NORTHERN TRUST
ASSET MANAGEMENT

RESEARCH INSIGHTS

US INCOME EQUITIES

A CHANGING DIVIDEND ENVIRONMENT

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Dividend investing has long been a cornerstone of wealth creation, offering investors a steady stream of income alongside potential capital appreciation. However, dividend strategies that focus primarily on traditional dividend-paying companies can sacrifice total returns during certain market environments. We explore the changing landscape for dividend yield in the US equity market and provide some insights on best practices for dividend investors.

CONVENTIONAL APPROACH TO DIVIDENDS

Traditional dividend strategies often prioritize generating income through investments in companies with a long history of consistent dividend payments. This typically involves emphasizing securities from sectors such as Consumer Staples and Utilities that distribute a significant portion of their profits to shareholders. Such firms tend to be more mature with stable balance sheets, which can be beneficial in periods of market stress.

However, in periods when investors view earnings retention – and thus lower capital returned to shareholders – as a condition to support future earnings growth, higher dividend-paying companies may underperform. In this context, firms with no or lower payouts may signal to investors that earnings retained are more valuable than cash returned to shareholders.

This has been the environment of the US equity market in the post-financial crisis era when inflation and interest rates were low and access to capital was plentiful. Growth companies, characterized by their high future earnings potential, significantly outperformed value companies and dividend payers. With cash yielding very little, investors readily ignored current cash returns from traditional dividend stocks and sought out higher returns by flocking to growth companies.

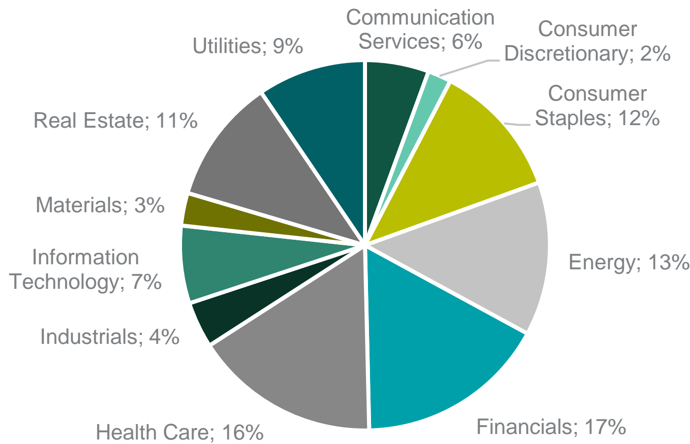
The rise in valuations and the corresponding market capitalization of low- and non-dividend payers has contributed to an environment where less than 30% of the US large cap market weighting pays a dividend greater than 2%.[1] While stock price appreciation has outpaced dividend growth leading to lower yields, the top two yielding groups in the Russell 1000 index currently sport a weighted average dividend yield of 3.8%[1]. However, these higher dividend groups comprise only 19% of the index's weighting.

Dividend strategies seeking to capture significant yield above and beyond the market's yield will invariably need to invest within the top two yielding segments. Although the sector representation of these highest-yielding parts of the market looks relatively diversified, the group as a whole is quite different from the overall market. A cap-weighted portfolio of these stocks has over 9% estimated tracking error vs. the Russell 1000 index[1].

[1] as of 3/31/2024

EXHIBIT 1: TOP TWO YIELDING SEGMENTS

Sector representation among the highest yielders differs substantially from the overall us equity market

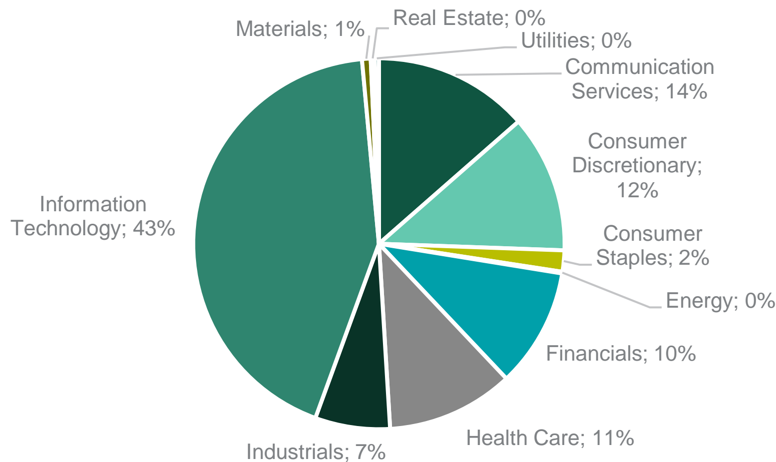


Source: Northern Trust, Bloomberg. Benchmark is the Russell 1000 Index. Market cap weighting sector representation of the highest-yielding and second highest-yielding segments. As of 3/31/2024. For illustrative purposes only. **Past performance is no guarantee of future results**. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

In contrast, the combination of the lowest-yielding segment grouped with non-dividend payers has increasingly become a large proportion of US market capitalization. Securities that comprise the low- and non- dividend paying groups represent over 54% of the Russell 1000 index's weight.[2] Although these stocks pay little income back to investors, growth rates and total returns have been superior as compared to the highest dividend payers.

EXHIBIT 2: LOWEST YIELDING AND NON-DIVIDEND SEGMENTS

Earnings growth and total returns have been strong among the low- and non-dividend paying groups



Source: Northern Trust, Bloomberg. Benchmark is the Russell 1000 Index. Market cap weighting sector representation of the lowest-yielding and non-dividend segments. As of 3/31/2024. For illustrative purposes only. **Past performance is no guarantee of future results**. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

[2] as of 3/31/2024

WHAT IS A DIVIDEND INVESTOR TO DO?

