“The right combination”

Song performed by Dolly Parton & Porter Wagoner, 1971.

It certainly was for Dolly Parton. Her chart topping duets with mentor Porter Wagoner launched her long and successful music career.

In the art of blending current income with future growth to produce winning portfolios, we agree with Dolly. The right combination is crucial.

Russell Hogan, December 2017

DUNDAS GLOBAL INVESTORS

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Dundas Partners was founded in 2010 to invest in the world's best companies. Our principles are independence in both thought and ownership and co-investment alongside our clients.

Many US investors already invest for dividend and capital growth at home but it is still early days elsewhere. The opportunities outside the US are, if anything, greater and our five year track record highlights our ability to find these companies and deliver excess returns.

Savers build their portfolios via compounding, reinvesting dividends. Investment consumers, principally retirees, spend their dividends and want to keep capital intact for as long as possible.

To answer these needs, our portfolios are built to deliver both capital and dividend growth.

Overview

Every equity portfolio manager seeks to balance a number of competing factors in order to achieve the best outcome. Diversify too much and the benefit of good stock decisions is dissolved, make the portfolio too concentrated and the losses can bite hard.

The tacit aim is 'Goldilocks' diversification – not so much that it detracts from good investment decisions but not so little that excessive exposures remain.

However, most global equity managers focus on share price appreciation to generate total returns and as a result consider only capital allocation between holdings. In a rising dividend portfolio, the aim is to secure capital growth ***and*** a sustainable rising stream of dividends.

Studies of long-term return such as London Business School's *Global Investment Returns Yearbook* confirm that where long run dividends go, share prices follow.

So how should we allocate to take dividends into account alongside capital? The portfolio's starting dividend position will have a lot to say about where it arrives in future. The tables below illustrate that capital and income allocation are quite different.

Top five ACWI stocks by market capitalisation	
Name	***GICS sector***
Apple	Information Technology
Microsoft	Information Technology
Amazon	Consumer Discretionary
Facebook	Information Technology
Johnson & Johnson	Health Care

Top five ACWI stocks by dividends	
Name	***GICS sector***
Apple	Information Technology
Exxon Mobil	Energy
Microsoft	Information Technology
Wells Fargo	Financials
JP Morgan	Financials

Sources: Bloomberg, MSCI.

'No such thing as a free lunch' - income today versus income tomorrow

Portfolio construction is about trade-offs and rising dividend portfolios are no different.

The most obvious trade-off is between stocks with high yield but little dividend growth potential and those capable of sustained dividend growth but low yield today.

Dividend growth comes at a price. Over the five years we have been investing the highest yielding sectors have seen the poorest dividend growth and vice versa. Income foregone today can provide substantial future benefits.

Where dividends go share prices follow

Quarter to quarter, the noise of share price moves drowns out the quieter, consistent voice of dividend announcements. Earnings announcements get the headlines, but those profit changes are 2.5x more volatile than dividend changes[1].

Over longer periods dividend increases provide the most stable measure of a company's long term sustainable growth. The biggest components of long-run total return are a stock's yield plus dividend growth.

Furthermore, studies show that companies with stable dividend growth have a much less volatile pattern of returns than those that experience dividend hiccups along the way.

Long term equity returns = Dividend yield + Dividend growth

[1]*Source: Irrational Exuberance. Robert J Shiller June 2014.*

The power of dividend compounding

A company that delivers 8% dividend growth for ten years provides an investor with an extremely valuable outcome – a doubling of dividends. One that delivers 12% for ten years triples the dividend income. This provides investors with wonderful choices – to reinvest that income stream through the purchase of more shares or to extract it to fund retirement, meet liabilities or, in the case of a foundation, to distribute that income to good causes.

A long-term relay race - getting the right runners in the right order

When constructing portfolios, a good rule of thumb is to think of dividends in three broad flavours – those of today, tomorrow and the future. The table below shows how these three categories offer different profiles of current versus future dividends. Today's dividends add slightly more in years 0 to 5 than tomorrow's dividends. However, tomorrow's dividends come through strongly in years 5 to 10. Look also at the progress made by future dividends, which are set to pick up the running thereafter.

