ClearBridge Investments September 2018

STRONG DIVIDEND GROWTH OFFSETS RISING RATES

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Key Takeaways

- 2018 has been a good year for dividend investors, as dividend increases in the U.S. have averaged 8% in the past year.[1]
- With the corporate tax rate reduced to 21%, dividends are the most tax efficient they have been in decades.
- In previous periods of rising interest rates, dividend growers have outperformed.

It has been an excellent year for dividend investors. In the past year, dividends have increased 8%, up from 7% the year before. We believe investors with a focus on dividend growers should benefit from this trend and are well positioned for a rising interest rate environment.

As interest rates have risen over the last year, many investors have asked if dividend payers are still a good place to be. They see bonds offering better rates than they did a year ago and wonder if the time for dividends has passed. And, indeed, as interest rates have increased in the early part of this rate cycle, dividend-paying stocks have experienced some turbulence.

Dividend payers often underperform in the early part of a rising rate cycle. But as the interest rate cycle matures, dividend payers in general, and dividend growers in particular tend to more than recoup that initial underperformance.

While there is no guarantee that the past is prologue in this interest rate cycle, there is good reason why dividend payers should hold up well amid rising rates. Growing cash flow is the only way to offset rising interest rates. So as the rate cycle progresses, a portfolio of high-quality dividend growers can help to offset the ravages of higher interest rates.

Economic Strength and Corporate Tax Cuts Driving Dividend Growth

Several factors have combined to make this a fertile environment for dividend growth. First, a robust U.S. economy provides a firm foundation. After a decade of post-crisis torpor, U.S. gross domestic product (GDP) growth has accelerated to over 4% in the second quarter of 2018. This improvement in the economy has boosted corporate earnings: S&P 500 Index companies' earnings growth in the second quarter of 2018 showed the third-highest earnings growth rate since 2010.[2]

Both the economy and corporate earnings have benefited from the recent cut in corporate tax rates. Lower tax bills result in higher net income, providing more cash to distribute to shareholders. Looked at from a historical perspective, the recent tax cut builds on a foundation that was laid in 2003. In 2003, the tax rate on qualified dividends was reduced to 15% from an individual's marginal income tax rate. This was a watershed event for dividend investors as it meaningfully reduced the drag of double taxation.[3] The recent corporate tax cuts further reduced the burden of double taxation, making dividends today a far more efficient mechanism for returning value to shareholders than they have been in decades (Exhibit 1).

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Exhibit 1: Dividends Becoming Increasingly Attractive

	Pre-2003	2003-2017	2018
Pre-Tax Income	US$ 100	US$ 100	US$ 100
Corporate Tax Rate	35%	35%	21%
Corporate Net Income	US$ 65	US$ 65	US$ 79
Dividend Tax Rate	39.6%*	15% †	15% ‡
After-Tax Dividend Value	**US$ 39.26**	**US$ 55.25**	**US$ 67.15**

Source: ClearBridge Investments. *Assumes maximum marginal tax rate. † For qualified dividends. ‡ For qualified dividends for individuals earning under US$400,000 and households earning under US$450,000. For simplicity, table assumes a 100% payout ratio.

Tax Implications Differ by Company

The benefits of tax cuts are not distributed uniformly across all companies and industries. The impacts vary according to several factors, including, importantly, a company's geographic footprint.

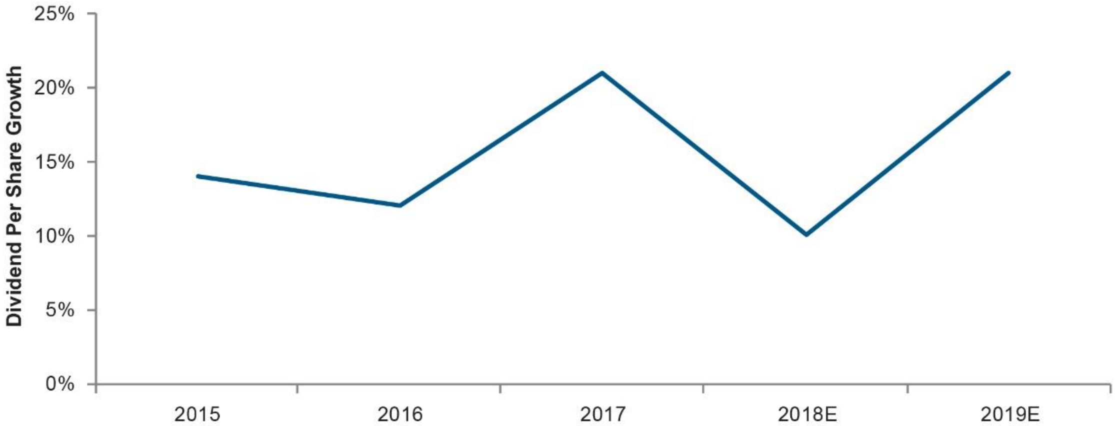
For years, many of the largest global companies used complex tax structures to drive their tax rate well below the U.S. statutory rate of 35%. With tax rates that already hovered in the low-to-mid 20% range, these companies have seen less benefit from the recent tax cuts. Domestically focused businesses, however, were unable to do this under the old regime and thus generally see bigger benefits from the tax cuts.

