Miller Howard
INVESTMENTS

Dividend Investing: Requiem or Revival?

QUARTERLY REPORT 1Q 2024

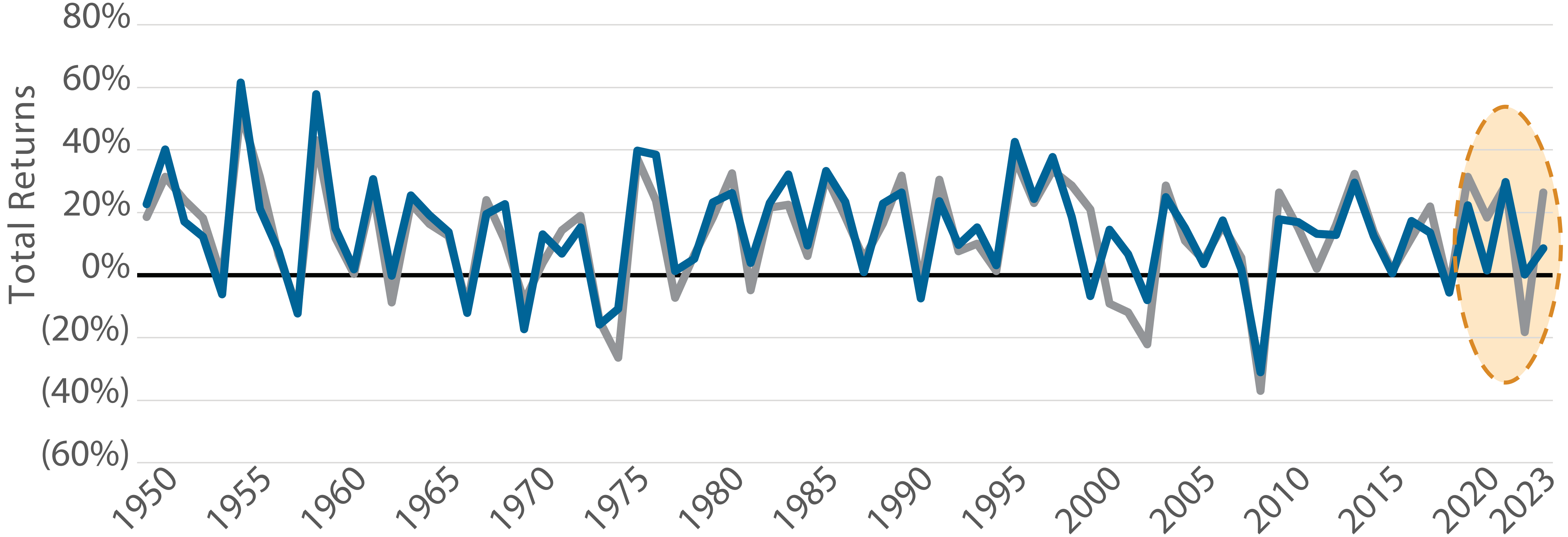
For decades, investors have looked to high-yield dividend stocks (defined as deciles 7-9 of dividend yield, where decile 10 is the highest yield), expecting both higher income and higher total returns. Markets zig and zag, but over the past 75 years, high-yield dividend stocks have outperformed the S&P 500 Index by a compound annual average return of 1.3%, with lower volatility. Historically, high-yield dividend stock returns have fluctuated fairly closely with the S&P 500, with high-yield dividend stocks outperforming in 57% of the calendar years. Seemingly small advantages have compounded over time to create meaningfully better long-term investment returns for high-yield dividend stocks.

But is the historical relationship between high-dividend stocks and the S&P 500 breaking down?

Over the past 75 years, 2023 was the second worst year for high-yield dividend stocks relative to the S&P 500, underperforming by 18%. In 2022, high-yield dividend stocks outperformed the S&P 500 by 18%, so one might argue that the two years offset each other. Yet high-yield dividend stocks underperformed the S&P 500 in two-thirds of the years since the Great Financial Crisis, so it is fair to ask, "Is dividend investing over?"

High-Yield Dividend Stocks Have Historically Outperformed

Calendar Year Total Return

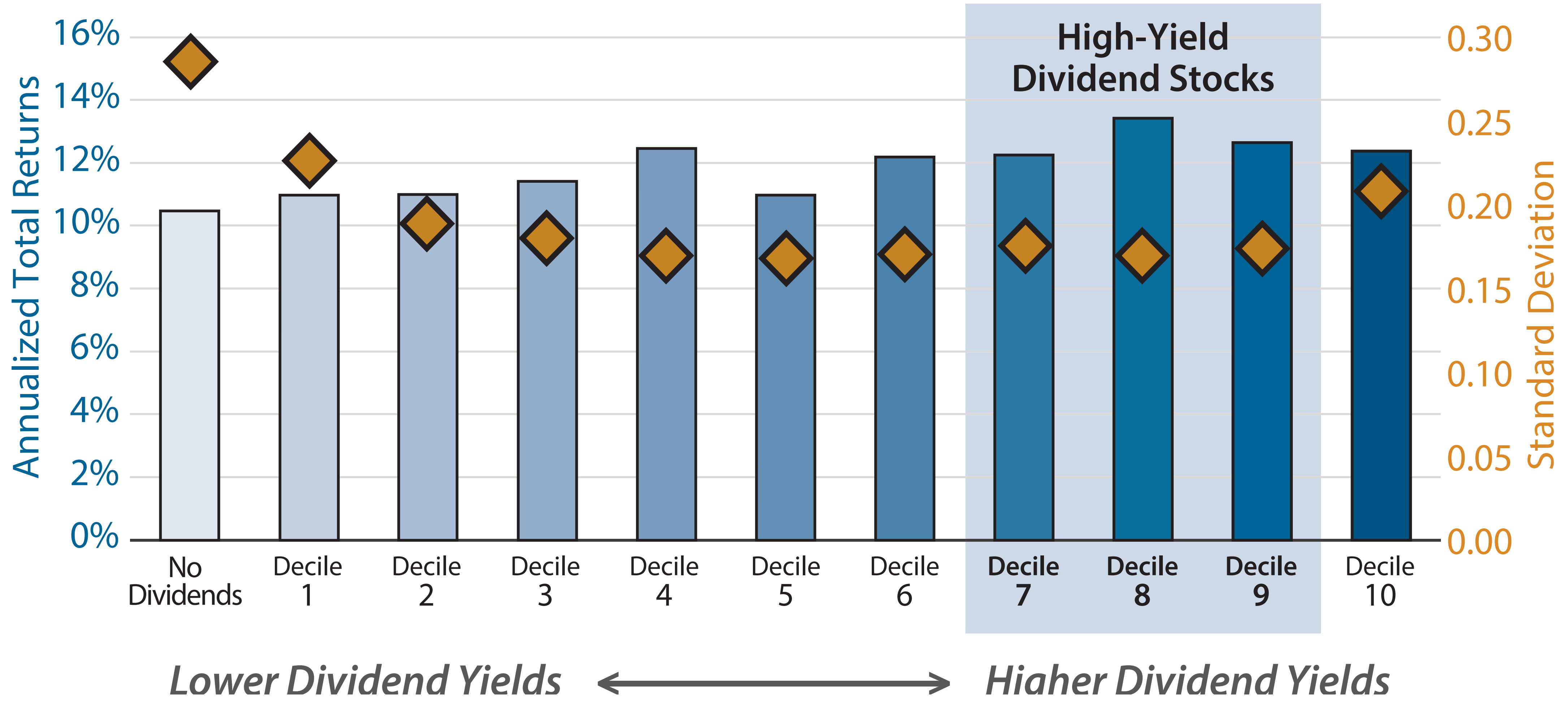


75-Year Annualized Total Return:
High-Yield Dividend Stocks: 12.8%
S&P 500 Index: 11.5%

