Aristocratic Dividends

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Dividends are a crucial component of any long term equity strategy and, simply put, might be the only tangible return earned by the permanent owner of an equity asset. They significantly contribute to long term equity market performance (between 30% and 50% of total returns depending on the source consulted[1]) and excepting corporate action, drive capital appreciation by virtue of investors' expectations of future payments. As a result, all other things being equal, LT has a preference for companies that are able to maintain their dividend records over long periods and see steady growth as a valuable signifier of a sustainable business model.

In our hunt for these companies, we have recently chanced upon a list of US businesses with the most exemplary dividend records, published annually as one of Standard & Poor's lesser known indices, the 'Dividend Aristocrats'. The index tracks the performance of an elite sub-set of S&P 500 companies that have not only paid a regular dividend for an exceptionally long period, but have managed to grow it every year for at least the past 25. Despite the harsh criteria, there's actually quite a few 'aristocrats', 51 in all, encompassing a surprisingly broad range of sectors. The full register is available from Standard & Poor's website.

11 of the 51 index constituents are consumer goods companies, 6 are in finance and 7 produce pharmaceuticals or medical devices. These are all sectors to which LT directs research effort thanks to the enduring qualities of their brands, franchises and proprietary R&D, sustaining dividend growth for over a quarter of a century. The companies here are therefore suitably well represented in our own Lindsell Train investment universe with 15 making both lists. Indeed, the top flight of dividend growers, those boasting over 50 years of unbroken increases, contains several we follow including Procter & Gamble, Johnson & Johnson and Coca-Cola. However, today just one dividend aristocrat sits in our global portfolio: Brown Forman, the Kentucky based distiller of Jack Daniels, Southern Comfort and a portfolio of other established spirits brands. For the time being, the 14 others don't offer us attractive enough entry points but we monitor them closely lest the situation changes.

Manufacturing represents a large chunk of the remainder (almost a quarter of the index with companies such as Dover Corp and Nucor), a fact we note with raised eyebrows given it is an area we typically tend to avoid when looking for candidate companies. We remain wary of their capital intensive business models and concede even greater surprise at the apparent longevity of more than one auto-parts manufacturer (e.g. Genuine Parts, Leggett & Platt). A couple of well established oil and utilities companies (Exxon Mobil and Con Edison) also feature. Again whilst these imply capital intensity, they often operate under local monopoly positions supported by regulatory protection. This allows them to build scale and distribution and has clearly done a great deal to enhance their proven staying power.

Information technology companies are particularly notable to us by their absence from the list[2]. Perhaps this is an unfair criticism, as most IT or computing firms are young companies and haven't been around long enough to rack up 25 years of dividend payments. However, information technology in itself is not new; IBM listed in 1915 and home computers have been available since the late 1970s with Apple going public in 1980. Yet technology changes at such a pace that most of these companies have a hard time surviving for as long a period as 25 years, let alone growing their dividends over that time. Moreover, most tech companies prefer to reinvest retained earnings, either to take advantage of growth opportunities, or to protect themselves from the onslaught of disruptive developments. So why then do we hold any tech stocks? Well, our holding in eBay aims to capture the former of these outcomes and we would hope that their PayPal division is receiving all the investment it requires to break new ground as the global payment method of choice. We are encouraged by its successes to date (PayPal now accounts for 18% of all internet payments, growing its transaction volumes at 25% pa) but remain wary of the power new technology has to disrupt.

ADP is perhaps the one 25-year-dividend-grower that comes the closest to calling itself an IT firm, as it offers software and outsourcing to help businesses manage payroll and other back office functions. This service integrates ADP into the workflow of its customers and provides it with stable cash flows from renewal contracts. This has over time afforded it the leeway needed to transition its business model, incorporate advances in tech and ultimately to both survive and prosper. This characteristic also explains our investment in the enterprise software company Intuit. Although old enough, Intuit does not feature on the dividends index having only commenced payments last year. Management have previously preferred to reinvest retained earnings in new initiatives such as cloud computing and e-payments, a policy that has driven double digit revenue growth for the past decade (12.6% pa between 2001 and 2011). It should be noted that they have also been prolific buyers of their own equity, having reduced their shares in issue by more than 30% over the past 10 years.

Getting back to the index, what does 25 years of dividend increases actually tell us about a company's performance over that time, and does it give any clue as to its future? As our only holding from the list, let's take Brown Forman as an example. If you had bought the shares back at the start of 1987 and hung on to them tenaciously for the following 25 years, you would have raked in 4 times your initial outlay in dividends alone. Obviously the market spotted this somewhere along the way and those shares are now worth over 16 times their starting value. Over the same period the S&P 500 has appreciated 6-fold. We think such performance is entirely justified and continue to value Brown Forman for its unique heritage, stable family ownership and best of all the monopoly characteristics of its brands (if you want to drink Jack Daniels, then Brown Forman really are the only ones who can make it for you). It's worth noting that over that 25 year period, Brown Forman has managed to sustain an average return on equity of an impressive 23% whilst expanding its operating margins from 18% to 30%. Like Intuit, the company has also cut their shares in issue by an impressive 17% during the past decade.

Looking at the long term performance of the whole Dividend Aristocrats index, it would seem that this wider group hasn't done so badly either. In the 22 years since the end of 1989 (the earliest available year that S&P provides data for), the index has produced a total return of 11.0% per annum[3], a little behind Brown Forman's 11.9% annualised total returns, but still well ahead of the S&P 500's 8.3%. Bear in mind that as with most other indices, S&P's list is adjusted each year to include new entries (24 year dividend growers who have just announced their next annual increase) or exits (those cutting or simply maintaining their dividends). In fact if you're prepared to engage in some full-on data mining and reconstruct the index retaining the same 2012 constituents going back 25 years then the annualised returns are an even more impressive 10.3% on price appreciation alone.

