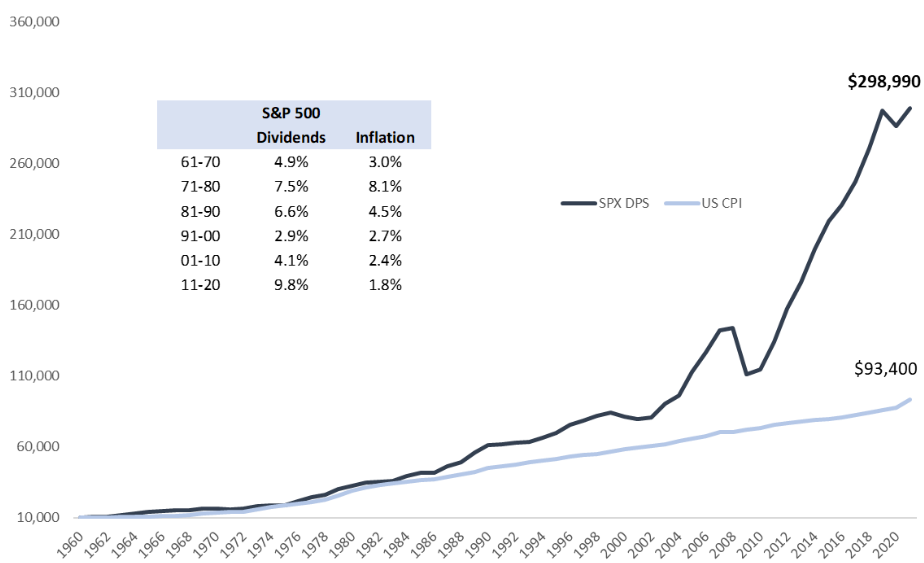
High Dividend Growth in Inflationary Environments

Concern over COVID-19's effect on the global economy has given way to inflation worries. A confluence of production/supply chain disruptions, geopolitical tensions, rising commodity prices, significant government stimulus, tight labour markets, and a broad return in demand as economies have reopened has caused inflation to run at levels not seen since the early 1980s.

Inflation is top of mind for investors, not only because it reduces purchasing power, but also because of the negative effects it has on bond prices and equity valuations, lowering the present value of the investments' future cash flows. However, when inflation is rising rapidly, dividends have a key advantage over bond coupons because the potential for growth can help investors preserve purchasing power.

Since 1960, S&P 500 dividends have grown by an average of 5.9% per year, more than 200 basis points above the rate of inflation, not only helping to preserve wealth, but grow it. Even in the 1970s where inflation was running higher than it is today, dividend growth largely kept pace over the decade.

Inflation and Dividend Growth through the Decades

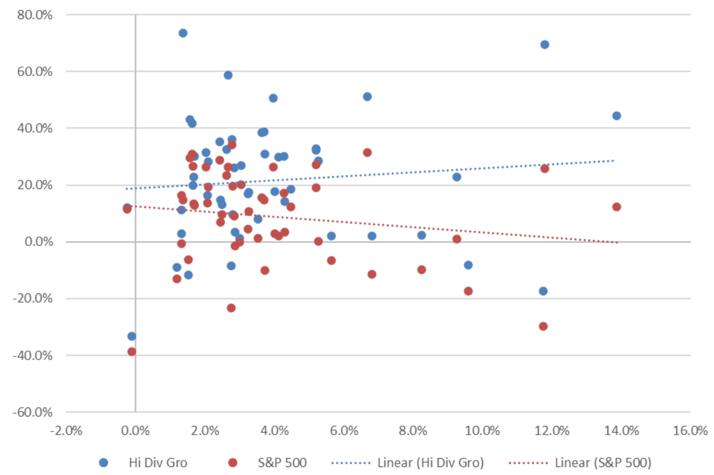


Source: Damodaran Online, Bloomberg, Bristol Gate Capital Partners.

In an effort to understand how inflation would affect our strategy, we analyzed data back to 1970, comparing the performance of high dividend growers to the broader market under various rates of inflation. The results in the chart below speak for themselves. The higher inflation went, the better High Dividend Growth did relative to the S&P 500.

