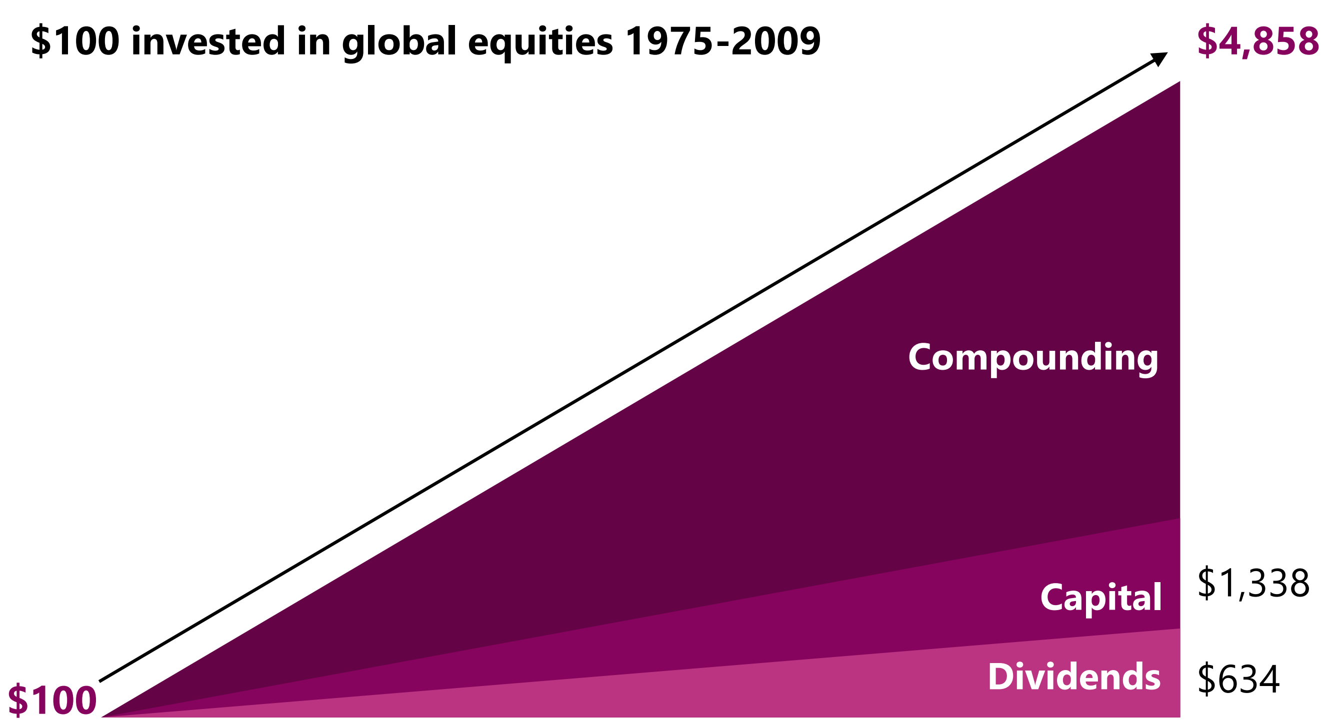
**Sources: MSCI Barra Research Bulletin – 'What Drives Long-Term Equity Returns?' January 2010, data from 2009 onwards calculated by Dundas using MSCI published data. Dundas has used the MSCI methodology to bring this up to 2014 and 2015.*

The power of compounding

We can agree that dividends deliver a substantial portion of long term returns. The example below highlights the stark effect of compounding those dividends.

Let's follow the progression of a $100 investment in global equities from 1975 to 2009. Analysis shows that a capital only return on $100 would have delivered $1,338; dividends received would have totalled $634. However, using dividends to purchase more shares would have provided compound returns totalling an impressive $4,858 : during down markets, dividends can buy more shares, thus enhancing returns as conditions improve.

