

---

# Amid Inflation and Volatility, Dividend-Growth Investing Holds Appeal

## So, where in the market is the Morningstar US Dividend Growth Index identifying rising shareholder payouts?

---

### Morningstar Inc.

March 2022

---

Dan Lefkowitz  
Strategist, Morningstar Indexes  
+1 (312) 696-6649  
dan.lefkowitz@morningstar.com

<https://indexes.morningstar.com/>

---

These are neryv times for investors. War in Europe, surging commodities prices, and monetary policy signals from the Federal Reserve have contributed to daily swings of 3% in the U.S. stock market. The U.S. inflation rate is at 40-year high, as we are constantly reminded. In such conditions (and for the long term), dividend-growth investing is a sensible means of participating in equities. Rising shareholder payouts help income-oriented investors preserve purchasing power. That's especially true when real yields on cash and bonds are negative. Meanwhile, for those seeking core equity exposure with a pure total return focus, dividend-growth investing leads to companies with pricing power that tend to deliver a smoother ride than the broad market. Given both the volatility and inflation that is currently raging, it's an opportune time to examine the Morningstar US Dividend Growth Index. What does the index's behavior tell us about dividend growth generally? How does dividend growth differ from traditional equity-income investing on the one hand and the broad equity market on the other? Where in today's market is the index identifying rising payouts? The answer provides a lens into improving and declining fortunes at the stock, industry, and sector levels.

### Key Takeaways:

- ▶ From the perspective of yield, investment style, and returns, dividend-growth investing represents a middle ground—positioned in between the broad equity market and its high-yield segment.
- ▶ Dividend-growth investing leads to stocks with durable competitive advantages and defensive characteristics. The approach often lags during market rallies but mitigates losses during down periods.
- ▶ At the sector level, financial services, industrials, and healthcare are currently rich in dividend growth. Within financials, banks (both diversified and regional), capital markets, and financial data and stock-exchange-related businesses are favored areas for dividend growth. Within industrials, aerospace & defense and industrial machinery are emphasized. Within healthcare, general drug manufacturers and medical device businesses are overrepresented.
- ▶ Although communications services, consumer cyclicals, and technology are currently underrepresented sectors within dividend growth, communications equipment-oriented businesses, discount stores, and semiconductors stocks are all favored industries.
- ▶ The energy and basic materials sectors are largely avoided by dividend growth.

### **Dividend-Growth Investing: A Middle Ground Between the Broad Market and High-Yield Equities**

Dividend-growth investing, as the name implies, targets companies that have increased their payouts over time. In contrast to a high-yield equity-income strategy, it's less about maximizing current income than identifying companies with improving prospects. Dividend-growth stocks don't typically top the yield charts for two reasons:

- 1) They tend to reinvest a larger share of their earnings to fuel growth, and
- 2) They rarely get cheap enough to offer eye-popping yields.

Businesses with the capacity to grow their dividends tend to have strong competitive positions. Corporate leadership at dividend growers show a knack for earning attractive returns on invested capital and a willingness to share that growth with investors, rather than engaging in value-destructive empire building. Their shares are attractive to income and total-return oriented investors alike.

Inflationary times only underscore the importance of dividends. Dividend growth determines the extent to which equity income keeps pace with the inflation rate. Especially when yields on cash and bonds are negative, dividends become a key contributor to portfolio cash flow. Thus, rising dividends can help investors preserve purchasing power.

For investors less concerned about current income, the relationship between dividend growth and inflation takes on a different dimension. A rising payout can signal a strong and improving position. Dividend-growers are often competitively advantaged companies that possess pricing power. They are not in the unfortunate position where a price increase would kill demand for their goods or services.

The **Morningstar US Dividend Growth Index** can be examined to better understand the nature of the approach. The index includes companies that have increased qualified dividend payments for five consecutive years. Five years isn't as long a history as other index providers require, but Morningstar's emphasis is more on the future than the past. To gauge the durability of dividend growth, eligible constituents must display positive consensus earnings forecasts from the analyst community. As a safeguard against dividend cuts and financial distress, stocks whose indicated dividend yields land in the top 10% of the universe are excluded as are companies with payout ratios above 75%. Individual constituent weight is capped at 3% and the index is weighted in proportion to the total pool of dividends available to investors. Index membership is reset annually, and weights are rebalanced quarterly. The most recent portfolio contained 419 stocks.

