M&G Investments

Seeking to invest in dividend growth

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- Focus on dividend growth – we believe rising dividends put upward pressure on a company's share price
- Rising dividends can also help provide some form of risk mitigation against inflation, in our view
- Diversified approach to dividend investing – seeking to cope with different market conditions

The value and income from the fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested. Investing involves risk, including the loss of principal. Where any performance is mentioned, please note that past performance is not a guide to future performance. The views expressed in this document should not be taken as a recommendation, advice or forecast.

The power of dividends

Investing in companies that pay dividends can be a well-established strategy for equity investors, particularly those in search of income. However, we believe the real power of dividend investing comes from investing in companies that grow their distributions to shareholders over time.

We see a progressive (or rising) dividend policy as a sign of a company with good capital discipline. This is because a company has to grow its business to support a rising dividend stream. Companies that are committed to increasing their dividends have to limit the amount of cash that is invested in the business, and must seek to only select the most profitable projects. We believe that dividends should not be an afterthought; they should be an integral part of good company management, so that the business grows in a sensible manner.

There is another compelling reason to invest in companies with rising dividends, in our opinion. History shows that many companies with long track records of dividend growth have enjoyed strong performance in their share prices over the long run, with the result that investors have benefited from solid total returns over time. We believe dividends and share prices go hand in hand.

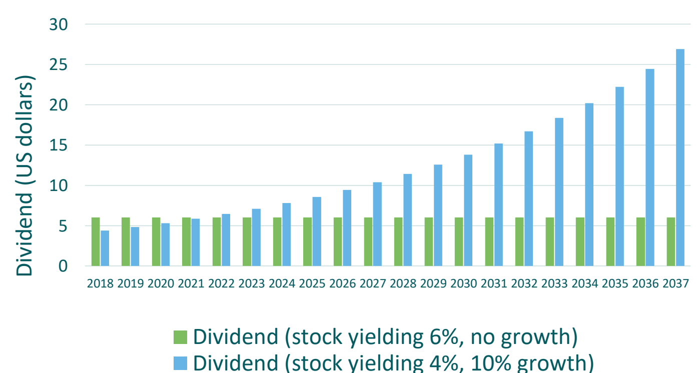
In the US, there is an elite group of companies called 'dividend aristocrats' that have increased their dividend for 25 consecutive years, or longer. While the dividend track record of these US firms might be exceptional, we believe 'dividend growers' with impressive track records of increased distributions can be found all over the world.

Focus on dividend growth

In light of the correlation between dividends and share prices, we strongly believe that investors should focus their attention on dividend growth, rather than dividend yield. Many traditional income funds use dividend yield as the key investment measure, but this approach is flawed, in our view. In our opinion, a high yield is not necessarily an automatic signal of value. In fact, we think a high yield is often a sign of a company in trouble or with limited growth potential; picking good stocks among such companies is an extremely difficult strategy.

Our investment process focuses on understanding a company's prospects for dividend growth – it is only when we have confidence in the future dividend stream that we assess whether the stock is available at an attractive yield. By applying this approach consistently, we believe that the fund can benefit from a favourable long-term tailwind: the combination of rising dividends putting pressure on the share price to perform, and the benefits of long-term compounding (see figure 1).

Figure 1: The power of long-term compounding



Source: M&G, 2022. For illustrative purposes only.

Estimated performance is not a guide to future performance.

Seeking a hedge against rising prices

An investment strategy that focuses on seeking companies that deliver growing dividends could also be valuable in an environment of high inflation, in our

opinion. Globally, prices have been rising rapidly in recent months.

Amid such strong inflationary pressures, it has become increasingly difficult to find sources of income that can keep pace with rising prices. However, across the globe there are numerous examples of companies that are increasing their dividend payouts by more than 5% a year, with many offering double-digit percentage dividend growth.

We believe that investing in these kind of companies, which offer consistently rising dividends, often above the level of inflation, could help provide a hedge to investors against the eroding effects of general price increases. By focusing on dividend growers, we aim to increase the fund's income distribution every year.

Three categories of dividend growers

Stocks are selected with different sources of dividend growth in order to build an strategy that could have the potential to cope in a variety of market conditions, and that should also be diversified across a broad range of countries and sectors.

It could potentially be possible to create portfolios of defensive stocks that might deliver steady dividend growth over the long run. (Defensive stocks are generally regarded as companies that can generate stable earnings throughout different market conditions). However, we are also aware that the performance of such a portfolio would have a clear bias, depending on the market environment: it could potentially outperform in an environment of low economic growth and low interest rates where safety is valued at a premium, but it could struggle when the environment is more robust and growth is available more cheaply.

To mitigate the defensive bias of dividend strategies, we believe stocks should be picked within clearly defined areas or categories, with distinct dividend characteristics.

Quality

High-quality companies are a natural hunting ground for investors seeking dividends. Typically, they are disciplined companies that already generate decent returns in excess of their cost of capital, but whose long-term potential for profitable growth is not given sufficient credit by the market. These quality companies, which tend to be large multinationals with good capital allocation skills, usually have strong market positions, stable cashflows and long-term growth opportunities that could allow them to potentially increase their dividends year after year.

Assets

Disciplined companies are by no means confined to stable industries; companies with good capital allocation skills can also be found in cyclical, or economically sensitive, industries. We actively seek cyclical companies that have the ability to increase dividends across economic cycles. These companies are much more difficult to find, but the strength of their asset base allows them to generate cashflows even during the tough times. The market's tendency to sell cyclical stocks indiscriminately during times of economic uncertainty presents opportunities for stockpickers to buy into disciplined companies in cyclical industries at cheap valuations.

Rapid growth

We should also seek to invest in beneficiaries of structural growth – companies that are growing quickly by virtue of their geography, industry or product line. These companies, due to their good capital discipline, are able to grow rapidly and generate solid cashflow at the same time, allowing dividends to increase at a fast pace.

The market has a tendency to underestimate the pace of growth in these companies and therefore this allows investors to potentially benefit from strong share price performance as well as a rapidly rising income stream.

Volatility presents opportunities for long-term investors

Periods of volatility such as that which followed Russia's military attack of Ukraine in February 2022 can present buying opportunities for investors with a long-term time horizon.

The resurgence of the value investment style (that is, stocks that are considered to be trading below their true value) in 2022 at the expense of growth underscores the importance of valuation. (Growth stocks are generally regarded as delivering rapidly increasing earnings and profits).

It is critical that we do not overpay for the growth we seek. Being selective will be paramount. We remain poised to take advantage of buying opportunities when they arise. Capitalising on these opportunities will ultimately determine performance in the years ahead, in our view, and we remain optimistic about the future.

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