Equity Perspectives

An Ameriprise Investment Research Group publication

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Dividend Dynamics: Total Return is Key

This is the first in a series of new dividend reports, Dividend Dynamics, each focusing on different attributes and considerations impacting decisions to use dividend-paying securities as part of a diversified equity portfolio.

Key Takeaways

- In our view, dividend investing has become a larger portion of the benefit to owning equities for wealth accumulation.
- We believe investors should focus more on total shareholder return rather than simple price appreciation, as it includes dividend income.

Dividends are a cash return on investment, as well as potential indicators of quality, value, and future growth. A dividend is a distribution of a portion of earnings or free cash flow, which the Board of Directors declares for shareholders to participate in the company's growth. Dividends are paid in cash, additional shares, or other property (e.g., the spin-off of a subsidiary).

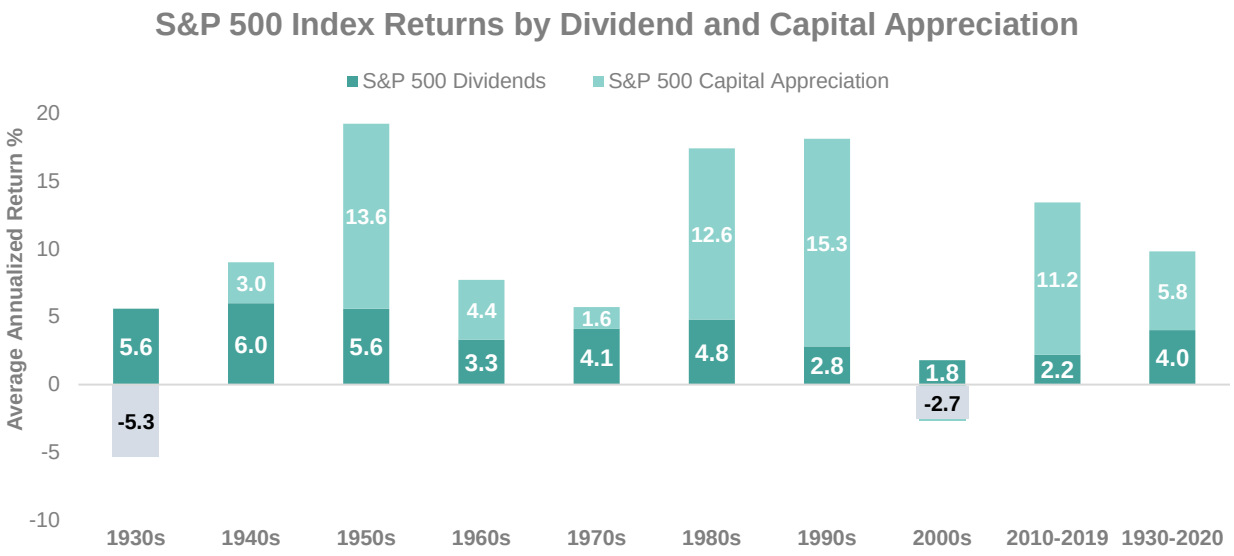
Whether investors are striving for growing income or an attractive total return, dividends can contribute meaningfully. Quarterly payments can provide a steady stream of current income, while reinvestment and compounding can fuel long-term wealth accumulation. Scientist Albert Einstein reputedly said compound interest was "…*the most powerful force in the universe…"* while famed investor Warren Buffett often attributes his success to compound interest. Furthermore, an increasing dividend rate may provide a hedge against inflation and the loss of purchasing power. In our opinion, using dividends in your equity allocation can make the difference in achieving your long-term retirement goals.

This report, "*Total Return is Key,"* discusses why equity investment performance should focus on total return rather than simple price appreciation. In a year of historic selloffs and rallies, investors can often overlook the income component of their return. However, we believe dividends help investors raise their portfolio's quality factor and generate attractive risk-adjusted returns over the long-term.