As of December 31, 2023.
Sources: Fama-French dataset of portfolios formed on dividend yield (cap-weighted deciles); Morningstar Direct; Miller/Howard Research & Analysis.
High-Yield Dividend Stocks (Decile 7-Decile 9) are an equal-weighted basket of the returns of decile 7, decile 8, and decile 9 of the the Fama-French cap-weighted dividend decile dataset where decile 1 is the lowest yielding stocks and decile 10 is the highest.

Let’s explore the reasons for the recent disconnect between high-yield dividend stocks and the S&P 500. Understanding the reasons for the divergence will allow us to make the case that instead of mourning the death of dividend investing, we should be preparing for a revival.

High-Yield Dividend Stocks Offer Attractive Risk/Reward Profile

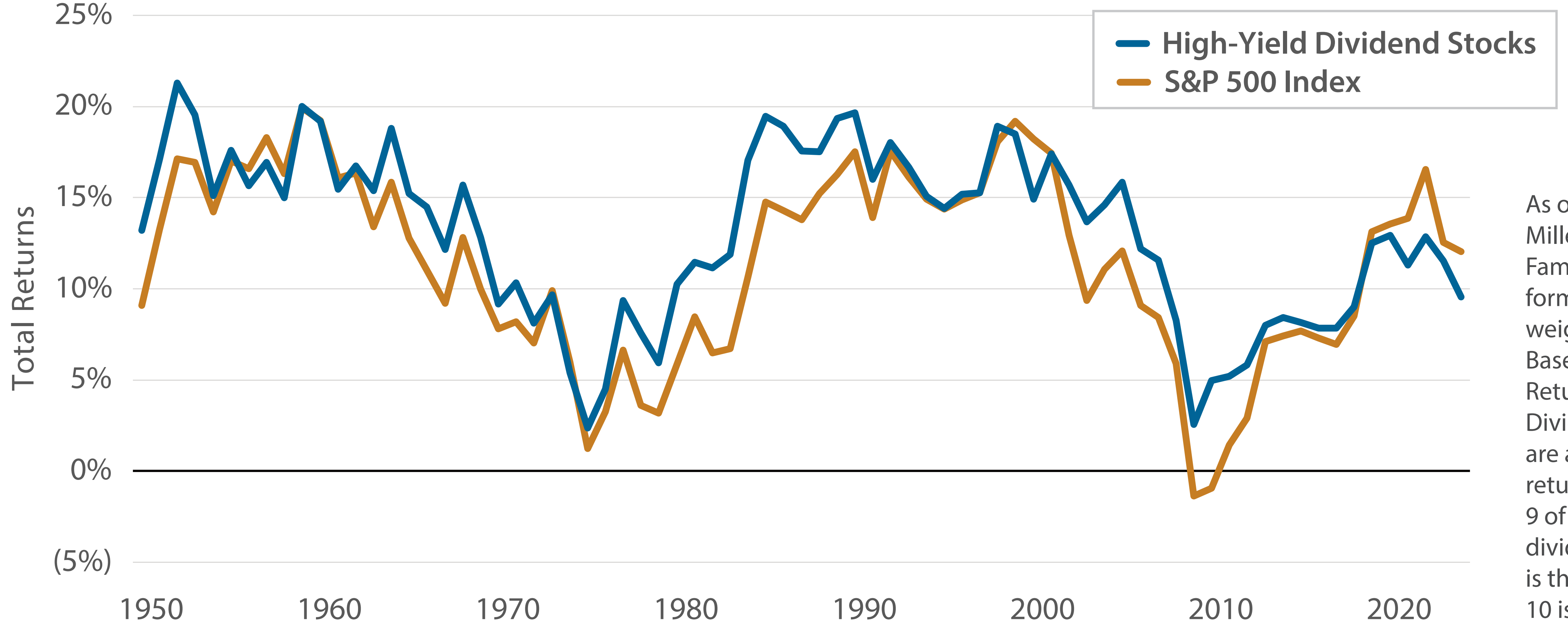


As of December 31, 2023. Sources: Miller/Howard Research & Analysis; Fama-French dataset of portfolios formed on dividend yield (cap-weighted deciles); Morningstar Direct. Based on the past 75 calendar years. High-Yield Dividend Stocks (Decile 7-Decile 9) are an equal-weighted basket of the returns of decile 7, decile 8, and decile 9 of the the Fama-French cap-weighted dividend decile dataset where decile 1 is the lowest yielding stocks and decile 10 is the highest.

We believe there are fundamental reasons for the recent underperformance of dividend stocks, but let's first consider whether it's just bad luck. **Over the past 75 years, high-yield dividend stocks have outperformed stocks with low or no dividends.** But it's also important to note that volatility is substantially higher for low or no dividends stocks. High volatility is a drag on performance, but it can lead to short-lived victories.

