The Marriage of Growth & Dividends

GREG ADAMS, CFA
Senior Vice President, Portfolio Manager

ALEX BERNSTEIN: Hello, I'm Alex Bernstein and you're listening to The Alger Podcast, Investing in Growth and Change. When investors think of Alger, they likely think of growth, innovation and disruption – and maybe not so much of dividends, and dividend-generating companies. And yet, dividends and free cash flow may be two of the greatest themes of the Alger Growth and Income strategy, which has been managed for more than a decade now by Portfolio Manager, Greg Adams. Here to talk about why he continues to believe so strongly in dividends and free cash flow – and why investors might not separate those themes from growth – is Greg Adams. Greg, thanks so much for joining me this afternoon.

GREG ADAMS: Happy to be here, Alex. Thanks.

ALEX: Greg, before we get into the strategy, where do you think we are right now in the markets?

GREG: Well, there's always a lot going on in the markets, and I think right now, not unlike the start of the year, the focus continues to be on interest rates and inflation. I think the differences though now is that I think there's a lot more confidence that we've hopefully seen the peak in inflation and that we're pretty close to the Fed being done with interest rate rises. So as a result, there was a lot of, of course, fear about a recession coming into this year. A lot of that has evaporated now, more thoughts of a soft landing or maybe even no landing, and then of course the AI kind of frenzy is certainly something that continues to be a focus for the markets.

I think one concern with what's happened in rates over the last year and a half, there's big lag effects with that. So, we're still likely to see some slowing in the economy. I think some headwinds for the consumer have started to develop. Savings have been depleted. We're starting to see a repayment of student loans have some impact.

So yes, I guess my concern is now that we've kind of lessened the recession fears, that a month or two down the road we start to see worries about economic weakness coming back into the market.

ALEX: Greg, as I mentioned in the beginning, dividend-producing companies and companies that experience strong cashflow are two significant themes in your portfolio. Why are they so important?

GREG: I guess first and foremost, income is part of the name. It's growth and income. So, in order to generate income, you need dividends to do that. And then we do have a yield target. In order to do that, we have to focus on dividend-paying companies.

ALEX: And you think the ideas of growth and dividends can be successfully woven together?

GREG: Yes, absolutely. I mean I think typically companies that are paying dividends tend to be more mature and further into their life cycle, but there's plenty of companies that pay dividends that continue to grow very nicely. Really the sweet spot is those that are paying dividends but still growing and growing the dividends and having the free cashflow to be able to facilitate that.

ALEX: How have dividends historically contributed to total returns in the stock market?

GREG: So, if you look at the market over ten-year rolling periods, dividends are often a very significant part of the total return in the market. For the entire decade of the 2000s, in fact, they were all of the return in the market. The actual price return was negative, but if you look at the ‘90s, the decade that preceded that, it was pretty low, only about 16 percent, but typically 20 to 40 percent of the return you get over any ten-year period is because of dividends and the compounding of dividends, and if you go out over longer periods of time, it's even more dramatic.

ALEX: And yet, you think this is underappreciated by investors?

GREG: I think it's easier to focus on the short term. So, people miss that compounding aspect of dividends. I mean I think if you look over the last 20 years, it's 40% of the return, and over the past 50 years, approaching 75% of the return is from being able to take those dividends and reinvest them into the index, into the stocks and get that compounding element.

ALEX: Do you think there's a perception that dividend-focused companies are “unsexy”?

GREG: Yes, absolutely, and I think they are a bit unsexy in some ways. I mean like I said before, they're more mature. They're a little further into the lifecycle because you need to be there to initiate a dividend. You have to be generating the free cashflow. So, a lot of the companies that are super exciting at any one point in time are often newer companies reinvesting into the business, not necessarily thinking about dividends.

ALEX: Was the rising interest rate economy of the last two years a boon to dividend growing companies?

GREG: Yes, it was and I think for a few reasons. I think dividends tend to be more stable. I mean there have been a few years in market history where dividends have shrunk dramatically, but they tend to be much less volatile than earnings. So, in periods like we had last year where the market's a little weak, people worried about inflation. That lower volatility aspect of dividends and, as a result, dividend-paying companies is fairly attractive.

I think the other thing in an inflationary environment is dividend growth tends to pretty much mirror Consumer Price Index (CPI) growth not necessarily in any one year, but if you look at kind of three-, five-year, ten-year periods, dividends tend to grow in line and are pretty reasonably correlated with inflation. So, I think that is another attractive development and certainly has helped last year especially.

ALEX: And what do you think the impact may be as rates stabilize?

