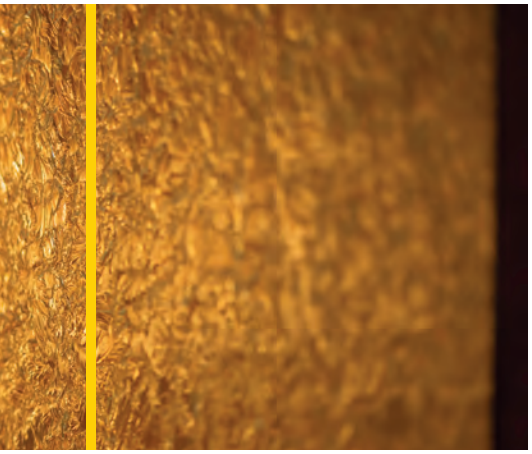

Wolves in Sheep's Clothing: Hidden Risks in Dividend Portfolios

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EXECUTIVE SUMMARY

In the past five years, we have witnessed a resurgence of interest in US dividend-paying stocks. This is due to investors seeking income generation in a zero-interest-rate environment, and a defensive way to increase their US equity exposure as well as concerns about bonds in a rising interest rate environment. We contend that investment managers have chased this bond-proxy trade with a myopic view of the potential rewards without fully considering the associated risks.

Historically, investors have pursued stocks that yield high dividends for their superior downside protection and significant contribution to total market return. In today's environment, however, chasing these yield-producing stocks without regard to entry points can be risky. In some cases, the risks may potentially even outweigh the benefits of dividend investing. Thus, investors interested in dividend-paying stocks need to consider the potential effects of currently prevailing market conditions, particularly the three which we address in this piece:

- The risks of a rising interest-rate environment
- The downside of valuation indifference
- The effect of a changing fundamental landscape

While these headwinds affect many investors, they are not insurmountable. Figure 1 shows that during a recent period when all of these risks coexisted, dividend investing using a fundamental, forward-looking and valuation-sensitive approach yielded results that compared favorably with other approaches.

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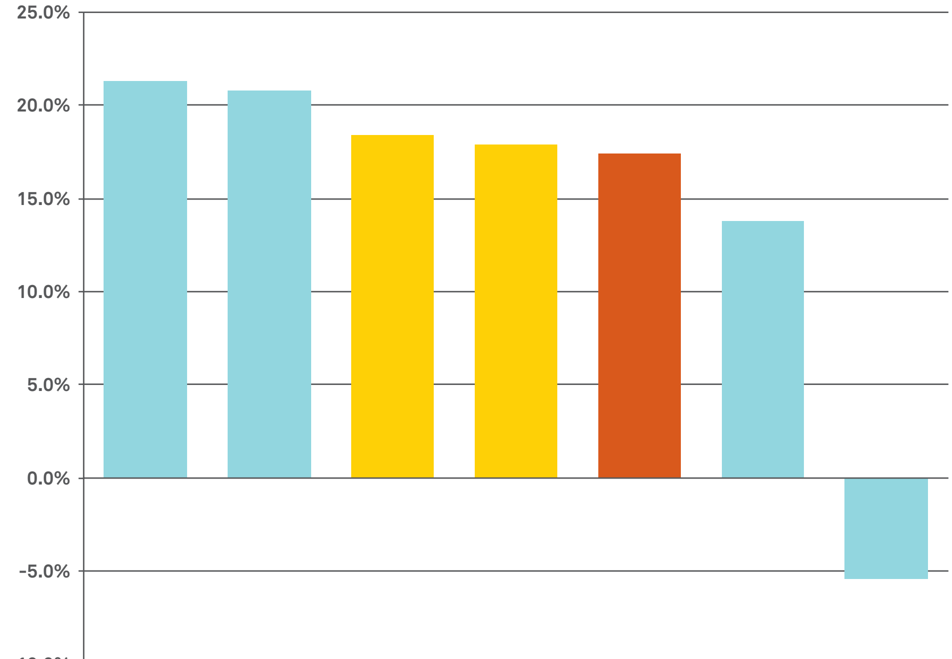
Figure 1: 10-Year US Treasury Interest Rate May 2013–December 2013



	TBCAM Equity Income (Gross of fees)	TBCAM Equity Income (Net of fees)	TBCAM High Dividend Income (Gross of fees)	TBCAM High Dividend Income (Net of fees)	S&P 500 Index	eVestment US Dividend Focus Equity Universe	Bond Proxies
Returns	21.3%	20.8%	18.4%	17.9%	17.4%	13.8%	-5.4%

Source: FactSet, eVestment. Note: Bond Proxies are represented by the Telecommunications and Utilities sectors of the S&P 500 index. Please refer to the back page for other important disclosures. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.

