Executive Summary

- A sizeable portion of high-dividend equities' return is in the form of cash. Therefore, dividend-paying stocks may help to cushion a portfolio's downside when the broader market is posting losses.
- Although high-dividend equity portfolios may underperform during strong growth markets, historically, dividend results have been more stable than price-only returns.
- An allocation to international dividend-paying stocks offers a powerful combination of potentially higher yields and enhanced portfolio diversification.
- Dividend-paying stocks, when included in hypothetical portfolios of various investor profiles, have helped to improve returns.
- The key to dividend investing is capturing equities with dividend growth to outpace the effects of inflation.

The long-standing case for a high and growing dividend equity strategy

The search for higher returns and lower risk has often left investors vacillating between different investment styles and vehicles. Now that volatility has returned to the market after a years-long hiatus, this vacillation is likely to become even more pronounced. Through multiple market environments, one strategy, high-dividend equity investing, has demonstrated consistently solid performance with little added risk, meriting an allocation in a wide range of portfolios. This paper examines how an allocation to high-yielding stocks can potentially boost performance and actually lower risk in certain portfolios.

A return to normal and getting back to the business of stock ownership

As a decade of exceptional monetary support winds down and interest rates and volatility levels return to more normal levels, investors stand to be rewarded for taking an ownership stake in quality businesses versus speculating in ever-changing share prices. It's an approach investment managers seeking to consistently provide a high and rising income stream have always maintained. As portfolio manager Daniel Peris explains, "The object is to construct, manage and measure investment portfolios as one might for an actual business, with a focus on the distributable cash flows to the owners of the businesses. In other words, judge investments first and foremost by how much money—real cash money—they generate."

More than amassing a group of stocks that pay dividends, a high-dividend equity strategy involves identifying companies that generate significant free cash flow and have a history of maintaining of increasing their dividends. Strong companies with healthy dividends are communicating their commitment to using this cash to enhance total return to shareholders. Many of these companies are found in income-producing sectors of the market such as Consumer Staples, Telecommunications Services, Energy and Utilities. It is not unusual for high-yielding securities within these sectors to present valuation advantages such as relatively low price/earnings, price/book value and price/cash flow ratios.

Return differential of high-dividend equities

When examining the benefits of high-dividend equity approaches, the Dow Jones U.S. Select Dividend Index is a useful proxy. To be included with the index, a company must have a non-negative five-year dividend-per-share growth rate, a five-year average dividend-to-earnings-per-share ratio of 60% or less and a three-month average daily trading volume of 200,000 shares or more.[1] Stocks meeting these criteria are ranked by dividend yield, and the top 100 weighted by dividend yield are selected. History is available back to Dec. 31, 1991, and the index is rebalanced annually—likewise, for international stocks.

Chart 1 illustrates how the return differential of high-dividend equities and the broader domestic and international markets have played out historically. For the period beginning January 1, 1999 and ending May 31, 2018, a high-dividend domestic equity strategy as represented by the Dow Jones U.S. Select Dividend Index generated an average annualized total return of 9.17%–302 basis points higher than the 6.15% annualized return of the S&P 500.

Similarly, international high-dividend equities delivered a performance edge. For the same period, a high-dividend international equity strategy represented by the MSCI World ex U.S. High Dividend Yield Index generated an average annualized total return of 6.16%–165 basis points higher than the 4.51% annualized return of the MSCI World ex U.S. Index.

High-dividend domestic and international equities have outperformed their non-dividend-paying counterparts

The advantages of dividend yield

The outperformance of high-dividend equities stems from several advantages offered by dividends and dividend-paying companies. For one, because a sizeable portion of their return is in cash, dividend-paying stocks may help to cushion a portfolio's downside when the broader market is posting losses. As Chart 2 indicates, dividend yield has generated an average positive return of 4.43% in down markets since 1926, which has helped to offset the average loss of 13.97% during these periods.

The ability of dividends to mitigate a portfolio's downside stems, in part, from their relative stability. Although high-dividend equity portfolios may underperform during strong growth markets, historically, dividend returns have been more stable than price-only returns, as Chart 3 illustrates. This relative stability is crucial for investors building portfolios to finance retirement, high education and other long-term goals.

