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Article

ESGenius: Fidelity research finds link between ESG and dividend growth

Our findings suggest ESG leaders are more likely than ESG laggards to offer attractive levels of long-term dividend growth across a range of economic scenarios.

PRO Matthew Jennings 19-07-2021 3 minuten: leestijd

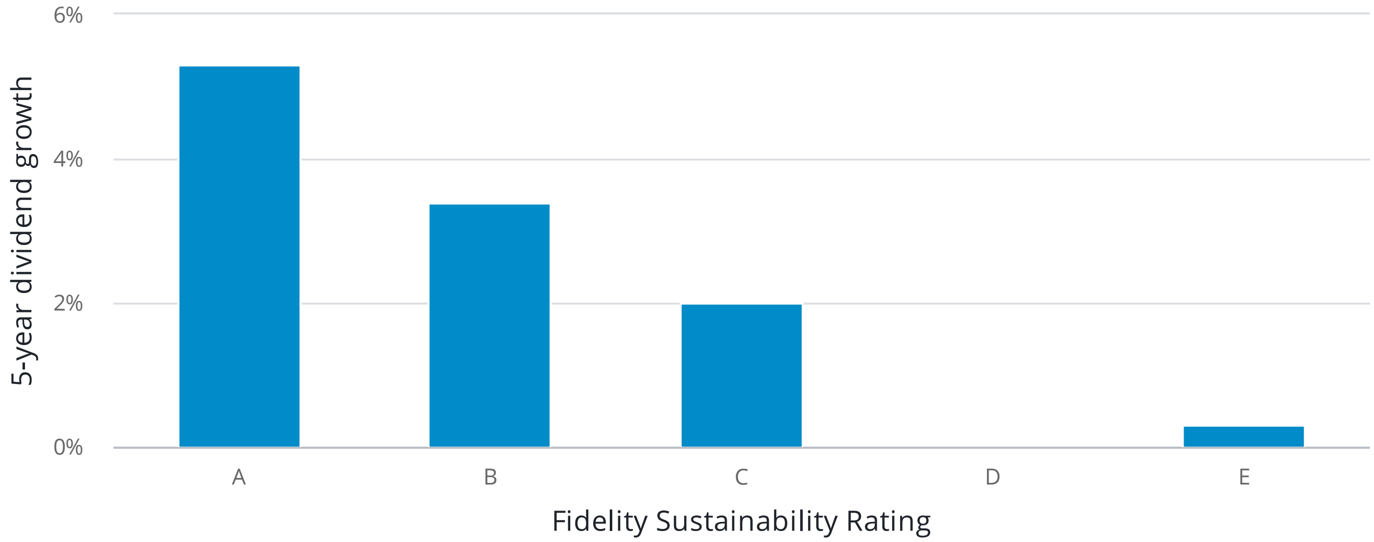
Equity income investors typically look for two things. One is an attractive yield, and the other is the potential for dividend growth. Our research has shown a link between a company's sustainability characteristics and historical dividend growth. Past performance is no guarantee of the future, of course, but the findings suggest that ESG leaders are more likely than ESG laggards to offer attractive levels of dividend growth over the long term, across a range of economic scenarios. Stable dividend growth can offer some mitigation during periods of rising prices.

Strong relationship between historical dividend growth and ESG quality

Factors such as a company's competitive position and end markets matter for dividend growth. But a sustainable operating model and a forward-thinking management team are also important. Analysis of Fidelity's sustainability ratings (which grade c. 4,900 companies from A to E) shows a strong relationship between historical dividend growth and ESG quality.

On average, companies rated A for sustainability have the highest levels of historical dividend growth, at over 5 per cent, with D- and E-rated stocks offering the lowest average levels of growth. The trend is not entirely linear because the smaller sample for E-rated stocks allows for individual companies to skew the median more than in other ratings groups.

Chart 1: Median 5-year dividend per share growth by Fidelity sustainability rating



Source: Fidelity International. Data as at 31 May 2021. The Fidelity Sustainability Ratings were launched in June 2019. As at 31 March 2021, they cover a universe of c. 4,900 issuers in equity and fixed income. For illustrative purposes only.

Nonetheless, there is a clear relationship; so why does it exist? Good management of environmental and social risks (and opportunities) tends to help companies avoid higher regulatory costs, litigation, brand erosion and stranded assets. Strong governance, meanwhile, reduces the risks associated with over-leveraged balance sheets or risky, value destroying M&A. This protects profits and allows them to be paid out to shareholders as dividends.

