M&G North American Dividend Fund

Why active for dividend growth in the US?

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FOR INVESTMENT PROFESSIONALS ONLY

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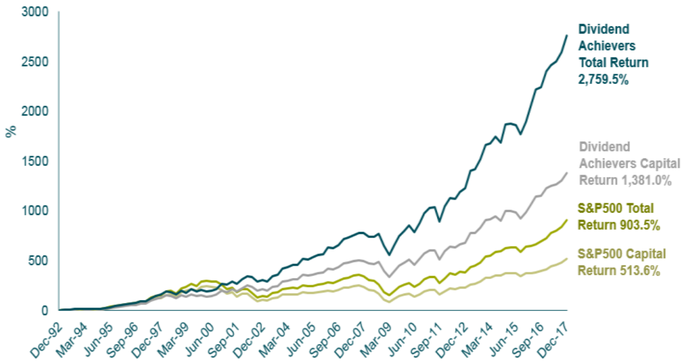
The M&G North American Dividend Fund pursues a dividend growth strategy in the strong belief that this focused approach provides a tailwind to outperform the US market. This belief is founded partly on analysis of the performance of M&G's so-called 'Dividend Achievers', a group of stocks listed in the US with a track record of raising their dividends for 25 consecutive years or more. There are various indices and ETFs that comprise companies with equivalent track records of dividend growth, and these might have some appeal to investors on the surface. However, passive dividend growth strategies have several crucial limitations, which we highlight in this note.

Please remember that the value of investments will fluctuate, which will cause fund prices to fall as well as rise, and you may not get back the original amount you invested. Changes in currency exchange rates will affect the value of your investment.

Dividend Achievers

One of the key drivers of our decision to embrace a dividend growth strategy in North America was the performance of a group of stocks that we refer to as the 'Dividend Achievers'. These are listed in the US and have a track record of raising their dividends for 25 consecutive years or more (see Figure 1). This group of companies has significantly outperformed the broader market over the long term, with the performance bolstered by the compounding power of a growing dividend stream.

Figure 1. M&G's Dividend Achievers vs S&P 500 Index (cumulative returns over 25 years)



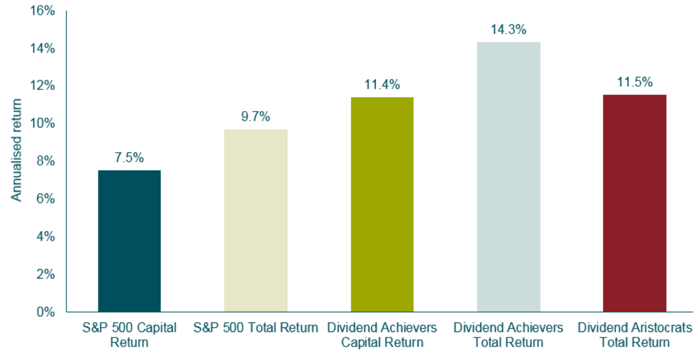
Source: FactSet, 31 December 2017. Returns in US dollars. Equally weighted portfolio rebalanced on a quarterly basis.

Past performance is not a guide to future performance.

Dividend Aristocrats

Investors often ask if there are indices and exchange-traded funds (ETFs) that seek to replicate the performance of this group of companies. There are – the S&P 500 Dividend Aristocrats is probably the best known of these indices and is tracked by a number of ETFs. Perhaps the most widely known of these ETFs is the ProShares S&P 500 Dividend Aristocrats ETF, which is US$3.5 billion in size (*as at 30 June 2018*). The index and ETFs differ from M&G's Dividend Achievers in that they are limited to the S&P 500, whereas our group of companies spans the whole US market. However, the fundamental rule that governs the two is identical: their constituents have all raised their dividends for at least 25 consecutive years.

Figure 2. M&G's Dividend Achievers vs S&P 500 vs S&P 500 Dividend Aristocrats (annualised 25-year returns)



Source: FactSet, 31 December 2017. Returns in US dollars. Equally weighted portfolio rebalanced on a quarterly basis.

Why, then, should investors not just buy an ETF that tracks this index to tap into the powerful tailwind of long-term dividend growth?

There are several reasons. First, these indices and ETFs cannot replicate the performance of M&G's Dividend Achievers. If we look at the annualised returns of the S&P 500, M&G's Dividend Achievers, and the S&P 500 Dividend Aristocrats, we see that the total return of the Aristocrats lags that of M&G's Achievers by almost 300 basis points per year (see Figure 2).

To put this into context, the power of compounding means that the effect of this annual 280-basis-points lag over the course of the 25-year period is that the cumulative total return of the Aristocrats is roughly *half* that of M&G's Achievers.

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Conceptually, some of the performance differential could be explained by the wider investment universe of M&G's Dividend Achievers, but in reality the effect of this is immaterial. The more fundamental reason for the difference is that M&G's Dividend Achievers are a proxy for a successful, forward-looking active investment strategy – it captures the potential rewards for an active strategy that can correctly predict which companies will grow their dividends through the cycle. The constituents do not change over time; they are the companies that had raised their payments to shareholders each year for at least 25 years as at the date when we ran the performance analysis. The performance of the universe therefore does not include any dividend cutters. You might initially criticise the data for 'hindsight bias' on these grounds, but this would be to misunderstand the data's purpose. The data's perfect hindsight in fact make them the appropriate yardstick to measure the potential returns for an active strategy that can pick the right dividend growers going forward.