Dividend category	Initial dividend	Growth rate	After 5 years	Added years 0 to 5	After 10 years	Added years 5 to 10
Today	$3.00	8%	$4.40	**$1.40**	$6.50	**$2.10**
Tomorrow	$1.75	12%	$3.08	**$1.33**	$5.50	**$2.42**
Future	$0.50	20%	$1.25	**$0.75**	$3.00	**$1.75**

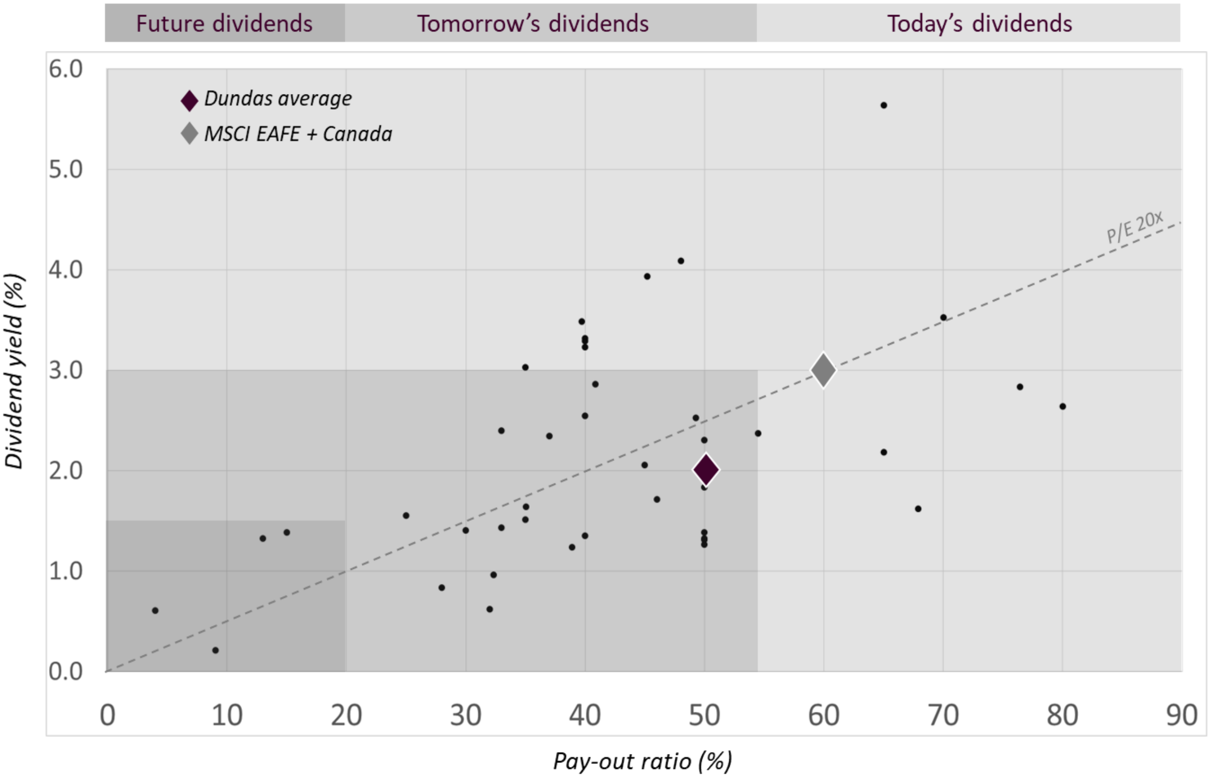
Today's dividends allow the portfolio to gain traction straight away in building the income stream. Typically these stocks yield around the market but, crucially, are growing faster. They are characterised by strong cash flows, mature but still growing businesses and pay-out ratios of around 50%.

Tomorrow's dividends are those that will start to kick in during the next three to five years. Initially yielding less that the market, these faster growing companies are the engine room of a rising dividend portfolio. They make up the income foregone via rapid dividend growth as they are typically paying out around 30% of profits, reinvesting the majority of earnings and cash flows to fund future growth. These companies give the portfolio the double benefit of strongly rising profits coupled with the prospect of rising pay-out ratios to deliver powerful dividend growth.

Future dividends will come from companies that are currently reinvesting all of their cash flows (and sometimes more) in their particular growth opportunities. Some of these companies may be paying a token dividend in order not to be excluded by investors. For others, the Board will likely communicate that dividends are still years away. Within a rising dividend portfolio these stocks will pick up the baton of growth in years five and beyond, providing a rapidly accelerating income stream as dividends are initiated and/or Boards target a meaningful pay-out ratio.

