Breckinridge CAPITAL ADVISORS

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MAXIMIZING LONG-TERM EQUITY INCOME POTENTIAL IS ABOUT DIVIDEND GROWTH, NOT DIVIDEND YIELD

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Key Takeaways

- For investors seeking higher long-term income and capital appreciation, a company's dividend growth rate can be a more important consideration than its dividend yield.
- A preference for high dividend growth has materially different implications for sector allocations when compared to focus on high dividend yield.
- When compared to other fundamentals, Return on Equity (ROE) provides an effective lens into identifying high quality companies that exhibit sustainable dividend growth.

For long-term investors, prioritizing strong dividend growth rates over elevated dividend yields can result in materially higher levels of income in later years and greater account balances, all else held equal.*

Consider the following scenario. An investor with $100,000 to invest is weighing two strategies and each strategy exhibits annualized price returns of 7 percent:

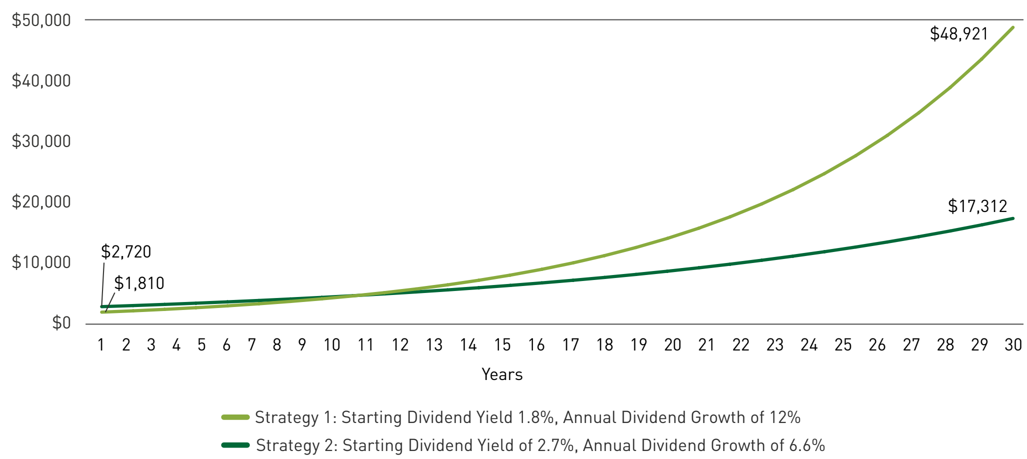
- Strategy 1 offers a **1.8** percent dividend yield with annual dividend growth of **12** percent.
- Strategy 2 has a dividend yield of **2.7** percent and annual dividend growth of **6.6** percent.

HIGHER LONG-TERM INCOME, ACCOUNT BALANCES FAVOR STRONG DIVIDEND GROWTH RATES

Despite Strategy 2's higher starting dividend yield, Strategy 1 generated a level of income that exceeds that of Strategy 2 by the end of year 10.

By year 30, the annual income generated by Strategy 1 is nearly triple that of Strategy 2 (See Figure 1).

FIGURE 1: ANNUAL INCOME GENERATED BY STRATEGY 1 EXCEEDS STRATEGY 2 OVER THE LONG TERM*



*Note: Assumes dividend growth rates are maintained through the entire 30-year time horizon, does not assume re-investment. Assumes initial $100,000 investment is not withdrawn or added to over the entire 30-year time horizon.

Source: Breckinridge Capital Advisors. For illustrative purposes only.

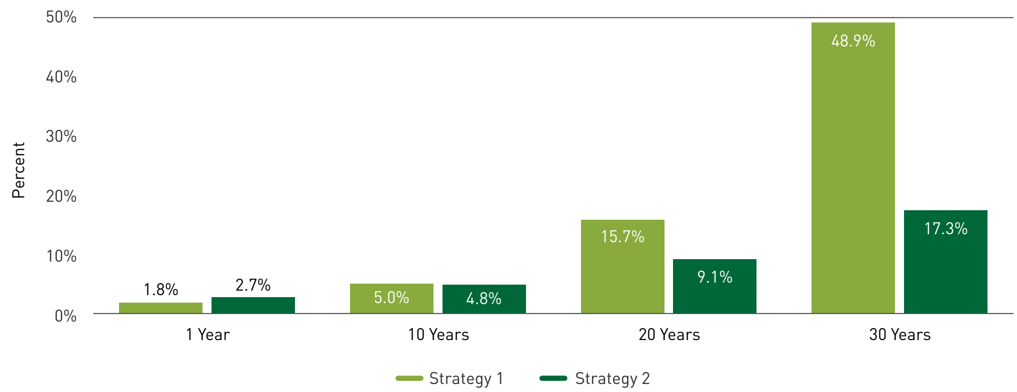
Although Strategy 2's higher beginning dividend yield in the example generated marginally higher income in years one through nine, the book yield, or yield on cost (YOC) basis,[1] significantly lags Strategy 1 in later periods (See Figure 2).

Should an investor choose to reinvest dividends, the break-even point is at about 16 years, when the ending account balance of each strategy would be roughly equal. Because of Strategy 2's higher beginning dividend yield, reinvested income is higher in years one through nine.

The compounding effect of the time value of money[2] results in higher account balances in earlier years, as more income is reinvested. However, the account balance in Strategy 1 begins to exceed that of Strategy 2 by the end of year 17. By the end of a 30-year investment horizon, Strategy 1's ending account balance is more than 20 percent higher than Strategy 2 (See Figure 3).

