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Investing for Dividend Growth

Webinar: The Strategy of Franklin U.S. Rising Dividends Fund

In this webinar, **Franklin U.S. Rising Dividends Fund portfolio managers Nick Gétaz and Matt Quinlan** discussed their strategy for investing in dividend-paying companies and how they have positioned the fund as the global economy recovers from the pandemic. Here are the key takeaways.

Strategy for the recovery

The extreme volatility during the sell-off of February/March last year presented opportunities to add quality names to the Franklin U.S. Rising Dividends portfolio. Tough economic conditions meant dividend cuts were predicted at the outset of the pandemic, but these cuts weren't as far reaching as expected, particularly in the portfolio where approximately 3% of holdings reduced dividends. Boosted by unprecedented fiscal and monetary stimulus, the second and third quarters saw a strong recovery in equity markets. The portfolio held up well during the initial sell-off, but some pandemic-specific elements (aerospace, medical devices/elective procedures, and discount retailer Ross Stores) weighed on performance. But as markets recovered, so too did these impacted companies. In the first six weeks of 2021, there have been different periods of market leadership from quality, high growth, and lower quality cyclical stocks. Quality as a style has under-performed over the past four weeks, which is not unusual for a recovery period when markets often favour some of the more hard-hit names. This lower quality rebound is often subject to higher volatility, however, as the market weighs the strength and staying power of the recovery. The U.S. Rising Dividends team is working to mitigate this volatility by adding exposure to neglected quality stocks.

Dividends over the long term

Historically, the evidence shows that dividend-growing stocks have tended to perform better than stocks that don't provide dividends, but with less risk. The chart on the page 3 shows dividend growers against the S&P 500 Index over the 30-year period ending December 31, 2020. This time frame includes multiple market cycles and downturns, including the Dot-Com collapse; the Global Financial Crisis; as well as "The Lost Decade", the 10-year period up to 2009 when U.S. equities (represented by the S&P 500 Index) had a near-zero return. Most recently, there was the market collapse of last February/March, although the index finished 2020 in positive territory, boosted by the performance of the FAANG stocks, which are not held in the portfolio and have been a major headwind in recent years. Taking a long-term view, corrections and drawdowns are inevitable, so it's crucial to build portfolios of high-quality companies that can navigate different economic cycles. Determining what constitutes "high-quality" in a company requires fundamental research and analysis, but a good starting point is identifying what firms have a track record of increasing dividend payments to shareholders.

Construction of a dividend fund

The Franklin U.S. Rising Dividends team believes that a rising dividend is evidence of three key characteristics: growth, strong capital allocation, and resilience. Companies that show substantial and sustainable dividend growth tend to experience greater long-term stock price appreciation. As such, selecting dividend growers has allowed this fund to outperform its Morningstar U.S. Equity category average over the most recent year-to-date, one-year, three-year, five-year and 10-year periods.[1] Being able to consistently increase dividend payouts, even during periods of wider economic malaise (the past year being a perfect example) points to a company that is well managed and with a resilient business model. Investors can therefore participate in market growth while still protecting their capital against downside risk.

Consistent dividend increases are at the heart of the Franklin U.S. Rising Dividends strategy (holdings with increased payouts in at least eight out of the last ten years, no decreases; and dividends that have at least doubled over the same period), but there are other factors to consider. Earnings should be reinvested for future growth, and firms must display a strong balance sheet with long-term debt less than 50% of total capitalization. A value overlay is also used to identify companies that are trading below their intrinsic value. Together, these screens are used to build a fund that is suitable for investors searching for a core U.S. equities strategy but who are concerned about volatility and timing uncertainty.

Dividend payers across sectors

As an actively managed solution, Franklin U.S. Rising Dividends Fund emphasizes the importance of sector diversification. Industrials, Information Technology and Health Care have the largest allocations in the fund; in contrast, there is no exposure to Communication Services, Utilities and Real Estate—the latter two sectors' growth prospects making them generally less attractive.

In Health Care, current holding **Medtronic PLC** is a good example of the type of company the investment team seeks out for the portfolio. With consistent dividend increases for 43 years, the world's largest medical device manufacturer has a diversified and resilient product portfolio. Medtronic is a leading provider of cardiovascular and surgical products, and the development of surgical robots and a suite of cardiac rhythm products position it for potential sales growth and efficiency gains in the coming years. The firm is also committed to return 50% of free cash flow,[2] which is another positive sign for its long-term prospects.

