TD Global Investment Solutions

Spotlight 10 Minutes
June 2024

A Conversation With

Kera Van Valen
Managing Director,
Portfolio Manager and
Senior Research Analyst,
TD Epoch

The Changing (or Unchanging) Dividend Environment

What are your thoughts on the current environment for dividends and the outlook going forward?

We view the current environment, and outlook going forward, as very supportive for dividends, and more broadly, for all forms of shareholder distributions, including share repurchases and debt reduction. While the pandemic was a bump in the road for dividends, as many companies adjusted payout policies due to uncertainty and public pressures to conserve capital, our experience was that many of our holdings maintained, and even grew, their dividends during that period and the majority have long since returned to "normal" payout practices. As the global economy has continued to heal post-COVID, we've seen a remarkable rebound in growth and more resilient demand than nearly anyone forecasted, leaving corporates in strong positions to continue generating healthy levels of free cash flow, enabling more capital return to shareholders. Further signaling an improving environment and expanding opportunity set for income focused investors are developments such as recent dividend initiations from traditionally "growthier" segments of the U.S. market, an improving view on share repurchases for European companies, and corporate governance reform in Japan driving a shift in capital allocation practices towards returning cash to shareholders.

On a longer-term basis, we believe the current interest rate hiking cycle marks broad monetary regime change, and whether we come out the other side with a soft-landing or a minor recession, we don't believe the zero-interest rate, easy-money world of the 10+ years preceding the pandemic will be returning any time soon. With the cost of capital elevated, corporations will need to be more disciplined in their capital allocation decisions, especially with regard to directing cash towards growth initiatives. Investing in acquisitions or

organic growth projects is only prudent when you believe you can earn a higher return than your cost of capital, and so, logically, we can assume that there will be fewer opportunities meeting this criteria in a higher rate environment. Outside of investment, the only other uses of cash are paying cash dividends, repurchasing shares, or reducing debt. Many corporates took advantage of recent years' near-zero interest rate environment by levering up and extending the duration of their debt capital, making it likely that issuance of new debt going forward will trend downwards. As low-interest issues roll off corporate balance sheets in coming years, and companies look to deleverage in the higher rate environment, we expect to see debt reduction coming back into the shareholder yield picture more notably. Share repurchase activity has been strong, and we expect that to continue given a higher cost of capital environment discourages capex projects and M&A activity, leaving more cash available to buy back shares. While more restrictive monetary policy is likely to pressure companies that are highly leveraged or operating at thin margins, mature firms with strong balance sheets, strong free cash flow generation, and shrewd management teams will find shareholder distributions to be an increasingly appropriate use of cash. In our view, we are entering a macro environment that will be conducive to dividend investing, and shareholder yield in general.

What are your thoughts around recent dividend initiations from some of the U.S. tech giants?

While to many these announcements appear to be a departure from the norm, to us, on a historical basis, they look more normal than novel. These companies, while well known as growth stories, have been mature, highly profitable, leaders in their respective industries for some time now, and traditionally these are the types of companies we expect to see initiate dividends. It's possible that these decisions were influenced in some small part by a changing monetary policy landscape, but it also stands to reason that they've simply concluded that they are generating significant enough free cash flow to support growth initiatives while also reaping the benefits of paying a dividend (i.e., a show of confidence towards future earnings, attracting a new segment of investors, more stability in stock returns). In fact, these companies are not looking to simply maintain their level of growth investment alongside a dividend payment, but have actually expanded their near-term capex guidance, signaling immense confidence in their long-term cash generation ability. Certainly, the more "old guard" members of "big tech," who initiated dividends many years ago and have continued growing rapidly to this day, demonstrate that dividend payments do not spell the end for business growth. This very idea is highly aligned with the core shareholder yield philosophy, as growth is an important component of our return framework; we require portfolio holdings to be both growing their free cash flow consistently and returning much of that cash to shareholders. We maintain moderate exposures to some of the names most commonly placed within the U.S. "big tech" cohort for this reason. In our view, that some others in the group are beginning to see benefit in committing to a dividend payment is a positive development for the industries they lead and for dividend investing in general.