See important disclaimers at end of document

High Dividend Growers and S&P 500 Returns vs. Inflation (x-axis)

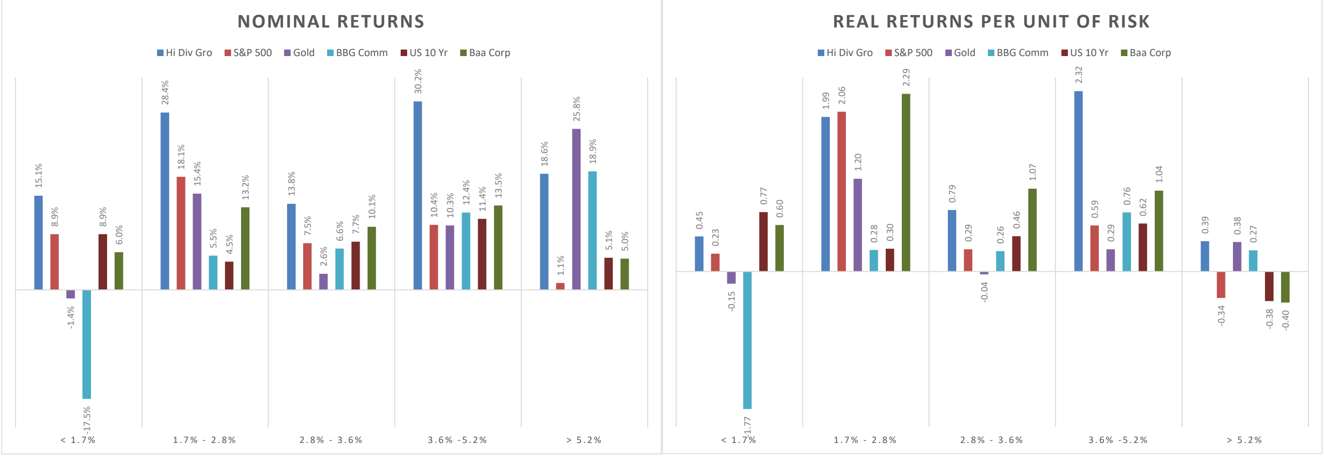


Notes: Annual data between 1970-2020. High Dividend Growers defined as the top quintile of dividend growth in the S&P 500, equally weighted and reset annually. Returns for the S&P 500 and High Dividend Growers are price returns only. We do not believe including dividends would materially change conclusions.

Source: Bloomberg, FactSet, St. Louis Federal Reserve, Bristol Gate Capital Partners.

We also analyzed returns of other assets at various levels of inflation (x-axis). The High Dividend Growth cohort performed admirably in all cases and particularly well in higher inflationary periods. Real returns per unit of risk, defined as return volatility in this case, were best on a relative basis when inflation was highest (in the top two quintiles).

Asset Returns in Various Inflation Environments



See important disclaimers at end of document

Notes: Annual data between 1970-2020. Inflationary environments broken down into quintiles, using year over year growth in the US Consumer Price Index. High Dividend Growers defined as the top quintile of dividend growth in the S&P 500, equally weighted and reset annually. BBG Comm is the Bloomberg Commodity Index. Return data is averaged. Returns for the S&P 500 and High Dividend Growers are price returns only. We do not believe including dividends would materially change conclusions. Real returns per unit of risk equals nominal return less inflation divided by standard deviation of returns.

Source: Bloomberg, St. Louis Federal Reserve, Damodaran Online, FactSet, Bristol Gate Capital Partners

Although commodities, a popular inflation hedge, also performed well in these instances, we prefer the durable characteristics of dividend growers. As Morningstar says:

> *Companies that are focused on growing dividends tend to be higher-quality, cash-rich businesses that hold up well in down markets, participate in up markets, and are capable of excess returns over a full market cycle.*
>
> *In addition to being core, defensive holdings, companies that are growing their dividends provide some protection from inflation: A rising dividend is fundamental to investors' ability to preserve purchasing power through their equity portfolio.*
>
> *It's also likely that dividend-growth stocks will be less sensitive to losses during periods of rising interest rates. For example, high-yielding stocks intuitively become a less attractive income source when yields rise on bonds, a less risky asset class. But because dividend growers tend to sport more modest yields, they were never the first choice for yield hounds in the first place.*[1]

Companies with the resources to consistently grow dividends at high rates tend to be profitable and financially sound. We also generally find they have an element of pricing power or cost advantage and higher margins that affords them the ability to absorb rising costs better than competitors or pass them down to the end customer.

