Stocks Growing Dividends Outperform when Interest Rates Rise

Description

The other day an associate of mine shared an interesting article by Fidelity Viewpoints focused on four ideas of where to look for dividend stocks when interest rates rise. As pointed out by the author, low rates over the last several years have driven investors to find current yield, but rising rates may prompt investors to sell these stocks, driving prices down.

So what is a dividend investor to do?

The first idea Fidelity offers up is to look for companies with the potential to increase dividends. Today, I will dig deeper into this idea and discuss a few dividend growers that may surprise you.

Why is dividend growth important?

When looking for dividend paying investments it can be tempting to look for the highest yielding stocks. Admit it, you have run a screen looking for the highest yielding stocks. Don't worry, we've all done this. There is nothing wrong with a high yielder screen, but it should be just one out of several variables used to narrow down the field.

High yield alone, even from a quality company with steady cash flows, is simply not always enough. Inflation is always lurking around the corner and over time will eat away at a stagnant payout. This is a big reason why dividend growers tend to outperform stocks with stagnant dividends.

Look for the signs

To find these dividend growers, there are three qualities that I look for – the ability, the desire, and a proven track record.

The ability

In order to continue to grow dividends, the company must have a strong balance sheet and the ability to produce increasing cash flows from which the dividends are paid.

Take **Suncor Energy Inc.** (TSX: SU, NYSE:SU) for example. Over the last four years cash flow has increased significantly from $2.8 billion in 2009 to $9.75 billion in 2012. During that same time period, the company has increased its quarterly dividend from $0.05 to $0.20. While growth in operating cash flow has declined slightly in 2013, free cash flow before dividends should still be near $2 billion leaving ample room to pay and potentially increase dividends without using leverage for capital expenditures.

The desire

Management has many alternatives when it comes to allocating its free cash flow. Some alternatives are good and some, not so much. As long as the company is investing adequate capital into future growth, paying dividends is an excellent alternative for shareholders. The best dividend growers will have a shareholder friendly management that is focused on total return. As evidence of this desire, it is always good when management puts itself on the record and makes total return and dividend growth part of its culture.

At **Tim Hortons Inc.** (TSX: THI, NYSE: THI), management has a stated goal to pay up to 30 – 35% of annual, normalized prior-year net income in dividends in the current year. In order to meet that goal, management has been investing in both the business and in its shareholders. In addition to capital expenditures to support continued growth, the company has been buying back shares and recently increased its dividend payout ratio to the 35% – 40% range. Management has shown a strong desire to return capital to shareholders with six consecutive dividend increases which averaged 20.6% annually as well as reducing the shares outstanding by nearly 22% since going public in 2006.

The track record

What better evidence is there that a company is dedicated to rewarding shareholders than a track record for doing so. **Corus Entertainment Inc.** (TSX: CJR.B) has been paying, and regularly increasing its dividend since late 2003. Since the beginning of 2004, the dividend has been increased at a compound annual growth rate of approximately 50%.

Although Corus has announced that it will fall short of earnings estimates for 2013, it has reaffirmed its guidance for free cash flow of approximately $140 million. Based on this guidance, dividends in 2013 will be approximately 60% of free cash flow, leaving plenty of room to maintain and further increase the dividend in 2014 as economic conditions improve.

The bottom line

While it is certainly understandable to want to stay with your slow growing, high yielding stocks, it's worth your while to look at dividend growth opportunities. A study by Ned Davis Research showed that stocks that initiate and grow dividends had an average annualized return of 9.5% from 1972 – 2012 compared to 7.2% for dividend stocks that did not increase dividends.

A annual variance of 2.3% may not sound like much of a difference, but it can have a material impact on your portfolio over thirty years. For example, an investor with $100,000 invested in dividendgrowers for that thirty year time frame would have a portfolio valued at approximately $1.52 millionwhen all is said and done. This compares to the investor that stuck with the stagnant dividend payersand only grew their portfolio to $800,000 over the same time frame.

Investing in dividend growers can mean the difference between retiring comfortably as a millionaire or just wondering what it might be like. It's your call!

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