This time-related approach to building a rising dividend portfolio brings a number of benefits to investors. It provides a balance between current income and future growth. It allows for companies in different industries and stages of development to be included to the benefit of diversification and substantially higher future growth rates. By refreshing the portfolio with new investment ideas while retaining the same underlying time-related approach, a single strategy can meet the goals of different cohorts of investors over an extended time horizon (the antithesis of a target date fund).

The chart below plots each stock held within the Dundas International Growth strategy by dividend pay-out ratio (bottom axis) and dividend yield (left axis). 'Tomorrow's dividends' represent more than 60% of the portfolio as the dividend growth engine room. 'Today's dividends' provide the bulk of current income, with a small allocation for rapid growth companies which will be the dividend payers of the future. This results in a blended portfolio yielding just over 2% with a pay-out ratio of around 50%.



Source: Bloomberg. The index is the MSCI EAFE + Canada.

Stock sizes within the overall portfolio framework

The limitations of 'capital value only' approaches to portfolio construction become clear. Weighting stocks according to their market capitalisation fails to address the income generated by those stocks which, as we highlighted earlier, can be quite different from capital allocation. Equal weightings to all stocks also fails to address this issue and is burdened by the costs of reweighting – and is against the long-term evidence in support of running winners, cutting losers and the asymmetry of returns.

Two factors are key in sizing individual stocks – the security of the dividend and the price paid for growth.

To use an example, ***3M*** is a US multinational industrial and consumer materials company. Spanish company ***Amadeus*** is the world leader in airline flight data collection and dissemination. Both have the same pay-out ratio and a similar yield yet one has thousands of customers across the world buying relatively small products while the other is tied to the fortunes (albeit with a degree of security) of a handful of airlines. Researching the security of dividend streams is a key part of the work of a rising dividend portfolio builder as discussed in our earlier paper on dividend security.

Nobel Laureate Thaller's work on behavioural finance explains why markets get carried away on the upside and the downside. Rising dividend investors must be alert to the dangers of overpaying for growth and should have disciplines in place to avoid doing so. In essence, this means avoiding giving up too much predictable current income to get more unpredictable future growth.

The stocks with the most secure dividends that are priced attractively relative to their growth rates will have the highest weightings in a rising dividend portfolio.

Understanding the risks

The biggest risk to the rising dividend investor is dividend cuts. It takes a lot of growth elsewhere in the portfolio to make good a substantial (as they tend to be) dividend cut. That risk is best managed through ongoing research.

At the portfolio level, the main risk is giving up too much current income and not achieving the future dividend growth rates required to offset it. This risk is best managed through the time-related categories outlined earlier in this paper, allowing a broad range of companies to be considered for inclusion in the portfolio.

Another risk at the portfolio level is that of unintended over concentration or lack of diversification. The issue here is that, during times of stress, invisible threads that connect different stocks (across geographies and even sectors) become all too visible, dragging down dividend growth rates across the portfolio. While quantitative analysis of the portfolio can - and should be - used to mitigate this risk, so too should a sound analysis of the underlying drivers of growth for individual stocks. Currently there is no global tourism sector in the indices but it comprises over 10% of world GDP and touches companies from consumer sectors, through industrials to financials. Insights like this provide a very valuable additional risk management tool.

All investors must be aware of the threads and watch out for them becoming the webs that catch the unwary.

The Dundas Partners approach

We use all of the techniques outlined above to help us to build our rising dividend portfolios. In particular, we pay attention to each stock's contribution to both current income and future growth based on our estimates. We also look closely at the threads that link the stocks in the portfolio, many of which cut across traditional country or industry based methods of diversification.

We seek to minimise cash in the portfolio – it provides neither current income nor future dividend growth. With respect to currencies, the underlying business currency exposure in the companies that we own is even more diverse than the currencies in which the shares are quoted. We let our companies decide on their own hedging strategies and no additional currency management is undertaken at the portfolio level.

Finally, we make specific exclusions from the stock universe. Neither tobacco companies nor munitions companies are considered for inclusion in portfolios.

In a world moving towards target dates, passive investing and market capitalisation based weightings, we believe that the successful management of rising dividend portfolios requires a substantially different approach.

About the author

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Russell shares the CIO role with founder Alan McFarlane, with responsibility for portfolio construction, risk management and the investment process.

Prior to joining Dundas, he spent 17 years at Aegon Asset Management, latterly in the role of CEO with responsibility for £33 billion.

Disclaimer

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