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The Boston Company
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Dividend Caution: Playing It Safe Poses Hidden Dangers

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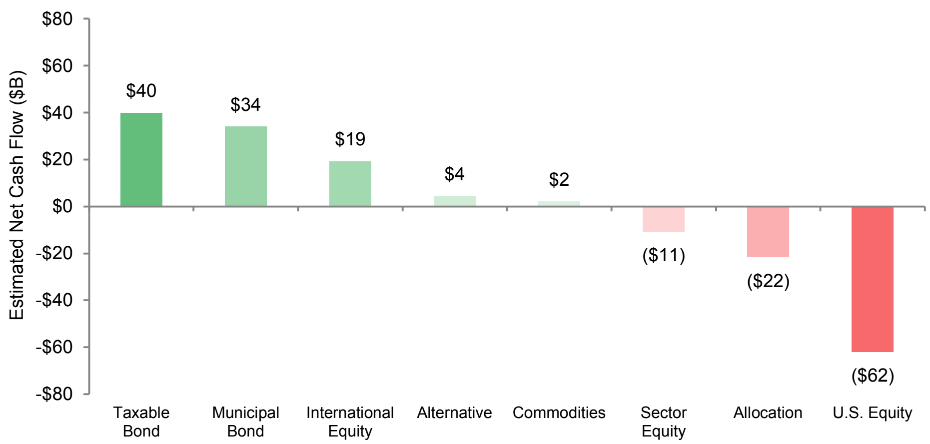
Against a backdrop of elevated investor anxiety, defensive and high dividend yield strategies have become popular safe harbor allocations for diversified portfolios. Looking forward, we believe heavily sought after, traditionally positioned dividend portfolios pose concealed performance hazards. These offerings have invested in companies with historically high valuations and weaker fundamental positions to provide the highest levels of yield. They are also heavily embedded in bond-proxy positions that could meaningfully underperform if U.S. interest rates begin to change course. We recommend investors de-risk these artificially "safe" positions and employ a more diversified, all-weather dividend solution for the next phase of the market.

Yield-hungry investors have invested in companies with historically high valuations and weaker fundamental positions

The Shift to Defense and Yield

Today's investment community continues to digest global headline risks, such as a slowdown in China, oil price volatility, Brexit and delayed Fed rate hikes. In addition, concerns have escalated about current equity market valuations, and a looming potential correction that could produce steep declines similar to those experienced in 2008. In this environment, investors have increased their focus on asset classes with lower levels of perceived downside risk. Categories typically viewed as safe havens, such as taxable bonds, municipal bonds and alternatives, have garnered strong positive net investor cash flows year-to-date, as evidenced by Exhibit 1. Conversely, U.S. equity funds experienced net outflows of $62 billion over the same time period.

Exhibit 1: Year-to-Date Estimated Net Cash Flows

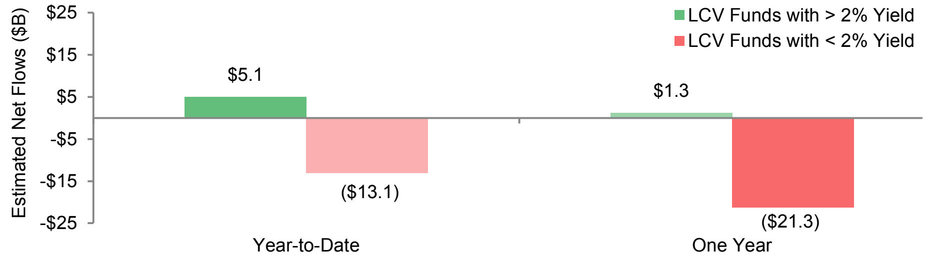


Source: Morningstar Direct, as of 6/30/2016.

Amid a backdrop of depressed interest rates, investors are seeking yield anywhere they can find it

This defensive posturing has affected specific U.S. equity allocations as well. Delayed interest rate hikes from the Fed have impacted sentiment, and many now believe U.S. interest rates will remain depressed for the foreseeable future. Investors are now seeking yield anywhere they can find it, spurring a large migration away from products focused on capital appreciation toward income-producing strategies. Exhibit 2 shows that funds in Morningstar's U.S. Large Cap Value category with a trailing 12-month yield of 2% or above generated positive net inflows over the year-to-date and 1-year periods. However, funds offering lower yields experienced sharp asset declines over the same timeframes. High dividend yield funds not only offer stronger levels of income, but they are also generally less sensitive to economic developments. As a result, they are known to provide more downside protection versus strategies solely focused on capital appreciation, adding to their appeal in today's yield-hungry, risk-off environment.

