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JANUS

Growth Stocks and Dividends

A Winning Combination

Summary After years of taking a back seat in the minds of growth investors, dividends are once again becoming an increasingly important component of total returns, particularly in the United States. Investors generally think of value-oriented sectors when they think of companies paying dividends. But more and more, growth companies are initiating or raising their dividends. Given the historically low interest rate environment and prospect for higher rates in the future, we think the ability to grow dividends will take on increased significance in the coming years.

With interest rates poised to rise, we think growth companies that pay dividends are in a unique position to meet the needs of yield-hungry investors, as companies that can grow earnings and free cash flow can increase their dividend payments and offset the erosion of principal in a rising rate environment.

But dividends are only part of the story. We believe the most attractive large-cap growth opportunities reside with companies that strike the right balance between dividend distributions, business reinvestment and other productive uses of excess cash flow. We think rigorous fundamental research, in-depth free cash flow and balance sheet analysis remain critical in identifying whether firms are using capital wisely and pursuing the most appropriate mix of strategies in potentially delivering the strongest long-term shareholder value.

In this brief, we discuss the changing dynamics impacting dividend payouts, why we believe companies can effectively pursue continued earnings growth while distributing more cash to shareholders, and what equity investors should consider in evaluating a growth company's use of excess cash flow.

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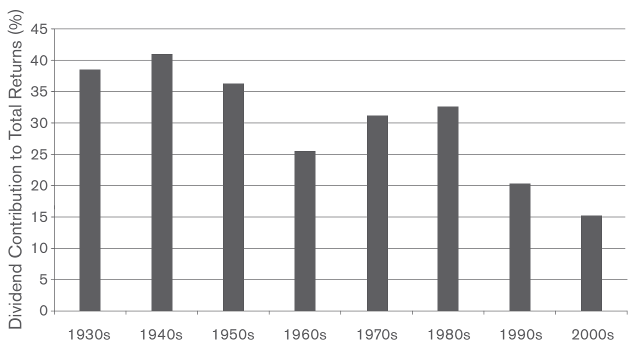
Historical Perspective

In 2013, 366 companies in the S&P 500 Index increased or initiated dividend distributions, while only 12 decreased or eliminated them. This greater emphasis on dividends may seem like a new phenomenon to today's investors, many of whom began investing during the 1980s and 1990s. But it is only over the past 20 years that many growth companies stopped paying dividends and instead retained their excess cash to reinvest in the business, repurchase their own shares in the open market or pursue merger and acquisition (M&A) activity. Over a much longer period, however, dividends have played a more significant role for stocks in general (see Exhibit 1).

Exhibit 1

Dividends as a Component of U.S. Equity Returns (S&P 500 Index)



Source: Morningstar. Through 12/31/2009.

Long-term data shows that over the last 80-plus years more than 43.7% of the average annual total returns for U.S. equities have come from dividends (see Exhibit 5 on page 7). From the end of 1929 through the end of 2013, the S&P 500 index's average annual total return was 9.7%. If dividends are removed from the equation, the average annual total return for the period would fall to roughly 5.4%. This demonstrates the power of compounding and the importance of dividends. We would add that dividends are important for company performance as well, given the added layer of discipline they tend to enforce on company management. Companies are now operating more efficiently and becoming more profitable, as seen through a greater generation of cash flows as a percentage of revenues. We think this increases incentive for management to return cash to shareholders in the form of dividends.

Changing Dynamics for Large-Cap Stocks

As illustrated in Exhibit 1, the influence of dividends on returns for U.S. stocks over the past 80 years has trended downward – particularly throughout the past two decades as firms have focused instead on reinvesting free cash flow into the business, repurchasing stock and/or making large acquisitions. Many U.S. investors were willing to take their returns in the form of price appreciation versus potential cash distributions, in part because of the return patterns set during the 1990s. The bull market that started in the 1980s resulted in dividends becoming a much smaller portion of the total return of equities as it continued throughout the 1990s. When the market made more of a sideways move during the 1960s and 1970s, dividends represented a larger component of total returns relative to the decades of the '90s and '00s, although still less than earlier in the century. If we have indeed entered a period similar to the 1960s and 1970s and history serves as our guide, dividends will likely become much more important. But if a raging bull market were to unfold, we could see the trend of the 1990s return.

