Our Guide to Dividend Income, in Two Charts

Instead of focusing on current yield, investors may be better served by considering the potential growth of dividend income over time.

Featured Contributor

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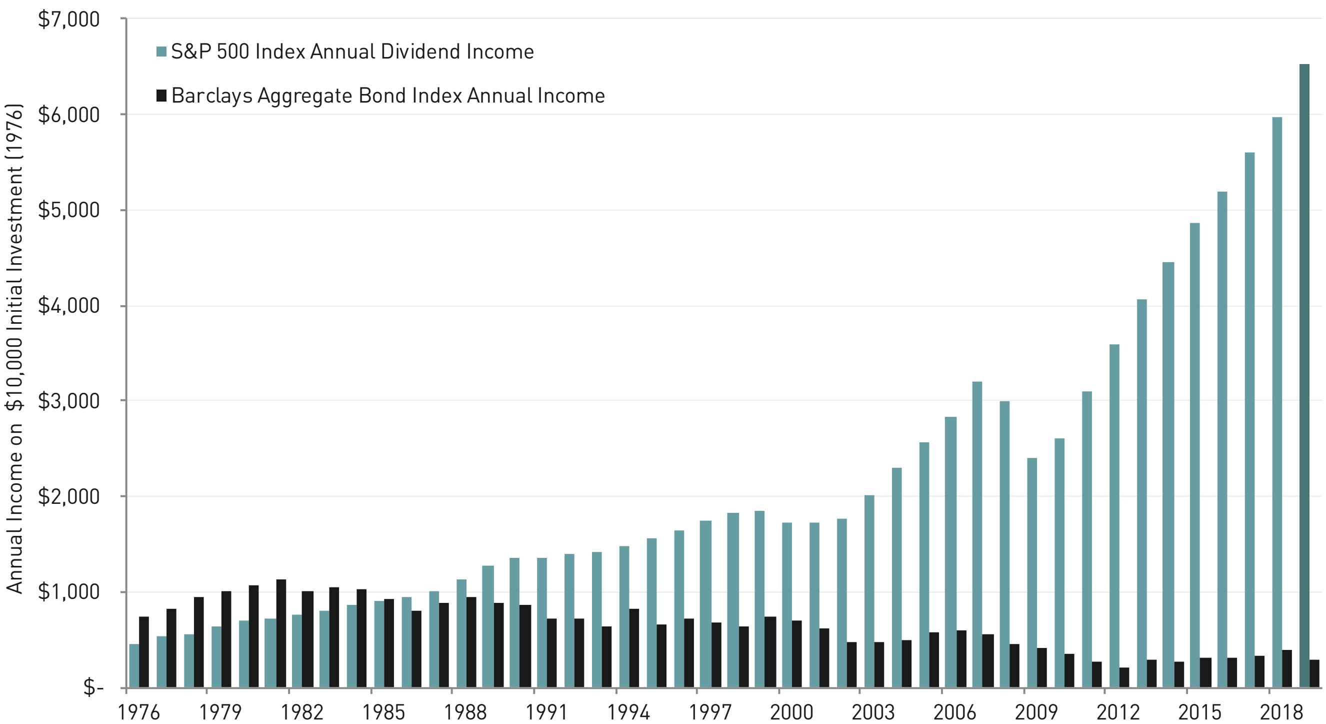
Chart 1. Dividend Stocks Historically Have Provided Income that Grows Over Time

Annual dividend income (S&P 500) and interest income (Bloomberg Barclays Aggregate) on $10,000 invested in the respective indexes, 1976-2019



	Initial Investment	First Year Income	Final Year Income	Ending Value
S&P 500	$10,000	$461	**$6,520**	**$358,220**
Barclays Aggregate	$10,000	$749	$283	$12,263

Source: Morningstar, FactSet, and Bloomberg Barclays Indices. Data as of December 31, 2019. The Bloomberg Barclays U.S. Aggregate Bond Index was launched in 1976. This example assumes that dividend and interest income is withdrawn each year. The change in principal value of each investment reflects capital appreciation only.

For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. The information provided is based on a hypothetical $10,000 investment in the indexes shown as of December 31, 1976. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. Dividends are not guaranteed and may be increased, decreased, or suspended altogether at the discretion of the issuing company. **Past performance is not a reliable indicator or guarantee of future results.**

In Brief

- With government bond yields at multi-year lows, investors may be searching for alternative sources of income. We think one such source worth considering is U.S. dividend-paying stocks.
- Perhaps more important than looking at dividend yield today is to consider that dividends can provide an income stream that may grow over time.
- That potential growth is illustrated by an important concept for dividend investors: Yield on cost, which is today's annual income relative to an originally invested amount.
- In our view, the potential benefits of dividend stocks could be enhanced by employing an active manager with a rigorous, disciplined approach to investing in the asset class.