Long Holding Periods Have Favored High-Yield Dividend Stocks

Rolling 10-Year Annualized Total Returns

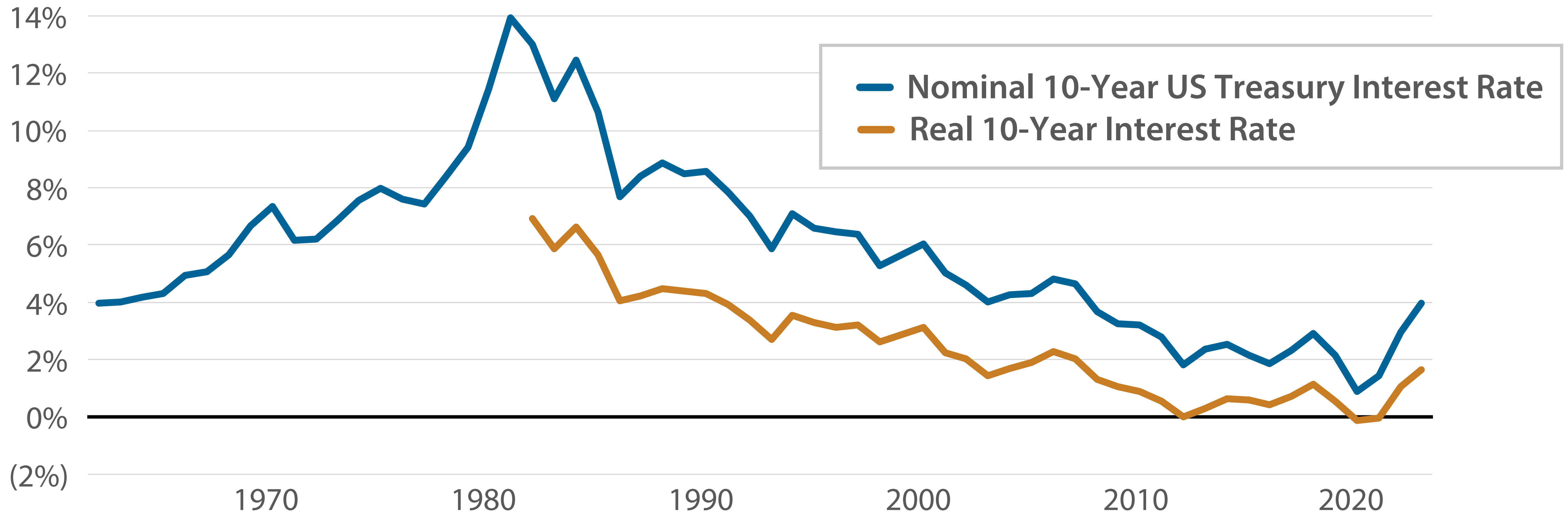


As of December 31, 2023. Sources: Miller/Howard Research & Analysis; Fama-French dataset of portfolios formed on dividend yield (cap-weighted deciles); Morningstar Direct. Based on the past 75 calendar years. Returns are annualized. High-Yield Dividend Stocks (Decile 7-Decile 9) are an equal-weighted basket of the returns of decile 7, decile 8, and decile 9 of the the Fama-French cap-weighted dividend decile dataset where decile 1 is the lowest yielding stocks and decile 10 is the highest.

For this reason, we believe it is better to evaluate the comparison between high-yield dividend stocks and the S&P 500 using long holding periods. For rolling 10-year holding periods, high-yield dividend stocks have outperformed 77% of the time, but there has not been a 10-year period since the one ending in 2017 in which investors were better off in high-yield dividend stocks, suggesting that there is more afoot than bad luck.

Financial television shows love to analyze wiggles in interest rates from one week to the next, with the goal of explaining stock price action. In our view, what is much more important is the impact of changes in long-term interest rates over the decades. After spiking up in the 1970s, the interest rate on 10-year Treasury bonds fell from nearly 14% in 1981 to under 1% in 2020. Using swaps to back out inflation expectations, the Federal Reserve of Cleveland estimates that real interest rates fell from roughly 7% in 1982 to 0%, first in 2012 and then in 2020 and again in 2021.

A Decade of Low Interest Rates



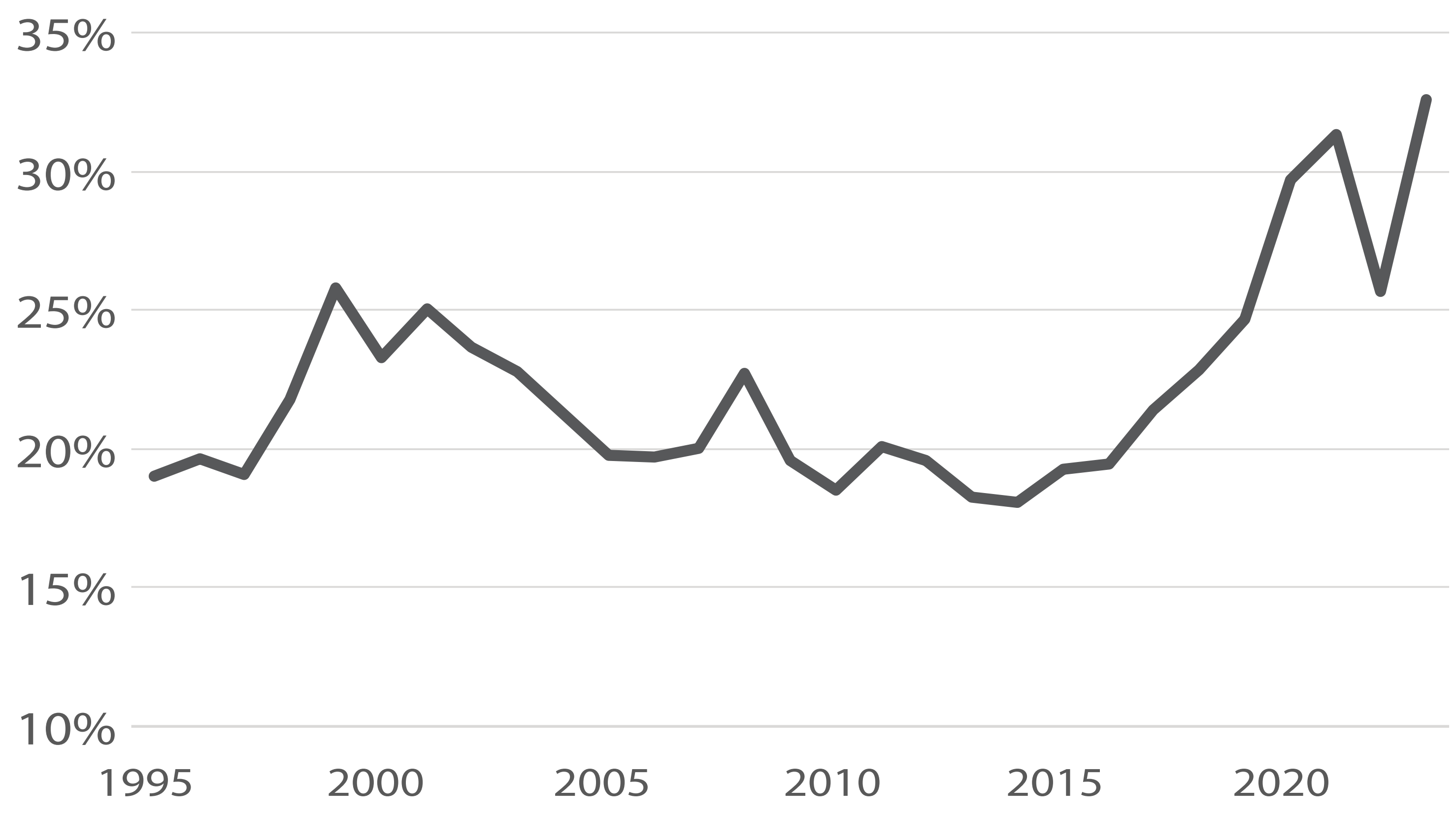
As of December 31, 2023. Source: Federal Reserve Bank of St. Louis. Real interest rate data prior to 1982 not available.