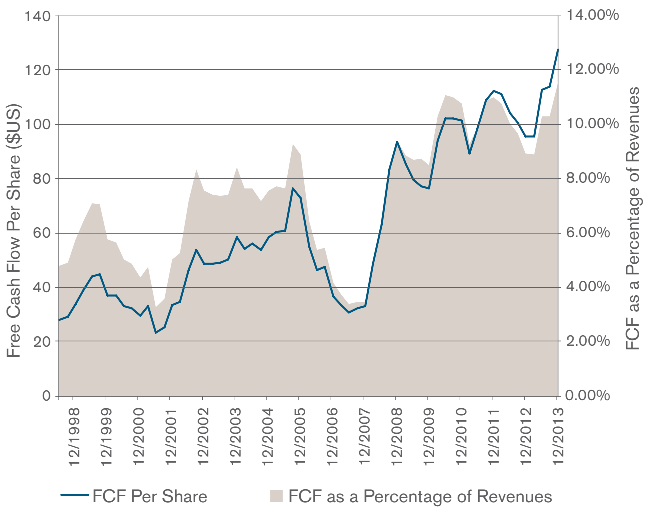
Another driver behind the downtrend in dividend yields in the 1990s and 2000s was the growing dominance of the technology sector, particularly in large-cap indices such as the S&P 500 Index. Many of these companies were in their high-growth phase and maintained little to no dividend. As the technology sector came to make up a greater portion of the S&P 500 Index, its dividend yield fell.

The pendulum is now shifting back in the United States, as a growing number of firms – most noticeably in the technology, consumer, industrials, energy and materials sectors – are returning cash to shareholders in the form of dividends. In some cases, excess cash has been returned through a one-time dividend payment. Consider the recent investment landscape. Prior to the recent run in equity markets, investors have experienced a decade of lackluster stock market returns, one of the severest recessions on record, historically low long-term interest rates and an uncertain economic outlook. Yet cash levels, productivity efficiencies and balance sheets for many firms have rarely been stronger. At the end of September 2013, nonfinancial companies in the Russell 1000 Index had balance sheets holding more than $1.6 trillion in cash and short-term securities, a 10.3% increase over the prior year. According to Federal Reserve data through the end of September 2013, cash as a percentage of corporate balance sheets was near its highest level since the mid-1960s. In addition, many firms have emerged from the financial crisis and subsequent recession stronger and leaner, capturing higher margins and improved cash flows by capitalizing on the productivity advancements of the past 10 to 15 years.

That said, investors should be careful not to chase yield, as not all dividends are created equal. Given the prospect of rising interest rates, we think investors should focus on those companies that are positioned to grow their dividends. When interest rates eventually rise from current historical lows, it will have an obvious negative impact on bonds. But companies that have a static dividend payment will also be negatively impacted, as that dividend is worth less to investors when rates are higher. However, companies that have an ability to keep growing their dividend will provide yield-hungry investors a buffer against rising rates. Understanding the dynamics impacting each company's dividend payout requires in-depth analysis of the firm's capital structure, business model and management incentives, among other things.

Exhibit 2

S&P 500 Free Cash Flow as a Percentage of Revenues (on per share basis)



Source: Bloomberg. Through 12/31/2013.

Free cash flows, management's intent and balance sheet health are some of the more important determinants of whether a firm can grow its dividend. Generally speaking, we are seeing higher-quality earnings from many companies, as indicated by improving free cash flow trends. Exhibit 2 looks at free cash flow (FCF) per share and FCF per share as a percentage of revenues for the S&P 500 Index over the past 15 years. It shows that firms' free cash flow generation has not only recovered from the recession, but that it was near a 15-year high at the end of 2013. Free cash flow as a percentage of revenues was nearly 11.5%, significantly higher than the period average of 7.3%. We think this suggests companies' businesses are generally healthy and have the ability to increase dividend payments. But a deeper analysis is necessary.