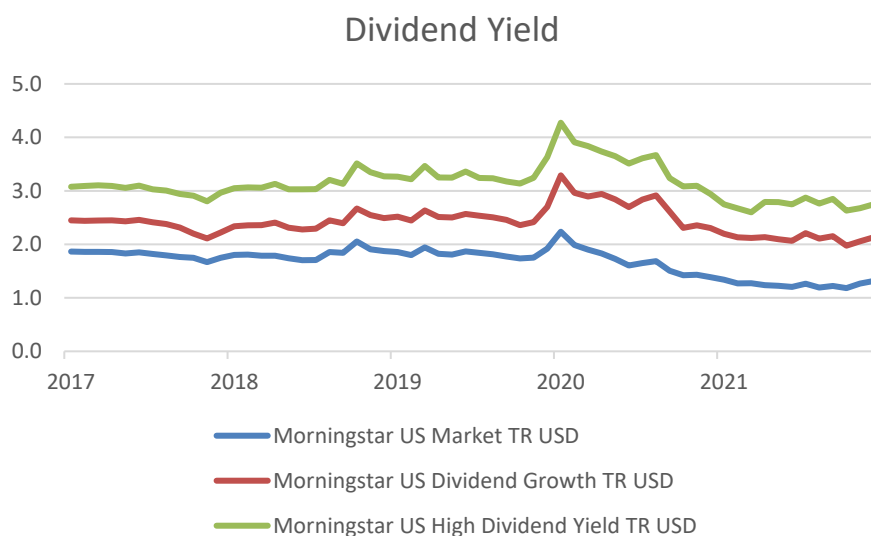
To illuminate how dividend-growth investing differs from the market and its high-yield segment, the index is compared with:

- ▶ Morningstar US Market Index, the broad benchmark from which it is derived. The index represents 97% of stock market value across large-, mid-, and small-cap stocks, and it is weighted by market capitalization.

- Morningstar US High Dividend Yield Index represents the higher-yielding half of the U.S. dividend-paying universe and is weighted by market capitalization.<sup>1</sup>

First, how do the indexes compare on yield? As illustrated in Exhibit 1, the Morningstar Dividend Growth Index has produced a yield above that of the market but below that of the high-yield equity income universe. As of Feb. 28, 2022, the dividend-growth index carried a trailing 12-month yield of 2.1%, compared with 1.3% for the broad U.S. equities market and 2.7% for the high-dividend index.<sup>2</sup> The reference 10-year U.S. Treasury note was yielding 1.83% at that time.

**Exhibit 1** US Dividend Growth Produces an Above-Market, but Not Sky-High Yield



Source: Morningstar Indexes. 3/31/17-2/28/22.

The market's low yield can partly be explained by many years of leadership by fast-growing, technology-oriented companies. Many of today's largest companies by market value pay no dividends. Amazon.com, Alphabet, Tesla, Berkshire Hathaway, and Meta Platforms, which collectively represented nearly 11% of the market's value as of Feb. 28, 2022, are not dividend payers. In contrast, several of the dividend growth index's top 10 constituents had yields above 2%, as of February month-end, including Johnson & Johnson, Procter & Gamble, JPMorgan Chase, Pfizer, Coca-Cola, Merck, Bank of America, and Cisco. Meanwhile, the high dividend index's top 10 included companies yielding more than 3%, including 3M, AbbVie, and ALLETE.

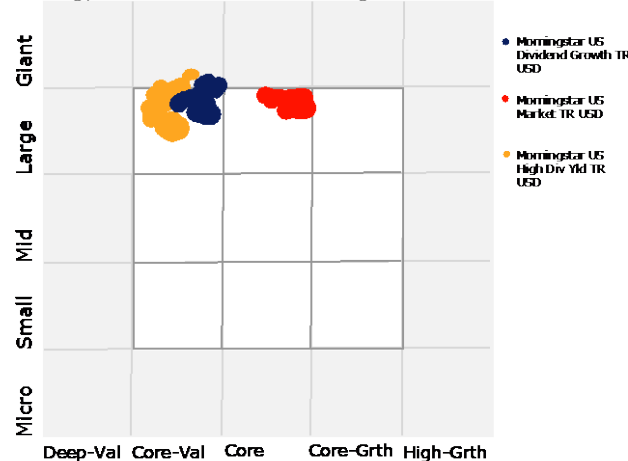
From a holdings-based perspective as well, dividend growth lands in between the broad equity market and the high-yield segment. Exhibit 2 depicts historical portfolios plotted on the Morningstar Style Box™ in which the vertical axis represents security size and the horizontal axis measures investment style.

<sup>1</sup> For a full methodological discussion of the indexes mentioned, refer to their construction rules and other documentation posted on the Morningstar Indexes' website: <https://indexes.morningstar.com/>

<sup>2</sup> Historical data includes some back-tested information. The Morningstar U.S. Dividend Growth Index was launched in 2014. The Morningstar U.S. Market Index was launched in 2002. The Morningstar High Dividend Yield Index was launched in 2022 with history modeled to 2006.