High interest rates cause investors to discount the distant future more severely. Whether forecasts 10 to 20 years out are conservative or optimistic does not really matter when interest rates are high because high discount rates force investors to focus on the short and medium term. Low interest rates do not cause optimistic long-term forecasts, but they can serve as a permission slip for investors to justify high valuations based on aggressive long-term outlooks.

In recent years, we have seen surging long-term earnings forecasts driven largely by rosy views of profits from technological innovation. Interest rates have been low for the past decade, encouraging very large market capitalizations for the perceived long-term winners. **The top 10 constituents in the S&P 500 accounted for 33% of the index's market capitalization at year end, a record for the past 30 years.**

Record Market Concentration

Top 10 as a Percentage of the S&P 500 Index



As of December 31, 2023. Sources: Bloomberg; Miller/Howard Research & Analysis. Based on two screens for members of the S&P 500 Index by calendar year end date. Members were ranked by market capitalization. The first screen was limited to the top 10 by market cap. The second screen was all other members. The total market cap of each selection period was used to calculate top 10 total percent market capitalization. Stocks with multiple classes (e.g., Alphabet) were combined.

The spike in market concentration has driven a wedge between high-yield dividend stocks and the market cap-weighted index. At the end of 2023, only five of the top 10 stocks (by market cap) paid a dividend, and of those five, none of the yields exceeded 1%. In contrast, 10 years earlier, the average dividend yield of the top 10 was 2.1%. As a general rule, market concentration that is driven by a run-up in price-to-earnings (P/E) ratios will result in low-yielding stocks dominating the list. For example, a company trading at 50x earnings with a 50% payout ratio will only yield 1%. High P/Es are simply not compatible with high dividend yields.

Long-term interest rates bottomed out in 2020, since rising to what we view as a more normal level. A continued rise in interest rates could be the trigger to reverse market concentration, but we see more cautious views regarding valuations and earnings forecasts to be the likely catalysts.

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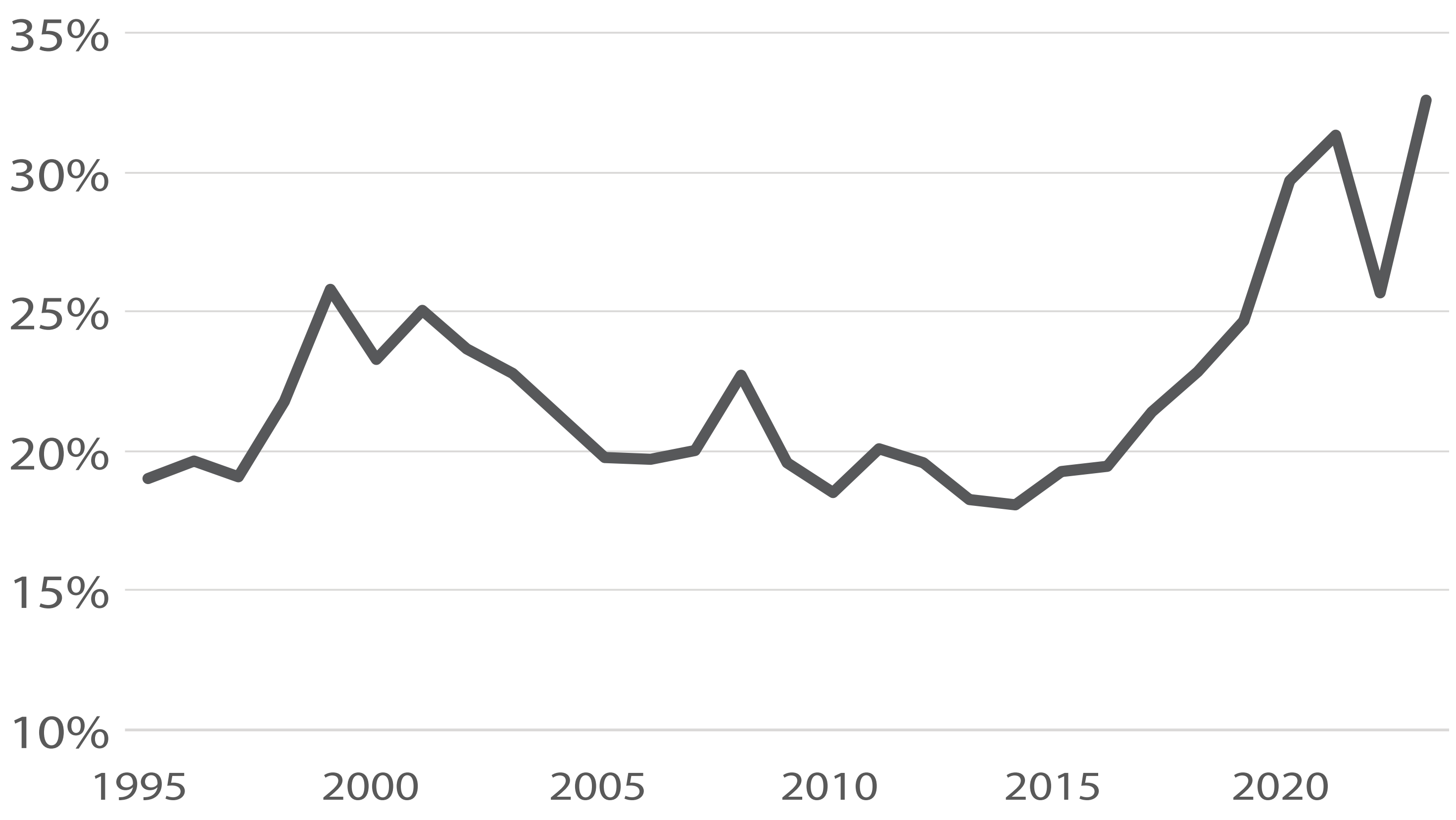

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What Can We Learn from 1999's Winners?