Uses of Free Cash Flow

The decision to begin paying or increase dividends is not a simple one, however. Coming out of the financial crisis, many companies have been reluctant to use their cash reserves, stockpiling them instead as a defensive measure should liquidity dry up again or the economy descend back into a recession. Concerns over a liquidity vacuum returning remain fresh on the minds of many management teams and have been driving a more cautious tone. In other cases, companies have been using the cash to pay down debt and improve balance sheet health. Though we view the deleveraging trend as positive, many shareholders have become increasingly frustrated that companies are not making better use of idle cash. After all, short-term interest rates are essentially zero, which means companies are not earning returns on their large cash balances. With paltry cash returns weighing down many firms' overall return on invested capital and because all capital has a cost, we generally believe management teams are obligated to return idle cash to shareholders, provided they are unable to invest in projects that earn a return greater than the company's overall cost of capital.

Companies generally can use excess cash in five ways:

- Business reinvestment
- M&A activity
- Debt reduction
- Stock buybacks
- Dividend distributions

In the new economic climate, many firms have re-evaluated the effectiveness of each category, and there has been a growing realization that a prudent, strategic mix of these capital deployment opportunities may produce the most beneficial shareholder value. Determining the most suitable combination requires an understanding of potential return on investment in each area, which can vary depending on specific firm cash flows and growth cycles. There also has been an increased awareness of some drawbacks and limitations for many of these options.

Business reinvestment. From our perspective, there are two basic forms of business reinvestment or capital expenditures (capex): maintenance and growth. Maintenance capex is simply the capital needed to maintain the current production level of a company's factories, equipment and other assets. Growth capex, on the other hand, is capital used in an attempt to increase or improve the firm's production capacity and/or market penetration. Companies that generate cash flows above the maintenance capex requirements have the ability to reinvest in the business in an attempt to foster growth and create shareholder value. The key question for any management team to ask is whether the expected internal rate of return for a given investment or project exceeds the firm's weighted average cost of capital. If it does, the investment has a better chance to create value; if not, management should look at alternative uses for its excess cash, such as dividends or share repurchases.

M&A activity. M&A has also proven to be problematic. Many high-profile acquisitions failed to deliver anticipated synergies or sustainable growth. Moreover, academic research and numerous case studies have illustrated that M&A activity can prove more beneficial for acquired firms than for acquirers. "Tuck-in" acquisitions, which are typically small and easily digested by the acquirer, tend to be more successful at translating capital investment into substantive value creation. Their relatively smaller size means more cash can be applied to other investments or uses.

Debt reduction. Typically, management incentives are closely tied to the company's equity performance. As a result, improving equity returns, which in many cases can come at the expense of bondholders, is generally the focus. This makes leveraging up the balance sheet somewhat more appealing to management, especially when debt is cheap. However, reducing debt can be an intelligent use of capital primarily because it may put the company in a better long-term position to return cash to shareholders in the form of dividends. After all, the more leverage in the capital structure, the less secure a dividend may be, all things being equal. But completely eliminating debt has some disadvantages, particularly in a low-interest rate environment. While the cost of equity is always greater than the cost of debt, corporations should consider which form of capital, debt or equity, is more expensive relative to its historical norms.

Since 2002, we have been in an extended period where the marginal cost of equity funding has been more expensive than its historical average. Meanwhile, the marginal cost of issuing debt has been below its historical average. For the most part, companies have taken advantage of the relatively low cost of debt by refinancing their debt at lower rates. The lower cost of financing has helped to improve the profitability of these firms. A little balance sheet leverage can be beneficial, but just like with dividends, companies must have the free cash flow to service this debt. Maintaining an optimal mix of debt and equity is generally the goal, and it can vary from industry to industry and company to company.