Another example is the largest position in the fund, **Microsoft**. The software behemoth has accounted for 8–9% of the portfolio over the past year, which is a significant weighting, but given its large benchmark weighting, the fund's relative overweight is approximately in line with the other top 10 positions. The reason it occupies such a large position in the fund is because it exemplifies the three important characteristics of growth, strong capital allocation, and resilience. In the team's view, Microsoft has a number of different growth drivers among its cloud, enterprise productivity and gaming offerings. Microsoft Teams has become a vital tool for many companies as its employees switched to working from home over the past year, which is further evidence of Microsoft's resilience and ability to thrive through different market cycles.

Outlook for 2021 and beyond

The Franklin U.S. Rising Dividends team is optimistic about the outlook for the both the U.S. and global economies. In an attempt to bring employment back to pre-COVID levels, the Biden administration has some ambitious plans to spur growth, including a US$1.9 trillion stimulus package and US$2 trillion in infrastructure spending. Gétaz and Quinlan believe that an improving economy could mean more opportunities for broader market participation, particularly in sectors such as Health Care and Industrials. Another sector to keep an eye on is IT; the fund's managers have high expectations for various technology companies, given the somewhat muted stock reactions to 2020's fourth quarter results, which were very strong.

Looking ahead, some of the key risks for market growth include inflation, certain sectors being left behind in the recovery, and the impact of QE tapering by central banks. Of course, these risks are contingent upon what progress is made in containing COVID-19 and whether public vaccination programs can drive infection and hospitalization rates down to levels where lockdowns are no longer necessary in the second half of 2021.

Long-Term Historical Performance for Dividend Growers

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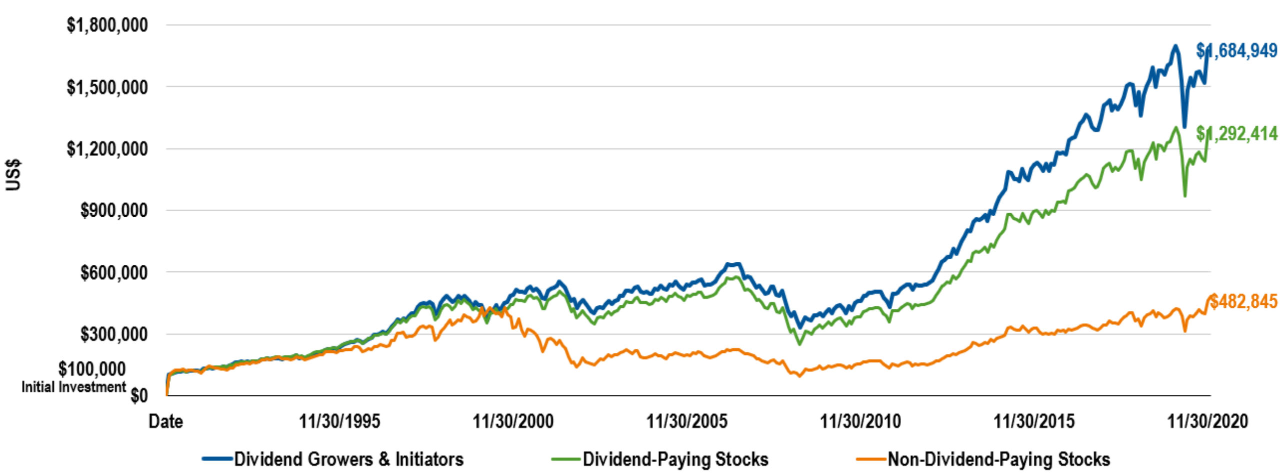
S&P 500 Index Stocks by Dividend Policy[3]—Growth of $100,000 Investment
30-Year Period Ended December 31, 2020



Franklin Equity Group

Franklin Equity Group brings together more than six decades of investment experience offering in-depth expertise in managing growth, value and hybrid/balanced equity strategies that cover global, regional and sector specialties.

Franklin U.S. Rising Dividends Fund

This fund seeks to achieve long-term capital appreciation by investing primarily in American equities, with at least 80% of net assets in companies that have paid consistently rising dividends.
Management Expense Ratio—Series F:1.30%; Management Fee—Series F: 1.00%

1. As of December 31, 2020. Franklin U.S. Rising Dividends Funds (Series F) one-year return: 13.22%, three-year: 12.31%; five-year: 11.80%; ten-year: 13.99%
2. Source: Bloomberg, as of 12/31/19. 2. Source: Medtronic Q4 quarterly release as of 01/31/21. Most recent data available. As of 01/31/21, Medtronic PLC was not part of the top ten assets in Franklin U.S. Rising Dividends Fund.
3. Source: © 2021 Ned Davis Research Group, Inc. The chart represents the dividend growers and initiators, dividend and non-dividend-paying stocks of the S&P 500 Index, based on a rolling 12-month dividend policy.

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