Morningstar’s Dividend Playbook

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Josh Peters, CFA is Morningstar’s director of equity-income strategy, the founding editor of DividendInvestor, and manager of its Dividend Select model portfolio.

- Launched in January 2005
- Released companion book in 2008: The Ultimate Dividend Playbook
- Received over 1,200 dividends thus far from our active portfolio holdings—all of which reflect actual, trades in real money, Morningstar-funded brokerage accounts
- Received 398 dividend increases since inception; just 16 dividend cuts
Why Dividends?

» Practical advantages for investors
  » For retirees, cash to fund regular portfolio withdrawals without having to sell shares
  » For savers, cash funds income growth/wealth accumulation through reinvestment
  » Better class of companies—typically well-established, defensive, financially healthy
  » Makes stocks easier to analyze and easier to own

» Much-needed discipline for issuers
  » Demonstrates ability willingness to reward shareholders directly
  » Represents a long-term commitment, enabling investors to return the favor
  » Helps block potentially self-serving or dubious allocations of capital

» Dividends are the ultimate source of security values
  » Bottom line is cash flow—not just to the firm, but directly to the investor
Numerous academic studies show that high-yielding stocks outperform the market over the long run.

Our study: Highest 30% of yields beat the market in 53 of 60 rolling 10-year CAGRs beginning in 1945.

Average beat of 206bp per year—or an extra $575 after 10 years on each $1,000 invested.

Source: Data from Kenneth R. French (http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html), Morningstar analysis.
Step 1: Defining an Investable Universe

- While the S&P 500 pays only 2.0%, much higher yields are available, especially in certain sectors—consumer staples (2.6%), energy (2.9%), utilities (3.6%) and telecommunications (4.9%)
- Heavy share buybacks and/or rapid dividend growth without a decent yield are no substitute for adequate current income
- Our basic stock screening parameters:

![Premium Stock Screener](http://screen.morningstar.com/AdvStocks/Selector.html#AnchorSelector), results as of 3/19/2015.
Step 2: The Dividend Drill
**The Dividend Drill: Is It Safe?**

- **Dividend safety** is the number-one priority for income investors—more than interest rates, changes in economic trends, even valuations.

- **How to avoid dividend cuts:**
  - Economic moats, which defend profitability and cash generation
  - Healthy balance sheets
  - Payout ratios that balance income against internal reinvestment needs and a cyclical safety margin
  - Continued dividend growth is the best indicator of safety, though even this isn’t perfect ...

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**Our Record: Outcomes by Dividend Action**

- Increased Dividends (89% positive returns)
- Flat Dividends (71% positive returns)
- Reduced Dividends (19% positive returns)

Outcomes reflect realized total returns for full holding periods of each active DividendInvestor portfolio position. Data through 3/19/2015. Source: Morningstar
The Dividend Drill: Will It Grow?

- **Dividend growth** drives total return by:
  - Furnishing additional income over time
  - Encouraging long-term capital appreciation
- Key drivers of dividend growth:
  - Earnings growth: Consider volume expansion, pricing power, future for operating margins, role of acquisitions/share repurchases
  - Dividend policy: Will dividends rise faster/slower/equal to per-share earnings?
- Useful approach: “extend the trend”
  - Latest 5- or 10-year rate as a stepping-off point for consideration of future performance

Data as of 3/19/2015. Source: Morningstar, company reports
The Dividend Drill: What’s the Return?

- **Total return** is always the bottom line, not income alone or growth/capital gains alone.

- Is the absolute return indicated by a safe current yield plus sustainable long-run dividend growth acceptable?
  - Hurdle returns of 7.5% for low risk companies with above-average yields;

- Am I paying a sustainable valuation: will total return = dividend yield + dividend growth?
  - Consider valuation: Our main indicator is price/fair value (preferred below 1.0)

- Preferred outcome is total return > yield+growth, valuation discipline necessary to avoid shortfalls.

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Data as of 3/19/2015. Source: Morningstar
Dividend Drill in Action: Verizon Communications

The Dividend: Is It Safe?
- Free cash flow is the best indicator; covers dividends about 1.5 times
- Economically defensive business; narrow moat and BBB credit rating

The Dividend: Will It Grow?
- Dividend increases each year since 2005
- Modest but accelerating growth recently

The Dividend: What’s the Return?
- Trading slightly below $50 fair value
- 4.5% yield plus 4%-5% estimated dividend growth suggests roughly 9% total returns

10-Year Earnings and Dividend Summary

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CAGR: 2.6% 3.3%

Data as of 3/19/2015. Source: Morningstar, company reports
Step 3: Portfolio Management

- What drives an individual stock’s returns works even better for a portfolio as a whole
  - Our Dividend Select portfolio targets 3%-5% yields, 5%-7% dividend growth, 9%-11% total returns
  - Currently yielding 3.9% with 6.1% long-run income growth profile
- Earning yields that are double the market average requires embrace of different results: *We go where the (safe and growing) dividends are...*
Our Results: Beating the Market Without Even Trying

Cumulative Total Return: DividendInvestor Portfolios vs. S&P 500

- Standard & Poor's 500 (CAGR: 7.9%)
- Combined DividendInvestor Portfolios (CAGR: 9.2%)

Cumulative Price Appreciation
- S&P 500
- DividendInvestor

Cumulative Dividend Return
- S&P 500
- DividendInvestor

Data from inception (1/7/2005) through 3/19/2015. Source: Morningstar
Josh Peters, CFA, owns all of the stocks held in the Dividend Select portfolio, including GIS, JNJ, O, VZ.