Stock buybacks. In theory, stock buybacks can be advantageous; but in practice, many have proven to be poorly timed, particularly during the 1990s and early 2000s. The dismal track record for buybacks reinforces the notion that management teams may not be well-equipped to judge the value of their companies. In many buyback situations, companies in need of capital have had to return to the capital markets to issue new equity, thus diluting the value of existing shares. A sizable number of buyback initiatives have served only to redistribute stock from external investors to company employees through compensation programs. This was especially the case within the technology sector 10 to 15 years ago where employees were being awarded a large number of stock options. In many cases, the maturation of the technology sector, the poor track record and general shareholder demands have begun to change management's thinking on this subject.

Dividend distributions. Dividends have garnered more attention lately as an increasingly viable use of capital that can enhance shareholder value. Conventional wisdom says that if a company pays a dividend, management views its growth prospects as limited or constrained, and therefore has decided to return cash to shareholders. Conversely, if a company retains more of its free cash flow to reinvest in the business, or has a low payout ratio, the belief is that it will be able to grow faster. But this is not necessarily the case. A company can pay a dividend and not constrain its growth because it is the returns a company generates on its capital that generally dictate growth. In theory, and often in practice, a company that produces high returns on its capital needs to invest less capital to get the same level of return, thus potentially freeing up more cash to distribute to shareholders or reinvest in the business. Companies with improving returns over time and a sustainable growth rate

Shareholder Demand

Shareholders have become increasingly vocal about their dissatisfaction with firms that delay disbursing underutilized cash reserves. Many companies have responded to this demand by dedicating a higher proportion of corporate earnings to distribution payouts or by paying a one-time dividend. In 2006, the average payout ratio for S&P 500 companies was 29.6%. In 2013, that figure rose to 34.4%, and some analysts predict it might begin to approach 50% in the years ahead.[1]

In addition, if cash and fixed income yields remain low, retiring baby boomers and other yield-hungry investors could further fuel demand for dividend-generating stocks, potentially driving equity returns for these securities higher. To clarify this point, a 5% to 6% dividend yield may not seem exciting at first glance, but consider that a 5% to 6% dividend yield coupled with a 5% to 6% free cash flow growth rate, can result mathematically in a 10%+ total return. Importantly, with this comes the potential for yield compression; as the demand for yield increases, investors drive the stock price higher, resulting in a decline in yield.

[1]Source: Bloomberg

will likely be able to pay out greater dividends. The higher the sustainable growth rate, the more likely a company can afford to pay a dividend and the less it needs to go to the capital markets to fund that dividend or any future growth.

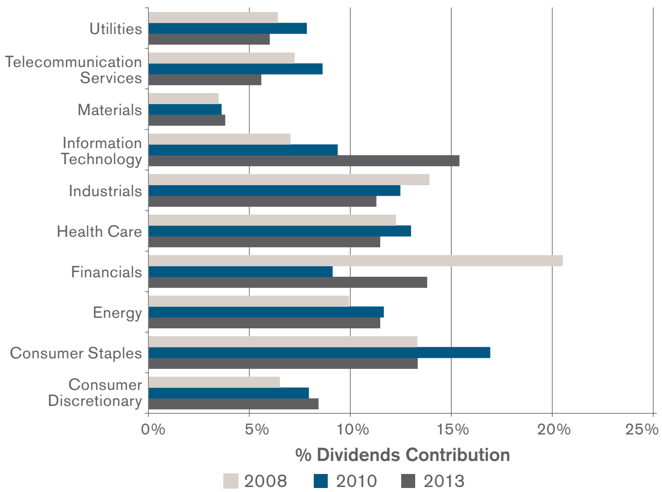
Academic studies suggest a strong correlation between a high dividend payout ratio and higher long-term earnings growth. While a high correlation does not necessarily mean causation, it does seem to make sense if you view a dividend as a signal that management feels secure about future growth. In addition, dividends tend to be "sticky" because management is often hesitant to reduce them given the typically negative reaction investors have to such an announcement. For this reason, dividends are viewed as less discretionary by management, which gives further credence to the notion of management having more confidence in the future. On the other hand, a low payout ratio may suggest a lack of confidence and/or that management may be hoarding cash to give it some cushion or some perceived flexibility. In many cases, this can lead to the squandering of shareholder capital as management may feel compelled to do what ends up being a wasteful acquisition or some other unwise investment to drive growth. In short, the presence of a dividend can help management maintain greater discipline with shareholder capital. Lastly, implementing distributions can potentially expand a firm's investor base and stabilize a company's stock performance. If shareholders enjoy more stable returns over time, their required rate of return could decline, thus bringing down the firm's cost of capital. In the current environment, we have seen a valuation premium being awarded to companies paying dividends. Going forward, we expect a valuation premium for those companies that not only pay dividends, but that have the ability to grow them.