Dividend

With government-related securities offering persistently low yields in recent years, investors have sought alternative sources of income. In that regard, one asset class that has attracted a lot of attention is dividend-paying stocks. In fact, as we highlighted in our October 7, 2019 *Market View*, the dividend yield on the S&P 500 index had exceeded the yield on the 10-year U.S. Treasury note for the first time since 2016. We are in a similar situation in early 2020, with the dividend yield of the S&P 500 right in line with the 10-year Treasury yield of 1.8%, according to Bloomberg data.

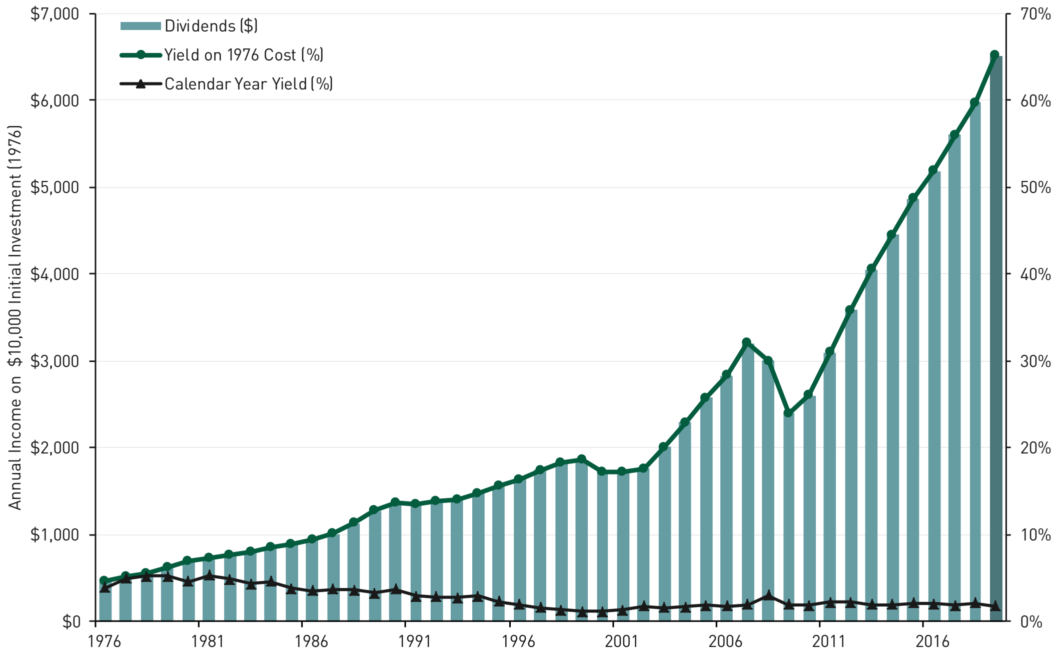
But focusing on the current yield misses out on what we believe is the real power of dividends: they not only provide a source of income today, but an income stream that has the potential to grow significantly over time. This is illustrated in Chart 1, which compares the annual income an investor would have received from a $10,000 investment in 1976 in (1) the S&P 500, and (2) the Bloomberg Barclays U.S. Aggregate Bond Index (the Aggregate Index), a broad measure of the U.S. investment grade bond market, *assuming the investor withdrew the income each year. [Note: The start date coincides with the inception year of the Aggregate Index.]*

As one might expect, the bond investment paid a higher current income in the first year, as, broadly speaking, bonds typically yield more than equities. However, the picture changes over time. As the underlying value of the equity investment grew, the annual income from dividends soon exceeded the income from bonds, with the margin greatly increasing over the years. In fact, by the end of 2019, the stock portfolio had grown to more than $350,000 and was producing more than $6,500 in annual income, or more than 14 times the initial income stream. *[Reminder: The ending market value figures reflect price appreciation only, as the chart assumes that dividends are being withdrawn each year.]*

What about the bond portfolio? Over 43 years, its value had barely changed: since inception, approximately 99% of the cumulative total return of the Aggregate Index has come from coupon return, with only 1% from price appreciation. The income stream has declined markedly, from $749 in Year One to $283 in the final period.

Chart 2. Dividend Paying Stocks Have Historically Provided a Growing Source of Income

Data for the S&P 500 for the period 1976–2019



Source: Morningstar, FactSet, and Bloomberg Barclays Indices. Data as of December 31, 2019. The Bloomberg Barclays U.S. Aggregate Bond Index was launched in 1976. This example assumes that dividend and interest income is withdrawn each year. The change in principal value of each investment reflects capital appreciation only.