Company	1999 Total Return	Next 5-Years Total Return	What Happened?
QUALCOMM	2619%	-51%	Story Right/1999 Price Too High
NEXTEL COMMUNICATIONS	337%	-42%	Investment Thesis Completely Wrong
LSI LOGIC	319%	-82%	Subsequent Revenue Growth Disappointing
NORTEL NETWORKS	306%	-93%	Investment Thesis Completely Wrong
ORACLE	290%	-51%	Story Right/1999 Price Too High
NETAPP	270%	-20%	Story Right/1999 Price Too High
NATIONAL SEMICONDUCTOR	217%	-16%	Subsequent Revenue Growth Disappointing
TERADYNE	212%	-74%	Subsequent Revenue Growth Disappointing
CABLETRON SYSTEMS	210%	-90%	Subsequent Revenue Growth Disappointing
COMVERSE TECHNOLOGY	206%	-66%	Investment Thesis Completely Wrong
High-Yield Dividend Stocks*	**-7%**	**62%**	
S&P 500 Index	**21%**	**-11%**	

Sources: Bloomberg; Morningstar Direct; Fama-French; Miller/Howard Research & Analysis. *High-Yield Dividend Stocks (Decile 7-Decile 9) are an equal-weighted basket of the returns of decile 7, decile 8, and decile 9 of the the Fama-French cap-weighted dividend decile dataset where decile 1 is the lowest yielding stocks and decile 10 is the highest. Based on the 10 best performing stocks in the calendar year 1999. None of the names above were held in Miller/Howard portfolios as of March 31, 2024.

Chasing runaway stocks has been dangerous in the past. We showed in a prior quarterly report (3Q 2023) that the top 10 performing S&P 500 stocks in 1999 all subsequently underperformed both the S&P 500 and especially high-yield dividend stocks.

What can we learn from this experience?

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First, the market was not 100% wrong. Today, revenue at Qualcomm, Oracle, and NetApp is seven times bigger than in 1999, and these companies are highly successful in their corners of the tech market. Yet investors who bought Qualcomm and Oracle at the peak did not get back to breakeven until 2014. Buyers of NetApp at its peak have yet to get their money back. The simple lesson is that getting "the story" right is not enough—you can pay too much for a story even if it turns out to be true.

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Other 1999 winners—LSI Logic, National Semiconductor, Teradyne, and Cabletron—fell victim to competition that challenged both revenue growth and profitability. The products produced by these companies still exist today, naturally having greatly evolved. However, investors did not foresee how much competition would dampen prices, market share, and income.

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Looking back at the last three stocks—Nextel Communications, Nortel Networks, and Comverse Technologies—is much more humbling for 1999 bulls. Nextel offered a mobile phone with a walkie-talkie feature. Anyone who had a plumber or electrician at their home in that era will remember the annoying screech of these phones. The market was convinced that this instantaneous communication was destined to be a long-term winner, not foreseeing how texting would prove to be a better solution.

The excitement around Nortel centered on its aggressive acquisition of multiple tech and telecom companies. Unfortunately, going on a buying spree as the market bubble inflated put Nortel on the path to eventual bankruptcy.

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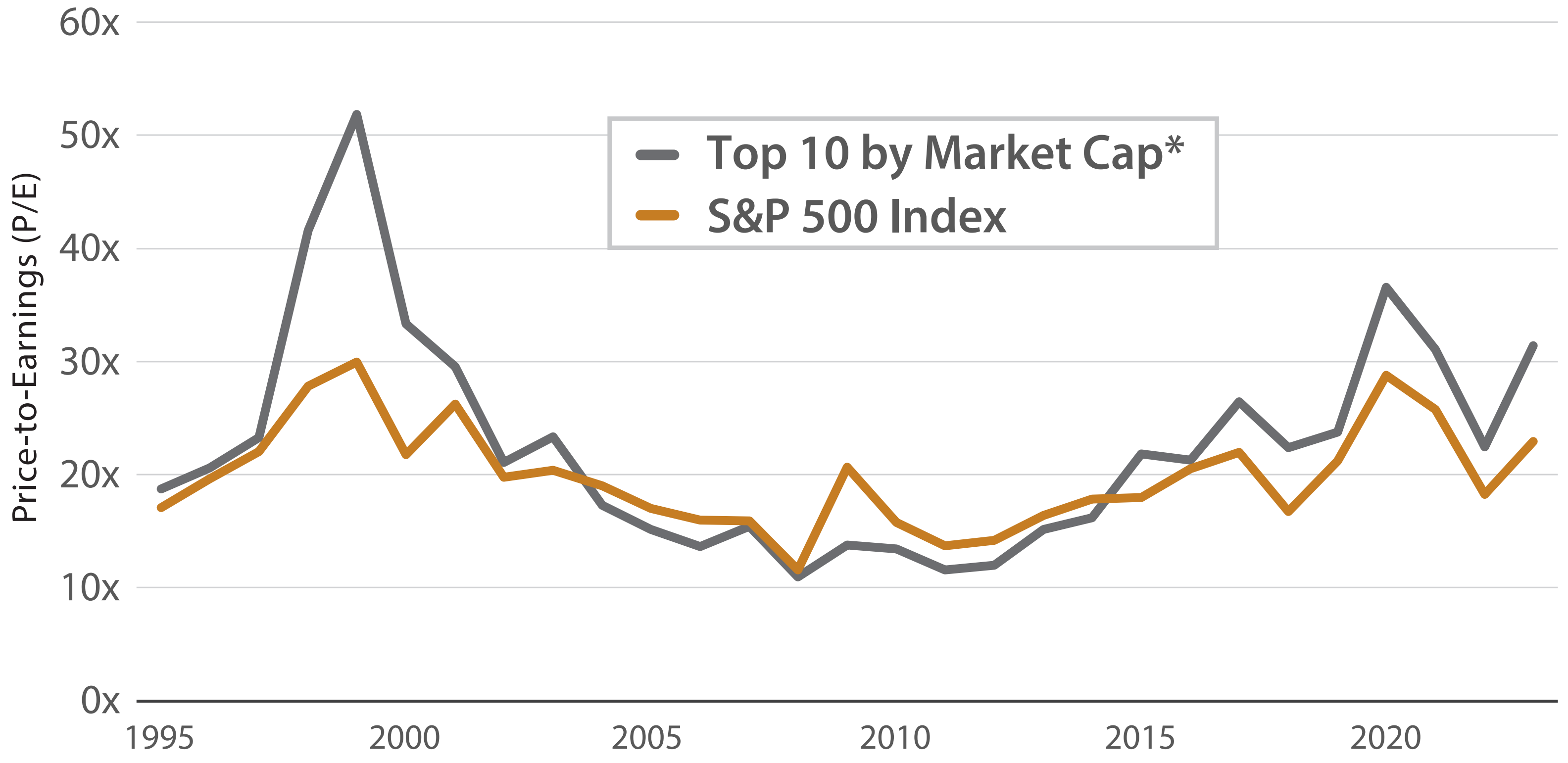
Lastly, Comverse Technology soared during the Tech/Telecom Bubble, with mobile phone voicemail systems as their dominant product. Sales slowed in the subsequent recession, depressing the stock price. The CEO and two other executives attempted to recover their compensation by backdating options. As a result of the ensuing scandal, Comverse was delisted from Nasdaq, and the CEO fled to Namibia as a fugitive, events not anticipated by 1999 bulls.