Sector Trends

There has been a clear and consistent pattern of large-cap firms expanding their dividend commitments. While this trend has manifested itself differently industry by industry, firm by firm, it is interesting to note that many growth-oriented sectors have steadily increased their dividend contributions to the overall market (see Exhibit 3). Technology stocks have been increasing payouts to shareholders through a number of means, which have included special one-time dividends, regular dividends and share buybacks. We see this trend continuing given the large amounts of cash sitting on many balance sheets of technology companies. Consumer and industrial stocks have greatly improved efficiencies in running their businesses. This too has translated into higher free cash flows and a trend toward higher dividend payments. A few companies in the energy sector are also showing a commitment to returning cash to shareholders by spinning out business units that can pay a healthy dividend. Following, we discuss some of these dynamics in more detail.

Exhibit 3

Sector Contributions to S&P 500 Dividends



Source: Standard & Poor's. Through 12/31/2013.

Technology. Nowhere has the trend to increase or initiate a dividend payment been more significant than in the technology sector. During the 1990s, approximately 90% of the large-cap technology companies offered no dividend, and the remaining 10% provided a dividend yield much lower than the S&P 500. Today, roughly 80% of large-cap technology firms (those with a market cap of more than $50 billion) pay a dividend, with 53% at or above the index. Bellwether technology companies such as Microsoft and Intel now carry dividend yields near or greater than 3%, which is roughly 90 basis points higher than the S&P 500. Microsoft raised its dividend by 20% in 2013. Meanwhile, its roughly 2.96% dividend yield, as of January 31, 2014, exceeded the yield on its own six-year corporate debt of roughly 1.91% and the yield on the 10-year U.S. Treasury bond, which was near 2.65%. Cash flow continues to be very strong for most technology companies, and investors can now potentially benefit from emerging dividends in addition to attractive growth prospects.

Oracle is another interesting example of a technology company that has raised its dividend profile. In the past, the firm has frequently used acquisitions to help drive growth. While Oracle still pursues an M&A strategy, its original decision in 2009 to initiate a dividend was based on the view that this move would open up its stock to a larger investor base. Since then, we've seen Oracle continue to grow its dividend, doubling its dividend in 2013 from the previous year. Other large-cap tech companies have also emphasized dividend growth recently. Apple initiated a dividend in 2012, and raised it roughly 15% in 2013. Meanwhile, EMC initiated a first-time dividend payment in 2013. Toward the end of 2013, Qualcomm announced it would return 75% of free cash flow to shareholders over the next five years, a big jump from the 62% of free cash flow the company returned over the previous five years. Qualcomm also pledged to grow its dividend faster than earnings. The company is growing its dividend while also using more cash to buy back stocks, which should reduce the company's share count and increase its dividend per share over time.

This relatively recent emphasis on dividend payments and dividend growth is partly due to maturation within the sector. As the technology industry has matured, growth rates have come down from their rapid pace, but remain attractive. As such, introducing dividends, or more recently, growing that dividend, has been a natural progression for many companies. It also reflects a desire on the part of these firms to expand their investor base and serves as an acknowledgment of some of the industry's missteps in chasing earnings growth at all costs. The past 20 years offer numerous examples of poor use of capital in which expected shareholder value failed to materialize or, worse yet, ultimately drove share prices lower.

Consumer. During the economic crisis, many consumer companies became much more efficient, capitalizing on cost savings from technology investments and also making significant spending cutbacks when necessary. As a result, many have extremely strong balance sheets and solid cash flows driven by higher margins and continued business growth through emerging market exposure. In contrast to the technology sector, the trend toward greater dividend payouts within this sector is less a function of a maturing industry, in our view, and more a function of strong balance sheets and better operating efficiencies.

