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Why US Tax Reform Could Drive Dividends Higher

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In the first few months of 2018, some US companies and multinationals have raised their dividends by 10% or more—a higher percentage increase than we've seen in a few years. Don Taylor, portfolio manager for Franklin Rising Dividends Fund and chief investment officer, Rising Dividends Strategies, Franklin Equity Group, explains why he thinks that trend is likely to continue as more companies make plans for extra cash due to US tax reform. He also shares his views on sectors he thinks have the potential for long-term dividend growth.

While the merits of the Tax Cuts and Jobs Act of 2017 enacted last December may be debatable, we see one clear benefit: many US companies will see an increase in after-tax cash flows. Many market observers are waiting to see what those companies plan to do with the extra cash in their coffers.

Dividends, often drawn from earnings, are one way in which companies may choose to reward investors. They are typically cash payments made on a regular basis, such as quarterly or annually.

Our research suggests companies that grow their dividends tend to experience greater long-term stock price appreciation than companies that maintain their dividends or don't pay one at all. And we have found that a consistently rising dividend tends to be an indicator of solid earnings growth, a resilient business model and a commitment by management to return cash to shareholders.

Tracking Dividend Increases

We define the "dividend season" as essentially a six-month period often starting in November and running through April. We have found that a number of companies tend to increase their dividend right before, or right after calendar year-end. Then, another group will do so around the time of their annual meetings.

Based on our analysis, the weighted average dividend increase for the underlying holdings of the Franklin Rising Dividends Fund's portfolio troughed at 8% at one point in 2017. However, in the first two months of 2018, we've seen some companies raise their dividends by 10% or more—a higher percentage increase than we've seen in the past several years. As of February 26, 2018, the weighted average year-over-year dividend increase of the holdings in the portfolio is now 9.25%—and we think this metric is likely to improve as we move through the course of this year.

In February, UPS, a US-based delivery company that primarily delivers packages in the United States, increased its dividend by nearly 10%.[1] In our view, that increase wouldn't have been as large without a reduction in the US corporate tax rate from 35% to 21%.

We've also seen multinationals—such as Air Products & Chemicals, Aflac and Pepsi—raise their dividends by double digits this year.[2] Those increases are larger than in past years and, in our view, are most likely due to a combination of the lower US corporate rate and incentives to bring home overseas cash. As part of recent US tax reform, foreign earnings can be repatriated to the United States at a tax rate of about 10% through 2025, instead of the previous standard 35% corporate rate.

Investment Implications

We expect select stocks in the industrials, materials and consumer discretionary sectors to likely raise dividends over the next two or three quarters of this year. In our view, these sectors stand to benefit from US tax reform and a stronger global economy. As earnings and cash flow improve with economic growth, companies will keep a higher proportion of that money because of the lower tax rate. That, in turn, is likely to lead to higher nominal dividends.

We expect to see the same potential benefits for other stocks in domestic sectors that are sensitive to changes in the economy, such as banks, commercial services, retail and utilities. That said, we don't invest in utilities because they already distribute relatively high dividends relative to earnings. And, we haven't invested in banks since they cut or eliminated their dividends in the midst of the 2007-2009 Global Financial Crisis.

At Franklin Rising Dividends Fund, we prefer companies that are dividend achievers—defined as companies that have consistently increased their dividends for 10 years or longer. Companies that fall under the dividend achiever category are usually leaders in their industries or market niches and have managements with long, positive track records. A 10-year period of rising dividends is a good gauge of corporate soundness, in our view, because at some point in that 10-year period the company is likely to have experienced a down cycle.

Companies that can continue raising dividends during a downturn have displayed some measure of fiscal strength. In our own portfolio, we deviate from some dividend-achiever indexes in that we expect the company to raise its dividend in just eight out of 10 years. This policy gives a company the chance to keep its dividend flat during tough times.

Our goal is to look for companies that have the potential to post robust dividend increases. Over time we are likely to see more and more companies, including technology companies, with a track record of rising dividends. Some of them will meet our screens, some of them won't, and some of them could be in a position to qualify further down the road. So, with a longer-term horizon in mind, we suspect we could see a greater emphasis on technology companies in our portfolio.

Over the next 5-10 years, we think companies we invest in will likely continue to increase dividends, and we are optimistic about the overall fundamental backdrop. Those opportunities, however, must meet our stringent investment requirements, which we adhere to no matter which way the economic winds are blowing.

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Franklin Rising Dividends Fund

All investments involve risks, including possible loss of principal. Value securities may not increase in price as anticipated or may decline further in value. For stocks paying dividends, dividends are not guaranteed, and can increase, decrease or be totally eliminated without notice. While smaller and midsize companies may offer substantial opportunities for capital growth, they also involve heightened risks and should be considered speculative. Historically, smaller- and midsize-company securities have been more volatile in price than larger company securities, especially over the short term. These and other risks are detailed in the fund's prospectus.

Investors should carefully consider a fund’s investment goals, risks, charges and expenses before investing. To obtain a summary prospectus and/or prospectus, which contains this and other information, talk to your financial advisor, call us at ***(800) DIAL BEN/342-5236*** *or visit* ***franklintempleton.com.*** *Please carefully read a prospectus before you invest or send money.*

[1] As of January 31, 2018, UPS represented 1.29% of total net assets of Franklin Rising Dividends Fund. Holdings subject to change.

[2] As of January 31, 2018, Air Products & Chemicals, Aflac and Pepsi represented 2.71%, 0.69% and 1.68% respectively of total net assets of Franklin Rising Dividends Fund. Holdings subject to change.

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