# Dividend-Focused Investing in a Rising Rate Environment

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With the Fed inching closer to raising interest rates, how will stocks that issue dividends fare in the new climate? In this paper, we present our thoughts on historical precedents, opportunities that may emerge, and our investment process.

## Dividend Stocks and Climbing Rates

For more than 30 years interest rates have been on a downward trend and the last time the Federal Reserve raised rates was approximately a decade ago. However, it now appears that trend may be ending as a federal-funds rate hike during the next few quarters cannot be ruled out. While it is unknown how fast interest rates will rise or by how much, a rising rate environment is a headwind for fixed-income investments as principal values erode in order for the underlying yield of the investment to remain competitive.

In regard to the pending changes in the Federal Reserve interest rate policy, we do not believe these changes will lessen the need for dividends in an income-oriented portfolio. In addition, a rising rate environment should favor moderate dividend payers that are growing their dividends over high-yielding equities with little to no dividend growth as these securities face similar headwinds as fixed-income investments.

It should be noted that stocks in general typically struggle during tightening cycles. However, this has not been the case when rates rise in a low-interest-rate environment. In the four out of the five periods going back to 1954 when a rate tightening cycle commenced and the federal-funds rate began at 3% or less, as it is currently, the stock market was higher over the next 12 months, based on a study by Cornerstone Macro.

Based on data going back to the 1970's (the last seven Federal Reserve tightening cycles), dividend payers in the S&P 500 underperformed non-payers six to 12 months prior to the start of a tightening cycle and eight months after the first increase. However, over the next eight to 16 months, dividend payers outperformed non-payers on average and more than made up for the deficit (see Table 1 and Chart 1).



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| Table 1: Initial Fed Rate Hike: Dividend Payers Versus Non-Payers | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Event Date | -12 Months | - 6 Months | -3 Months | 3 Months | 6 Months | 9 Months | 12 Months | 24 Months | |
| 1973-01-15 | N/A | 13.29 | 6.61 | 5.71 | 16.43 | 11.37 | 19.47 | 1.10 | |
| 1977-08-31 | 3.48 | 2.91 | -1.62 | -5.65 | -5.12 | -16.73 | -20.82 | -20.92 | |
| 1980-09-26 | 9.58 | -1.23 | -5.83 | 6.90 | -0.24 | -1.44 | 8.89 | 24.98 | |
| 1987-09-04 | -8.77 | -7.22 | 0.77 | 7.87 | 4.10 | 2.66 | 5.89 | 7.59 | |
| 1994-02-04 | -7.16 | -6.64 | -3.16 | 1.84 | 4.93 | 1.92 | 3.18 | 4.09 | |
| 1999-06-30 | -12.22 | -8.75 | -1.15 | -5.36 | -21.83 | -31.62 | -25.15 | 3.39 | ←.com bubble |
| 2004-06-30 | -3.19 | 1.87 | 2.99 | 10.49 | 2.73 | 11.57 | 7.10 | 11.60 | |
| Median | -5.17 | -1.23 | -1.15 | 5.71 | 2.73 | 1.92 | 5.89 | 4.09 | |
| Average | -3.05 | -0.82 | -0.20 | 3.12 | 0.14 | -3.18 | -0.20 | 4.55 | |
| % Positive | 33.33 | 42.86 | 42.86 | 71.43 | 57.14 | 57.14 | 71.43 | 85.71 | |

*Source: Ned Davis Research, Inc. Copyright 2014 Ned Davis Research, Inc. Further distribution prohibited without prior permission.*


**Chart 1: Initial Fed Rate Hike: Dividend Payers Versus Non-Payers**

**Over the intermediate term, dividend payers tend to outperform non-payers after the initial rate increase.**

**S&P 500 Dividend Payers/Non-Payers Ratio Around Start of Tightening Cycle**

**Payers > Non-Payers**


*Source: S&P Capital IQ Compustat*

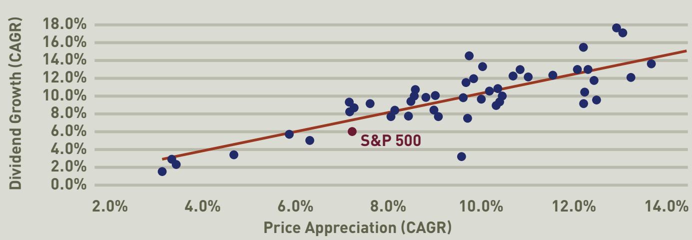
## Growing Dividends, Rising Stock Prices

Historically, there has been a strong correlation between dividend growth and stock price appreciation over the long term. Chart 2 represents companies in the S&P 500 that have maintained or grown their dividends between 1971 and 2014, without any dividend cuts (or spin-offs/divestments resulting in a lower dividend rate) during that 43-year period. We note the correlation between dividend growth and price appreciation for these securities is above 80% and point out that the 43-year period encompasses rising and falling rate cycles, economic expansions and recessions, as well as both bull and bear markets. More recently, during the past few years, dividends have been growing at double-digit rates for the S&P 500 and the Russell 1000 Value indexes. Given that the dividend growth rates for these indices are expected to slow to a mid- to high-single-digit rate, companies that are able to grow their dividends above the benchmark averages could be poised to outperform the major indices based on historical data.

