Isolated Dividends: The New Inflation Hedge

For decades, investors have owned equities primarily for the potential long-term appreciation they provided while turning to other asset classes such as commodities to hedge their portfolio against inflation. However, what investors may not know is that dividends are potentially the most effective hedge against inflation, as they historically have been highly correlated to CPI, more so than any other asset class. One reason investors have overlooked dividends as an inflation hedge is that this exposure was not available as a stand-alone investment – that is, until now.

The higher correlation between dividends and inflation relative to traditional asset classes is intuitive if one considers that dividends generally are directly proportional to nominal company earnings and that inflation is reflected in earnings. In an inflationary environment, nominal earnings increase, but for stockholders any such increase in nominal earnings can be largely (if not completely) offset by a contraction of the P/E multiple. Dividends, by contrast, are a near-pure play on nominal earnings, in our view, without the effect of P/E multiples on underlying stock prices.

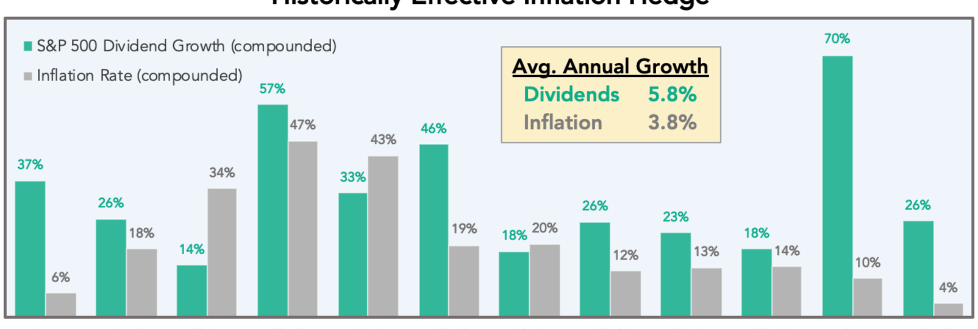
Since 1960 the annualized growth of S&P 500 Index dividends has been 5.8%, compared to 3.8% for CPI (a proxy for inflation) – an average annual outperformance of +2% per year, while being positively correlated over this period.

The Inflation Cycle from 1970-1980

Taking a closer look at one of the greatest inflationary periods in recent U.S. history, 1970-1980, supports this thesis that there is a high correlation between dividends and inflation. During this period, the S&P 500 Index and 10-year Treasury Bond both underperformed their long-term averages and exhibited a high level of volatility. It is well established that interest rates and inflation move in tandem with each other (this period was no exception). Also, S&P 500 dividend growth and inflation were particularly closely correlated (~60%) during this period of roughly 8% annual inflation. One can reasonably conclude, therefore, that dividend growth would have operated as an effective hedge against the inflationary and rising rate environment of the 1970s.

As one might expect during periods of high inflation, commodities performed very well relative to the other traditional classes, albeit with significant volatility. Unlike equities and bonds, which are impacted by contracting P/E multiples and rising interest rates, dividends outperformed their long-term average with much less volatility (about 1/5 the volatility of the S&P 500 Index). This resulted in outsized risk-adjusted returns in comparison to these traditional asset classes.

Historically Effective Inflation Hedge



Investing in Isolated Dividends Today

As we near the late innings of an economic cycle characterized by record QE/fiscal stimulus, historically low global interest rates and inflation levels, and a prolonged bull market, investors seeking to adapt to the changing economic landscape might consider increasing their exposure to corporate dividends. If rising interest rates and inflation are among your investment theses, come talk to the Metaurus Team about accessing isolated dividend exposure today.

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