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Yields for Today—and Tomorrow

To be sure, the annual dividend yield on the S&P 500 has declined over this period, from more than 5% in the late 1970's to below 2.0% in recent times. But instead of just looking at annual yield, one may want to consider *yield on cost*, or the income received today as a percentage of the original $10,000 investment (see Chart 2).

If you consider that the original $10,000 investment in 1976 is now generating an annual income of over $6,500, as illustrated in Chart 2, the yield on cost exceeds 65%. These numbers may seem extreme due to the long time horizon of this example, but a similar story can be told looking at shorter periods: as the value of the underlying stock portfolio rose over time, the investor earned more income from the dividend yield on an increasingly larger dollar amount.

Bonds can certainly play a role in an investment portfolio, offering the potential for greater stability and lower portfolio volatility. (Read more about where we see opportunities within today's fixed income market.) But dividend paying stocks can also provide a source of income, with the potential for capital appreciation and a growing income stream in the future, which may be of particular interest to those planning for retirement income.

Alternative Approaches to Dividends

But simply chasing the highest dividend yields has potential drawbacks. First, research has shown that the highest dividend payers have historically lagged the broader universe of dividend paying stocks. Second, those sectors that have traditionally offered the highest dividend yields—like real estate, utilities, and consumer staples—have benefitted from the recent bias for safety. As a result, these sectors now trade at relatively high valuations, while offering relatively low earnings growth. Finally, these sectors, the so-called "bond proxies," tend to be very interest rate sensitive, and can face headwinds during periods of rate volatility.

Instead, we believe investors may wish to consider a more balanced approach to dividends that limits sector biases, and seeks to identify the most attractively valued dividend stocks from all sectors, potentially enabling them to benefit from dividend income and a greater chance of capital appreciation.

Alternatively, rather than focusing on high dividend payers, one may want to consider a portfolio of dividend growers. Companies with consistent dividend growth are often market leaders with stable business models, strong balance sheets, and management teams committed to shareholders. Given the high-quality nature of this universe, a portfolio of consistent dividend growers tends to be less volatile than the broader market in times of stress, and may provide investors with a source of rising income and long-term growth.

We think the potential long-term benefits of dividend paying stocks are clear. However, we believe a thoughtful approach to dividend investing, which, in our opinion, requires in-depth research and a rigorous portfolio construction process, is vital to accessing these benefits while balancing risk and reward.

A Final Word

Coming into 2020, we remain positive on the outlook for the U.S. economy, and believe investors should maintain exposure to equities. As Lord Abbett Partner and Director of Strategic Asset Allocation Giulio Martini opined in a previous *Market View*, "the equity risk premium [for U.S. stocks] is still very positive and the equity earnings yield compares very favorably to the 10-year Treasury bond yield."

We believe dividend payers represent a particularly attractive opportunity within equities. As investors are weighing their options for income, they should not overlook the power of dividends and their potential to provide a source of income that can grow over the long term.

A Note about Risk: The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. While growth stocks are subject to the daily ups and downs of the stock market, their long-term potential as well as their volatility can be substantial. Value investing involves the risk that the market may not recognize that securities are undervalued, and they may not appreciate as anticipated. Smaller companies tend to be more volatile and less liquid than larger companies. Small cap companies may also have more limited product lines, markets, or financial resources and typically experience a higher risk of failure than large cap companies. The value of an investment in fixed-income securities will change as interest rates fluctuate and in response to market movements. As interest rates fall, the prices of debt securities tend to rise. As rates rise, prices tend to fall.

No investing strategy can overcome all market volatility or guarantee future results.

Dividends are not guaranteed and may be increased, decreased, or suspended altogether at the discretion of the issuing company.

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Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes.

Bond proxies refer to stock-market sectors containing mature, slow-growth companies that return a large portion of their earnings to shareholders when paying dividends, resulting in "bond-like" yields for investors.

Dividend yield is equal to the dividend divided by the stock price. Dividend yield is one measure of a stock's value. A high dividend yield may indicate that a stock is relatively inexpensive.

Dividend policy: A stock is classified as a dividend payer if it paid a cash dividend any time during the previous 12 months, a dividend grower if it initiated or raised its cash dividend at any time during the previous 12 months, and non-dividend payer if it did not pay a cash dividend at any time during the previous 12 months.

Yield is the annual interest received from a bond and is typically expressed as a percentage of the bond's market price.

Yield on cost is a measure of dividend yield calculated by dividing a stock's current dividend by the price initially paid for that stock.

The **Bloomberg Barclays U.S. Aggregate Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

The **S&P 500® Index** is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

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