**Chart 2: Growing Dividends, Rising Stock Price**

**Historically, there has been a strong correlation between dividend growth and price appreciation.**

**Dividend Growers in the S&P 500**
**Period: 1971-2014**




*Source: PNC Capital Advisors and Factset Research Systems*
*Indices are unmanaged and do not reflect the deduction of expenses typically associated with investing, including investment advisory fees. Indices are not available for direct investment.*

## Importance of Dividend Payers in a Portfolio

Since 1926, dividends have accounted for approximately 43% of the total return for the S&P 500. This is especially true during periods when historical returns for the stock market were below average such as 2003 through 2008. During that period, dividends accounted for more than 80% of the S&P 500's total return. Equally important, the outperformance of the dividend growers and payers has come with less risk (as defined by standard deviation of returns).

**Chart 3: Total Return versus Price Return**

**There is a clear compounding effect in performance between companies with and without reinvested dividends in the S&P 500 Index.**

S&P 500 – 20 Year Performance Chart


*Source: PNC Capital Advisors and Factset Research Systems*
*Indices are unmanaged and do not reflect the deduction of expenses typically associated with investing, including investment advisory fees. Indices are not available for direct investment.*

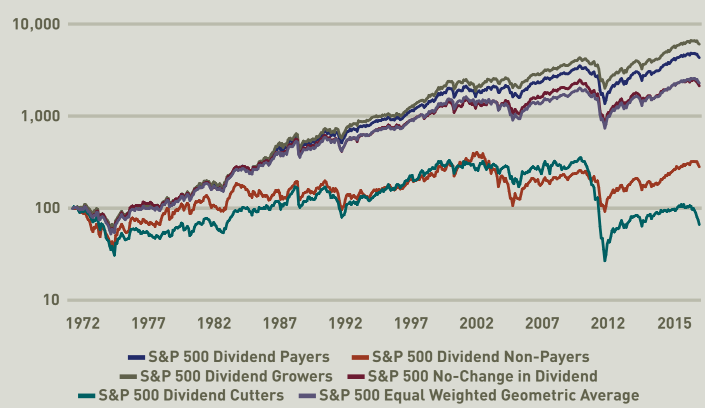
In addition, in terms of performance there is a clear difference among S&P 500 stocks between dividend-paying and non-dividend-paying companies as shown in Chart 3. This is due in part to the compounding effect of reinvested dividends, however, dividend-paying stocks outperformed non-dividend-paying stocks during the period from March 31, 1972 to May 31, 2015.[1] It's also worth noting that dividend-paying stocks outperformed the S&P 500 Total Return Index in approximately 66% of the months when the index experienced negative returns during the period from July 31, 1995 to July 31, 2015.[2]

In addition companies that are not just issuing dividends, but growing them have performed better over the long run. For instance, as Chart 4 demonstrates, between March 31, 1972 and May 31, 2015, a strategy of investing in stocks with growing dividends would have outperformed a strategy of investing in all dividend-paying stocks, as well as a strategy of investing in dividend-paying stocks that did not increase dividends. Furthermore, a dividend growth investment strategy also outperformed a strategy of investing in non-dividend-paying stocks. We note that paying a quarterly dividend typically requires that a company have a predictable business model that can generate stable earnings. That's one of the reasons the PNC Dividend Focus portfolio has an investment philosophy that includes a focus on dividend growth to drive total return.

**Chart 4: Total Return: Stocks by Dividend Policy**

**Dividend Growers have provided higher long-term returns relative to dividend payers and non-dividend-paying stocks.**

**Returns of S&P 500 Stocks by Dividend Policy**
*Monthly Data 1/31/1972 - 5/31/2015 (Logarithmic Scale)*
*Geometrically Weighted*




Returns based on monthly equal-weighted geometric average of total income of S&P 500 component stocks, with components reconstituted monthly.

*Source: S&P Capital IQ Compustat*
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## Sectors Exhibiting Dividend Growth

With the Fed poised to boost interest rates, which sectors of the economy are offering the most attractive dividend growth and yield combinations? Based on data from FactSet Research Systems, the Industrial Sector's current yield of approximately 2.3% as of October 28, 2015 is above its 10-year average of 1.9%, as well as the S&P 500 Index's dividend yield of 2.1%. The average dividend growth rate for the Industrial sector also exceeds the S&P 500 Index's 11.3% estimated 2015 dividend growth rate. While the Consumer Discretionary sector offered the most robust dividend growth over the past year, the current dividend yield of about 1.5% is well below that of S&P 500 Index. Meanwhile, the Telecom and Utilities sectors are the highest-yielding sectors at about 5.2% and 3.9% respectively, but dividend growth for both sectors is well below average.

