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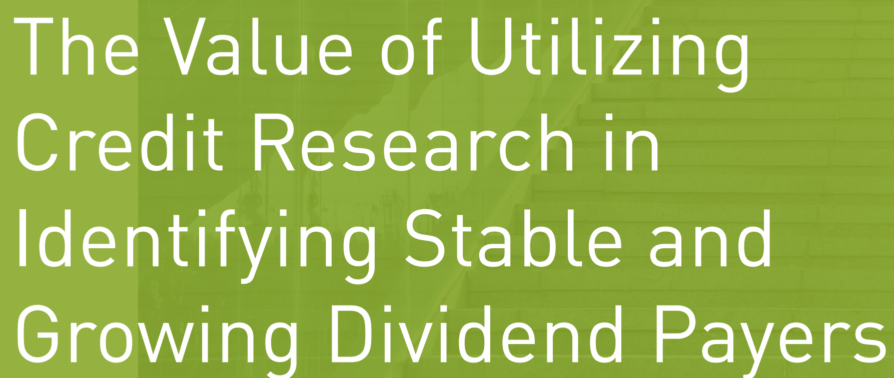

The Value of Utilizing Credit Research in Identifying Stable and Growing Dividend Payers

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KEY TAKEAWAYS

- The tightening of financial conditions, with the Federal Reserve (Fed) ending an era of easy monetary policy that has persisted for over a decade, emphasizes the value investors potentially can realize by focusing on high quality companies with strong balance sheets.
- Research shows that dividend payers that issue high-quality public corporate investment grade (IG) U.S. debt tend to pay stable and growing dividends, offering investors a potential path to improved risk-adjusted equity income and total returns to complement IG fixed income allocations.
- Agency rating downgrades may have a negative impact on dividend policy in the form of dividend cuts or eliminations, thus highlighting the importance of fundamental credit analysis when constructing portfolios of dividend paying companies.

Investors may intuitively expect companies with higher credit ratings to exhibit careful consideration of dividend policies and payments. Research supports that intuition. Economic and financial market conditions in 2023 and beyond may bring added focus for investors to consider the fundamental credit quality ratings of the companies they seek to invest in, whether it be stocks or bond allocations.

In its 2023 credit outlook, S&P Global Ratings offered, "In the near term, S&P Global Ratings expects pressures on credit ratings to intensify, as corporate borrowers find it more difficult to pass through high input costs to consumers struggling with rising prices and a mild recession in some of the world's largest economies. We forecast speculative-grade corporate default rates in the U.S. and Europe to double."[1]

A period of renewed emphasis on credit quality may support a bias among income-oriented investors for equities and bonds issued by companies with the highest IG credit ratings.

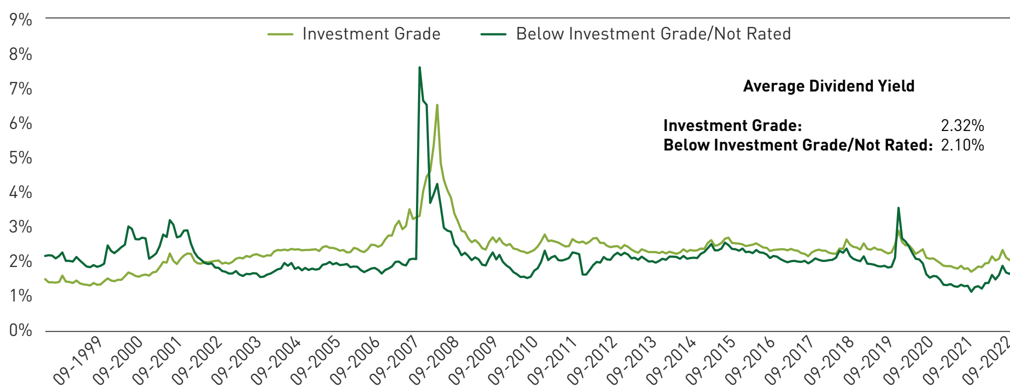
High bond credit ratings often indicate desirable dividend-paying characteristics

Research shows that historically, U.S. large-cap companies that pay dividends, issue public debt, and have IG ratings exhibit favorable dividend payer attributes that equity investors focused on income may find attractive.

Companies that issue public debt, rather than only private placements, are less influenced by short term earnings and are more likely to exhibit dividend smoothing policies.[2] Further research supports that the management teams of high quality IG companies favor dividend policies that consider the growth in dividends per share, are reluctant to make changes to the dividend that may have to be reversed in the future and are more likely to avoid reducing dividends.[3]

In contrast, firms with below investment grade (BIG) ratings or that are not rated (NR) flow through more of earnings as dividends and display little dividend smoothing behavior, seeming to follow a residual dividend policy. Based on research, the combination of these behaviors may lead to more volatility in dividend policy and may introduce additional volatility in stock prices, which, when taken together, can be seen in higher volatility in dividend yields for this subset of companies relative to IG dividend-paying companies (See Figure 1).[4]