Investment style is determined through a 10-factor style assignment methodology. Value metrics such as price/earnings and price/cash flow are included, as well as growth measures such as long-term earnings growth and book value growth. The centroid is plotted based on the weighted average of index constituents. Centroids increase in size as they become more recent.

**Exhibit 2** According to Morningstar's Holdings-Based Style Map, Dividend Growth Is a Large-Value Strategy, but Closer to Core Than High-Dividend Yield



Source: Morningstar Direct. Time Period: 3/31/17-2/28/22.

The dividend-growth index consistently lands in the large-cap value segment of the U.S. equity market, though it sometimes hugs the border of value and core. The index's top 10 constituents as of Feb. 28, 2022, included a mix of value stocks, such as Johnson & Johnson, Pfizer, Merck, and Bank of America, core stocks like Procter & Gamble and Coca-Cola, and growth stocks Apple and Microsoft.

The high-yield segment of the market lands more firmly in the value camp. Its top 10 constituents are mostly large-cap value stocks, many of them overlapping with the dividend growth index but also including Exxon Mobil and AbbVie. No growth names are included. After all, Apple and Microsoft's trailing 12-month yields were both below 1% as of early March.

Meanwhile, it's unsurprising that the two dividend-focused indexes prefer slower-growing companies with lower valuations than the broad market. The Morningstar US Market Index has moved toward growth, having been led for many years by turbo-charged stocks like Tesla, Nvidia, Apple, Microsoft, Amazon.com, and Alphabet.

Where dividend growth diverges from both the broad market and the high-yield segment is in its preference for wide-moat stocks and avoidance of no-moat stocks. A company with an economic moat around its business possesses a competitive advantage that leads to profitability and—back to the inflation discussion above—pricing power. Morningstar's Equity Research team turned a Warren Buffett concept into a methodological framework, assigning economic moat ratings to the more than 1,500 companies under coverage. A moat protects a company's profits from competition—in the same way

that medieval castles kept enemies at bay with water-filled trenches. Profits are defined as returns on invested capital over and above a firm's estimated cost of capital or weighted average cost of capital. To earn a narrow or wide economic moat rating, a company must possess a structural feature that prevents excess returns from quickly eroding. Companies with a narrow moat are expected to generate profits above their cost of capital for at least the next 10 years. Wide-moat companies should deliver profits to persist for at least 20 years.

Morningstar Equity Research has identified five sources of economic moat: intangible assets, switching costs, network effect, cost advantage, and efficient scale. Moat ratings are determined through a rigorous, peer-reviewed process using both quantitative and qualitative inputs.<sup>3</sup>

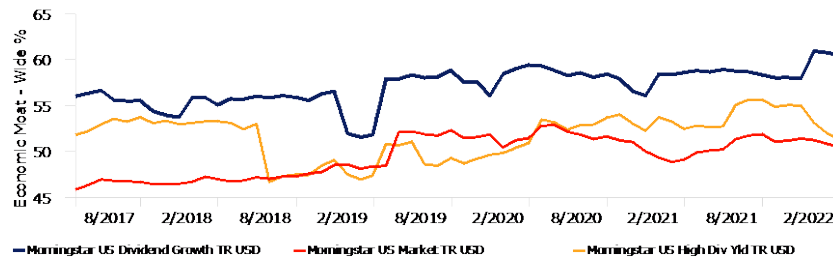
Exhibit 3 demonstrates dividend growth's preference for wide-moat stocks and avoidance of no-moat stocks relative to the market and the high-yield segment.

---

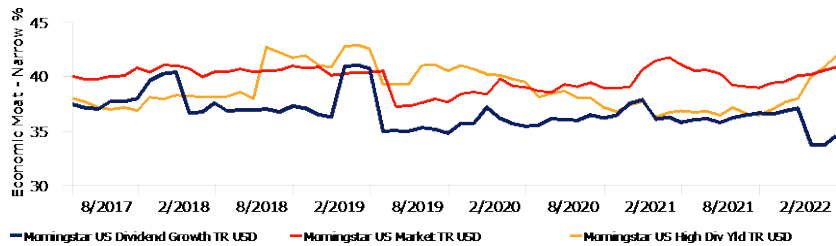
<sup>3</sup> Please refer to the Morningstar Equity Research Methodology for more information.

**Exhibit 3** Dividend Growers Are Likelier to Be Wide Moat, Less Likely to Be No Moat

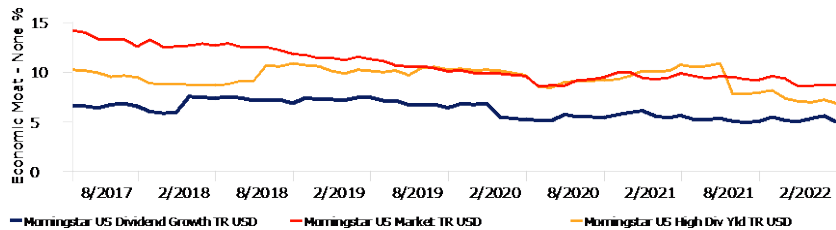
**Wide Moat**



**Narrow Moat**



**No Moat**



Source: Morningstar Direct. Data as of Feb. 28, 2022. Time Period: 3/1/17- 2/28/22.