GREG: I think if rates stabilize, it's still a good environment for dividend-paying stocks. Dividend payout ratios are pretty historically low. So, I think there's room to grow dividends. I think companies need to have confidence in order to initiate and grow dividends because it's unlike stock buybacks which are also important but can be much more variable. When you make a commitment to a dividend, companies do not want to cut dividends if at all possible, so they need to have a little bit more confidence. So, I think stabilizing of the rate environment helps on that front. I think lots of cash and historically low payout ratios is a pretty good environment for growing dividends.

Then the other thing that's kind of interesting this year is the Inflation Reduction Act, the IRA. As part of that, there's now a one percent surtax on stock buybacks. So I think on the margin, that will start to favor a little bit more movement towards dividends and dividend growth.

ALEX: Greg, you also greatly favor companies being able to effectively generate free cash flow?

GREG: Yes, I do think free cashflow is super important because that is really what companies use to reinvest in their business and continue to grow and return to shareholders ultimately. So, you need to have the free cashflow in order to pay the dividend, and then one of the things I focus on is that payout ratio of that cash to the current dividend if a company is paying a dividend and then how much extra is there for them to still reinvest in the business but also increase and grow that dividend. So, I think it's super important, growing that cashflow.

ALEX: Can you tell me a bit about how you construct the growth and income portfolio?

GREG: So, we think about the portfolio in a few different buckets. As I mentioned, we have that yield hurdle that we're trying to meet, companies that have high dividend yields. So there we're looking for sustainability of that. The payout ratio, as I mentioned, is important. We don't want to see that too high because when the payout ratio gets pretty high, there's more risk obviously to that dividend. If the company runs into some trouble, they may have to cut the dividend. So companies with higher dividends, but where there's still some room in terms of the payout ratio and where they have a history of increasing, even if it's a small amount every year, that's pretty important.

In terms of the growthier part of the portfolio, these may be companies that aren't paying dividends yet or have small dividends, and then that free cashflow is really important because we want them to have the ability to grow that dividend, but also continue to grow the business.

The sweet spot for the portfolio is I think the companies that can kind of combine all of it. So above market dividend yield, attractive free cash generation and free cashflow valuation and growing the dividend kind of at above average rate.

ALEX: With dividend-generation and free cash flow really being table stakes?

GREG: Yes, yes. I mean every company that we invest in is a free cash generator or, if they're not based on our modeling, I think they're going to start to generate free cashflow in the near term.

ALEX: And I assume sustainability of those dividends is equally important?

GREG: Yes, we try and find companies where we think they're well positioned for not just the next year but for multiple years that we can kind of ride through the ebbs and flows, that those dividends will continue to grow and compound for us. But yes, when we start to have concerns about the sustainability of the dividend, that's a big red flag for us, and we tend to exit those positions. And then if obviously we think the free cashflow is at risk for any reason, that can also be a driver to move on.

ALEX: Greg, can you talk a bit about some of the other themes that you're focused on in the portfolio and how they tie-in?

GREG: I think one theme that's been in the portfolio for the last couple of years and I think is still a good theme is energy and kind of the shift that you've seen there in those companies in terms of capital discipline versus much more undisciplined spending on drilling and exploration in years past. Because of the issues in the pandemic, the near-death experience for a lot of these companies when oil prices collapsed, we think they're now much more disciplined and focused on returning cash to shareholders and continue to see really good free cash generation there, not paying a lot for it, and they're growing the dividends. So, energy is definitely a theme in the portfolio. So Exxon, Chevron, and one of the European names, Total.

I think there are some interesting opportunities in healthcare as well. One of the companies we like is AbbVie which kind of ticks all the boxes again in terms of very attractive free cashflow, growing the dividend, and a company that's right now managing through some generic competition for their big product, but they've got lots of interesting things in the pipeline. So, we see them returning to growth.

ALEX: One theme that's running through so many portfolios today is artificial intelligence. Is that a theme of the Growth and Income strategy?

GREG: Well, we've talked a little bit about AI. This portfolio doesn't maybe get too exposed in all the names that people think of immediately when it comes to artificial intelligence, but one name that we continue to like a lot is Broadcom. It's a fairly diversified semiconductor company that’s also got some software exposure, but we think they have a pretty big networking semiconductor business that's definitely benefiting from AI and the beneficiary of AI. So that's a name we like a lot. Again, a little bit above market yield, but they've also been growing their dividend, mid teens historically, so we believe growth potential.

ALEX: Greg, any final thoughts on dividends and free cash flow?

GREG: I think it's always a good time to think about that, and I think I always come back to the compounding element of it. And I think we're set up to potentially see a period of higher dividend growth because of the cash on balance sheets and the low payout ratio.