Exhibit 2: Morningstar LCV Funds Estimated Net Cash Flows by Yield Profile



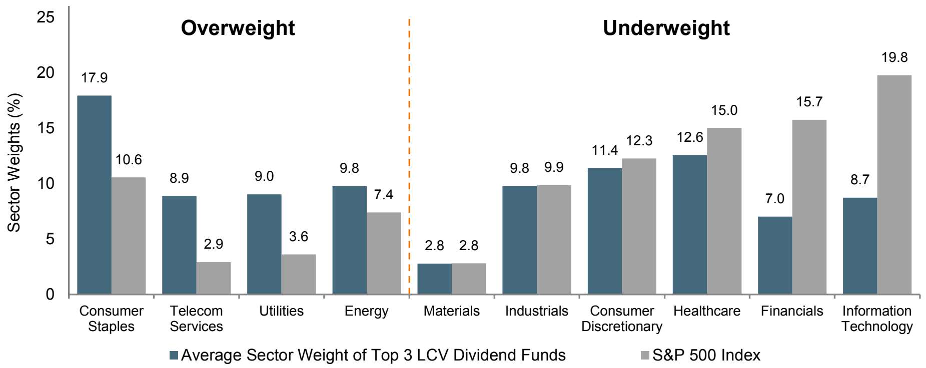
Source: Morningstar Direct, as of 6/30/2016, based on trailing 12-month data.

We believe there are hidden, overlooked risks in traditional dividend portfolios

The Hidden Pitfalls of Traditional Dividend Portfolios

This trade continues to gain momentum, but we believe there are hidden, overlooked risks in traditional dividend portfolios. Understanding the sources of yield and their impacts on performance is critical when evaluating dividend strategies. For instance, three high dividend yield funds have stood out versus their competition, generating a combined $8.8 billion in net inflows over the last year.* In Exhibit 3, the average sector weights of these three funds are compared against the S&P 500 Index. On average, this preferred cohort was overweight the Consumer Staples, Telecommunication Services and Utilities sectors given their higher-yielding profiles. Conversely, the funds maintained limited exposure to segments such as Information Technology and Financials.

Exhibit 3: Sector Weights of Top 3 LCV Dividend Funds vs. S&P 500



Source: Morningstar Direct, as of 6/30/2016. LCV funds selected based on one-year estimated net flow.

* Morningstar Direct, as of 6/30/2016.

Funds positioned for yield alone could face performance pressures as investors renew their focus on valuation and fundamentals

Per Exhibit 4, this positioning positively impacted their performance results in the first half of 2016 as Consumer Staples, Telecommunication Services and Utilities were among the top-performing S&P 500 sectors. However, due to overcrowding, these sectors now carry loftier valuations (price/earnings multiples) relative to the rest of the market. Additionally, they generally exhibit lower dividend-growth rates versus other sectors such as Information Technology and Financials. Overall, investors have been willing to invest in yield at any cost. However, a renewed focus on valuation and fundamentals could usher in a strong reversal, posing significant challenges for the highest-yielding sectors. In fact, the performance results in the third quarter of 2016 signal a potential inflection point away from high-dividend sectors to more fundamentally driven, less expensive sectors, as shown in Exhibit 5.

Exhibit 4: S&P 500 1H2016 Sector Performance

	Sector	1H2016 Return	Average Dividend Yield	Average P/E	Average 3-Year Dividend Growth
Sentiment Yield & Oil	Telecom Services	24.8%	3.2%	23.3x	4.0%
	Utilities	23.4%			
	Energy	16.1%			
	Consumer Staples	10.5%			
	Real Estate	10.5%			
Fundamentals Growth & Value	Materials	7.5%	2.0%	15.8x	9.5%
	Industrials	6.1%			
	Consumer Discretionary	0.9%			
	Health Care	0.6%			
	Information Technology	-0.3%			
	Financials	-5.9%			

Source: FactSet Research Systems, 1/1/2016 - 6/30/2016.

Exhibit 5: S&P 500 3Q2016 Sector Performance

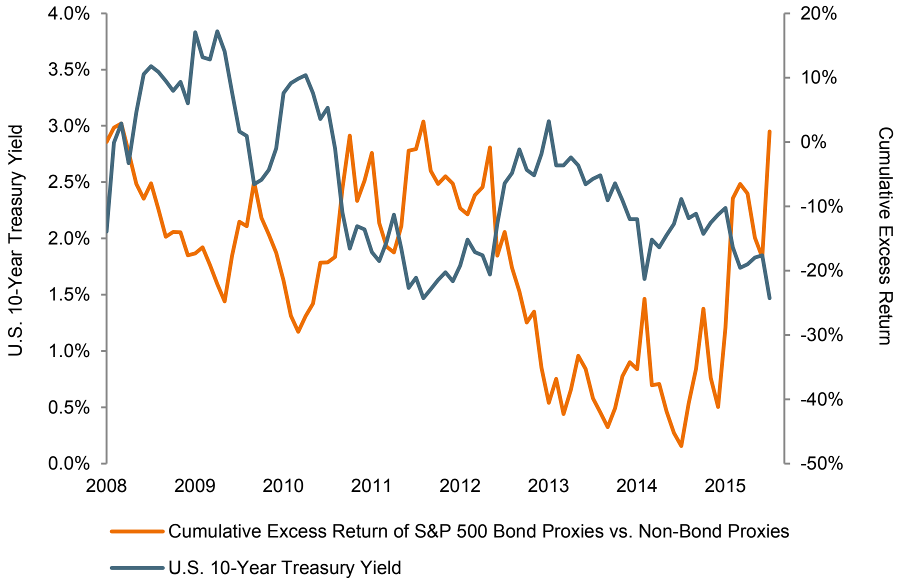
	Sector	3Q16 Return	Average Dividend Yield	Average P/E	Average 3-Year Dividend Growth
Fundamentals Growth & Value	Information Technology	12.9%	2.0%	17.3x	9.9%
	Financials	6.8%			
	Industrials	4.0%			
	Materials	3.7%			
	Consumer Discretionary	3.1%			
Sentiment Yield & Oil	Energy	2.2%	3.1%	23.7x	4.8%
	Health Care	1.0%			
	Real Estate	-2.1%			
	Consumer Staples	-2.6%			
	Telecom Services	-5.6%			
	Utilities	-5.9%			