All of this is not to denigrate 1999 investors—with over two decades of hindsight, we know the full story. Surely, those of us investing today will have our own share of regrets in the future too. The point is that forecasting 10, 20, and 30 years out is difficult, yet it is what high price-to-earnings (P/E) multiples require.

Mega-Cap Stocks Trade at an Unusually High Premium



As of December 31, 2023. Sources: Refinitiv; Bloomberg; Miller/Howard Research & Analysis.
* Based on the aggregate market cap of the 10 largest stocks in the S&P 500 Index, divided by the trailing 12-month net income of those same stocks, as of each calendar year end. Stocks with multiple share classes were combined.

"But it's different this time!" bulls will argue. That might be true, but we are seeing some signs of excess similar to the Tech/Telecom Bubble.

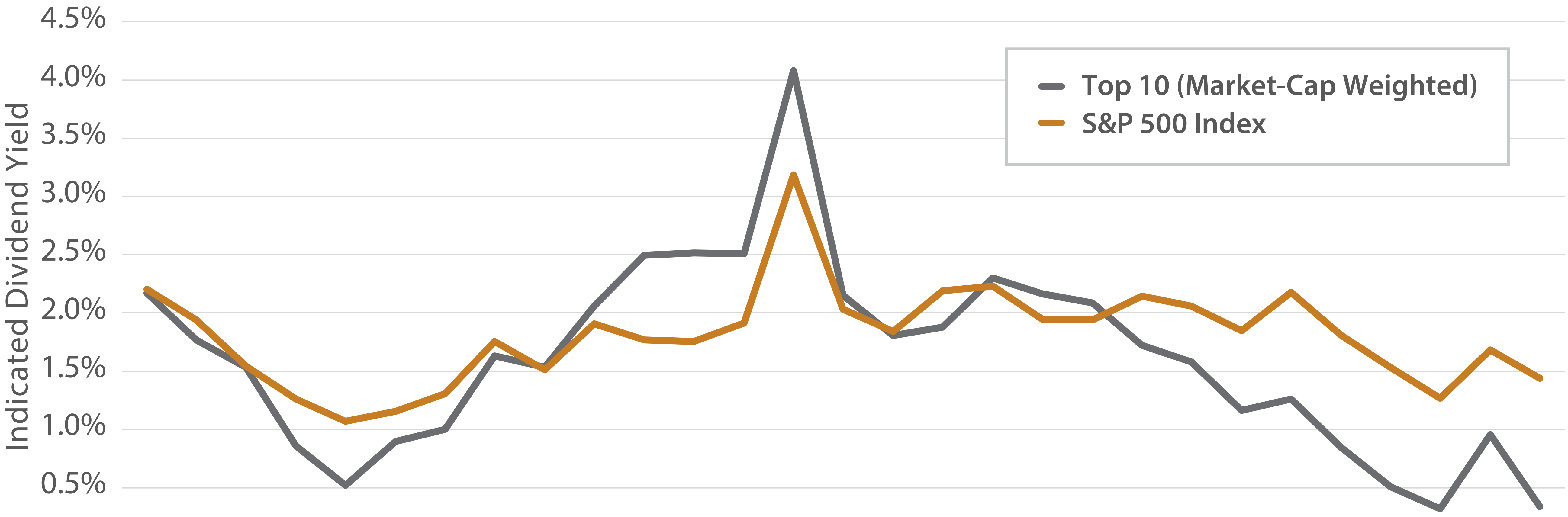
The average trailing price/earnings ratio for the top 10 highest market capitalization names is now at a greater spread relative to the S&P 500 than at any time since the Tech/Telecom Bubble. Some bulls will contend that means the top 10 still has room to run, but that strikes as a "greater fool" thesis—all but admitting that valuations will normalize in the future.

From the standpoint of dividend yield, the top 10 is now well below the yield of the top 10 during the Tech/Telecom Bubble.

It's difficult to call a top, but we can say that the top 10 is now:

- At a record high percentage of the S&P 500,
- At a record low in terms of dividend yield, and
- Gapping away from the S&P 500 on P/E (but still not at the extreme we saw in the late 1990s).

Record Low Dividend Yields for 10 Largest Stocks in the S&P 500 Index



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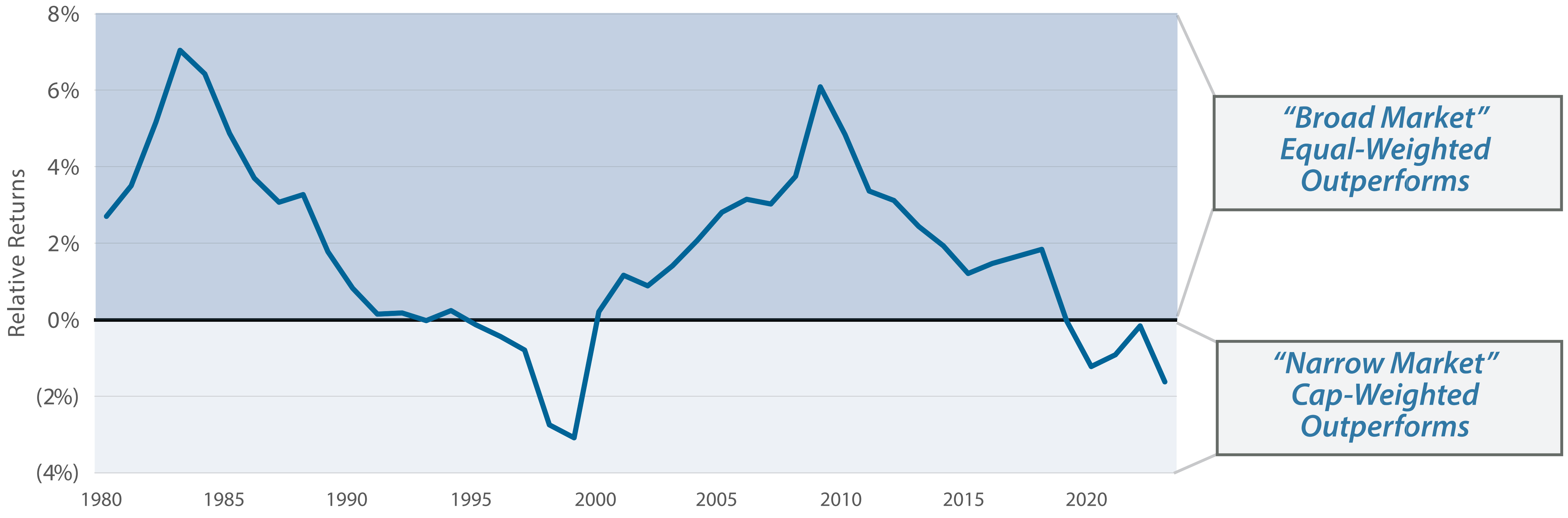
Equal-Weighted Usually Outperforms Cap-Weighted S&P 500 Index



As of December 31, 2023. Sources: Refinitiv; Miller/Howard Research & Analysis. Based on rolling 10-year annualized relative returns. Broad (narrow) market concentration is defined as years when the equal-weighted S&P 500 outperformed (underperformed) the cap-weighted S&P 500.