We do not know whether inflation will prove to be temporary or not. We learned long ago not to pontificate on macro events and more importantly, not to construct a portfolio for any specific view. The future is largely unknown and being prepared for variety of outcomes is the best course of action. We believe focusing on companies exhibiting high dividend growth and strong fundamentals puts the odds of success on our side regardless of what the environment throws at us.

[1] https://www.morningstar.com/articles/855088/whats-the-difference-between-dividend-yield-and-dividend-growth-stocks

Important Disclosures

There is a risk of loss inherent in any investment; past performance is not indicative of future results. Prospective and existing investors in Bristol Gate's pooled funds or ETF funds should refer to the fund's offering documents which outline the risk factors associated with a decision to invest. Separately managed account clients should refer to disclosure documents provided which outline risks of investing. Pursuant to SEC regulations, a description of risks associated with Bristol Gate's strategies is also contained in Bristol Gate's Form ADV Part 2A located at www.bristolgate.com/regulatory-documents.

This piece is presented for illustrative and discussion purposes only. It should not be considered as personal investment advice or an offer or solicitation to buy and/or sell securities and it does not consider unique objectives, constraints, or financial needs of the individual. Under no circumstances does this piece suggest that you should time the market in any way or make investment decisions based on the content. Investors are advised that their investments are not guaranteed, their values change frequently, and past performance may not be repeated. References to specific securities are presented to illustrate the application of our investment philosophy only, do not represent all of the securities purchased, sold or recommended for the portfolio, it should not be assumed that investments in the securities identified were or will be profitable and should not be considered recommendations by Bristol Gate Capital Partners Inc. A full list of security holdings is available upon request. For more information contact Bristol Gate Capital Partners Inc. directly. The information contained in this piece is the opinion of Bristol Gate Capital Partners Inc. and/or its employees as of the date of the piece and is subject to change without notice. Every effort has been made to ensure accuracy in this piece at the time of publication; however, accuracy cannot be guaranteed. Market conditions may change and Bristol Gate Capital Partners Inc. accepts no responsibility for individual investment decisions arising from the use of or reliance on the information contained herein. We strongly recommend you consult with a financial advisor prior to making any investment decisions. Please refer to the Legal section of Bristol Gate's website for additional information at bristolgate.com.

A Note About Forward-Looking Statements

This report may contain forward-looking statements including, but not limited to, statements about the Bristol Gate strategies, risks, expected performance and condition. Forward-looking statements include statements that are predictive in nature, that depend upon or refer to future events and conditions or include words such as "may", "could", "would", "should", "expect", "anticipate", "intend", "plan", "believe", "estimate" and similar forward-looking expressions or negative versions thereof.

These forward-looking statements are subject to various risks, uncertainties and assumptions about the investment strategies, capital markets and economic factors, which could cause actual financial performance and expectations to differ materially from the anticipated performance or other expectations expressed. Economic factors include, but are not limited to, general economic, political and market factors in North America and internationally, interest and foreign exchange rates, global equity and capital markets, business competition, technological change, changes in government regulations, unexpected judicial or regulatory proceedings, and catastrophic events. Readers are cautioned not to place undue reliance on forward-looking statements and consider the abovementioned factors and other factors carefully before making any investment decisions. All opinions contained in forward-looking statements are subject to change without notice and are provided in good faith. Forward-looking statements are not guarantees of future performance, and actual results could differ materially from those expressed or implied in any forward-looking statements. Bristol Gate Capital Partners Inc. has no specific intention of updating any forward-looking statements whether as a result of new information, future events or otherwise, except as required by securities legislation.