THE RISKS OF A RISING INTEREST-RATE ENVIRONMENT

Recently, underwhelming fixed-income yields have driven investors into a select group of high-yielding equities that have become known as bond proxies.[1] These stocks traditionally offer many of the same characteristics investors seek in bonds, namely income and downside protection. Investors have also often sought these stocks in an effort to preserve legacy fixed-income capital for a time when interest rates inevitably rise.

1 Bond proxies can include select names within Utilities, Telecommunications Services, Consumer Staples and real estate investment trusts, as well as other industries. For illustrative purposes in this paper, we use "bond proxies" to refer primarily to the Utilities and Telecommunication Services sectors.

Many investors, however, were surprised by the magnitude of the underperformance by (and, in some cases, outright capital loss from) these bond proxies during the interest-rate spike caused by former Federal Reserve Chairman Ben Bernanke's tapering talk in May 2013. (See Figure 2.) While interest rates have reversed course in 2014, we still believe the most likely path for rates is higher over the long term.

Figure 2: Periods of Rising Interest Rates and Related Performance

	Oct. 1993 – Nov. 1994	Oct. 1998 – Jan. 2000	Jun. 2003 – Jun. 2006	Dec. 2008 – Apr. 2010	May 2013 – Dec. 2013	Average
10 Year UST Change (bps)	281	263	207	189	140	219
S&P 500 Return	2.5%	48.8%	32.0%	39.9%	17.4%	30.6%
Telecom Sector Return	-1.1%	40.9%	29.6%	6.9%	-4.8%	20.0%
Utilities Sector Return	-1.2%	-3.3%	39.6%	9.9%	-6.0%	16.7%

Source: Bloomberg, FactSet.

Equities tend to appreciate meaningfully during periods of rising rates, but not all stocks and sectors benefit equally.

Equities tend to appreciate meaningfully during periods of rising rates, but as Figure 2 shows, not all stocks and sectors benefit equally. In the most recent periods of materially higher rates, the Utilities and Telecommunication Services sectors consistently and significantly underperformed. The only two exceptions were utilities in 2003 and telecoms in 1998, when the sector yields were not materially different from the market (i.e., they were not functioning as bond proxies). Moreover, in half of the observations, the sectors' performance was negative on an absolute basis and capital was not preserved.

When seeking protection against interest-rate risk, investors may consider companies that are sensitive to the health of the economy and that enjoy high yields and/or superior dividend growth prospects. For example, Information Technology and Financials are two economically sensitive sectors that have seen dividend growth rates of roughly 30 percent during the past three years. Although investors may give up a modest amount of yield (albeit while still maintaining a premium to the market), they can benefit from better upside performance and downside protection.

Successful dividend investing should include a focus on underlying business fundamentals.

THE DOWNSIDE OF VALUATION INDIFFERENCE

The highest-yielding bond proxies have historically traded at a 10 to 20 percent discount to the overall market, due to their limited growth prospects. However, this relative discount has broken down over the past five years as investors have aggressively pursued high-yielding stocks without much regard for price. Paying too much for a desired benefit–in this case, a superior yield–can significantly undermine its overall value. (See Figure 3.)

Figure 3: Percent Excess Return

Valuation as Measured by P/E

Dividend Yield	Attractive	Unattractive
High	1.5%	–0.4%
Low	0.4%	–0.5%

Source: Wolfe Trahan Accounting & Tax Policy Research, Company filings, Bloomberg, Standard & Poor's, FactSet. Note: Dividend Yield - 500 largest companies ex-REITs; 1990-2/6/13. Dividend yield is not sector neutral. P/E is sector neutral.

Figure 3 shows excess returns for four groups of stocks based on the attraction of dividend yield and valuation. The high-dividend- yielding stocks provide higher returns than the low-dividend-yielding stocks for a given level of valuation, which underscores a primary appeal of dividend investing. Regardless of the level of their dividend yield, richly valued stocks (measured by a high price-to-earnings ratio in this case) underperformed. Stocks that offer high yields at attractive valuations are the attributes that serve as cornerstones of The Boston Company's investment approach.