Today's market concentration is not just focused on the top 10 stocks, but runs throughout the S&P 500, with larger-cap stocks outperforming the rest of the index. In 2023, the S&P 500 was up 26.3%. Taking the same stocks and equal weighting them, the total returns were only 13.9%. Same stocks, just different weights. **The recent superiority of the cap-weighted S&P 500 over the equal-weighted version indicates a narrow market, with returns concentrated in the largest companies.**

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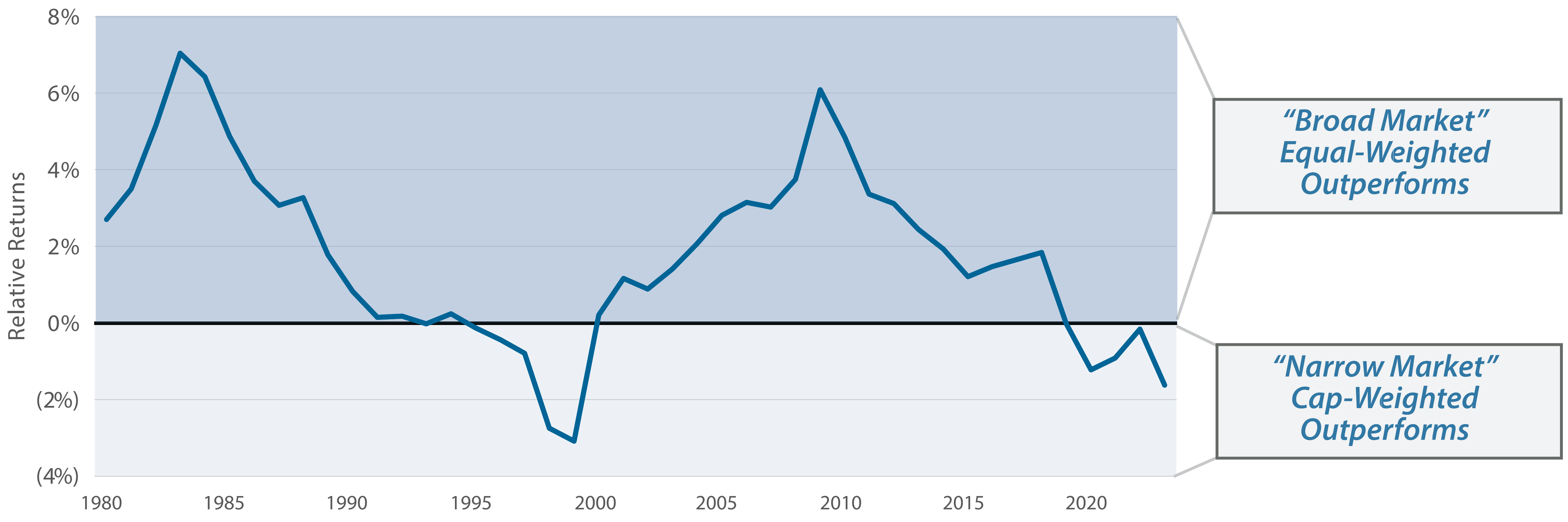

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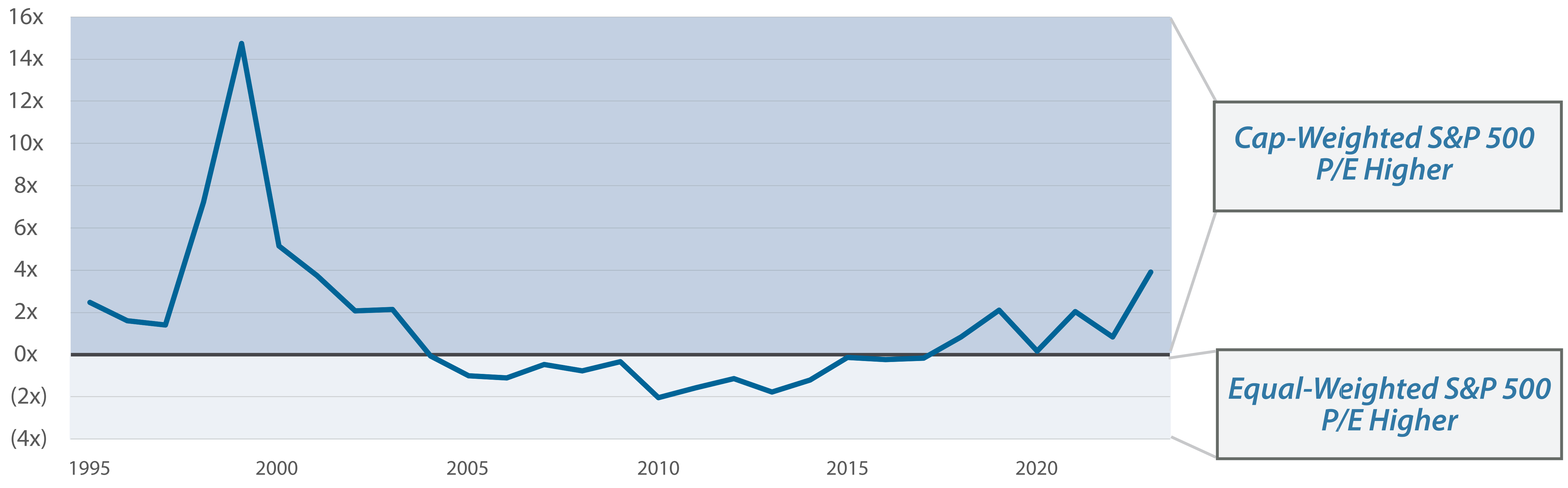
Over the long term, markets are typically broad, with the equal-weighted index typically outperforming the cap-weighted. Using rolling 10-year holding periods, the equal-weighted version has historically outperformed 75% of the time. The simplest explanation of the historical superiority of the equal-weighted version is that it periodically trims winners and adds to losers to maintain equal weights. The cap-weighted version (i.e., the S&P 500 Index that we all know) does no periodic rebalancing—it's just buy and hold forever.