How have dividends fared in a 'higher for longer' interest rate environments?

"Higher for longer" interest rate environments tend to favor dividends as a driver of equity market returns, as funding growth becomes more challenging and price multiples see headwinds from a higher discount to future cash flows. In the simplest terms, equity market returns are driven by three things: earnings growth, dividends, and changes in valuations, which are reflected by price multiples and represent the value markets are placing on the expected growth trajectory and future cash flows of a business. Dividends are always positive contributors to return, earnings growth is nearly always a positive contributor to return, valuations, however, are more volatile, sometimes contributing and sometimes detracting from return. Valuations demonstrate an observably significant relationship with interest rates, expanding in lower rate environments and contracting when rates are higher. This makes intuitive sense when considering that low interest rates are stimulative to growth, as capital needed for expansion is cheaper, and that the opposite is true when rates are high. The years following the global financial crisis and through the end of the COVID pandemic were defined by ultra-accommodative monetary policy and low interest rates, driving extraordinary multiple expansion. While present usage of the term "higher for longer" is largely tied to near-term elevated rates being used to combat inflation, we believe that even when we are back at target inflation levels and rates begin to come down it is highly unlikely that rates will return to the stimulative levels they sat at for years before COVID. As a result, over the long term we expect markets to

become more fundamentally driven and for dividends to make up a larger share of equity returns.

How does the current dividend environments illustrate the benefits of taking a more holistic view on capital allocation?

A more normalized monetary policy environment will likely make shareholder distributions a more attractive use of capital for companies, but as we've stated already, cash dividends are not the only avenue through which cash can flow to shareholders. While cash dividends are the most obvious and direct way to return capital to shareholders, taking a broader view and recognizing that share repurchases and debt reduction are, in many ways, equivalent returns of cash allows investors to maximize the value they're receiving from companies and also to diversify into segments of the market that may traditionally less likely to be paying dividends. Both share buybacks and debt reduction increase equity shareholder's claims on company cashflows, and so we sometimes refer to them as "dividends by another name."

Collectively, we refer to cash dividends, share repurchases and debt reduction as "shareholder yield." Dividend payments are far more committal than share repurchases, as dividend cuts are often viewed as signals to investors that the business is under pressure. As a result, many companies, especially in the U.S., have opted to focus more on share repurchases as a mechanism for returning cash to shareholders, retaining the flexibility to dial distributions up and down without spooking the market. While we do generally require all holdings to pay a cash a dividend, by taking a wholistic shareholder yield approach to investing we've been able to diversify our exposures within sectors such as information technology and consumer discretionary. While many companies in these conventionally growthier sectors have robust cash flow generation and strong balance sheets, those paying dividends tend towards lower yields, which may discourage traditional income investors from owning them. Through a shareholder yield lens, however, we've found many of these companies to be suitable for portfolio inclusion due to ample contributions to total shareholder yield from either debt reduction or share repurchases.

Learn more about TD Global Investment Solutions

www.tdgis.com

For institutional investors only. TD Global Investment Solutions represents TD Asset Management Inc. ("TDAM") and Epoch Investment Partners, Inc. ("TD Epoch"). TDAM and TD Epoch are affiliates and wholly owned subsidiaries of The Toronto-Dominion Bank. ®The TD logo and other TD trademarks are the property of The Toronto-Dominion Bank or its subsidiaries. The information contained herein is distributed for informational purposes only and should not be considered investment advice or a recommendation of any particular security, strategy or investment product. The information is distributed with the understanding that the recipient has sufficient knowledge and experience to be able to understand and make their own evaluation of the proposals and services described herein as well as any risks associated with such proposal or services. Nothing in this presentation constitutes legal, tax, or accounting advice. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Certain information provided herein is based on third-party sources, and although believed to be accurate, has not been independently verified. Except as otherwise specified herein, TD Epoch is the source of all information contained in this document. TD Epoch assumes no liability for errors and omissions in the information contained herein. TD Epoch believes the information contained herein is accurate as of the date produced and submitted, but is subject to change. No assurance is made as to its continued accuracy after such date and TD Epoch has no obligation to any recipient of this document to update any of the information provided herein. No portion of this material may be copied, reproduced, republished or distributed in any way without the express written consent of TD Epoch.