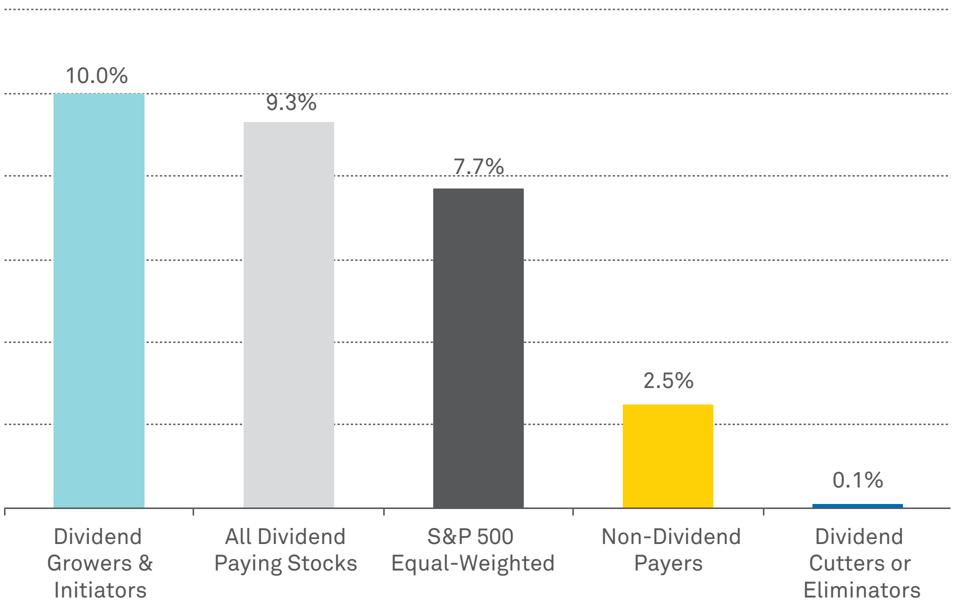
THE EFFECT OF A CHANGING FUNDAMENTAL LANDSCAPE

Successful dividend investing should also include a focus on underlying business fundamentals. For example, the traditional business models of high-yielding utility companies are likely to undergo profound change as the industry finds itself subject to disruptive pressures such as rooftop solar and home automation. We see these changes putting downward pressure on the amount of electricity which utilities will sell to consumers and lead them to try to charge higher rates to cover their large fixed bases. These rate increases, however, will likely face considerable political pushback from public utility commissions, as many lower-income consumers are unable to afford rooftop solar systems and would bear the brunt of higher electricity costs. Thus, with volumes declining and rate inflation challenged, the financial position of some utilities will deteriorate over time.

Some companies and management teams will react far better than others to this evolution, and the returns of their companies' stocks are likely to diverge accordingly. Those who are unable to manage this transition effectively may also have to cut their dividends, a move which is almost always draws scorn from investors and subsequent selloffs. Fortunately, forward-looking active investment managers, who are skilled at identifying management's ability and willingness to continue to pay and grow their dividends, are capable of identifying these winners and losers and positioning their portfolios accordingly. (See Figure 4.)

Utility companies are using financial re-engineering to unlock shareholder value.

Figure 4: Average Annualized Returns of S&P 500 Stocks by Dividend Cohort (1972 – 2014)



Source: Ned Davis Research. Monthly data 1/31/72 – 7/31/14.

Utility companies are using financial re-engineering to unlock shareholder value. In the past year alone, at least five utility companies have spun out their fixed assets into "yield cos." These fast-dividend-growing, tax-advantaged companies have enjoyed tremendous early outperformance. (See Figure 5.) Few passive and/or quantitative managers have exposure to these types of securities despite their powerful combination of high dividend growth and robust performance because of their limited float and/or liquidity and lack of historical data. We believe that a forward-looking fundamental manager can overcome these challenges.

CONCLUSION

Many investors have been increasing exposure to dividend-paying stocks of late, but have done so with a narrow focus on high yields alone. Unfortunately, this has introduced unintended risks into their portfolios, stemming from a rising interest-rate environment, valuation indifference and/or a changing fundamental landscape.

Fortunately, we believe these risks can be effectively mitigated to allow investors to realize the tried- and-true benefits of dividend investing. But to do so, investors need to broaden their investment criteria beyond high yield alone and include dividend growth prospects, economic sensitivity, fundamental position and valuation attractiveness.

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