NORTHSTAR FINANCIAL PLANNERS INC.

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FINANCIAL PLANNING NOTES
CLIENT NEWSLETTER

THE ALL-INFLATION ISSUE!

INFLATION: ARE DIVIDEND STOCKS THE ANSWER?

Inflation in the U.S. has surged to the highest level in nearly 40 years, reaching 7.9% in February 2022.[1,2] This, coupled with the U.S. Federal Reserve's decision to raise interest rates, has alarmed many investors.[3] Some are turning to dividend-paying stocks, hoping to receive more income protection and higher returns.[4] Will it work?

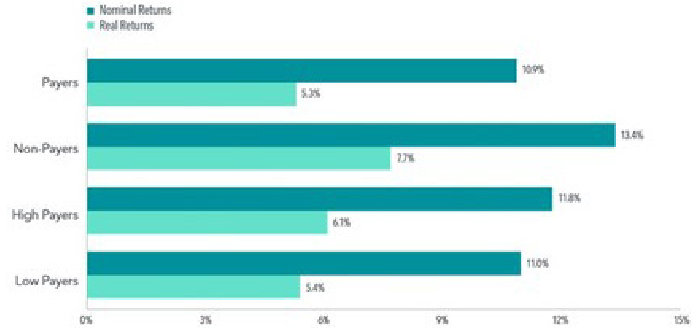
Before diving into the performance of dividend-paying stocks, it's important to note that the percentage of firms paying dividends has declined globally.[5] 68% of U.S. companies were paying dividends in 1927, while only 38% of firms paid in 2021. By focusing only on dividend-paying stocks, we will be sacrificing diversification. In addition, a dividend-focused strategy does not necessarily provide stable income. In fact, changes in dividend policy are common, especially during times of higher uncertainty. For example, many dividend payers cut their dividends during the pandemic—in the first three quarters of 2020, dividends from each dollar invested in U.S. markets decreased by 22% compared to the same period in 2019.[6]

But do dividends help combat high inflation? To answer this question, we study the performance of Fama/French U.S. portfolios formed on dividend yield from 1928 to 2021.[7] At the end of each June, all U.S. companies are divided into two groups, payers and nonpayers, based on whether they paid a dividend during the previous 12 months. Then, within the payers, high payers are defined as the 30% of firms with the highest dividend yields, and the low payers are the bottom 30%. As of December 2021, the weighted average dividend yield is 1.8%, 0.7%, and 3.7% for payers, low payers, and high payers, respectively.

Exhibit 1 shows that all four dividend portfolios had positive nominal and real average returns in high-inflation years, when inflation was on average 5.5% per year.[8,9] So outpacing high inflation over the long term is not a unique advantage of dividend-paying stocks. In addition, the return differences between payers vs. nonpayers and high payers vs. low payers are not reliably different from zero. Therefore, we don't see strong evidence that dividend-paying stocks deliver superior inflation-adjusted performance during high inflation periods.

Exhibit 1. No Special Delivery

Average annual returns of dividend portfolios in high-inflation years, 1928–2021

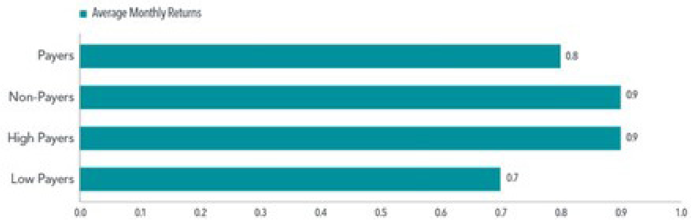


Past performance is no guarantee of future results.

What about rising interest rates? We first look at the average monthly returns for different dividend portfolios in months with rising 3-month Treasury yields. **Exhibit 2** shows that dividend payers, nonpayers, high payers, and lower payers had similar average monthly returns from March 1934 to December 2021. The conclusions are similar using the effective federal funds rate and 10-Year Treasury yields.[10] Piling into dividend stocks would not have led to superior returns in months with rising interest rates.

Exhibit 2. Unconvincing

Average monthly returns of dividend portfolios in months with rising 3-month Treasury yields, March 1934–December 2021



Past performance is no guarantee of future results.

What should investors do? It is natural to be concerned about the potential impact of high inflation and rising interest rates on portfolios. However, we believe our analysis shows there is no reason to expect dividend-paying stocks or high dividend payers to offer more protection and higher returns during these periods. Market prices reflect the aggregate expectations of all market participants, including expectations about inflation and interest rates. Staying disciplined and broadly diversified, instead of chasing dividend stocks, may put investors in a better position to achieve their investment goals.

—Dimensional Fund Advisors

Article source: "Should You Chase Dividend Stocks to Combat Inflation and Rate Hikes?" by Mia Huang, mydimensional.com, 5 April 2022.