Sector sustainability has an impact

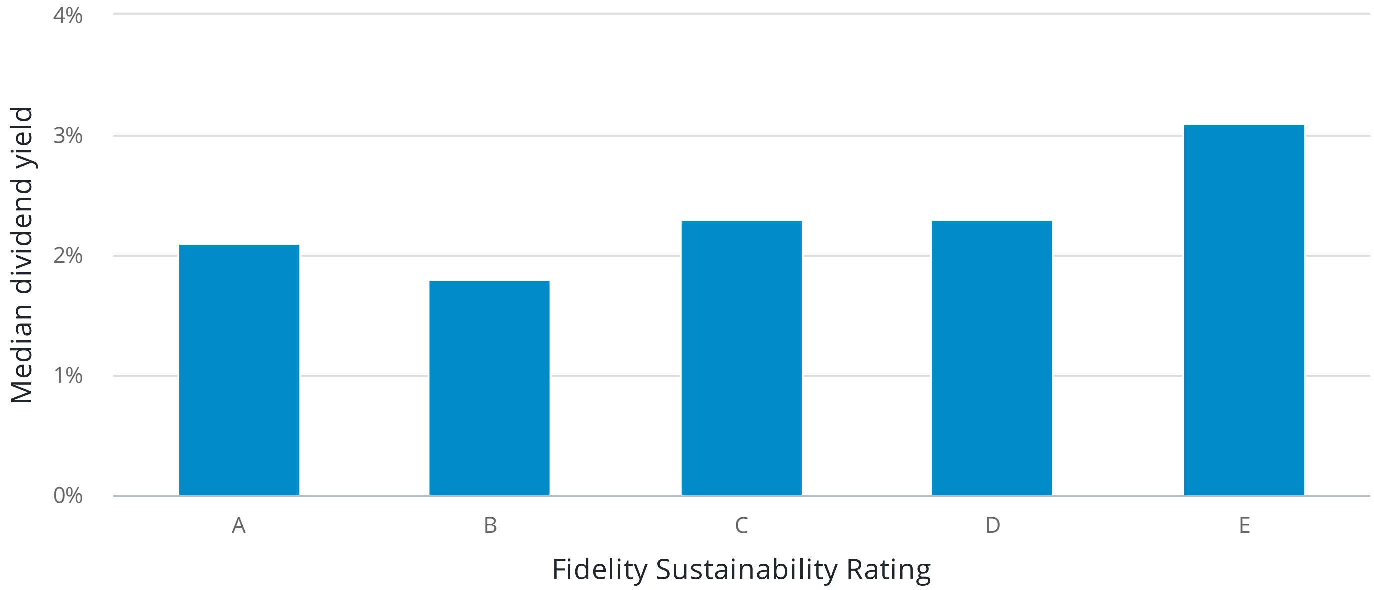
However, companies in sectors with structural sustainability issues - whether well managed or not - may face weaker dividend growth. For example, oil majors Shell and BP[1] both significantly reduced dividend distributions last year to fund the transition to lower carbon assets. Other energy companies may follow suit in the face of growing calls to increase investment in renewables.

By contrast, utilities with renewable energy operations are benefiting from regulatory and investment tailwinds. Enel, one of the earliest utilities to invest a lot of money in renewable energy and now the largest renewable provider in the world by power output, has committed to 7 per cent annual growth in dividends through to 2023. In a completely different sector, Unilever - another business Fidelity rates highly for sustainability - has a strong record of long-term dividend growth (around 6 per cent annualised over 20 years).

ESG leaders can offer attractive dividend yields

Given their superior dividend growth prospects, one might expect stocks rated highly for sustainability to trade at significantly lower dividend yields. Encouragingly for income investors, this does not seem to be the case. The difference in yield between the highest and lowest ESG-rated stocks is modest, and certainly manageable within the context of a broad investment universe such as global equities. Some ESG leaders even offer yields that match or exceed those of lower-rated stocks. For example, Enel currently offers around 4.5 per cent dividend yield, and Unilever around 3.5 per cent.

Chart 2: Median dividend yield by Fidelity sustainability rating



Source: Fidelity International. Data as at 31 May 2021. The Fidelity Sustainability Ratings were launched in June 2019. As at 31 March 2021, they cover a universe of c. 4,900 issuers in equity and fixed income. For illustrative purposes only.

One of the variables influencing dividend yield is the company's pay-out ratio, which reflects attitudes toward capital allocation. The right pay-out level will depend on company-specific factors such as the need to reinvest to ensure franchises remain resilient and to manage leverage. However, we believe that sensible dividend distributions (that take a long-term perspective) are a marker of good governance as they help to align shareholders with management and reduce 'agency risk' - the risk that management and shareholder interests diverge.

A second variable is company valuation. Valuations can be affected by many (interrelated) factors, including growth expectations, cost of capital and investor sentiment. ESG investors tend to be wary of stocks where yields are high due to low valuations that reflect unsustainable business models. Pay-out levels from such companies are unlikely to be maintained. Tobacco, for example, is a high yield sector where concerns around health impacts and regulation feed into uncertainty around dividend security and growth potential.

High quality ESG businesses, however, should be able to maintain dividends at more sustainable levels and, as our research shows, offer better potential dividend growth over time. This finding complements research Fidelity's analyst team undertook last year that showed how ESG leaders outperformed ESG laggards during the Covid-19 crash and recovery. Our ESG ratings can help identify companies with strong ESG characteristics. Tilting portfolios towards this type of firm can help maintain the purchasing power of equity income portfolios, which could prove useful if inflation remains elevated as economies reopen.

See also: Why dividends make sense in an inflationary environment (fidelityinternational.com)Jiraporn, Kim & Kim: Dividend Pay-outs and Corporate Governance Quality: An Empirical Investigation – The Financial Review, 46 (2011)

[1] Note: Reference to specific securities should not be construed as a recommendation to buy or sell these securities and is included for the purposes of illustration only.

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