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MAXIMIZING THE POWER OF DIVIDEND GROWTH THROUGH ACTIVE MANAGEMENT

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The assertions in this paper are based on Fenimore Asset Management's opinion. Fenimore Asset Management is manager of the FAM Funds.

Highlights Include:

- Sound dividend-growth policies are often indicative of companies with strong underlying financial strength.
- Dividend-growing businesses have historically provided positive absolute equity returns, and consistently better returns than the S&P 500 Index.
- Active management of dividend-growth stocks can potentially weed out at-risk companies and help to maximize potential future growth.

This white paper examines why dividend-growth stocks may be an excellent investment and how active management may create additional benefit.

Introduction

Identifying companies with a history of growing dividends, and specifically with explicit and sound dividend-growth policies, has historically allowed investors to harness strong performance. The stocks of such companies have consistently outperformed the S&P 500 Index, with lower risk.[1] Active management seeks to enhance investors' return from dividend-growth companies by distinguishing those with sustainable financial strength and growth from those with less promising prospects.

Sound Dividend-Growth Policies Can Signal Underlying Financial Strength

Investors searching for quality companies within the universe of equities have a highly effective filter in the form of dividend-growth policies. Clearly communicated dividend-growth policies often denote companies of solid financial strength based on our experience.

For a company's management to commit to paying a sustainable growing dividend, after all, it must have confidence in the business's ability to sustainably generate a growing amount of excess cash flow — typically through growing sales and earnings.

Furthermore, a dividend-growth policy serves as an accountability tool. Given the negative implications associated with dividend cuts, such as financial stress or elevated reinvestment needs, and investors' historical distaste for dividend cuts, management teams have largely sought to avoid them. But formal dividend-growth policies can impose even more discipline upon managers as they make capital allocation decisions.

Capital allocation, requiring companies to carefully balance reinvestment in the business and return of cash to shareholders, is a sensitive undertaking. Too much investment, and the business might not have the cash needed to cover its dividend payout; too little, and it will be unable to sustain the growth of its cash flows.

Dividend-growth companies have historically done well at balancing these priorities, in our opinion, as reflected in the positive aggregate performance of their stock. As Paul Hogan, my fellow portfolio manager on the FAM Dividend Focus Fund, pointed out in his white paper, *Dividend Growth for the Long Term*, between January 31, 1972, and April 30, 2016, dividend growers and initiators returned 9.8% per year on average. Over the same period, dividend payers that did not change their dividend returned just 7.3%. Non-dividend-paying stocks returned a mere 2.4%.

Furthermore, as Paul's paper highlights, dividend growers' risk/reward profiles (as measured by annualized standard deviation of returns) have historically bested those of non-dividend payers, dividend cutters and companies that did not raise their dividend.

Dividend-growth companies' positive risk/reward relationship may be ascribed to their solid financial attributes. These typically include strong balance sheets and growing cash flows.

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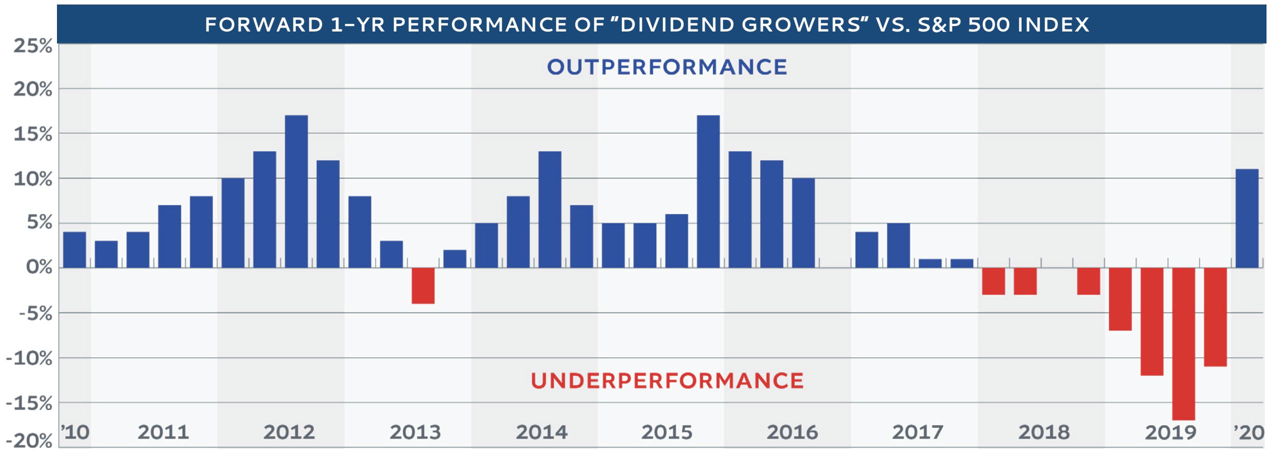
[1]*Paul Hogan, Fenimore Asset Management, Dividend Growth for the Long Term, September 2016. Research Study was from 1/31/1972 – 4/30/2016.*

Dividend Growers' History of Strong Absolute Returns

Dividend-growing companies' (those that grow their dividend at least annually) underlying strengths have translated into positive absolute and relative stock returns, as the chart below illustrates.

Dividend Growers Consistently Outpace S&P 500[2]



Past performance not indicative of future results.

To illustrate dividend growers' historical outperformance, we analyzed a decade's worth of data from 432 companies, each with a market cap of at least $1 billion, that we consider "sound dividend-growth companies," based on two criteria:

1. They paid a growing dividend every year since 2011, or since the date of dividend initiation if it occurred after 2011.
2. Eighty percent of the time or more they maintained a payout ratio (defined as dividends paid divided by gross operating cash flow) of less than 70%. In other words, we judged their dividend payout to be sustainable.