I think the other message is probably having that longer-term time horizon because that's the real benefit of focusing on dividends and income in a portfolio and that reinvestment aspect. I think the beauty of this portfolio is it lets us add to companies that we like that have maybe underperformed a little bit in the near term and redeploy and build positions that way without having to sell something to add to that position.

ALEX: Greg thanks so much for joining me this afternoon.

GREG: Thanks, Alex. Great talking to you.

ALEX: And thank you for listening. For more information on the Alger Growth and Income Strategy, and for more of our latest insights, please https://www.alger.com.

DISCLOSURE

The views expressed are the views of Fred Alger Management, LLC (FAM) and its affiliates as of September 2023. These views are subject to change at any time and may not represent the views of all portfolio management teams. These views should not be interpreted as a guarantee of the future performance of the markets, any security or any funds managed by FAM. These views are not meant to provide investment advice and should not be considered a recommendation to purchase or sell securities. Holdings and sector allocations are subject to change.

Important Information for US Investors: This material must be accompanied by the most recent fund fact sheet(s) if used in connection with the sale of mutual fund and ETF shares. Fred Alger & Company, LLC serves as distributor of the Alger mutual funds.

Important Information for UK and EU Investors: This material is directed at investment professionals and qualified investors (as defined by MiFID/FCA regulations). It is for information purposes only and has been prepared and is made available for the benefit investors. This material does not constitute an offer or solicitation to any person in any jurisdiction in which it is not authorised or permitted, or to anyone who would be an unlawful recipient, and is only intended for use by original recipients and addressees.

The original recipient is solely responsible for any actions in further distributing this material and should be satisfied in doing so that there is no breach of local legislation or regulation. Certain products may be subject to restrictions with regard to certain persons or in certain countries under national regulations applicable to such persons or countries. Alger Management, Ltd. (company house number 8634056, domiciled at 85 Gresham Street, Suite 308, London, EC2V 7NQ, UK) is authorised and regulated by the Financial Conduct Authority, for the distribution of regulated financial products and services. FAM and/or Weatherbie Capital, LLC, U.S. registered investment advisors, serve as sub portfolio manager to financial products distributed by Alger Management, Ltd. Alger Group Holdings, LLC (parent company of FAM and Alger Management, Ltd.), FAM, and Fred Alger & Company, LLC are not an authorized person for the purposes of the Financial Services and Markets Act 2000 of the United Kingdom ("FSMA") and this material has not been approved by an authorized person for the purposes of Section 21(2)(b) of the FSMA.

Important information for Investors in Israel: This material is provided in Israel only to investors of the type listed in the first schedule of the Securities Law, 1968 (the "Securities Law") and the Regulation of Investment Advice, Investment Marketing and Investment Portfolio Management Law, 1995. The Fund units will not be sold to investors who are not of the type listed in the first schedule of the Securities Law.

Risk Disclosures: Investing in the stock market involves risks, including the potential loss of principal. Growth stocks may be more volatile than other stocks as their prices tend to be higher in relation to their companies' earnings and may be more sensitive to market, political, and economic developments. Local, regional or global events such as environmental or natural disasters, war, terrorism, pandemics, outbreaks of infectious diseases and similar public health threats, recessions, or other events could have a significant impact on investments. A significant portion of assets may be invested in securities of companies in related sectors or industries, and may be similarly affected by economic, political, or market events and conditions and may be more vulnerable to unfavorable sector or industry developments**. Past performance is not indicative of future performance. Investing in innovation is not without risk and there is no guarantee that investments in research and development will result in a company gaining market share or achieving enhanced revenue.** Companies exploring new technologies may face regulatory, political or legal challenges that may adversely impact their competitive positioning and financial prospects. Also, developing technologies to displace older technologies or create new markets may not in fact do so, and there may be sector-specific risks as well. As is the case with any industry, there will be winners and losers that emerge and investors therefore need to conduct a significant amount of due diligence on individual companies to assess these risks and opportunities.

Source: Hartford Funds, The Power of Dividends: Past, Present & Future.

Dividend yield is a measurement comparing a company's stock price to the dividend it pays investors. A stock's dividend yield shows how much recurring income stockholders have gotten in the last year as a percentage of the current value of shares they own.f

The following positions represent assets under management for the Alger Growth & Income Strategy as of July 31, 2023: Chevron Corp., 1.75%, Exxon Mobil Corp., 1.37%, Totalenergie Se, 0.75%, Abbvie, Inc., 2,08%; Broadcom, Inc., 3.42%.