A generation ago, a dividend investor could rank the market by yield, target companies paying higher yields and expect to have a reasonable sampling of US equities. That is not the case today. Investing strictly within the highest-yielding parts of the market, or even within stocks paying an above-median yield, leads to portfolios that have significant active risk when compared to the broader US equity market.

To mitigate such biases and risk, investors can consider investing across the whole spectrum of dividend paying securities. We believe one should not reach for yield within equities – there can be too much of good thing. In lieu of focusing strictly on yield, it may be advisable to balance income needs and capital appreciation objectives by taking a total return approach. To that end, dividend investors may wish to embrace lower-yielding stocks, as including such stocks in a portfolio may assist in capturing desirable characteristics (e.g. growth).

For dividend investors, a total return strategy involves an evaluation of the overall health and prospects of a company, balancing immediate income needs with long-term growth. This approach can reduce the risk of relying on potentially unsustainable high yields and promotes investment in robust, growing companies that can provide both steady dividends and significant capital gains. Additionally, under a total return approach, dividend income should be viewed at the portfolio level, not at the individual security level. There are many ways to achieve an elevated yield. Smart portfolio construction – by investing throughout the equity market – can accomplish both yield and price appreciation objectives.

To illustrate, exhibit 3 presents the growth of $100 in the Northern Trust Quality Dividend Focus US strategy, which deploys a total return approach, as compared to the median US Dividend manager. The NT QDF portfolio achieves these results with minimal active risk (top decile tracking error rank).

EXHIBIT 3: TOTAL RETURN STRATEGY

Trailing 5-years: Northern Trust Quality Dividend Focus as compared to the median dividend manager

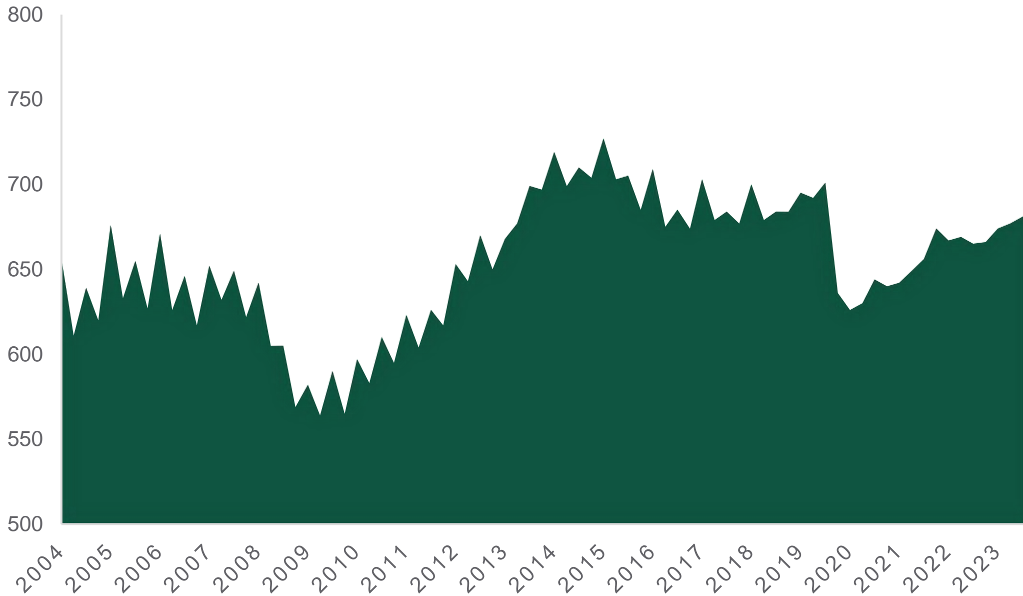
Source: eVestment. Northern Trust Quality Dividend Focus US SMA Composite and eVestment US Dividend Focus Equity Universe- Median. Growth of $100 using monthly returns from 3/31/2019 through 3/31/2024. For illustrative purposes only. **Past performance is no guarantee of future results**. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

PAYERS ARE ON THE RISE

At the onset of the COVID crisis in March of 2020, companies sought to conserve capital, and, in many cases, curtailed dividend payouts. There were more dividends suspended in 2020 than the previous 10 years combined. The COVID crisis's impact on dividends was more acute than the global financial crisis, with a higher number of dividend disruptions occurring over a shorter period. However, over the past few years, the number of companies paying a dividend has steadily increased.

EXHIBIT 4: DIVIDEND PAYERS

The number of firms paying a dividend has steadily increased following 2020's cuts



Source: Northern Trust, Bloomberg. Benchmark is the Russell 1000 Index. Count of dividend paying stocks. As of 3/31/2024. For illustrative purposes only. **Past performance is no guarantee of future results**. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

Recently, mega-cap growers Alphabet and Meta Platforms initiated quarterly dividend payments. Apple and NVIDIA have been paying increasing dividends for over a decade, and seventeen of the top twenty Russell 1000 index constituents now pay a dividend. Many of these firms have an attractive trifecta –paying dividends, buying back large sums of stock, and growing earnings. Yet, these non-traditional dividend stocks are often neglected by income investors due to their lower yields.

CONCLUSION

With inflation, interest rates and borrowing costs remaining elevated, efficient use of cash has greater importance for firms and shareholders. Investors have welcomed increased dividend payments from many, perhaps unexpected, parts of the market. Dividend investors may find it beneficial to invest in these relatively newer and sometimes lower-yielding dividend payers. By focusing on capturing desirable exposures and managing risk, while emphasizing total portfolio yield over individual stock yield, dividend investors can construct a diversified portfolio that balances income and return objectives.

Thank you to Isabel Machlin, CFA for her contributions.

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