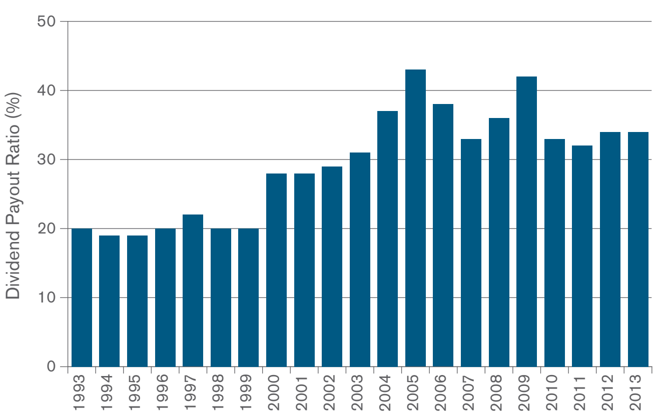
One example of this is Nike, which has averaged 8.7% annual earnings growth over the last five years. Over the same time period the company has grown its dividend by 13.2%. Notably, the payout ratio has grown only slightly for Nike, as most of the growth in dividends was a result in earnings growth. At the same time, the firm has consistently used some of its cash for stock buybacks each year. Nike's management believes it can grow earnings while paying dividends, which supports the notion of confidence we mentioned earlier.

Mattel is another example within the sector of a growth company that is becoming more efficient and improving cash flow, allowing it to return more cash to shareholders while at the same time steadily grow earnings. Lean manufacturing has helped the company improve operational efficiencies while digital marketing and online consumer messaging have lowered total marketing costs and improved profitability of select products. These and other efficiencies have allowed the company to maintain a healthy 50% payout ratio while still growing earnings at a clip of 10% per year in recent years. The company has said that payout ratio could continue to increase over time.

Industrials. Within the S&P 500 Index, 85% to 90% of industrial companies pay a meaningful dividend despite the capital-intensive, cyclical nature of many businesses. We think dividends force management to decide the best way to use excess cash. Historical payout ratios within the industrials sector have typically been in the 20% to 40% range (see Exhibit 4), with dividend changes usually driven by earnings growth.

Exhibit 4

S&P 500 Industrials Sector Annual Dividend Payout Ratio



Source: Bloomberg. Through 12/31/2013.

Over the last decade, many U.S. industrials have become extremely efficient businesses by implementing process management models such as Six Sigma,[2] lean manufacturing and just-in-time production. They have also aggressively expanded their businesses globally, which makes them much more diversified than they were in the past. Many of these companies have emerged from the recent recession with extremely solid balance sheets and relatively high cash levels. They have continued to generate excess cash and further improve their financial

[2]Six Sigma is a business management strategy – originally developed by Motorola, USA in 1981 – that seeks to improve the quality of process outputs by identifying and removing the causes of defects (errors) and minimizing variability in manufacturing and business processes. It has widespread application in many sectors.

position in spite of experiencing only a slow recovery. In previous economic downturns, these firms were not nearly as well run or cash-efficient, and many were forced to reduce their dividends during past recessionary periods.

We think the sector overall has navigated the financial crisis and subsequent slow economic growth period much more successfully, generating cash more consistently and returning it to shareholders. One example that highlights the consistency and strength of industrial cash flows – and how that drives dividend payments – is Union Pacific. In spite of being an incredibly capital intensive business, with capital expenditures making up approximately 16% of revenues, Union Pacific twice raised its dividend in 2011, then made a 20% increase to the dividend in 2012 and another 15% increase in 2013. The company has also announced it will target a 30% to 35% payout ratio as an official company policy, demonstrating management's confidence it can continue to manage the business well enough to pay a high percentage of earnings out in the form of dividends in the future.