$100 invested in global equities 1975-2009



So, if dividends are a sound marker of success, how do we go about selecting investments for our portfolios?

Dividend disciplines

The global market provides a sizeable universe of companies that can be divided into two broad categories according to their dividend profiles.

Mature, slow-growing companies
Let's look first at well-established companies that have little need to invest in their own growth. They typically pay out a high proportion of profits - around 75% - in the form of dividends and offer a yield that is significantly higher than the market. For example, GlaxoSmithKline yielded 5.7% at the end of 2010 - considerably higher than other global companies.

So far, so attractive. However, investments in these businesses come with a catch. In difficult markets, their pay-out ratios leave little margin before a decline in profits removes their capacity to sustain or increase the dividend. Reserves may compensate temporarily for this shortfall but when profits do recover, the priority will be to rebuild those reserves, detracting from the ability to pay a dividend. Either way, long-term growth prospects will be lower and the likelihood of a dividend cut is higher.

Fast-growing companies
An alternative is to find companies in faster-growing markets, which typically retain most of their profits to fund their expansion. These companies pay out a lesser amount in dividends. For example, Microsoft had a yield of 2.0% at the end of 2010.

On the face of it, the gap between a 5% and 2% yield appears quite daunting. However, it narrows surprisingly quickly for two reasons. Firstly, the dividends of the fast-growing companies increase much faster in the good times: our research suggests a dividend growth rate of around 10 to 12% per annum compared with only 5% for the slower growing businesses. Dividends will therefore double in six to seven years compared with 14 years for the less buoyant companies. Secondly, as the faster growing companies only pay out around one third of profits, they have far greater scope for maintaining and growing dividends even when times are tough.

Returning to our examples, Microsoft's compound returns per annum have been: share price +16.6%, dividends +23.3%. For GlaxoSmithKline, returns were +2.3% and +4.5% respectively.

Business characteristics

At Dundas, whilst we do take these broad dividend discipline approaches into account, our collective experience and internally generated research also tell us that the companies in the rudest health exhibit three common characteristics:-