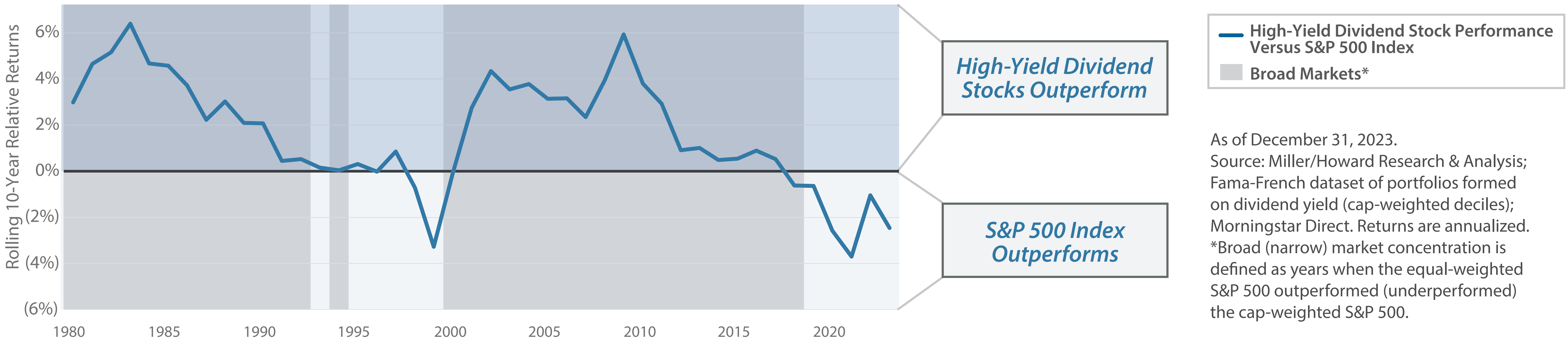
Cap-Weighted S&P 500 Index Trading at a Premium



As of December 31, 2023.
Sources: Refinitiv; Bloomberg; Miller/Howard Research & Analysis.
For years prior to 2010: For the equal-weighted S&P 500 Index, price-to-earnings (P/E) was calculated as the equal-weighted aggregate market capitalization divided by the aggregate of members equal-weighted positive trailing 12-month net income.
For the cap-weighted S&P 500 Index: P/E was calculated as aggregate market capitalization divided by the the aggregate of members cap-weighted positive trailing 12-month net income. P/E ratios above 100x were winsorized at 100x. Years after 2010 were sourced from Bloomberg.

The outperformance of the cap-weighted index might make sense if it could be explained entirely by faster growing earnings of larger-cap companies. But, just as we saw in the Tech/Telecom Bubble, expanding price/earnings ratios explain much of outperformance of the largest-cap companies. Once again, the market is showing a bias towards the very largest companies—a bias that runs contrary to the superior long-term performance of the equal-weighted S&P 500. As we will show, **the current tilt towards the largest market capitalization companies also creates a headwind for high-yield dividend stocks.**

High-Yield Dividend Stocks Historically Outperform in Broad Markets



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*Broad (narrow) market concentration is defined as years when the equal-weighted S&P 500 outperformed (underperformed) the cap-weighted S&P 500.

We have shown that both high-yield dividend stocks and the equal-weighted S&P 500 have historically outperformed the cap-weighted S&P 500 over most 10-year holding periods. It turns out that the two approaches tend to beat or trail the S&P 500 in the same years. For 10-year holding periods ending in the years since 1980, high-yield dividend stocks have outperformed by an average of 2.6% annual return in broad markets, defined as when the equal-weighted S&P 500 outperformed the (cap-weighted) S&P 500 Index. During narrow markets, when the equal-weighted version underperformed, high-yield dividend stocks underperformed by 1.2% annually.

Why are the two approaches correlated? First, they both are "buy low/sell high" strategies. The equal-weighted index must periodically sell winners and buy underperformers to maintain equal weights. High-yield dividend stocks have a similar characteristic in that dividends typically adjust slower than stock prices, meaning that dividend yields drop for winners and rise when stocks fall. Staying within the high-yield dividend stock universe requires selling some winners and buying some laggards.

Both high-yield dividend stocks and the equal-weighted index will underperform when mega-caps outpace the market. For the equal-weighted index, this is true by construction. Historically, high-yield dividend stocks have trailed when mega-caps zoom, simply because the outperformance of very large-cap stocks is often driven by rising price/earnings ratios—and their associated low dividend yields.

What would cause a revival for dividend stocks? In our view, high-yield dividend stocks can return to their historic outperformance once the trend towards market concentration reverses. Animal spirits can be unpredictable, but we see a long list of forces pushing back. First, much of the recent mega-cap dominance has been driven by price/earnings multiple expansion. Profits in the 2030s and 2040s will be what they will be—at some point stock prices have to fully reflect long-term profit prospects. Bear in mind that dividends are puny for the top 10, meaning investors are not really paid to hold these stocks—the whole game is having a correct view of long-term profitability.

Second, high valuations encourage potential competitors to enter the market. A recent example is the raft of new electric vehicle programs in response to Tesla's stock market success.* Tesla's stock peaked in 2020 and faced headwinds as investors realized that the company would face stiff competition.

Lastly, rapidly growing large-cap companies tend to attract the attention of regulators. Recall the antitrust case against Microsoft* in the late 1990s. Recently, US tech companies have faced aggressive push back from regulators, both in Europe and the US.

*As of March 31, 2024, Tesla was held in a Miller/Howard portfolio that is not yet available to investors; Microsoft was not held.

In our view, the day will come when stock market performance will no longer be concentrated in just the largest-cap companies. As returns broaden, we expect high-yield dividend stocks to resume their historical outperformance. And in the meantime, we expect high-yield dividend stocks to continue generating solid investment returns. We will continue following our investment philosophy—getting paid to own stocks with high and growing dividends.

Methodology for Charts:

Analysis based on Russell 1000 Index dividend payers, defined as stocks in the Russell 1000 as of the prior year-end that paid a dividend in the 4th quarter of that prior year. To calculate dividend action in basis points, we subtracted the prior year 4th quarter dividend from the current-year 4th quarter, and then multiplied by 4 to annualize. The result was divided by the stock price at the prior year-end and then multiplied by 10,000 to convert to basis-points (bps). (Semi-annual payers were adjusted accordingly. Specials were excluded from our calculations.)

DISCLOSURE

Miller/Howard Investments Inc. is an independent, research-driven investment boutique with over three decades of experience managing portfolios for major institutions, mutual funds, and individuals in dividend-focused investment strategies. The firm is 100% employee-owned through an Employee Stock Ownership Plan (ESOP).

We continue to evolve and develop strategies that strive to provide investors with various levels of current income and dividend growth. Our objectives are to generate total returns in line with the broad equity market and provide a high and rising stream of income with the lower volatility that an investor might seek from bonds or other income alternatives. With a primary goal of reliable income and long-term returns, coupled with a belief that investors can play an important role in securing a sustainable future, our shareholder advocacy efforts include environmental, social, and governance (ESG) research and/or screening, direct engagement with companies, filing shareholder resolutions, proxy voting, coalition building, and public policy involvement.

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DEFINITIONS

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S&P 500 Index® widely regarded as the best single gauge of large-cap US equities and serves as the foundation for a wide range of investment products. The Index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

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