Dividends Enhance Total Returns

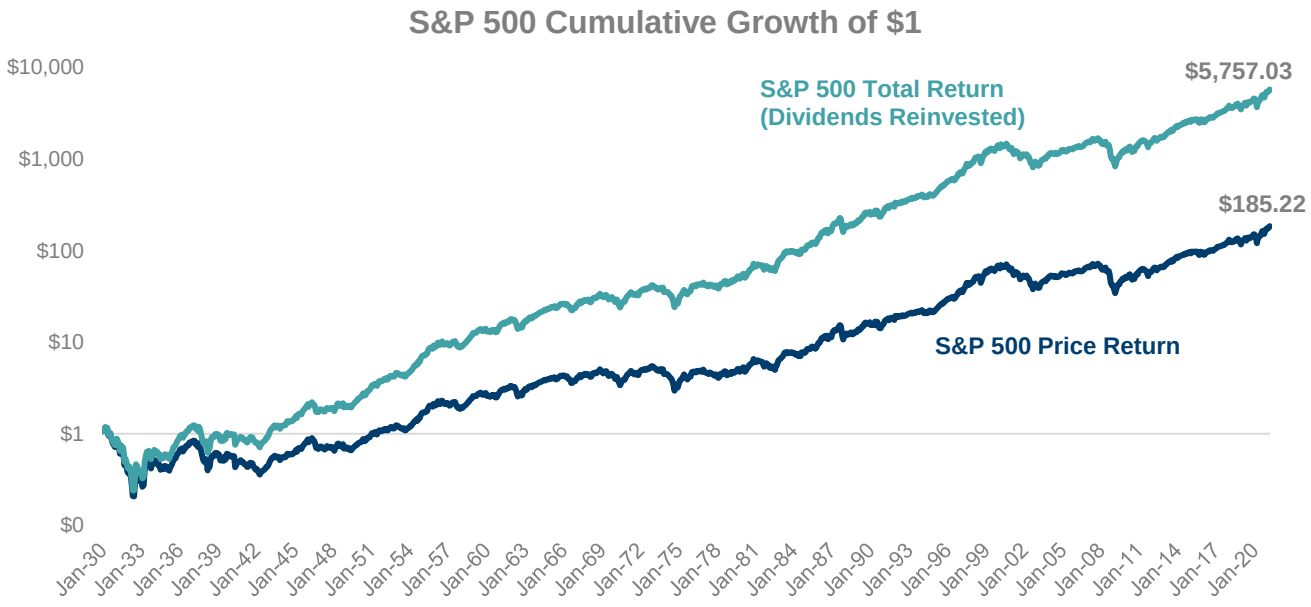
Assuming no fees or taxes, total return is defined as an investment's price appreciation plus any dividends received (income). For example, if an investor's common stock appreciated 10.0% in a year and paid a cash dividend resulting in a 2.0% yield, the year's total return is 12.0%. In our view, investors often ignore the income portion of their total return. However, we illustrate this as the most powerful portion for driving long-term wealth accumulation over a 5-year, 10-year, and 25-year time horizon.

Over time, dividend-paying stocks can produce competitive returns and often be more appealing than non-dividend-paying investments on a risk-adjusted basis. According to data provider, *S&P Dow Jones Indices (SPDJI),* the annualized total return, consisting of capital appreciation and dividends reinvested, of the S&P 500® Index from 1926 to year-end 2020 was 10.38% per year. The dividend component of that total return was 38.72%.



Source: Columbia Threadneedle Investments and American Enterprise Investment Services Inc. Past performance is no guarantee of future results and this example is for illustrative purposes only.

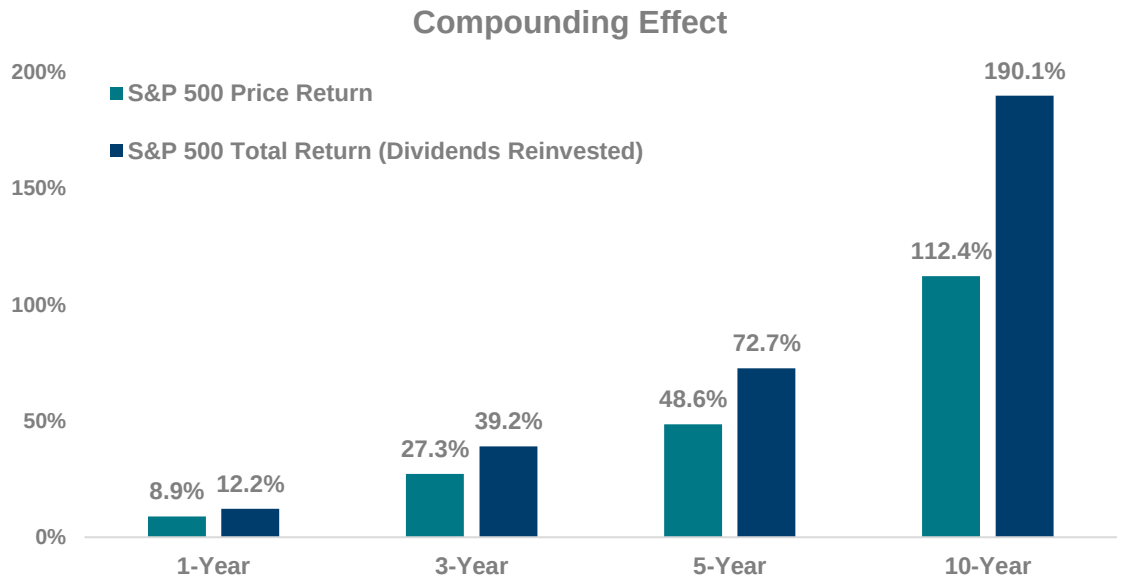
The impact of compounding dividends for stocks included in the S&P 500 Index can be profound. While it is not possible to invest directly in indexes, at the end of March 2021, the theoretical impact of compounded dividends in those stocks would have produced total returns that vary greatly. We chose the S&P 500 Index because it is one of the most widely followed indexes and has many of its constituent members that pay cash dividends.