In addition to displaying more stability than price-only returns, dividends continue to offer an important tax advantage for many investors. The new tax law fully preserves the qualified dividend income tax rate at 15% for taxpayers in the four middle tax brackets (22%, 24%, 32% and 35%). For individuals in the highest tax bracket of 37%, whose income is at or above $425,800 ($479,000 for joint filers), the rate for dividends is capped at 20%. For all but the lowest income levels, these rates are less than ordinary income tax rates.

The 3.8% Medicare surtax on dividends and capital gains, initiated to help fund the Affordable Care Act, remains in effect for joint filers who have more than $250,000 of adjusted gross income and single filers with more than $200,000. Keep in mind that this 3.8% surtax only applies to investment income above the thresholds noted above for joint/single filers.

Chart 1: High-Dividend Domestic and International Equity Outperformed Their Non-Dividend-Paying Counterparts

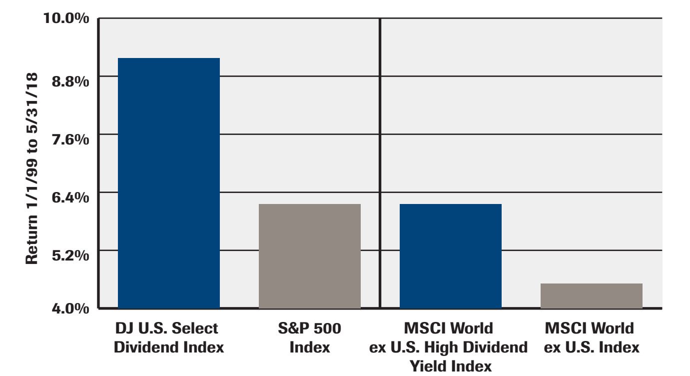


Chart 2: Dividends Have Supported Returns in All Markets — S&P 500, 1926 to 2018

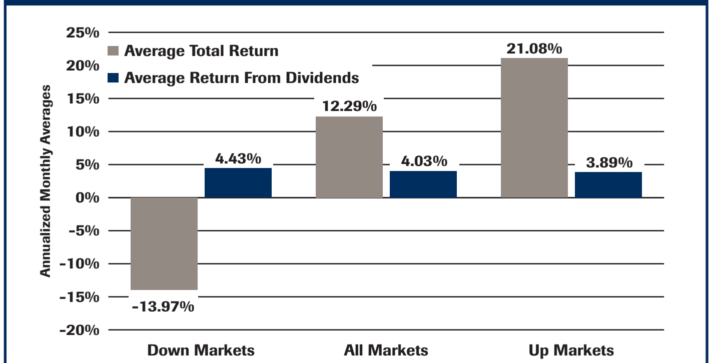
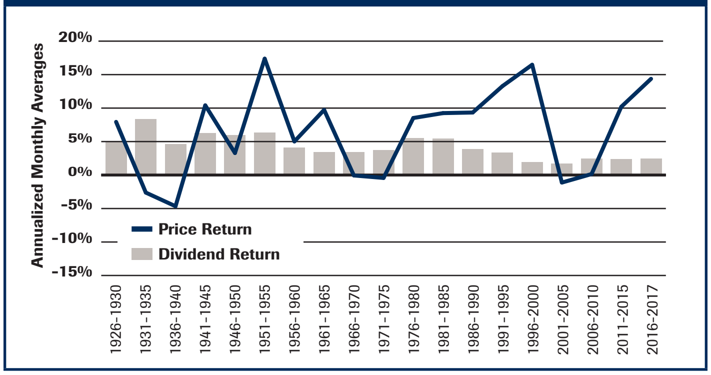


Chart 3: Dividend Returns Have Been More Stable Than Price-Only Returns of S&P 500, 1926 to 2017 in 5-Year Periods



Source: Standard & Poor's. 1/1/26-12/31/17.
These charts are for illustrative purposes only and are not representative of the performance of any particular investment.
Past performance is no guarantee of future results.

High-dividend strategies and rising rates

While dividend-paying companies are not interest-rate sensitive, their share prices can be. As a result, there's been some concern that dividend payments could be negatively affected as rates normalize. Particularly in what has been an extended period of low yields, traders and market makers have tended to view many dividend-focused securities as bond proxies and have pulled away from them on Federal Reserve rate hike announcements.