Maybe this isn't all that surprising given the hindsight afforded. A company that's been able to grow its dividend over such an extended time period might be expected to outperform the market. Perhaps of more interest is whether we can now make any predictions about the futures of these companies, i.e. is there any more to come? Despite Brown Forman's impressive showing over the last 25 years, the current share price suggests that perhaps there is. Over the 25 years, Brown Forman has grown its dividends annually by 10.6%, or 7.7% ahead of US inflation. Excluding December's special $4 cash payment, the current regular dividend payout is 90 cents per share (two and a half times covered), for which you are being asked to pay $64. This might sound like a lot, but if growth were to continue at this rate for the next 25 years, then the dividends collected over this time would more than cover the cost of purchase. We argue that there is still more price appreciation to go for too, as applying a discount model to the company's free cash flows into perpetuity reveals how remarkably sceptical the market still is that they will be sustained4. For example, even if we require no real growth from Brown Forman' cash flows (i.e. maintaining the current $500m adjusted for future inflation), we still need to discount future years by a rate of 3.6% to reach today's NPV share price. This represents a material, and in our view unwarranted, risk premium above the generally accepted 'risk free' rate (i.e. the current US long bond yield of 3.0%).

To conclude, I thought it worth looking back at the dividend track record of LT's global equity representative portfolio (launched in March 2011). Taking data going back as far as Bloomberg will allow (a mean of 19 years) the 25 stocks in our portfolio have, in real terms grown their dividend payments by an average of 9.6% pa. That's ahead even of the S&P's US dividend aristocrats on 8.7% growth (24 year mean). Highlights include several Japanese holdings, with Canon, Astellas and the green tea maker Ito En all boasting more than 2 decades of double digit dividend growth, defying the country's deflationary environment. Whilst not adhering to a policy of growth every single year (and hence not making the S&P's index), Disney is also worthy of considerable praise having posted a dividend growth of 11.6% pa over the past 33 years.

Certainly there are provisos, and nothing about the future is assured. Several companies have fallen off the index after long and venerable runs, indicating that aristocratic status today provides no guarantees for tomorrow. Looking back to the Index's composition ten years ago confirms that warning. Just under half (29) of the 61 companies in the index in 2002 have survived as dividend aristocrats today. A decade earlier, the 2012 index retains just 9 of 1992's 46 companies. Clearly only the best of the best are able to persistently withstand erosion from competitive forces over such extreme time frames, and we will do our best to find them. However, by choosing from only those we judge to be at the very top of their game we think there is every chance that our companies will continue to flourish. Indeed, over their recently reported 1st quarter Brown Forman's now 137 year old Jack Daniels brand enjoyed an incredible 15% growth in sales. This is a trend we expect to see continue as new customers in emerging economies acquire the taste and disposable income to indulge and see no reason why the brand shouldn't retain its popularity for at least another 25 years.

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NOTES:

[1]For example a 2008 Standard and Poor's research note calculated that one third of the S&P 500's total returns since 1926 were attributable to dividend payments.

[2]Arguably, this paucity of tech representation hasn't done the Dividend Aristocrats index much harm, allowing it to miss out on much of the drama of the dotcom bubble in the early 2000s. Whilst it didn't partake in the boom of 2000, it also barely flinched during the following crash remaining almost flat between September 2000 and September 2002 whereas the S&P 500 shed around 40% of its value.

[3]Index total returns from calendar year end 1989 when the S&P Dividend Aristocrat index begins, to year end 2011. The list is an equally weighted index (rebalanced each quarter) of S&P 500 constituents (with a float adjusted market cap of $3bn or greater) that have increased their dividends every year for at least the past 25 years. Constituents are updated annually in January.

4The above discussion on the significance of dividend payments allows investments to be 'simply' valued as the sum of all future dividend payments. Whilst this falls foul of several practical complications (businesses can return capital in other ways or can be acquired at a premium for strategic reasons), as a concept it serves as a sensible starting point for those attempting the challenge of valuation. Of course, many companies (including some we own) pay no dividends, issue rather than buy-back shares and are under no threat of take over. They instead retain earnings, which if invested at consistently high returns should prove a more efficient way of creating value, growing the business and enhancing future returns. Clearly a rational long term investor should support this strategy and we are no exception, tending to view company management as the best placed to make such calls. This does however cause payout rates to vary considerably, making valuation methodologies based on dividend streams alone difficult for all but the most mature of businesses. As a result, we are prompted to look at free cash flows as a clearer indication of dividend paying potential and like many other investors, feel that these companies can be usefully valued using discount cashflow models. As with all such methodologies, the more confidence one can have in one's predictions, the more robust the model, otherwise uncertainty needs to be factored in with a risk premium. We are therefore particularly keen to find companies that keep this uncertainty to the absolute minimum, e.g. those with cash flows that have in the past proven especially reliable. After all, any business that has managed to throw off cash for a suitably long period must surely possess a business model with a certain degree of durability. Hence the value to us of the Dividend Aristocrats Index; the rules for inclusion are strict, however representation alongside such a venerable peer group seems to us as good a sign as any of a history of reliable cashflows.

Source for all figures unless stated otherwise: Lindsell Train & Bloomberg.

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