Over the 10-year period, dividend growers' one-year future returns, on a rolling quarterly basis, averaged 16% — compared with 12% for the S&P 500. Moreover, dividend growers outperformed the S&P in 29 of 38 periods, or approximately 75% of the time. This was the case despite the success in recent years of the FAANG(M) cohort of stocks (Facebook, Amazon, Apple, Netflix and Alphabet — formerly known as Google — along with Microsoft), which we estimate to be more than 22% of the S&P 500's weighting.

Importantly, dividend growers' performance wasn't driven by a few strong outliers. Sixty-eight percent of such stocks beat the S&P's 12% average return. And a full 80% of the index's dividend-growth companies recorded average forward one-year returns of 10% or more.

While growing dividends can help investors identify strong performance potential, the return impact of the dividend payments themselves should not be overlooked. Dividend payments have historically accounted for a substantial percentage of the S&P 500's total return. Although their contribution has fallen in recent years, dividends still can provide investors with a performance "head start." Over the three years ended December 31, 2020, for example, dividend contributions accounted for 6.60% of the S&P 500's total return.[3]

A growing question in today's environment for equity investors is the impact of rising interest rates. Historical evidence suggests that dividend-paying stocks could hold up well in such a scenario. Studying the period from January 31, 1972 through April 29, 2016, Paul Hogan found that during periods in which the Federal Reserve tightened interest rate policy, the return of dividend-paying stocks within the S&P 500 was positive 2.17%. That was slightly ahead of the non-payers, which averaged a 2.06 return%.

Active Management of Dividend-Growth Stocks Looks to Identify the Most Durable Performers to Potentially Maximize Future Performance

> **The financial strengths of dividend-growing businesses, along with their historically strong stock returns, can make them a compelling investment opportunity. But simply screening for historical dividend growth may leave investors exposed to unnecessary risk.**

That's because backward-looking screens fail to capture a company's current financial situation and future business prospects — which are, after all, the source of the stock's value. Failing to evaluate a holding's business prospects can leave investors vulnerable to a dividend cut or suspension. And as the next table shows, companies that announce cuts or suspensions of dividends experience significant stock price impacts — both before the announcement and well afterward.

[2] *Fenimore Asset Management Research & FactSet, as or 3/31/2012*
[3] *Source: Y Charts*

Dividend Cutters Have Experienced Lingering Underperformance

AVERAGE PERFORMANCE FROM DATE OF DIVIDEND CUT/SUSPENSION	1-YR PRIOR	1-YR AFTER
Dividend Cutters/ Suspenders	-28%	-10%
S&P 500 Index	8%	12%
Underperformance	-36%	-22%

Past performance not indicative of future results.

To create this table, we analyzed return data for 112 companies that had annual dividend-growth policies but announced a dividend cut or suspension between 2011 and 2019. In the year prior to the announcement of their dividend cuts, these companies underperformed the S&P 500 by an average of 36 percentage points as markets sniffed out deteriorating financial conditions.

Some of the most common issues that presage dividend cuts include:

- A poor operating environment.
- Heightened reinvestment needs.
- Shaky financials.

Notably, however, underperformance continued throughout the 12 months after the negative dividend announcements: The group underperformed the S&P 500 by another 22 points on average during that period.

Look Deeper Than the Screens

Simply screening for dividend growth can subject investors to backward-looking biases, not just in terms of individual businesses, but in terms of sector exposure as well. At any given moment, screening for dividend growth can often highlight businesses that have generated excess cash in past economic cycles, but does not account for future prospects. This frequently creates weightings toward “old economy” stocks, but underexposes investors to stocks in sectors with potentially better growth prospects, such as technology.

Backward-Looking Data May Miss Future Growth Potential

SECTOR WEIGHTING

SECTOR	DIVIDEND GROWTH	S&P 500 INDEX	RUSSELL 2000 INDEX
Communication Services	1.4%	10.9%	2.8%
Consumer Discretionary	5.6%	12.4%	13.5%
Consumer Staples	7.3%	6.1%	3.6%
Energy	1.9%	2.8%	2.6%
Financials	34.4%	11.3%	14.5%
Health Care	5.6%	13.0%	19.5%
Industrials	15.9%	8.9%	16.3%
Information Technology	5.4%	26.6%	13.3%
Materials	7.3%	2.7%	4.1%
Real Estate	4.9%	2.5%	7.1%
Utilities	10.3%	2.7%	2.7%

Past performance not indicative of future results.

The table above illustrates the issue. To create it, we identified 427 companies that have grown their dividend for at least 10 consecutive years, including 2020 — a year that saw a significant number of dividend cuts and suspensions.

We then compared these companies’ sector weightings with those of two popular benchmarks — the S&P 500 and the Russell 2000. As the chart shows, screening by historical dividend growth would leave an investor significantly overexposed to financials and utilities — but underexposed to high-growth sectors like health care and information technology.

The bottom line: Active management, by taking into account individual stocks’ fundamental strengths and weaknesses as well as broader considerations such as sector trends, could mitigate investment risk and maximize potential total return.

Conclusion

Dividend-growth policies can help investors identify companies with strong financial and business attributes. They not only denote management confidence in the strength of their business, but also discipline management as it makes critical capital allocation decisions. As we demonstrated, over the last decade, the stocks of companies with dividend-growth policies have generally outperformed the broader market.

But active management may make dividend-growth investing even more effective. By carefully curating the dividend growers within a portfolio, active managers seek to mitigate risk and seize opportunities that a passive approach would fail to identify. In short, dividend growth could be an excellent way to invest, and active management may serve to amplify its potential.

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