Federated portfolio manager Daniel Peris notes that this is a short-term phenomenon. "Rates are not expected to rise in a dramatic fashion over a condensed period of time. A rapid spike in rates would negatively impact the broad market, not just dividend stocks," he said. "Longer term, a return to a more normalized rate environment is healthy for the economy, the market and dividend-paying companies. That's especially true for companies—those dividend payers—that provide necessary goods and services like household products, shelf-stable food, pharmaceuticals, telecom services and tobacco."

The fact is consumers can put off spending on fashion and tech gadgets, but need to buy soap, paper products, fill prescriptions, use the Internet and keep the lights on even when the economy slows. Also, over the past five to seven years, corporations, including dividend-payers, have taken advantage of the low-rate environment to finance debt. They will continue to benefit from those low financing costs for some time to come, even in a rising-rate environment.

Determining high-dividend equity allocations

Many investors understand the benefits of a high-dividend equity strategy but are uncertain how to allocate their portfolios to capitalize on it. An appropriate allocation depends on an investor's goals, risk tolerance and time horizon. Although past performance does not guarantee future results, historical returns may shed light on the potential advantages of high-dividend equities within aggressive, moderate and conservative portfolios.

Each of the hypothetical allocations that follow illustrate how high-dividend equities—which include allocations to international high-dividend equities—have enhanced average annual total return and generally reduced volatility over the time period from January 1, 1999 through May 31, 2018, a time period selected based on the inception date of the MSCI World ex U.S. High Dividend Yield Index. There is a clear message here for investors. High-dividend equities may have appeal that goes beyond occupying a small slice of a conservative portfolio. A high level of reinvested dividends typically cushions a portfolio during down markets and contributes significantly to long-term total return—factors that are important to almost all investors.

Aggressive portfolio

High-dividend equities may help aggressive investors deal with one of their most vexing challenges—mitigating the potential downside of a portfolio weighted mostly to stocks. Changing the equity allocation from 50% stocks of the S&P 500 and 30% international stocks to 25% stocks of the S&P 500, 25% domestic dividend-paying stocks, 15% international stocks and 15% international dividend-paying stocks improved the annualized total return by 116 basis points and modestly reduced risk as the Aggressive Portfolio illustrates in Chart 4.

Moderate portfolio

As illustrated in Chart 5, a portfolio crafted for a moderate risk tolerance does not have to settle for middle-of-the-road returns. Allocating 30% of the portfolio to high-dividend domestic and international dividend payers improved annualized total return by 87 basis points while also reducing risk.

Conservative portfolio

High-dividend equities traditionally have been associated with conservative portfolios designed to pursue growth with reduced risk. Allocating half of the stock portion of a conservative portfolio to high-dividend domestic and international equities, as Chart 6 illustrates, may help an investor pursue those dual objectives.

It's interesting to note that the return of the conservative portfolio with high-dividend equities was higher than the aggressive portfolio that did not include high-dividend equities—but with significantly less risk. The relatively low standard deviation of the "with dividend stocks" portfolio stems from the 80% allocation to a combination of bonds and high-dividend domestic and international equities, investments that historically have offered lower downside risk.

Following a period of historically low volatility, recent pullbacks are a reminder that markets can and likely will become somewhat bumpier in the years ahead. Volatility is a normal part of investing. Stocks selected for their high-quality income have historically

Chart 4: Hypothetical Aggressive Portfolios[2]