Wide-moat stocks represented roughly 60% of the dividend-growth index's weight as of Feb. 28, 2022, well ahead of the broad equity market and its high-yield segment, while roughly 5% was no moat. Recently, the dividend-growth index has diverged markedly on narrow-moat stocks. Apple and Tesla are two reasons for higher narrow-moat representation in the broad market. Narrow-moat-rated Apple represents nearly a 6% weight in the Morningstar US Market Index but only a 2.8% weight in dividend growth. Narrow-moat-rated Tesla was a 1.6% weight in the market but was absent from the dividend-growth index. The Morningstar US High Dividend Index, for its part, includes many narrow-moat-rated stocks that the dividend-growth index does not, including Exxon, Chevron, Verizon, and AT&T, which collectively consume roughly 6.5% of that index's weight.

So how does this impact behavior? As depicted in Exhibit 4, the dividend-growth index's trailing returns for one-, three-, and five-year periods lands between the broad equity market and the high-yield segment.

---

**Exhibit 4** Dividend Growth's Trailing Returns Land Between the Market and the High-Yield Segment

<b>Index</b>	<b>Total Return 1-Year %</b>	<b>Total Return 3-Year %</b>	<b>Total Return 5-Year %</b>	<b>Standard Deviation of Returns 5-Year</b>
Dividend Growth	18.2	15.6	14.1	15.2
U.S. Market	12.6	17.6	14.8	16.3
High Dividend Yield	18.6	12.1	10.3	15.5

---

Source: Morningstar Direct. Data as of Feb. 28, 2022.

Over the trailing one-year period, in which value has generally outperformed growth, it's unsurprising to see the high-yield segment posting the best performance. Over the three- and five-year periods, in which growth has beaten value, the broad market has outperformed the two dividend indexes.

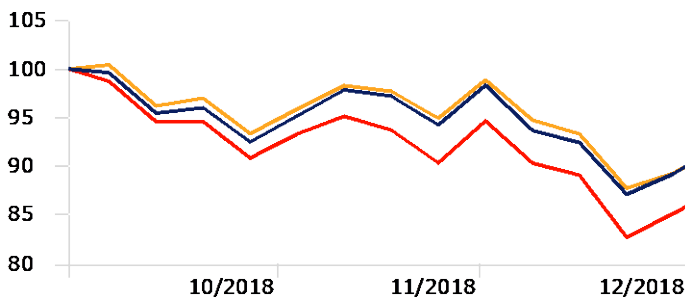
Notably, when it comes to standard deviation of returns, a measure of volatility, the dividend growth index has provided the smoothest rides of the three benchmarks. This attribute was on display during some difficult market conditions over the past five years, including the fourth quarter of 2018 and the pandemic-driven downturn in the first quarter of 2020. See Exhibit 5.

**Exhibit 5** Dividend Growth Has Lost Less Than the Market During Downturns

**Q4 2018**

Time Period: 10/1/2018 to 12/31/2018

Currency: BASE



— Morningstar US Dividend Growth TR USD — Morningstar US Market TR USD — Morningstar US High Div Yld TR USD

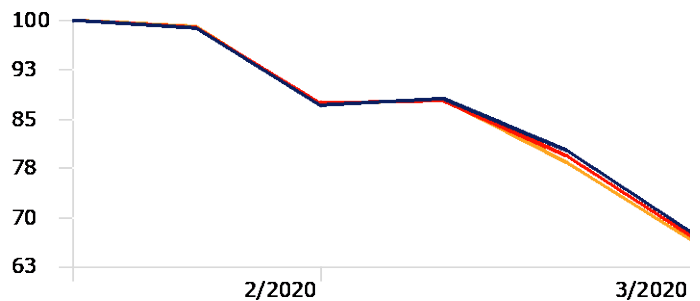
Currency: BASE

	Return	Std Dev	Excess Return
Morningstar US Dividend Growth TR USD	-10.43	24.71	3.31
Morningstar US Market TR USD	-13.74	26.50	0.00
Morningstar US High Div Yld TR USD	-11.07	23.77	2.67

**COVID Shock**

Time Period: 2/16/2020 to 3/21/2020

Currency: BASE



— Morningstar US Dividend Growth TR USD — Morningstar US Market TR USD — Morningstar US High Div Yld TR USD

Currency: BASE

	Return	Std Dev	Excess Return
Morningstar US Dividend Growth TR USD	-32.15		0.61
Morningstar US Market TR USD	-32.77		0.00
Morningstar US High Div Yld TR USD	-33.35		-0.59

Source: Morningstar Direct.