FIGURE 1: DIVIDEND YIELD
U.S. LARGE CAPITALIZATION EQUITY DIVIDEND PAYERS



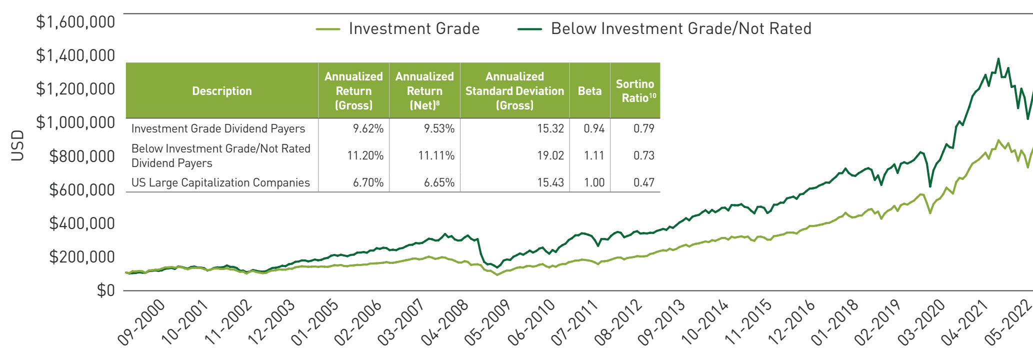
Source: FactSet and Bloomberg, as of 03/22/2023. U.S. large cap companies are based on dividend-payer SPY ETF holdings, returns and dividend yields from 9/30/1999 through 12/31/2022 from FactSet. The dividend-payer cohort was determined monthly by identifying securities that had a positive dividend yield for the period. The remaining securities are classified as non-dividend payers. IG securities were determined using historical S&P ratings from Bloomberg. 9/30/1999 data is the earliest available data for SPY ETF. This is estimated data. Results are presented gross of fund fees. **Past performance is not indicative of future results.**

This bifurcation of dividend policies between dividend-paying IG companies and NR companies or those that are rated BIG is notable when considering the lower overall volatility of IG dividend yields that also tend to be higher on average as well.

Additional research shows a relationship between dividend payment policies and a company's perception of its credit quality rating. For example, companies anticipating or receiving a credit rating downgrade are more likely to reduce dividends. In addition, once companies are upgraded, they are more likely to maintain the existing dividend policy.[5] As a result, companies with IG ratings are likely to maintain a smoother dividend stream, to focus on growing dividends per share, and avoid cuts.

Investors who focus on dividend equity strategies potentially can realize improved risk-adjusted returns when investing in the high-quality IG subset of companies relative to unrated, or below-IG companies. In addition to the stability and growth of the dividend income, we note that historical total returns among the high-quality IG subset of companies have exhibited lower standard deviation, Beta and less downside volatility as highlighted by a stronger Sortino ratio[6] relative to NR companies or those rated BIG (See Figure 2).[7]

FIGURE 2: CUMULATIVE MARKET VALUE (NET)[8,9]
U.S. LARGE CAPITALIZATION EQUITY DIVIDEND PAYERS

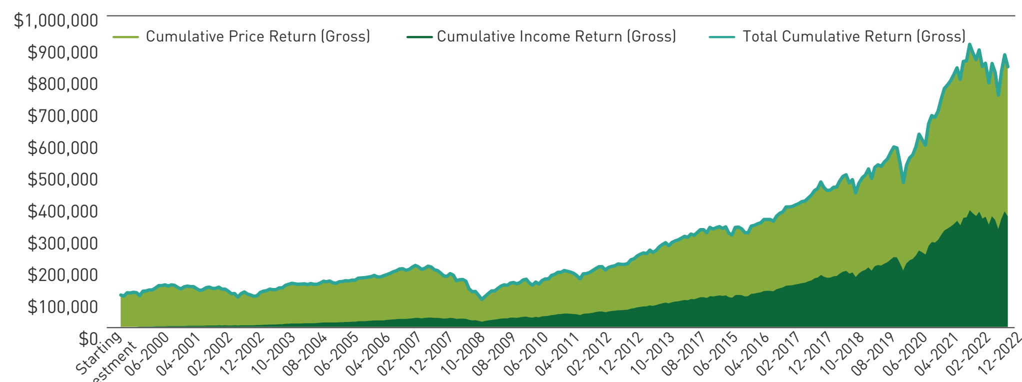


Description	Annualized Return (Gross)	Annualized Return (Net)[8]	Annualized Standard Deviation (Gross)	Beta	Sortino Ratio[10]
Investment Grade Dividend Payers	9.62%	9.53%	15.32	0.94	0.79
Below Investment Grade/Not Rated Dividend Payers	11.20%	11.11%	19.02	1.11	0.73
US Large Capitalization Companies	6.70%	6.65%	15.43	1.00	0.47