Past Performance: Any performance information referenced represents past performance and is not indicative of future returns. There is no guarantee that the investment objectives will be achieved. To the extent the material presented contains information about specific companies or securities including whether they are profitable or not, they are being provided as a means of illustrating our investment thesis. Each security discussed has been selected solely for this purpose and has not been selected on the basis of performance or any performance-related criteria. Past references to specific companies or securities are not a complete list of securities selected for clients and not all securities selected for clients in the past year were profitable. The securities discussed herein may not represent an entire portfolio and in the aggregate may only represent a small percentage of a clients holdings. Clients' portfolios are actively managed and securities discussed may or may not be held in such portfolios at any given time. Projected or Targeted Performance: Any projections, targets, or estimates in this presentation are forward-looking statements and are based on TD Epoch's research, analysis, and its capital markets assumptions. There can be no assurances that such projections, targets, or estimates will occur and the actual results may be materially different. Additional information about capital markets assumptions is available upon request. Other events which were not taken into account in formulating such projections, targets, or estimates may occur and may significantly affect the returns or performance of any accounts and/or funds managed by TD Epoch.

Projected or Targeted Performance: Any projections, targets, or estimates in this presentation are forward-looking statements and are based on TD Epoch's research, analysis, and its capital markets assumptions. There can be no assurances that such projections, targets, or estimates will occur and the actual results may be materially different. Additional information about capital markets assumptions is available upon request. Other events which were not taken into account in formulating such projections, targets, or estimates may occur and may significantly affect the returns or performance of any accounts and/or funds managed by TD Epoch.

TD Epoch's approach to ESG is rooted in our belief that the consideration of ESG factors complements traditional financial analysis. As set forth in our ESG Policy, our ESG approach is aligned with the firm's investment philosophy and integrated into our investment analysis process and investment professionals generally will take ESG issues into consideration, as appropriate, when making investment decisions, subject to Epoch's investment strategy objectives, clients' investment guidelines and applicable laws. Examples of how Epoch's investment professionals may incorporate ESG considerations in their research and company engagements are set forth in Epoch's ESG Policy.

The use of ESG factors in the investment process could result in selling or avoiding investments that subsequently perform well or purchasing investments that subsequently underperform. Epoch uses proprietary, internal research and analysis, and also subscribes to various independent third party research providers that provide corporate ESG research. Epoch is generally dependent upon information and data obtained through third-party reporting that may be incomplete, inaccurate or unavailable, which could cause Epoch to incorrectly assess a company's ESG practices. We recognize there is regulatory uncertainty and scrutiny relating to ESG, that require Epoch to make judgments concerning how the firm will comply before industry best practices have been developed. Accordingly, Epoch's ESG Policy and related procedures will change as the firm's judgments concerning its regulatory obligations change.

Non-US Jurisdictions: This information is only intended for use in jurisdictions where its distribution or availability is consistent with local laws or regulations.

Australia: Epoch Investment Partners, Inc. (ABRN: 636409320) holds an Australian Financial Services Licence (AFS Licence No: 530587). The information contained herein is intended for wholesale clients and investors only as defined in the Corporations Act of 2001.

United Kingdom: Epoch Investment Partners UK, LTD is authorized and regulated by the Financial Conduct Authority of the United Kingdom (Firm Reference Number: 715988).

South Africa: Epoch Investment Partners, Inc. is a licensed Financial Services Provider (license number 46621) with the Financial Sector Conduct Authority.