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PRIVATE WEALTH MANAGEMENT

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The Pressure to Pay Dividends

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What Makes Something a "Good" Investment?

For many conservative investors, we generally think the "best" investments... to sustain portfolio value after inflation, and provide steady income... are high quality dividend-paying stocks. The profile of these stocks generally includes companies with an investment grade credit rating and a growth outlook that supports the ability to consistently grow dividends. Said more simply, we are looking for "increasing" cash flow from a strong credit, providing growing income over time versus static unchanging cash flow payments from bonds. Cash flows that grow are better than cash flows that don't grow. Bonds play a role, but we unequivocally view stocks as better investments.

Dividends are Important

An ideal investment strategy, in our view, combines investments that provide both capital gains and dividend income, being careful not to over-emphasize one versus the other. We've written in previous memos that dividends can be a "must have" in the strategy equation, to balance growth and income, without compromising long-term total-return performance. We think of dividends as just one part of a company's "total return" formula to provide competitive returns to shareholders.

The S&P 500 history of dividend growth, has been consistently impressive. But can investors be confident that dividends will grow in the future? We think that part of the answer comes from considering how companies think about dividends in the context of overall capital allocation. We think understanding why companies pay dividends, and their wherewithal to pay those dividends, provides visible "proof points" that can help to maintain the commitment to being a long-term investor.

Earnings Drive Stock Prices

To begin, the market performance of stocks is very closely linked to earning growth, showing the market's prioritization of earnings trends, as opposed to capital allocation decisions, such as the decision to pay dividends. Chart 1 shows the close linkage between the S&P 500 and S&P 500 earnings. Many factors influence stock prices, but over the long term, we think that earnings growth is the most important. Earnings drive stocks prices; dividends don't drive stock prices. Still, the comfort level with a company's earnings outlook gives management the confidence needed to pay dividends, steady earnings trends have contributed to steady dividend trends.

In addition to earnings trends, we believe that steady profitability, creating "net economic profit", is a key driver of price/earnings valuation multiples. Chart 2 compares "return on equity" and the price/earnings multiple of the S&P 500.

These measure of profitability and valuation have fluctuated over time, but we believe the consistent profitability of the S&P 500 is a key consideration when evaluating the stability of valuation multiples. We think steady GDP growth, and steady earning growth and profitability, are a key consideration for capital allocation decisions, including long-term commitments for expansion. There are a lot of problems to worry about, but we think it's a mistake to be overly pessimistic about the resilience and growth outlook for the U.S. economy. History has favored the optimists.

Economics is about Confidence

We think confidence in the likelihood of future growth can be developed by appreciating the ongoing ability of companies to successfully convert assets into sales, profits, and dividends. Chart 3 shows the long-term growth in the S&P 500 assets, sales, and earnings, providing a key insight that **"the system"** appears to be working, in that steady growth has been achieved while earnings growth has been faster than asset growth.

The "system" we showed in chart 3 is a combination of the "investment cycle" and "capital allocation", illustrated on Table 1. The investment cycle shows the steps associated with converting assets into profits. Capital allocation includes a company's choices to allocate profits each year between reinvestment into the business, or returning capital to shareholders through dividends and stock buybacks.

Table 1

Investment Cycle	Capital Allocation
Invested Capital (Equity and Debt)	**Reinvestment** • Growth Capital Expenditures • Research and Development • Mergers and Acquisition
Sales	
Earnings	
Maintenance Capital Expenditures	Dividends
Free Cash Flow	Stock Buybacks

Total Shareholder Return

Capital allocation decisions are based upon a combination of industry and company-specific factors, but must be linked to an ongoing strategy for providing competitive returns to shareholders.

Why do companies pay dividends? A company's capital allocation decision to pay dividends is determined, we think, by either of two reasons. The first is to provide a formula to help meet a target shareholder return, by combining earning growth with dividend yields. The second is to proactively manage a company's balance sheet to distribute profits representing "excess cash", to avoid asset growth that could penalize key performance measures, such as return on invested capital. We believe a company's valuation multiple is based upon the market assessment of whether a company's growth has been "good growth", meaning sales growth while maintaining, and not reducing, profitability measures as a percentage of sales.

Table 2 illustrates the need to proactively manage the amount of a company's assets, and the possible need to reduce "excess cash" by paying dividends. The top part of Table 2 shows an example of how a company's economic performance is diluted if profit growth is slower than asset growth. The bottom part of Table 2 illustrates how paying dividends, to reduce the amount capital retained in the business, can provide a solution to avoid diluting economic performance.

Table 2: Performance Dilution When Profit Growth is Slower Than Asset Growth

	Year 0	Year 5
Free Cash Flow (**10%** Growth)	100	161
Invested Capital (**10%** Growth)	1000	1610
NOPAT (**5%** Growth)	100	128
Return on Invested Capital	**10%** →	**8%**

Distribute "Excess Cash" Through Dividends

	Year 0	Year 5
Free Cash Flow (**10%** Growth)	100	161
Dividends (**10%** Growth)	50	80
Invested Capital (**5%** Growth)	1000	1276
NOPAT (**5%** Growth)	100	128
Return on Invested Capital	**10%** →	**10%**

Data Source: Bloomberg 09.15.23

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Excess Profits?