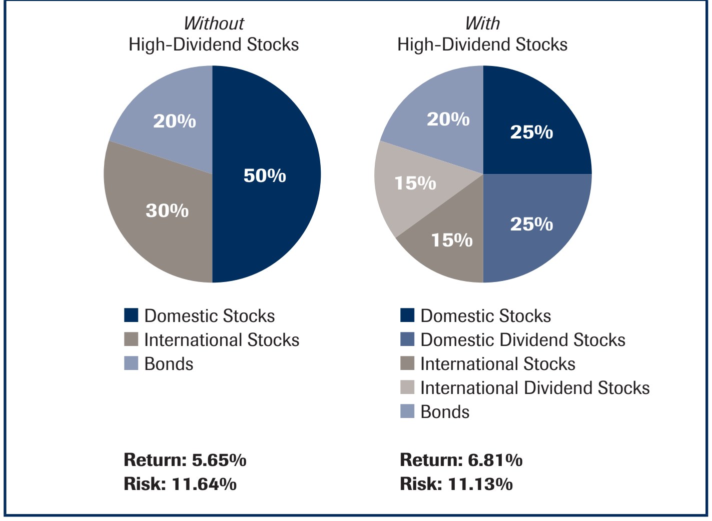


Chart 5: Hypothetical Moderate Portfolio[2]

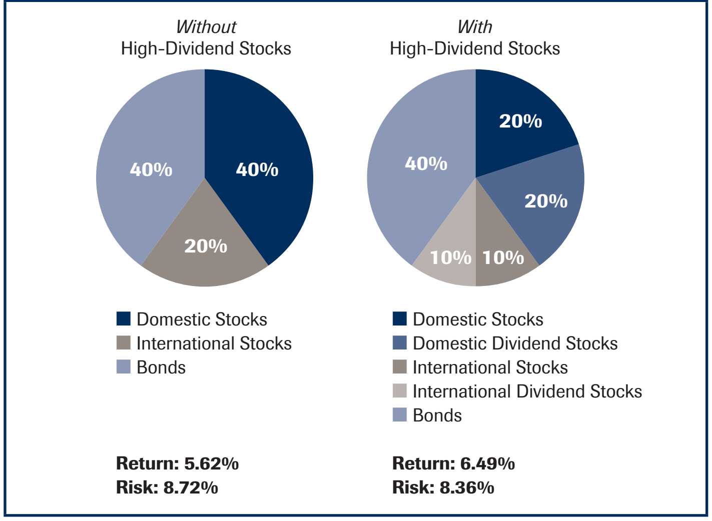
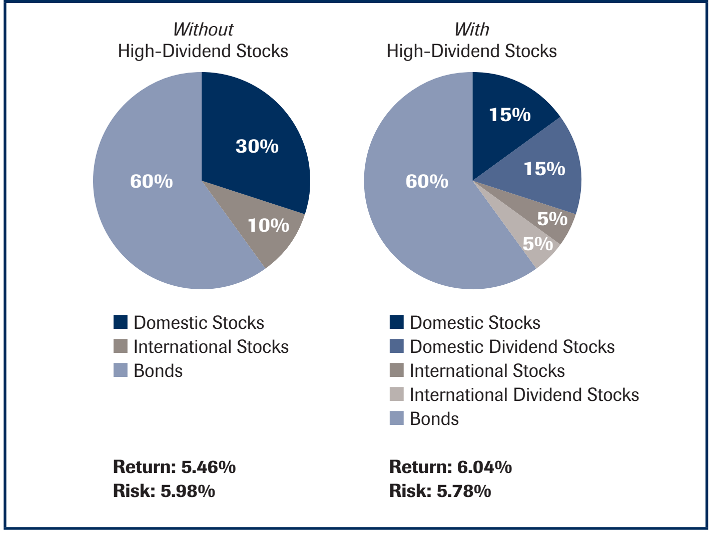


Chart 6: Hypothetical Conservative Portfolio[2]



Past performance is no guarantee of future results.

These charts are for illustrative purposes only and are not representative of the performance of any particular investment. Charts are for a select time period. Other time periods may not result in the same favorable returns.

See footnote 2 for source information.

offered greater protections during periods of market turbulence. Their relative stability has been attributable to their strong, mature business profiles, along with their solid balance sheets and ample free cash flow generation. Such reliable business models have enabled these companies to prudently increase their dividends over time.

Dividend growth, inflation and income

The risk and return associated with the aggressive, moderate and conservative portfolios assume all dividends are reinvested to enhance total return. But many investors instead rely on cash dividends to supplement other sources of income. When constructing portfolios for these investors, it's important to consider not only risk and return but also how the portfolio's potential for income compares with historical trends in inflation.

"Inflation is the enemy of income investors. There are portfolio managers who create income-oriented portfolios by making them bond-like. But the problem with this approach is that there is little likelihood of an increase in the income stream. By investing in stocks with the potential for growth in dividends, the income stream may move higher, which benefits investors who expect their need for income to rise over time," explained Peris.