Source: Morningstar, S&P Dow Jones Indices, American Enterprise Investment Services Inc. Monthly data as of 03/31/2021. Data prior to February 1970 for the S&P 500 Total Return Index reflects the predecessor Ibbotson/Morningstar Index. Past performance is no guarantee of future results and this example is for illustrative purposes only. It is not possible to invest directly into an index.

Time Matters in Compounding

To further illustrate the importance of compounding, we look at the impact of the time horizon on investment performance. As we move from 1-year, 3-year, 5-year, and finally 10-year periods for S&P 500 returns, the compounding effects between price and total return widen as the time horizon increases.



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Deciding Between Dividend Growth or Yield

Although investing for decades can maximize the benefits of compounding, we acknowledge not all investors have decades to wait. We encourage investors to decide what type of dividend portfolio best meets their time horizon and income goals. We classify dividend-paying equities into two segments: dividend growth and high yielding. High dividend growth companies typically increase their dividends faster than the overall market, whereas high-yielding companies payout a greater percentage of earnings as dividends.

Select a Dividend Strategy that Meets Your Needs	
Dividend Growth	**High Yielding**
✓ Above Average Dividend Growth	✓ Below Average Dividend Growth
✓ Modest Yields between 1% and 3%	✓ Yields Considerably Higher than 3%
✓ Generally Higher Earnings Growth	✓ Generally Slower Earnings (Mature)
✓ Investment Style is Growth	✓ Investment Style is Value

Source: American Enterprise Investment Services Inc.

Choosing the right type of dividend stock portfolio is important. For individuals in or nearing retirement, high-yielding income might be more appropriate. On the other hand, high dividend growth may be more suitable for individuals with a longer time horizon, and those in-between could do a combination. We recommend investors consider possible dividend strategies as part of their asset allocation discussion with their financial advisor.

Over the last decade, asset managers, academics, and the financial press have engaged in a heated debate over the merits of Growth and Value style investing due to the solid outperformance of Growth stocks. By their nature, most dividend stocks are viewed as Value stocks. While performance has been challenging for Value and income investment strategies since the Great Recession, we believe investors' increasing risk appetites amid a global backdrop of central bank stimulus and historically low interest contributed to the underperformance. In our view, the backdrop of persistently low long-term interest rates appears to be nearing an end given the recent rise in 10-year Treasury yields. We believe rising rates could improve the performance outlook for Value investing in 2021 and beyond as monetary policies pivot towards managing growth expectations as the pandemic's economic ramifications lessen.

Additional Resources

- *Attractive Yields & Stable Payouts*
- *Recommended List Investment Strategies*
- *Equity Recommended List and Company Notes*
- *Starting Point Recommended List*
- *Ameriprise Model Portfolios*

Further Reading on Dividend Dynamics

This report is part of a series on dividend investing authored by the Investment Research Group. We believe a consistent and objective approach to assessing quality companies capable of generating sustainable free cash flow can help investors make better decisions when selecting dividend-paying equities. We believe that the topics discussed in this report, in conjunction with the entire series, help build the framework for providing the development and implementation of a sound dividend growth and/or dividend yield strategies. For further reading on other aspects of dividend investing topics, see the reports and resources in the table to the right.

Conclusion

Dividend investing has become a larger proportion of the benefit of owning equities, in our view. Dividends have the potential to significantly improve total returns and enhance risk-adjusted returns to help mitigate volatility. Dividend growth and income can potentially neutralize inflation, produce tax shields, and take advantage of compounding and reinvestment that is generally not available in other income-producing investments (particularly fixed income). Our advice remains to start small, grow over time, and remain in the right dividend strategies. Stay dedicated to quality factors and understand that wealth accumulation takes discipline and patience. The next report in the series will focus on those quality factors that could help drive investors' decisions during the selection process.

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Non-investment-grade (high-yield or junk) securities present greater price volatility and more risk to principal and income than higher rated securities.

Growth securities, at times, may not perform as well as value securities or the stock market in general and may be out of favor with investors.

Value securities may be unprofitable if the market fails to recognize their intrinsic worth or the portfolio manager misgauged that worth.

DEFINITIONS OF TERMS

A **10-year Treasury note** is a debt obligation issued by the United States government that matures in 10 years. The 10-year yield is typically used as a proxy for mortgage rates, and other measures.

INDEX DEFINITIONS

Indices shown or mentioned are unmanaged and do not reflect the impact of fees. It is not possible to invest directly into an index.

The Standard & Poor's 500 Index (S&P 500) is an index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 Index is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

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