Banks stand out as one sector that particularly benefits from the tax cuts, as most of them, including many of the largest banks, are primarily U.S.-focused. The change in the tax rate alone has lifted net income for many banks by around 20%.

Banks have also benefited from a friendlier regulatory environment. The Fed recently raised the asset threshold for large bank regulations to US$250 billion from US$50 billion. The Fed also appears to be more open to rethinking some of the most onerous and opaque aspects of the annual Comprehensive Capital Analysis and Review (CCAR) stress tests, which would ease some of the restrictions on capital returns this exam has imposed in the past.

The combination of rising interest rates (which increase banks' net interest margins), lower taxes and an easing regulatory burden should drive increased after-tax earnings and bigger returns to bank shareholders. Consequently, banks seem well positioned to continue boosting their dividends at a double-digit rate (Exhibits 2 and 3).

Exhibit 2: Banks Continue Double-Digit Dividend Growth



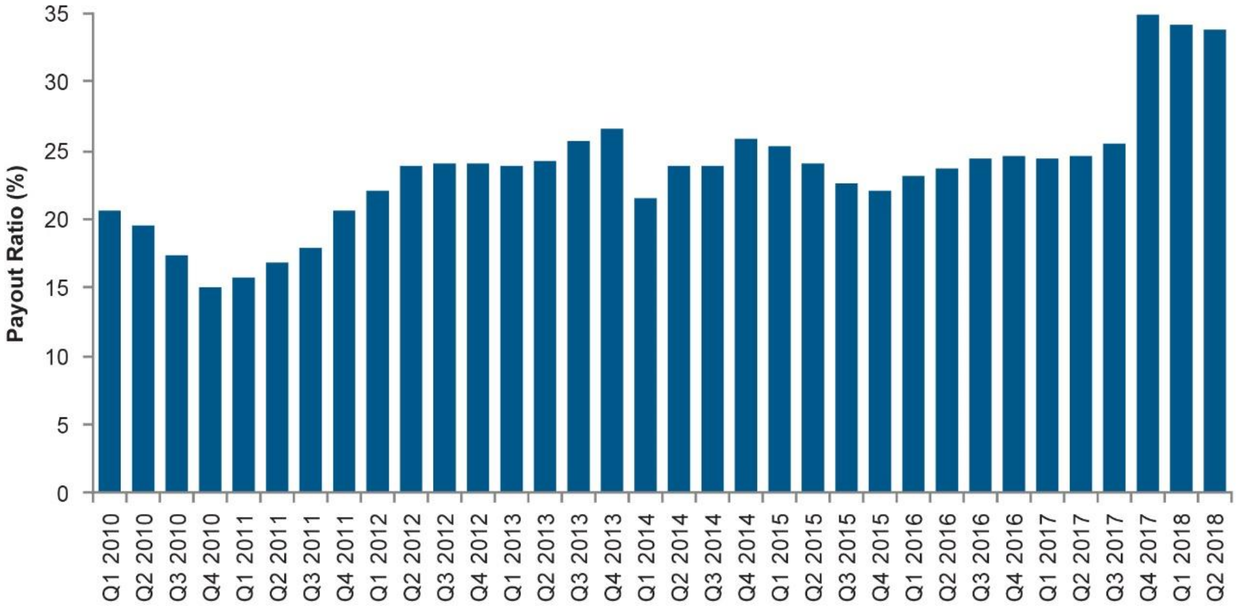
As of September 7, 2018. Source: ClearBridge Investments, Bloomberg LP., S&P 500 Banks Industry Group GICS Level 2 Index. E=Estimate.

With strong capital positions, a benign credit environment, an easing regulatory burden and the potential for rising earnings and dividends, bank securities have become more attractive. As a result, over the last two years we favour banks even as we are aware that (a) the credit cycle will ultimately turn and (b) the benefits of lower income taxes will likely erode over time due to competitive pressures.

Conclusion

Dividend increases have been strong in 2018, evidence dividend payers are taking full advantage of strong economic fundamentals and tax cuts to boost returns to shareholders. We expect healthy dividend growth to continue. As always, we focus on dividend growers that have the power to compound returns at attractive rates over the long term. Nine years into a bull market and with valuations at cyclical highs, we believe investing in a diversified portfolio of high-quality companies with the ability to raise their dividends on a sustainable basis represents a sound course.

Exhibit 3: Bank Payout Ratios on the Rise



As of June 30, 2018. Source: ClearBridge Investments, Bloomberg LP., S&P 500 Banks Industry Group GICS Level 2 Index.

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Clarion Partners
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* As of 31 August 2018.

GICS = Global Industry Classification Standard

[1] As of August 31, 2018. Source: ClearBridge Investments, Bloomberg LP. Median increase from a universe of companies in the S&P 500 Index.

[2] Source: FactSet Earnings Insight, September 7, 2018.

[3] The shareholder is taxed first at the corporate level, as the corporation pays taxes, and then pays additional taxes on the dividends received.

IMPORTANT INFORMATION

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