Balancing risk and return

A high level of dividend income can provide a distinct advantage when fixed-income yields are low, the outlook for inflation is uncertain and the broader equity market is volatile. While a specific allocation depends on individual circumstances, high-dividend equities can be an important part of a wide range of portfolios. With increasing numbers of investors looking to enhance returns while financing retirement, higher education and other long-term goals, interest in high-dividend equity investing—both domestic and international—is likely to remain strong in the years ahead.

Thinking globally can pay dividends

While many U.S. companies have been more likely to spend a greater proportion of their income on capital expenditures, acquisitions and share repurchases, companies overseas typically pay out a higher percentage of their net income as dividends. It's simply how most of them allocate their cash flows, and it's what their shareholders demand.

Here are three reasons why dividend-seeking investors may want to expand their horizons by including an allocation to international dividend-paying equities:

- Potentially more attractive yields—The S&P 500 currently yields approximately 1.90%. In comparison, developed international markets provide dividend yields ranging from 3.0% to 4.5% in countries such as the United Kingdom, Canada, Australia, Switzerland and Norway.
- Performance—Many mature countries outside the U.S. are at an earlier stage of economic acceleration than we are in the U.S. This represents a potential performance opportunity for international dividend strategies. Also, as is true among U.S. companies, international stocks that initiate and pay growing dividends have historically outperformed their non-dividend-paying and growing counterparts.
- Enhanced diversification—Non-U.S. dividend funds also deliver an added layer of diversification through exposure to an expanded range of countries, currencies and economies.

Of course, when it comes to international markets, there are both countries and companies prudent investors will generally avoid. But given an overall "culture of dividends" that exists overseas, investors may benefit by combining the power of international investing with a dividend focus.

Source: 2016 AgTech Investing Report

The time frame beginning date of January 1, 1999 was based on the inception date of the MSCI World ex U.S. High Dividend Yield Index.

High-dividend equity is represented by the total return of the Dow Jones U.S. Select Dividend Index; the broader market by the S&P 500, an unmanaged index of 500 stocks designated to measure the performance of the broad domestic economy through changes in the aggregate value of 500 stocks in all major industries. Investments cannot be made directly in any index. Chart covers the time period beginning January 1, 1999 and ending May 31, 2018.

The broad international equity market is represented by the MSCI World ex U.S. Index, which captures large- and mid-cap representation across 22 of 23 Developed Markets (DM) countries--excluding the United States. With 1,013 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. International high-dividend-equity is represented by the MSCI World ex U.S. High Dividend Yield Index, which is based on the MSCI World ex U.S. Index, its parent index, and includes large- and mid-cap stocks across 22 of 23 Developed Markets countries. The index is designed to reflect the performance of equities in the parent index (excluding REITs) with higher dividend income and quality characteristics than average dividend yields that are both sustainable and persistent. The index also applies quality screens and reviews 12-month past performance to omit stocks with potentially deteriorating fundamentals that could force them to cut or reduce dividends.

[1] *Source: Dow Jones Indexes.*

[2] *Sources: Standard & Poor's, Dow Jones, Bloomberg Barclays and Morningstar, Inc. For the period beginning January 1, 1999 and ending May 31, 2018. Domestic stocks are represented by the total return of the S&P 500, domestic dividend stocks by the Dow Jones U.S. Select Dividend Index, international stocks by the MSCI World ex U.S. Index, international dividend stocks by the MSCI World ex U.S. High Dividend Yield Index, bonds by the Bloomberg Barclays Aggregate Bond Index. Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices. Asset allocation does not ensure a profit or protect against loss. Risk is measured by standard deviation.*

International investing involves special risks including currency risk, increased volatility, political risks and differences in auditing and other financial standards

Actual investments cannot be made in an index.

There are no guarantees that dividend-paying stocks will continue to pay dividends. In addition, dividend-paying stocks may not experience the same capital appreciation potential as non-dividend-paying stocks

Views are as of June 15, 2018 and are subject to change based on market conditions and other factors. This should not be construed as a recommendation for any specific security or sector.

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