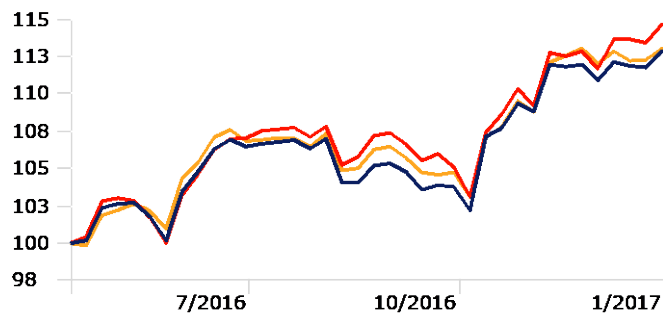
On the flip side, in up markets over the past few years, the dividend-growth index can look sluggish. In the second half of 2016, especially during an exuberant period following the U.S. presidential election, then again when the coronavirus vaccines lifted hopes of recovery, stock market rallies left dividend-growth stocks behind. See Exhibit 6.

**Exhibit 6** Dividend-Growth Index Has Lagged During Some Equity Market Rallies

**Brexit & Trump**

Time Period: 5/15/2016 to 1/29/2017

Currency: BASE



Legend: Morningstar US Dividend Growth TR USD (blue), Morningstar US Market TR USD (red), Morningstar US High Div Yld TR USD (yellow)

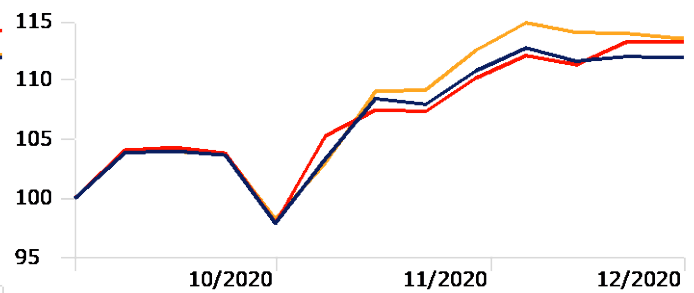
Currency: BASE

	Return	Std Dev	Excess Return
Morningstar US Dividend Growth TR USD	12.85	10.07	-1.81
Morningstar US Market TR USD	14.65	10.27	0.00
Morningstar US High Div Yld TR USD	13.04	9.24	-1.61

**Vaccine**

Time Period: 10/4/2020 to 12/27/2020

Currency: BASE



Legend: Morningstar US Dividend Growth TR USD (blue), Morningstar US Market TR USD (red), Morningstar US High Div Yld TR USD (yellow)

Currency: BASE

	Return	Std Dev	Excess Return
Morningstar US Dividend Growth TR USD	11.95	21.87	-1.36
Morningstar US Market TR USD	13.31	22.78	0.00
Morningstar US High Div Yld TR USD	13.59	21.98	0.28

Source: Morningstar Direct.

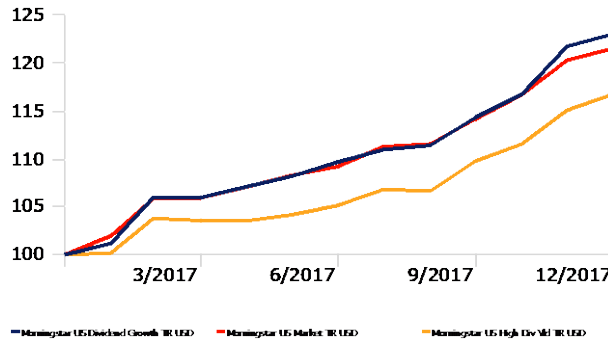
The dividend-growth index has outperformed during down times as well as in an up-market led by low-volatility stocks. In 2017, many investors were captivated by "smart beta" ETFs driven by "factors" like low volatility, which academic research ties to superior risk-adjusted performance. See Exhibit 7.