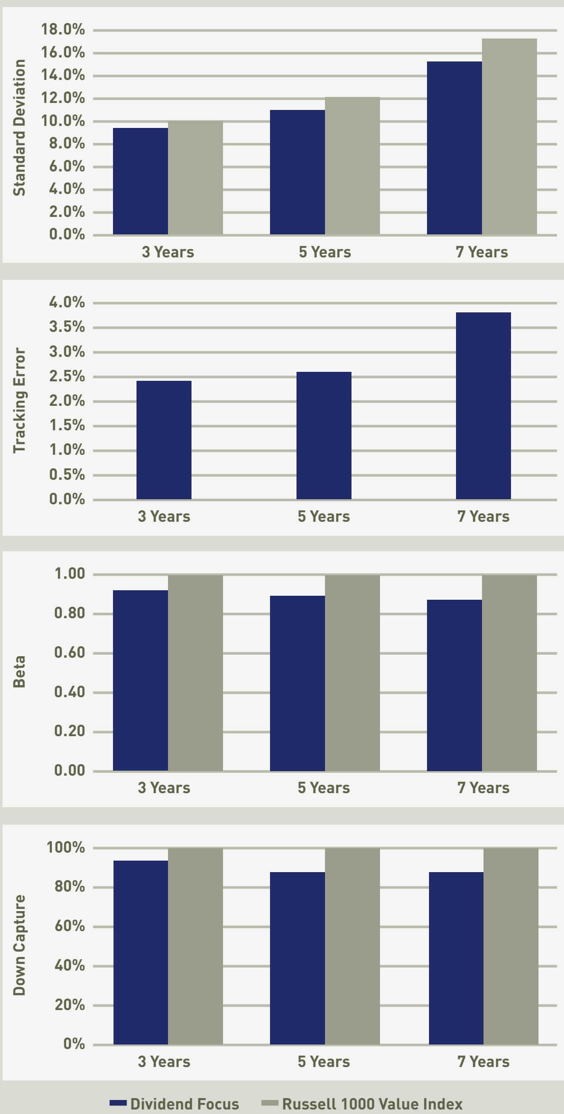
However, once the Federal Reserve begins to raise its benchmark interest rate, the Financial sector may offer the most attractive dividend growth/yield combination as dividends for that sector on average grew by 17.3% year-over-year and are projected to grow 9.7% during the next 12 months – the fastest rate of all the sectors. This compares to a 7.6% projected dividend growth rate for the S&P 500 over the next 12 months. The current dividend yield for the Financial sector (approximately 2.0%) is slightly below that of the S&P 500 Index.

## Dividend payout ratio: room to rise?

The current dividend payout ratio for the S&P 500 is 48.6%, which compares to its 10-year average of 46.5%. Given that the payout ratio is comparable to its historical payout, we anticipate that future dividends may increase at the growth rate of earnings. However, we note that there are two sectors, (Consumer Discretionary and Financial) that may have the potential for increased payouts that exceed earnings growth. Both the Consumer Discretionary and Financials sectors currently have a dividend payout ratio that is less than that of the S&P 500 and also lower than its historical sector-specific dividend payout average over the last 10 years. On the negative side, there are currently three sectors Consumer Staples, Industrials, and Energy, that have dividend payouts above the S&P 500 average and also above its sector-specific 10-year average payout. We view these three sectors as potentially having future dividend growth that may lag earnings growth and/or experience dividend cuts. Going forward, stock selection may be increasingly critical in identifying companies with the ability to grow dividends at a rate that is faster than earnings growth and in avoiding companies that may potentially cut dividends.

**Chart 5: Dividend Focus - Focus on Risk Management**

**The investment process leads to a less volatile portfolio with five-year downside capture of 89% versus the Russell 1000 Value Index.**




*Data as of 9/30/2015.*
*Source for Russell Indexes: Russell Periodicity: Monthly.*
*Created with Zephyr StyleADVISOR.*

## Focusing on growth

In addition to using the PNC Multi-factor Model as a key overlay in the investment process, the Dividend Focus investment process focuses on companies with attractive dividend yields that are growing their dividends, because historically there has been a high correlation between stock price appreciation and dividend growth. High-yielding securities typically act similar to fixed-income securities, especially those with little to no dividend growth. In a rising interest rate environment, high-yielding securities tend to underperform. According to the Barclays U.S. Equity Strategy team, over the past 20 years, the high dividend yield factor had positive returns in only two out of eight years when 10-year Treasury bond yields rose. Also, since 1986, dividend growers have kept up with the S&P 500 when interest rates increased, but high-yield stocks lagged. In addition, Ned Davis Research noted that from 1972 through 2012, companies that initiated or consistently raised dividends outperformed and were less volatile than the companies that either did not pay, cut or just maintained their dividends.

The strategy is centered on delivering a portfolio of companies that provides a relatively attractive yield, growing income stream, and downside protection. We believe such a portfolio of dividend-paying stocks can provide investors with a valuable income stream and favorable risk-adjusted returns through market cycles, as shown in Chart 5.

[1]Based on data from Ned Davis Research Inc.

[2]Based on research from FactSet Research Systems Inc