Footnotes

[1]"Consumer Price Index - February 2022," Bureau of Labor Statistics, US Department of Labor, March 10, 2022.

[2]US inflation is measured as the annual rate of change in the Consumer Price Index for All Urban Consumers (CPI-U, not seasonally adjusted) from the Bureau of Labor Statistics.

[3]Nick Timiraos, "Fed Raises Interest Rates for First Time Since 2018," Wall Street Journal, March 17, 2022.

[4]Hardika Singh and Michael Wursthorn, "Investors Gobble Up Dividend Stocks During Market Turbulence," Wall Street Journal, February 8, 2022.

[5]Stanley Black, "Global Dividend-Paying Stocks: A Recent History" (white paper, Dimensional Fund Advisors, March 2013).

[6]"Dividends in the Time of COVID-19," Insights (blog), Dimensional Fund Advisors, November 30, 2020.

[7]See the Index Description for more information regarding Fama/French Portfolios formed on Dividend Yield.

[8]High-inflation years are defined as having inflation greater than the full sample median, 2.68%, from 1928 to 2021.

[9]Real returns are calculated using the following method: [(1 + nominal annual return) / (1 + inflation rate)] – 1.

[10]"Federal Funds Effective Rate (FEDFUNDS)," Federal Reserve Bank of St. Louis (Percent, Monthly, Not Seasonally Adjusted).

COMBAT INFLATION NOW AND IN THE FUTURE: 4 STEPS

Are you feeling inflation's squeeze? A lot of people are. The inflation rate is the highest it has been since 1982, and prices are affected across the board.

Perhaps you remember the financial pain that previous inflation bouts have inflicted. Or maybe you're younger and this is the first time you've had to wrangle with rising costs. Regardless, you're probably wondering what you can do about inflation.

Here are four steps to help you combat inflation both now and in the future.

1. Re-evaluate Your Budget

If you're coming up short on essentials like groceries and utilities, take a second look at your budget. It's our hope that inflation will stabilize soon, but in the meantime, you need to make sure your "must-haves" are covered, which means increasing your budgeted amounts for those categories. This could mean reducing expenditures in other categories, such as memberships or subscriptions.

If you don't have a budget, consider starting one so that you avoid overspending (so easy to do when inflation is on the rise!). Apps to consider include Mint, Goodbudget, EveryDollar, Personal Capital, and YNAB (You Need a Budget).

2. Limit Your Cash Holdings

Many people feel safer having their money parked in a savings or checking account. But there is another way to look at it: More than likely, that account gives you an interest rate that is far less than the inflation rate. So, essentially, your money is *losing* value.

Now, there are instances where you need to keep your money liquid. For example, we generally recommend keeping an emergency fund with three to six months' worth of expenses. Because emergency funds cover, well, emergencies, you need to be able to access the money immediately. Invest the money in equities and you'll need to sell your stocks before you can use the money, and you'll face potential taxes for the sale.

So, in this case, a low interest rate is the trade-off for easier accessibility. Otherwise, for medium- to long-term goals, you can consider investment and savings vehicles that offer a higher rate of return. This brings us to step #3.

3. Invest for the Future

Historically, investing has proven an optimal way to offset inflation since the average annual stock market return has been around 10%. Still, you may feel tempted to reduce your savings right now to ensure you cover current expenses. We generally suggest cutting spending in other budget categories before you touch your contributions to investment accounts, such as your 401(k) or IRA.

Fidelity issued a distressing finding in its 2022 State of Retirement Planning report: 45% of younger savers (ages 18 to 35) who quit their jobs last year and cashed out their 401(k)s saw no point in saving for retirement until "things get back to normal."

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No matter your age, please don't wait for anything to get back to normal. It may never happen. But by saving regularly over a long period, you help build a nest egg that is large enough to give your future self some financial flexibility even in times of high inflation.

Build a diversified portfolio designed for your risk tolerance and return needs. If you're unsure how to achieve this, consider working with a financial advisor.

4. Consider Whether Inflation "Hedges" Are Appropriate for You

Finally, you might look into whether traditional inflation hedges are appropriate. These may include investing in dividend-paying or commodity companies, buying bonds that adjust their payouts based on the inflation rate, or purchasing real estate as an investment.

Final Thoughts

These four tips can help mitigate the impact of inflation. Depending on whether inflation continues to rise or (finally) drops, you may need to take another look at your budget. Continue to invest for the long term to increase your financial flexibility in retirement, when you will likely be on a fixed income.

If you're unsure about your financial plan, consider working with an advisor. Our Plantation, FL fiduciary wealth management firm helps create personalized strategies for each client. We generally advise that you work with a fiduciary financial advisor so you can feel assured that the advice you receive is in your best interest.