**Exhibit 7** Dividend Growth Shone During 2017's Low-Volatility-Driven Market

**Low Vol**

Time Period: 1/1/2017 to 12/31/2017

Currency: BASE



Currency: BASE

	Return	Std Dev	Excess Return
Morningstar US Dividend Growth TR USD	22.97	5.05	1.49
Morningstar US Market TR USD	21.47	3.85	0.00
Morningstar US High Div Yld TR USD	16.73	4.61	-4.74

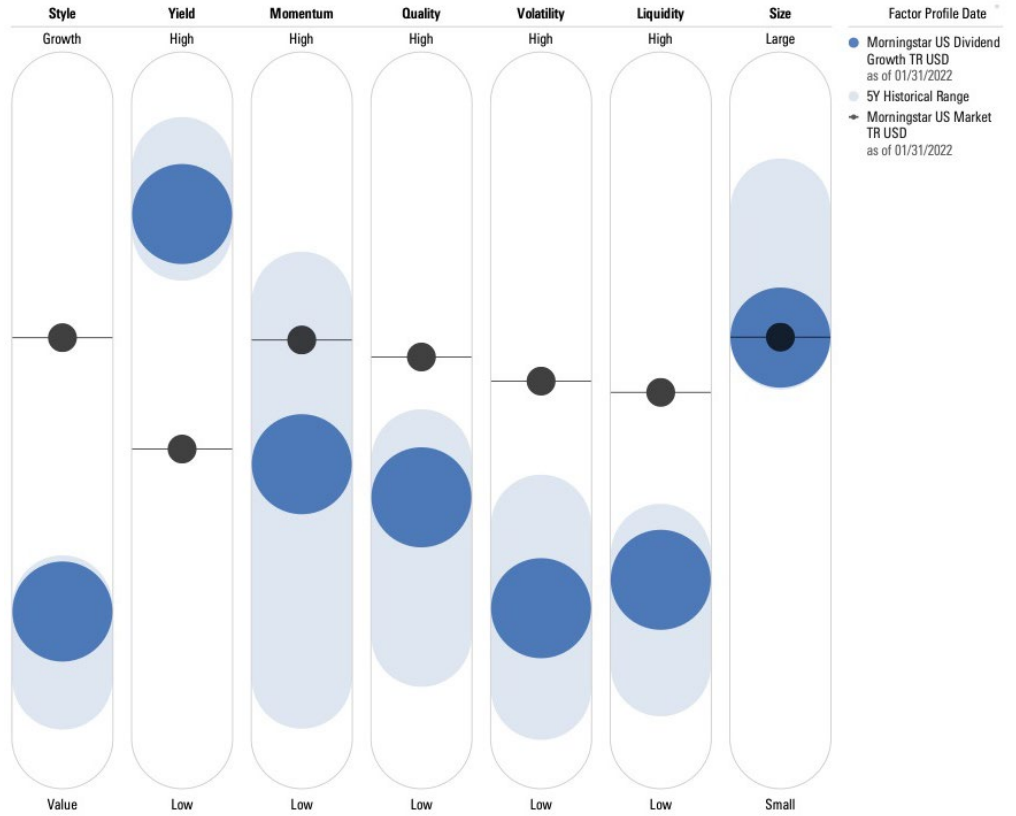
Source: Morningstar Direct.

Indeed, volatility is one of the areas of the most significant divergence from the market, according to the Morningstar Factor Profile depicted in Exhibit 8.

**Exhibit 8** Dividend Growth Prefers Less-Volatile, High-Yielding, Value-Leaning Stocks (Among Other Factors)

**Factor Profile**

Portfolio: Morningstar US Dividend Growth TR USD • Benchmark: Morningstar US Market TR USD • Risk Model: Standard Factor Model (USD)



Source: Morningstar Direct. Data as of March 23, 2022.

The tool visualizes an equity portfolio's relative exposure to seven commonly accepted drivers of risk and return. Unsurprisingly, the dividend-growth index is more value-leaning than the market and has more exposure to yield. Morningstar describes the Volatility factor as "measuring the maximum observed spread in long-term returns, based on the trailing 12-month standard deviation of daily returns. Lower exposure to the volatility factor indicates smaller variation in long-run outcomes."<sup>4</sup>

The appeal of low-volatility equity strategies is multidimensional. Some academic research has suggested that less-volatile stocks tend to outperform their more-volatile counterparts.<sup>5</sup> It's also the case that investors are more likely to capture a fund's total return if it's less volatile. Morningstar research found that the gap between total returns and money-weighted returns was largest with more volatile

<sup>4</sup> The Morningstar Factor Profile Methodology is posted in Morningstar Direct, where the tool is available <https://direct.morningstar.com/research/doc/957091/Morningstar-Factor-Profile-Methodology>

<sup>5</sup> See: Haugen, Robert A., and A. James Heins, (1972) "On the Evidence Supporting the Existence of Risk Premiums in the Capital Markets," Wisconsin Working Paper, December 1972 and Frazzini, Andrea and Pedersen, Lasse (2014). "Betting Against Beta." *Journal of Financial Economics*, 111(1), 1-25.

investments, indicating that investors tend to buy high and sell low.<sup>6</sup> Less-volatile investments are a good way for risk-averse investors to participate in the market's upside but manage at least some of the downside.