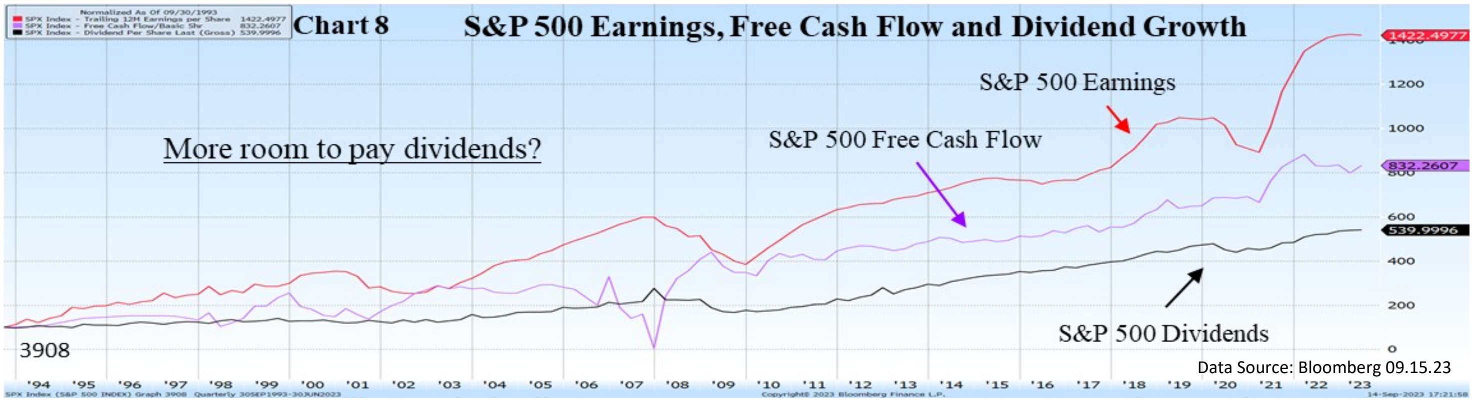
"Excess profits" seems like a good problem to have. Thinking of dividends as "an excess profit problem" suggests that companies are in a very strong position, with enough capital to sustainably grow their business, as best they can with the opportunities available, while sharing profits with shareholders. Chart 4 compares the long-term growth in S&P 500 assets and dividends, and the key role of paying dividends to sustain target levels of economic performance.

The Wherewithal to Pay Dividends

How can we confirm the existence of these excess profits, and whether trends in profitability are sustainable? Chart 5 shows the level of sales, earnings and profits for the S&P 500 and chart 6 compares the growth of sales and profits. Chart 7 shows the growth in earnings, free cash flow and dividends per share of the S&P 500, showing the larger gap between "profits" and dividends paid to shareholders.

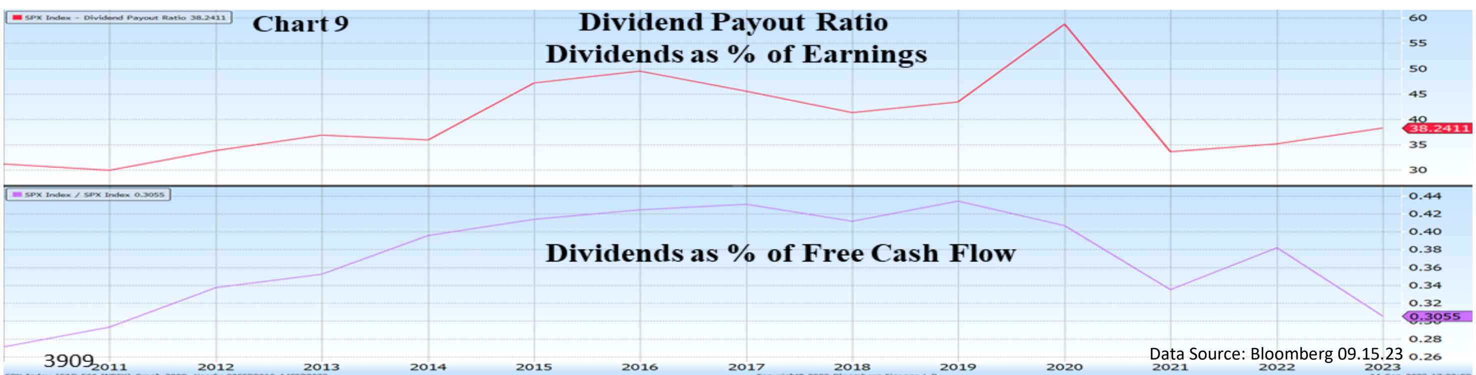
"Investment Cycle" Trends Have Been Steady

Chart 7 suggests that company profits have been sufficient to both reinvest and pay dividends, and if capital allocation priorities were different, dividends could be much higher. This is a good problem to have, but forces companies to choose carefully amounts to be reinvested versus paid as dividends. The fact that companies are choosing to reinvest, and not just pay dividends, provides an indication of the potential for economic growth. Chart 8 reinforces this point by comparing earnings, free cash flow and dividend growth.



The Sustainability of Dividends

Why haven't dividends grown faster? We have a positive view of this question. Capital allocation trends reflect a prioritization to reinvest for growth…because growth opportunities have been available. Chart 9 shows the "dividend payout" ratio for the S&P 500, measuring the percentage of earnings paid out as dividends, and dividends as a percentage of free cash flow. The percentage of profits allocated between reinvestment and dividends has been steady for decades.



Dividends are an Inflation Hedge

Companies face substantial pressure to perform for investors, to successfully manage the investment cycle and to make prudent capital allocation decisions for investors. Chart 10 provides a great proof point for long term income-oriented investors, comparing S&P 500 dividend growth with inflation. The future is uncertain, but the record of the past 30 years has been pretty good. There be dragons, but from our view the potential for future growth is very good.

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