Source: FactSet Research Systems, 7/1/2016 - 9/30/2016.

Bond-proxy-heavy dividend funds could underperform as interest rates begin to normalize

Interest rate sensitivity is also important to consider when analyzing dividend portfolios. The performance of the highest-yielding sectors such as Consumer Staples, Telecommunication Services, Utilities and Real Estate Investment Trusts (REITs) have benefited from a backdrop of declining/low interest rates. However, when the U.S. 10-year Treasury yield has increased, these sectors have traditionally lagged the rest of the market, as shown in Exhibit 6. These types of securities are often labeled as “bond proxies,” meaning their relative performance is primarily attributed to the direction of the U.S. 10-year Treasury yield at any given time.

Exhibit 6: U.S. 10-Year Treasury Yield vs. S&P 500 Cumulative Excess Return of Bond Proxies vs. Non-Bond Proxies



Source: FactSet Research Systems, monthly data 1/1/2008 - 6/30/2016.

Equity markets have largely been in a risk-off state over the most recent cycle, which has benefited bond-proxy securities. However, we believe their valuations have grown excessive, providing little downside protection as markets change. Furthermore, economic data in the U.S. appears poised to positively surprise, potentially leading to a change in Fed policy and future interest rate normalization. This could spark a meaningful rotation away from the most defensive, highest-yielding stocks and pose significant performance challenges for bond-proxy-heavy dividend funds.

A Strategy for an Evolving Market

The Boston Company’s Income Stock strategy looks beyond yield and considers dividend growth, fundamentals and valuation—a holistic approach better suited for this market

We believe investors need to look beyond yield alone and consider dividend growth potential, economic sensitivity, fundamental positioning and valuation. The Boston Company’s Income Stock strategy centers on companies’ ability and willingness to pay dividends, while also focusing on equities with attractive valuations and strong fundamentals. As such, the strategy has performed solidly across various markets, including rising interest rate environments. We believe this strategy provides a solution for investors looking to de-risk their “safe” holdings and embrace a dividend approach for the road ahead.

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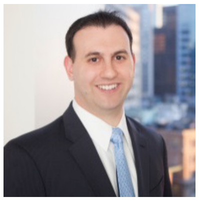
John is a senior portfolio manager of U.S. dividend-oriented and large-cap strategies. In addition, he functions as a senior research analyst on the Dynamic Large Cap Value strategy, where he is responsible for the Consumer, Technology and Telecommunications sectors. John joined The Boston Company in 1992, became a U.S. large-cap senior fundamental research analyst in 1999 and a U.S. large-cap portfolio manager in 2005. John graduated with distinction from Babson College with a B.S. in accounting and management information systems. He received an M.S. in finance from Boston College. He holds the Chartered Financial Analyst® designation and is a member of the CFA Institute and the Boston Security Analysts Society.



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Joe is a portfolio strategist for The Boston Company, focused primarily on the U.S. retail channel and the firm's US Small Cap Value investment team and involved in the team's daily activity without stock decision-making responsibility. He is responsible for communicating the team's strategies to clients, prospective clients and consultants, serving as the critical interface between client-facing staff and the investment team. In this role, Joe guides the messaging and positioning of investment strategies, helping to create marketing materials and content, responding to investment-related client-inquiries and ensuring relevant investment insights of the portfolio management team is delivered internally and externally in a timely, effective way. Previously at The Boston Company, Joe was a product manager, providing market research, analysis and project support to enhance the development and promotion of the firm's products and capabilities. Before that role, he was a client service analyst, responsible for generating a diverse range of analytical data and client reporting materials. Prior to joining The Boston Company, Joe was a senior portfolio accountant at Standish/Mellon Asset Management, where he was responsible for account maintenance, trade processing, cash and asset reconciliations. He also previously served as a trust specialist at Mellon Financial Corp. Joe received a B.A. in finance from Bryant University and an M.B.A. from Bentley University.

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