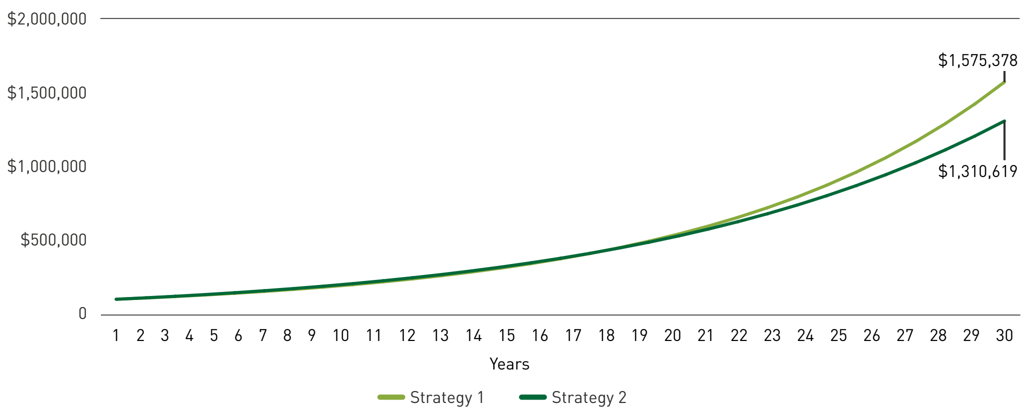
1. Yield on cost (YOC) is an investment metric used to determine the rate of return on the original cost of an investment, taking into account any changes in the income generated by the asset over time. In dividend growth investing, YOC is the annual dividend income paid by a stock divided by the original purchase price (cost basis) of the shares. This metric highlights how an investor's income stream from an investment has grown (or declined) due to changes in dividend payments over time, regardless of fluctuations in the stock price.
2. Time value of money is the fundamental financial principle that a dollar today is worth more than a dollar received in the future because money available today can be invested and earn a return, increasing its value over time.

FIGURE 2: YIELD ON COST BASIS SHIFTS TO FAVOR STRATEGY 1 OVER THE LONG TERM



Source: Breckinridge Capital Advisors. For illustrative purposes only.

FIGURE 3: STRATEGY 1'S ENDING ACCOUNT BALANCE WITH REINVESTED DIVIDENDS EXCEEDS STRATEGY 2'S TOTAL BY MORE THAN 20% AFTER 30 YEARS



Source: Breckinridge Capital Advisors. For illustrative purposes only.

DIVIDEND GROWTH & DIVIDEND YIELD MAY POINT TO DIFFERENT SECTOR ALLOCATIONS

Prioritizing high dividend yielding stocks over high dividend growers often results in different sector preferences. A bias to higher dividend yield often results in exposure to companies in mature industries such as Energy and Utilities. On the other hand, higher dividend growth measures tend to result in higher exposures to Healthcare and Information Technology. Investors with longer time horizons can benefit from higher exposures to growth-oriented companies with a track record of sustainable dividend increases.

HIGH RETURN ON EQUITY (ROE) IS AN INDICATOR OF HIGH DIVIDEND GROWTH

ROE is a measure of capital efficiency that outlines profit per dollar of equity capital invested. Firms that are consistently generating high ROE are better positioned to achieve strong dividend growth over time.

Historically, there has been a strong positive correlation between firms that have high dividend growth rates and high ROE, whereas there has been an inverse relationship between firms with high dividend yields and those with high dividend growth.

While understanding these fundamental correlations are a useful starting point, they can break down for a variety of reasons, such as elevated use of leverage, inadequate free cash flow or weak liquidity. A decomposition of ROE through the use of the DuPont Formula[3] can help to better frame the drivers behind firms that exhibit strong capital efficiency.

FIGURE 4: DUPONT FORMULA HELPS EXPLAIN UNDERLYING DRIVERS OF STRONG ROE

$$\text{ROE} \gg \frac{\text{Net Income}}{\text{Equity}} \gg \text{Profit Margin} \times \text{Total Asset Turnover} \times \text{Equity Multiplier}$$

The key takeaway is that high ROE reflects the prudent use of capital and should be considered a baseline requirement for high dividend growth, but ultimately dividend payout decisions are influenced by additional factors including a firm's financial policy, growth prospects and cash flows that are often captured through a company's fundamental credit rating.

THE BRECKINRIDGE PERSPECTIVE ON DIVIDEND INVESTING

Dividend growth rates can vary from year to year because companies may adjust payouts based on earnings. The Breckinridge High Quality Dividend and Sustainable High Quality Dividend strategies seek high quality dividend payers with higher dividend growth rates; in other words, companies that are likely to grow their dividends strongly over time.

Breckinridge focuses on large, well-capitalized firms with long track records of consecutive dividend payments that also exhibit strong profitability. Our rules-based methodology includes the ROE metric, which has proven to be strongly correlated with both the high dividend growth and high Quality factors.

Given some of the challenges to ROE as a pure play forecaster of future dividend growth, we believe that prioritizing higher ROE and lower relative payout ratios (Please see: *Navigating the Risks: High Payout Ratios and Stable Dividend Income*) is an effective strategy to identify companies that can achieve sustained dividend growth over the long term.

3. The DuPont formula breaks down a company's ROE into three components: profitability (Net Profit Margin), efficiency (Total Asset Turnover), and financial leverage (Equity Multiplier). By multiplying these three ratios, the formula provides a more detailed view of how a company generates returns for its shareholders, allowing for better analysis of performance drivers and strategic improvements.