Going forward, we expect to see many industrial companies continue growing their dividends, particularly companies in Europe. As Europe's economic crisis dragged on, industrial companies held large cash buffers on their balance sheets. Many of the companies underwent large restructuring efforts as well. Now, with Europe's economic backdrop finally improving and restructuring rightsizing the cost base for many of these industrial companies, management teams are more comfortable paying out their large cash buffers in the form of larger dividends.

Energy. We see evidence that energy companies are also responding to shareholder demand for dividends, by spinning out parts of their businesses to create high-dividend paying companies. Examples include SeaDrill, which spun out a master limited partnership (MLP) that would own and operate the semi-submersible drilling rigs created by the parent company. The spinout frees up capital for the parent company to build more rigs and distribute more cash to shareholders.

More recently, Noble Corporation announced it would spin off its older, standard rig fleet into a standalone business. The move leaves Noble with a deepwater drilling fleet whose growth potential will be attractive to a shareholder base seeking growth, but creates value for yield-seeking investors by spinning out a company that will likely pay higher dividends as it generates cash from the older rigs.

Conclusion

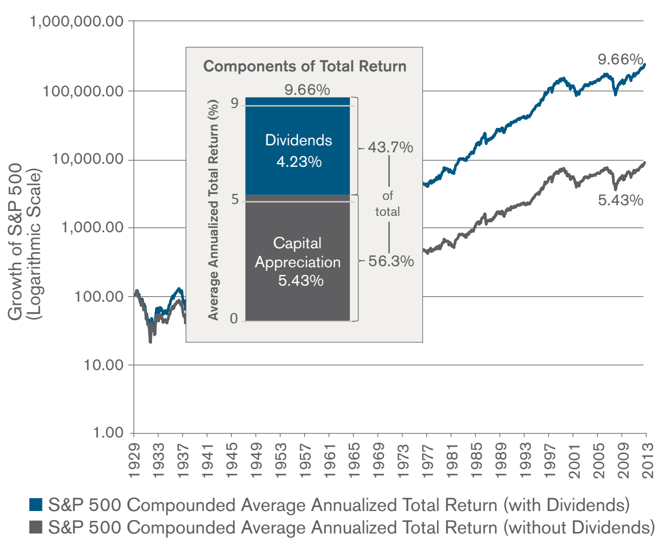
Overall, we believe the general market focus on dividends should prove beneficial to growth-oriented, large-cap investors. The positive attributes of dividend-paying stocks are well-documented: the potential for more stable returns, strong defensive characteristics and significant long-term compounding benefits (see Exhibit 5). While dividend-paying companies in general will be favored relative to nonpayers, we think companies with the ability to grow dividends will be rewarded most. As interest rates rise, and investors seek both capital appreciation and current income, we believe the market will reward higher multiples for growth companies that have the potential to increase dividends in the future.

Dividends alone, however, do not determine the most attractive long-term growth investments and are only one component in driving overall shareholder value.

Exhibit 5

Dividend Compounding Potential Can Be Significant

(Hypothetical Growth of $100)



Source: Morningstar. Through 12/31/2013.

While distributions can supplement stock appreciation, investors must carefully evaluate how companies plan to deliver consistently stronger free cash flow growth in assessing the sustainability of a firm's dividend, or the firm's ability to grow it. Historically, the market has punished dividend reductions much more drastically than it has rewarded increases, and a slip back into economic recession could easily prompt firms to lower payouts, depending on the severity and duration of any renewed downturn.

Ultimately, dividend payouts should be viewed as one of several viable options that firms have to deliver shareholder value. Generating consistent, high-quality growth requires a skillful combination of capital investment and disbursement strategies that best fit each specific firm situation. As such, fundamental, bottom-up research can help identify which companies have the cash flow efficiencies, innovation capabilities, growth potential and dividend strategies required for long-term success. We think these are the growth firms with the most potential to reward investors over time.

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Past performance is no guarantee of future results.

The hypothetical example shown on page 7 in Exhibit 5 does not represent the returns of any particular investment.

Income may be subject to state or local taxes and to a limited extent certain federal tax. Capital gains are subject to federal, state and local taxes.

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Russell 1000® Index measures the performance of the 1,000 largest companies in the Russell 3000® Index.

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