[8] Fee is 9.45 bps on the SPY ETF
[9] Based on an initial investment of $100,000.
[10] Sortino Ratio is a return vs. risk trade-off metric that uses downside deviation as its measure of risk.
Source: FactSet and Bloomberg, as of 03/22/2023. U.S. large cap companies are based on dividend-payer SPY ETF holdings, returns and dividend yields from 9/30/1999 through 12/31/2022 from FactSet. The dividend-payer cohort was determined monthly by identifying securities that had a positive dividend yield for the period. The remaining securities are classified as non-dividend payers. IG securities were determined using historical S&P ratings from Bloomberg. 9/30/1999 data is the earliest available data for SPY ETF. This is estimated data. Results are presented gross of fund fees. **Past performance is not indicative of future results.**

Dividend income has been a material portion of the total return stream for investors, accounting for more than 40 percent of total cumulative returns for the IG subset of companies (see Figure 3).[9]

FIGURE 3: INCOME AS A PORTION OF TOTAL RETURN
U.S. LARGE CAPITALIZATION IG DIVIDEND PAYERS



Source: FactSet and Bloomberg, as of 03/22/2023. U.S. large cap companies are based on dividend-payer SPY ETF holdings, returns and dividend yields from 9/30/1999 through 12/31/2022 from FactSet. The dividend-payer cohort was determined monthly by identifying securities that had a positive dividend yield for the period. The remaining securities are classified as non-dividend payers. IG securities were determined using historical S&P ratings from Bloomberg. 9/30/1999 data is the earliest available data for SPY ETF. This is estimated data. Results are presented gross of fund fees. **Past performance is not indicative of future results.**

As a result, we believe that we can leverage our expertise in assessing fundamental credit quality to assess financial robustness and identify growing and stable dividend payers. As shown in Figure 3, cumulative income stream has been a large portion of cumulative total returns and we believe a focus on credit quality is an important element of identifying stable and growing dividend payers.

An experienced IG fixed income manager may enhance a dividend equity strategy

Breckinridge has 30 years of experience in managing fixed income portfolios for high-net-worth individuals and institutional investors. Rigorous, fundamental bottom-up research is paramount to our investment process. Additionally, for more than a decade, Breckinridge has integrated environmental, social and governance (ESG) factors into the research process.

As the economy transitions away from an extended era of easy money, equity investors may benefit from an approach that assesses companies through the careful lens of fixed income research. Breckinridge believes that when fundamental credit research is combined with rules-based portfolio management, investors can better identify companies likely to sustain and grow dividends over the long-term.

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#326407 (3/29/23)

FOOTNOTES:
1. "*Global Credit Outlook 2023, No Easy Way Out*" S&P Global Ratings, December 2022.
2. "Dividend Smoothing and Debt Ratings," Aivazian, Varouj A.; Booth, Laurence; and Cleary, Sean. *Journal of Financial and Quantitative Analysis*, Volume 41, Number 2, June 2006. Copyright 2006, School of Business Administration. University of Washington, Seattle, Washington.
3. "Dividend Smoothing and Debt Ratings," Aivazian, Varouj A.; Booth, Laurence; and Cleary, Sean. *Journal of Financial and Quantitative Analysis*, Volume 41, Number 2, June 2006. Copyright 2006, School of Business Administration. University of Washington, Seattle, Washington.
4. Based on an initial investment of $100,000.
5. "The Influence of a Credit Rating Change on Dividend and Investment Policy Interactions," Khieu, Hinh D.; Pyles; Mark K., *The Financial Review*, Volume 51, Number 4, November 2016.
6. The Sortino ratio measures the risk-adjusted return of an investment asset, portfolio, or strategy. It is a modification of the Sharpe ratio but penalizes only those returns falling below a user-specified target or required rate of return, while the Sharpe ratio penalizes both upside and downside volatility equally.
7. Shows cumulative market value.
8. Fee is 9.45 bps on the SPY ETF
9. Based on an initial investment of $100,000.
10. Sortino Ratio is a return vs. risk trade-off metric that uses downside deviation as its measure of risk.

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All investments involve risk, including loss of principal. Diversification cannot assure a profit or protect against loss. Fixed income investments have varying degrees of credit risk, interest rate risk, default risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer-term securities.

Equity investments are volatile and can decline significantly in response to investor reception of the issuer, market, economic, industry, political, regulatory or other conditions. In addition, when interest rates rise, equity investments, including dividend-paying securities, may become less attractive to investors as bonds and other fixed-income investments may offer higher yields. There is no guarantee that a company will continue to pay, increase or declare a dividend.

Breckinridge believes that the assessment of ESG risks, including those associated with climate change, can improve overall risk analysis. When integrating ESG analysis with traditional financial analysis, Breckinridge's investment team will consider ESG factors but may conclude that other attributes outweigh the ESG considerations when making investment decisions.

There is no guarantee that integrating ESG analysis will improve risk-adjusted returns, lower portfolio volatility over any specific time period, or outperform the broader market or other strategies that do not utilize ESG analysis when selecting investments. The consideration of ESG factors may limit investment opportunities available to a portfolio. In addition, ESG data often lacks standardization, consistency and transparency and for certain companies such data may not be available, complete or accurate.

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