By contrast, the performance of indices and ETFs will inevitably be hampered by dividend cuts and the subsequent share price reactions. This is because they cannot make a judgement on companies' abilities to grow their dividends going forward. They are always looking backwards, as they are constructed from historic data, in the full knowledge that the past is not a good guide to the future. Active managers, by contrast, can avoid the pitfalls of dividend cuts by applying fundamental analysis. The limitations of passive strategies were exposed during the financial crisis: between 2007 and 2010, the number of stocks in the Dividend Aristocrats Index fell by almost a third as the difficult economic conditions caused many companies to cut their dividends. Selling a stock in the immediate aftermath of a dividend cut is often the worst time to exit the position, as so much bad news is reflected in the price.

In managing the M&G North American Dividend Fund, we use fundamental analysis to avoid dividend cutters. In the event of a dividend cut (which is yet to happen since we initiated our dividend growth strategy in the US), the fund has a process in place to optimise the selling of the holding in question. Following the announcement of the cut, the holding moves into the 'Sale at the right price' bucket, where it remains until the valuation returns to an appropriate level and the stock can be sold.

Valuation matters

Just as indices and ETFs cannot judge future dividend growth prospects, they cannot assess valuation. They are constructed mechanically from quantitative data, without taking a view on whether a stock is cheap or expensive for the growth being generated. Valuation matters for equity returns over the long run, but only active managers can make judgments on whether a stock's valuation is appropriate. They may be wrong on certain occasions, but we firmly believe that more often than not those with skill can add value with a valuation discipline.

Consumer staples have provided a perfect example in recent years of the pitfalls of ignoring fundamentals and valuation. An index could not determine that these stocks were expensive relative to history and their historic rates of growth were not sustainable because of competitive pressures and lack of investment. The combination of a de-rating of the stock prices and downward earnings revisions has since led to significant underperformance. An active manager could have recognised this and steered clear of these stocks, as we have done in our portfolio.

Sector skews

In addition to their more philosophical limitations, dividend growth indices and ETFs often have structural flaws. In particular, their sectoral composition tends to be imbalanced. As they comprise companies that have raised their dividends through several economic cycles, they tend to have a defensive bias. 40% of the stocks in the S&P 500 Dividend Aristocrats Index are defensives, compared to 29% in the S&P 500 and the M&G North American Dividend Fund. Indeed, a significant part (25%) of the Aristocrats' defensive exposure is concentrated in consumer staples. As such, the performance of the index and any ETFs that track it is vulnerable to significant setbacks in environments in which bond proxies underperform. By contrast, the M&G North American Dividend maintains a balanced portfolio by investing across three buckets: 'Quality' (defensives), 'Assets' (cyclicals), and 'Rapid growth' (growth).

We have seen the perils of a lack of diversification play out in the recent phase. Bond proxy sectors have materially underperformed the broader market through 2017 and so far in 2018 in an environment of rising interest rates. Consumer staples have been especially weak, for the reasons mentioned previously. The 25% allocation to this sector has therefore been particularly painful for the Dividend Aristocrats Index's performance. It is no surprise that the index has meaningfully underperformed the broader market during this period. It has also underperformed the fund, which – in addition to maintaining a balanced portfolio – has benefited from using the levers of active management to select stocks in defensive sectors that boast strong earnings and dividend growth. Such stocks are less likely to sell off with bonds because they offer more than just a high yield.

Fund performance

Cumulative performance over fund manager tenure			
Period	**1 year**	**3 years**	**Since tenure***
S&P Dividend Aristocrats Index	20.0	49.5	34.9
ProShares S&P 500 Dividend Aristocrats ETF	19.6	47.5	33.0
Fund (EUR A Acc)	21.7	50.1	33.3
S&P 500	22.3	50.8	38.9

Source: Bloomberg, Morningstar, Inc., as at 31 August 2018, Euro Class A Accumulation shares. *28 April 2015.

Currency	Total return, calendar years (% pa)				
	2017	**2016**	**2015***	**2014***	**2013***
Fund (EUR A Acc)	8.9	20.2	4.5	24.8	24.2
S&P 500 Index	7.0	15.3	12.9	29.5	26.7
IA North America Sector	4.5	12.6	9.8	25.3	25.4

Source: Morningstar, Inc., as at 31 August 2018, Euro Class A shares, income reinvested, price-to-price basis. *On 28 April 2015, the fund's name and objective changed. The past performance shown before this change was therefore achieved under circumstances that no longer apply.

Past performance is not a guide to future performance.

Invest with balance and judgement, not rules

The consistency of the Dividend Aristocrats Index and ETF's underperformance since we initiated our dividend growth strategy in the US points to several of the issues we have highlighted above. The index's performance has been meaningfully hampered by the weakness of bond proxies over the past two years, to which it has been exposed because of its inability to assess fundamentals and its flawed composition.

The passive strategy has been hurt by its reliance on rules, rather than judgement. By contrast, active managers are not forced to make inferior investment decisions by rules and have the flexibility to both avoid the hazards of ignoring fundamentals and pursue the best opportunities the market has to offer.

As such, we remain steadfast in our valuation-driven approach of creating a balanced portfolio of stocks with the potential to grow their dividends going forward. In our view, this is the optimal way to harness the powerful tailwind of long-term dividend growth in the US stockmarket.

John Weavers
M&G
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Please note that the fund invests mainly in company shares and is therefore likely to experience larger price fluctuations than funds that invest in bonds and/or cash.

Further risks associated with this fund can be found in the fund's Key Investor Information Document.