TD Asset Management

INVESTMENT SOLUTIONS

Going with the Flow

Cash flow is often a key determinant in valuing companies. In most cases, the stronger the cash flow, the stronger the company's financial health. Here at TD Asset Management Inc. (TDAM), we watch cash flows particularly carefully because dividends are paid from available cash, and we believe that dividend investing can generate desirable investment outcomes.

Growing with the flow

As companies generate cash flows, they must decide what to do with available cash. Their options may include:

- Investing in their business
- Making acquisitions
- Repurchasing shares
- Repurchasing debt
- Paying dividends

While each of these options can add value to a company, companies that return cash flows to investors in the form of dividends often offer better return on invested capital. And those that are able to grow their dividends have outperformed versus other companies in their sector. Why? We believe a growing dividend stream can be evidence of a strong business model. After all, if a company is able to raise its dividend, that's an indication it's able to grow its cash flow. Increasing cash flows indicate that the company has a durable competitive advantage, and the market assigns a higher valuation to these companies (see table on page 2).

Returns of S&P 500 Dividend Growth Companies

June 30, 1997 – June 30, 2017

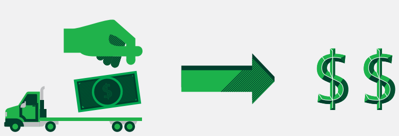
Sector	Annualized return from dividend growth companies	Annualized added value vs. broad sector	Risk* vs. broad sector (<1 = less risk, 1 = neutral, >1 = more risk)
Consumer Discretionary	12.2%	-0.2%	0.97
Energy	11.9%	0.5%	1.06
Financials	10.3%	0.4%	0.98
Healthcare	13.7%	2.4%	0.90
Industrials	**13.1%**	**2.5%**	**0.97**
Information Technology	13.2%	0.6%	0.89
Materials	13.6%	3.4%	0.99
Consumer Staples	12.7%	2.9%	1.01
Telecommunications	9.3%	2.1%	0.89
Utilities	11.6%	1.2%	0.98

Source: Bloomberg Finance L.P. *Beta

We compared the highest dividend growers in each sector to the aggregate performance of that sector and provide the results in the table above. The data is pretty convincing. Dividend growth stocks outperformed in every sector except Consumer Discretionary. For example, investing in Industrials companies that had the highest 5-year trailing dividend growth would have generated an annualized total return of 13.1%, 246bps more than the overall sector's return. Now 246bps might not seem like much, but over time the alpha created can compound significantly.

The Dividend Growth Advantage[1]

Investor A invested $10,000 in
all Industrial sector stocks
After 20 years, the investment was worth **$75,279**



Investor B invested $10,000 in
dividend growth Industrial sector stocks
After 20 years, the investment was worth **$116,873**

The other side of the coin is risk, as in how much volatility do you have to incur to generate that outperformance? There is good news here also, as in most sectors the underlying group of dividend growers was less volatile than the sector average. This again relates to the theory above. If a company has consistently rising cash flows, it is likely to have less volatility in revenues, margins and profits. And if a stock has less fundamental volatility, it should have lower price volatility, which means the market would assign it a lower risk premium.

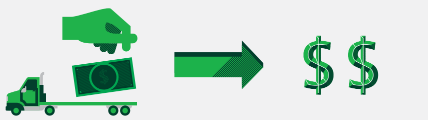
Quality counts

Quality companies, those with strong balance sheets and entrenched competitive positioning, should have growing free cash flows, so we tested whether introducing a quality standard[2] to dividend growers enhances performance even further. We selected companies that had low debt, high return of capital, large market capitalizations, strong cash flow growth and above average dividend growth. The results were impressive.

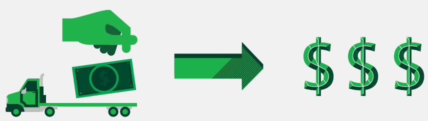
Over the 20 years from June 30, 1997 to June 30, 2017, these quality dividend growth companies outperformed the S&P 500 index by 492bps, and they outperformed dividend growth companies by 187bps. The breadth of the outperformance was widespread, with value being added in

The Quality Dividend Growth Advantage[1]

Investor A invested $10,000 in
all Industrial sector stocks
After 20 years, the investment was worth **$75,279**



Investor B invested $10,000 in
dividend growth Industrial sector stocks
After 20 years, the investment was worth **$116,873**



Investor C invested $10,000 in
quality dividend growth Industrial sector stocks
After 20 years, the investment was worth **$162,814**

all but one sector. In addition, risk was reduced, with beta coming in at 0.92 overall.

The future is fundamental

Our research demonstrates the outperformance of companies that pay and grow dividends, and dividend strategies have become very popular over the past several years as low interest rates led investors on a search for yield. But what does the future hold? We believe that continued low rates will provide an ongoing tailwind for dividend stocks. However, given their strong historical performance, we see current valuations as fair to full, which means that fundamental analysis will be a key to distinguishing value moving forward.

Fundamental analysis includes vetting business models, evaluating competitive positioning, forecasting future cash flows, interviewing management teams and anticipating structural changes. We believe that careful fundamental research can identify the high quality dividend growers of the future.

[1] 20-year returns from June 30, 1997 – June 30, 2017.

[2] Quality measures we used included: Net debt/Earnings before interest, taxes, depreciation and amortization <4, Return on invested capital >15, Market cap > 1B, Growth of cash flow per share over 3 years >5, and above average dividend net 5-year growth rate.

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