### Where Is the Market's Dividend Growth Coming From?

As discussed, companies that are growing their dividends tend to be sturdy businesses whose positions are improving. So, index composition provides a lens into rising and declining fortunes in today's market. As depicted in Exhibit 9, the dividend-growth index exhibits some notable sector deviations from the market and the high-yield segment.

**Exhibit 9** Dividend Growth Is Strong in Consumer Defensives, Healthcare, Industrials, and Financials

Sectors	Dividend Growth %	U.S. Market %	High Dividend Yield %
Basic Materials	2.5	2.5	3.2
Communication Services	1.8	9.0	4.5
Consumer Cyclical	6.1	11.8	12.8
Consumer Defensive	13.0	6.1	12.8
Healthcare	17.4	13.2	14.6
Industrials	13.6	8.8	12.5
Real Estate	0.0	3.5	0.0
Technology	17.5	25.6	10.3
Energy	1.2	3.6	8.5
Financial Services	22.0	13.6	19.9
Utilities	4.9	2.5	6.9
High Dividend Yield	18.6	12.1	10.3

Source: Morningstar Direct. Data as of Feb. 28, 2022.

Unsurprisingly, both the dividend growth index and the high-dividend yield index have above-market exposure to the consumer defensive, industrials, financials, and utilities sectors. All tend to be dividend-rich, recalling the quote attributed (perhaps apocryphally) to Willie Sutton, who, when asked why he robbed banks, responded: "Because that's where the money is!" Stocks like Procter & Gamble and Coca-Cola (consumer defensives), Raytheon and Union Pacific (industrials), JPMorgan Chase and Bank of America (financials), and NextEra Energy (utilities) are prominent constituents of both indexes.

But the dividend-growth index stands out for devoting more weight to industrials, financial services, and healthcare than both the market and the high-yield segment. Within industrials, aerospace & defense and industrial machinery are two industries favored by the dividend growth. That includes companies like Raytheon, Lockheed Martin, General Dynamics, and Northrop Grumman within the former grouping, and Illinois Tool Works, Emerson Electric, Eaton, and Cummins within the latter.

<sup>6</sup> See: Arnott, Amy. "Why Fund Returns Are Lower Than You Might Think." Aug. 20, 2011. <https://www.morningstar.com/articles/1056151/why-fund-returns-are-lower-than-you-might-think>

Within financial services, the dividend-growth index favors banks--both diversified and regional--as well as capital markets and financial data and stock exchange-related businesses. Just three constituents are responsible for the diversified bank weight: JPMorgan Chase, Bank of America, and Citigroup. The regional bank weight is spread over more than 40 companies, including Truist Financial, PMNC, Zions Bancorporation, Bank OZK, and Glacier Bancorp. The capital markets cohort includes the likes of Morgan Stanley, Goldman Sachs, Raymond James, Evercore, and MarketAxess, while financial data and stock exchanges includes the likes of CME, Intercontinental Exchange, and Moody's.

The healthcare overweight within the dividend-growth index is driven largely by general drug manufacturers and medical device businesses. The former industry grouping includes J&J, Pfizer, Merck, Bristol-Myers Squibb, Amgen, Eli Lilly, Zoetis, Perrigo, and Graham Holdings. The latter comprises Abbott Labs, Stryker, and Steris.

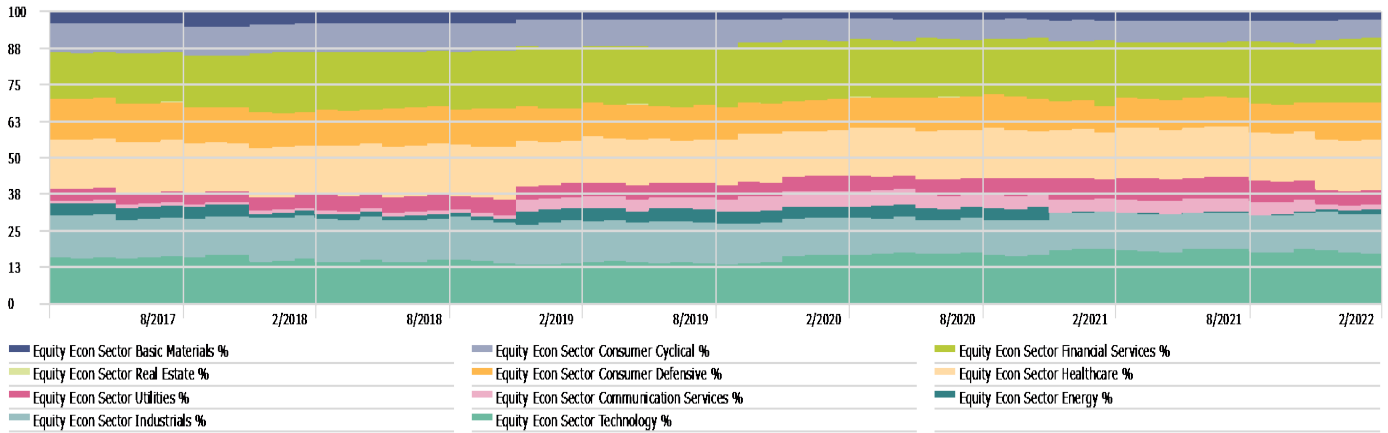
Communication services, consumer cyclicals, and energy are all underweights for dividend growth. Traditional telecoms like Verizon & AT&T face some headwinds. Communications equipment, however, is one overrepresented industry within dividend growth. Constituents include Cisco, Hewlett Packard, and Motorola Solutions. Within consumer cyclicals, discount store businesses Walmart, Target, Costco, and Dollar General are a bright spot. Energy, for its part, is a sector ramping up its dividends, benefitting from high oil prices. But many energy companies had to reduce or suspend dividends in 2020 when the pandemic-driven slowdown sent oil futures into negative territory. The fact that the energy sector is favoring variable dividends today reflects uncertainty and a desire to maintain flexibility should fortunes decline.

