QV UPDATE

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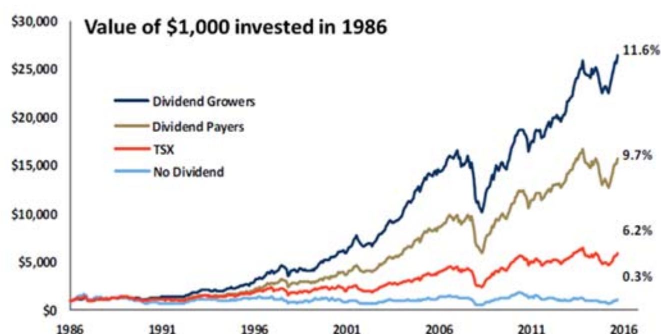
Decisions, decisions...

In Canada, dividend growth has been an advantageous investment strategy for decades. The chart below shows the significant outperformance of dividend payers and growers relative to the broader index over the last 30 years. In addition to significantly enhancing returns, the dividend growth strategy has done so with comparatively less volatility.

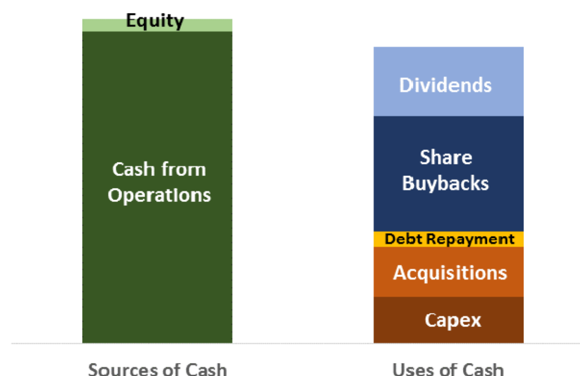


Source: RBC CM Quantitative Research. Assumes all dividends are reinvested.

Dividend growth is something we often look for in potential investments, as it can be a sign of quality in the underlying businesses. Regardless of yield, companies that grow dividends over time tend to compound earnings faster than those that pay a stable dividend or none at all. They tend to generate consistent cash flows, and the increases themselves may demonstrate management's confidence in the business outlook.

With a finite amount of capital at its disposal, a company must choose how it will allocate its financial resources among various priorities. Should it pay dividends, invest in organic growth, pursue acquisitions or pay down debt? There are many factors at play and the effective outcome depends on the type of industry, the maturity of the company, and the particular business strategy it is pursuing.

Some of our favourite quality businesses strike an attractive balance between consistently returning capital to shareholders and investing in growth over time. Richelieu Hardware, a long term holding in our small cap strategy, is a fantastic example, having grown both dividends and earnings per share by approximately 10% per year over the last 10 years. As shown in the next chart, it has been able to do so by relying almost exclusively on internally generated cash flow.



Source: S&P Capital IQ, QV Investors

Internal funding means that a company can implement its growth strategy without having to dilute existing shareholders through equity issuance or increase balance sheet risk by issuing debt.

However, the source of capital is only one part of the equation. To evaluate whether a company's capital allocation decisions have created value over time, we rely on financial ratios such as return on capital and return on equity, for which Richelieu has achieved attractive long term rates of 16% and 14%, respectively.

Although the collective outperformance of dividend growers is undeniable, the capital allocation decision for individual companies is much more complex. While many of our holdings pay and grow dividends over time, there are some who pay none at all. While Richelieu generates high cash flow in a capital-light business model, others rely more heavily on external sources of funding for growth. When evaluating potential investments, we must assess the effectiveness of a company's capital allocation decisions in light of the industry dynamics at hand. Vastly different operating environments call for vastly different strategies. Certain businesses may not have the capacity to increase dividends, choosing instead to reinvest in more attractive growth opportunities. At the end of the day, we favour management teams that have successfully allocated capital over time while prudently managing balance sheet risks.

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