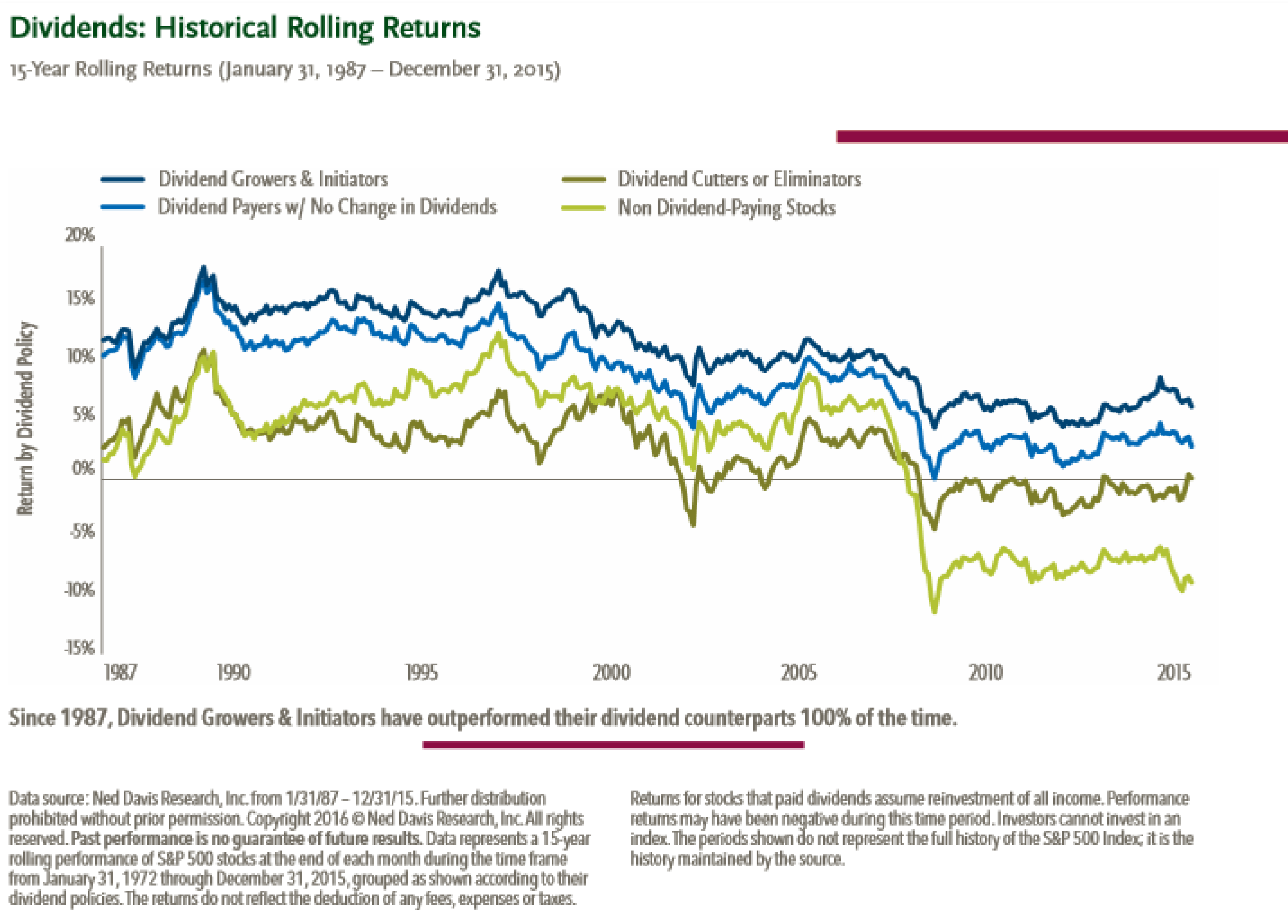
- An attractive profit margin that demonstrates a robust relationship with customers and a strong competitive advantage;
- A pattern of sufficient profit retention to fund significant reinvestment;
- Crucially, a commitment to provide a meaningful dividend that will grow sustainably over time. Paying dividends is an essential capital discipline for these businesses.

These companies provide shareholders with an ever-increasing incentive to invest – not only are they developing their business to earn higher profits; they are providing the opportunity to pay sustainable and growing dividends.

The Americans have coined the phrase 'dividend aristocrats' - these are companies that have increased their dividend in 25 consecutive years! Whilst Dundas owns five of the list of 53, our search focuses more intently on the aristocrats of tomorrow.

Corroborative evidence

The chart below illustrates that dividend payers have consistently outperformed their counterparts over long periods.



Further corroboration can be found from the following sources *(click to access articles)*:-

Allianz

CREDIT SUISSE

Merrill Lynch

Conclusion

We are all too aware of the importance of sheltering our lifetime savings from the storms of the global economy.

Some investors may consider it possible to generate higher dividend returns in the short term. They would be right. There is, of course, a wealth of companies that are prepared to pay out the majority of their earnings in order to keep dividends high and shareholders happy. We will explore them further in our next paper. However, this instant gratification can only be achieved at the expense of long term, sustainable business growth. We consider that approach unwise and the risk unacceptable.

Dundas' investment team has over 140 years' collective experience of navigating these waters.

We have learned - and the evidence supports our conviction - that dividend growth stocks are characterised by strong, sustainable business models and consistent growth in revenues, earnings and cash flows. This is the reason they lie at the heart of our investment philosophy and significant personal investment alongside our clients.

Disclaimer

For further information

Dundas Global Investors
41 Northumberland Street
Edinburgh
EH3 6JA
United Kingdom

Tel: 00 44 131 556 2627
Web: www.dundasglobal.com
Email: info@dundasglobal.com