Then there's technology. The largest single sector exposure for the market overall is an area where the dividend-growth index is underweight relative to the market but overweight relative to the high-yield segment. Semiconductors is one industry within technology that is overrepresented in the dividend-growth index. Companies like Intel, Texas Instruments, Qualcomm, Analog Devices, Microchip Technology, Skyworks, and Power Integrations are all benefitting from soaring chip demand.

How has the dividend-growth landscape changed over the past five years? Looking at the sector composition of the dividend-growth index, as depicted in Exhibit 10, provides answers.

**Exhibit 10** Dividend Growth Is Heavier Than it Once Was on Financials, Healthcare, and Technology, and Lighter on Consumer Cyclical, Energy, and Communication Services  
**Equity Sectors (Morningstar)**

Time Period: 3/1/2017 to 2/28/2022



Source: Morningstar Direct.

Financials has seen a 6-percentage-point increase in index weight versus five years ago. Technology has also become a more meaningful portion of the dividend-growth universe, though the sector's share within the broad U.S. equity market has expanded far more. Healthcare and utilities' weights within dividend growth have also risen, but not dramatically.

On the flip side, basic materials, consumer cyclicals, and energy, have come down in sector representation within the dividend-growth index. This also is in line with their declining fortunes within the market.

**Dividend Growth Isn't a Market Portfolio in Disguise**

That the dividend-growth index tracks broader market trends is unsurprising. As discussed, dividend growth is something of a middle ground between traditional equity income and a core equity portfolio. But that doesn't mean dividend growth is market-like. The Morningstar US Dividend Growth Index yields significantly more, tilts toward value, and prefers companies with economic moats. In a market regime dominated by volatility and inflation, dividend growth offers a smoother ride, rising income, and exposure to companies with pricing power. ■■

### About Morningstar Indexes

Morningstar Indexes combine the science and art of indexing to give investors a clearer view into the world's financial markets. Our indexes are based on transparent, rules-based methodologies that are thoroughly back-tested and supported by original research. Covering all major asset classes, our indexes originate from the Morningstar Investment Research Ecosystem—our network of accomplished analysts and researchers working to interpret and improve the investment landscape. Clients such as exchange-traded fund providers and other asset management firms work with our team of experts to create distinct, investor-focused products based on our indexes. Morningstar Indexes also serve as a precise benchmarking resource.

To learn more about Morningstar Indexes, visit: <http://global.morningstar.com/indexes>

Contact:

[indexes@morningstar.com](mailto:indexes@morningstar.com)

U.S. + 1 312 384-3735

Canada: +1 416 489-7074

Europe: +44 203 194 1401

Japan: +81 3 5511 7540

India: +91 22 6121 7123

Hong Kong: +852 2973 4680

Singapore: +65 6340 1285

Australia: +61 2 9276 4446



22 West Washington Street  
Chicago, IL 60602 USA

©2022 Morningstar. All Rights Reserved. © 2022 Morningstar. All rights reserved. The information, data, analyses and opinions contained herein (1) include the proprietary information of Morningstar, (2) may not be copied or redistributed, (3) do not constitute investment advice offered by Morningstar, (4) are provided solely for informational purposes and therefore are not an offer to buy or sell a security, and (5) are not warranted to be correct, complete or accurate. Morningstar has not given its consent to be deemed an "expert" under the federal Securities Act of 1933. Except as otherwise required by law, Morningstar is not responsible for any trading decisions, damages or other losses resulting from, or related to, this information, data, analyses or opinions or their use. Past performance does not guarantee future results. Before making any investment decision, consider if the investment is suitable for you by referencing your own financial position, investment objectives, and risk profile. Always consult with your financial advisor before investing.