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Don't Ignore Dividends: Nine Ways Dividends can Help Investment Portfolios.

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We believe equity investors often ignore the dividend component of the equity return stream and do not appreciate the role high dividend-paying stocks can play in a portfolio. Dividend stocks can boost yield, improve capture ratios, increase IRR and generate more alpha than some alternative investment asset classes.

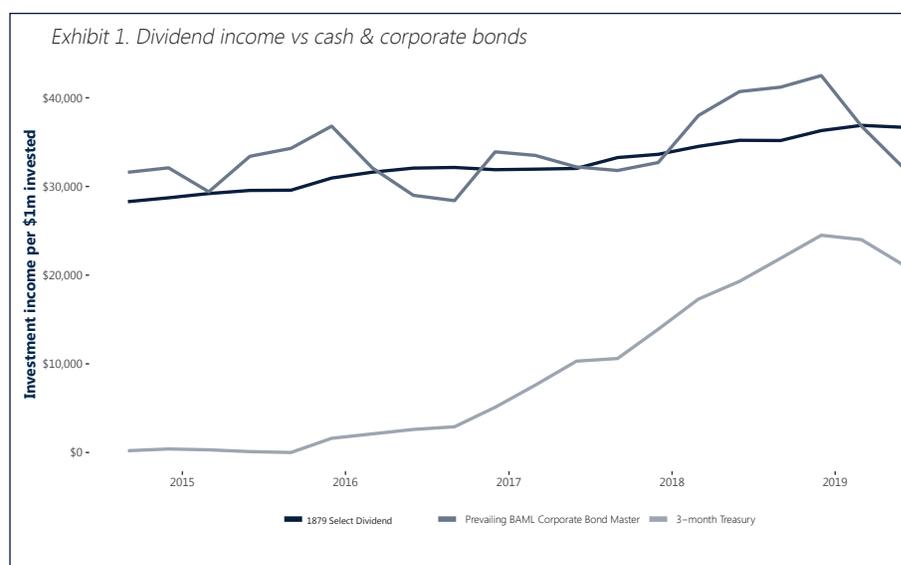
Yet investors are underinvested in dividend strategies. The eVestment database, for example, lists only \$141 billion of assets under management for reported equity income strategies out of a total of \$79 trillion of investment strategies listed. We discuss why investors might ignore dividends and list nine reasons dividends can help improve portfolio return quality.

Financial academia has long concluded that capital structure – how a firm is financed – has no impact on how that firm is valued. Franco Modigliani won the Nobel Prize in Economics for his work in this area in what became known as Dividend Irrelevance Theory. That work sought to explain the high premium investors then paid for dividend paying stocks and concluded that irrational investor behavior was the culprit.

Dividend stocks have a number of attributes that can make them an invaluable allocation in a diversified portfolio, some of which were not apparent when Modigliani performed his research in 1961. We detail some of them below.

1.) Dividends generate a consistent, predictable and growing income stream that can help to meet projected cash requirements.

One of the primary advantages of dividend income versus fixed income investments is that dividends generally grow over time, while fixed income is, well, fixed. Because corporate dividend policy is seen as a means for management to signal the internal view of company health to broader markets, dividends are not typically cut making them fairly stable over time. This results in a steady, yet growing income stream that compares favorably to both cash and corporate bond investments. Exhibit 1 (to the right) shows the income trend for the current portfolio of the 1879 Select Dividend Strategy versus yields



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available on the ICE BAML Corporate Bond Master Index and the yield on short-term US Treasuries. We show income from our own portfolio because it excludes financials and companies at risk of dividend cuts. It is clear that dividends can serve as a source of income that can be used to meet future cash requirements.

2.) Dividends exhibit much lower variation than other components of total shareholder return.

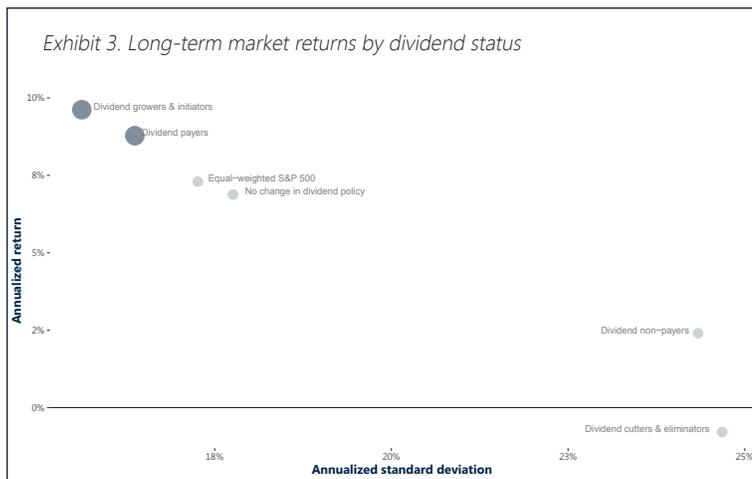
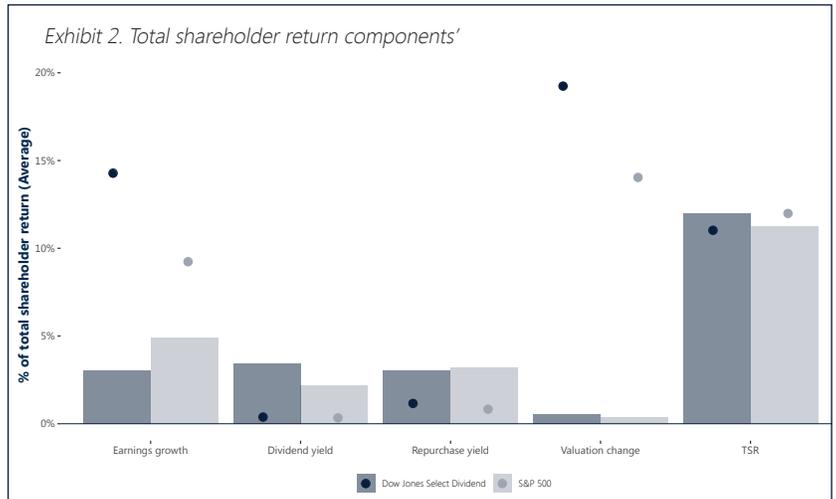
Total shareholder return (TSR) is a measure of corporate value creation developed at the Boston Consulting Group and extended by numerous practitioners. TSR helps to disaggregate company return drivers into a model of underlying return components:

Revenue growth	x Margin Change	= EBITDA growth	+ Dividend yield	+ Share repurchase yield	+ Debt repayment	+/- Valuation change	= Total Shareholder Return
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The TSR model provides insight into the growth and capital deployment strategies that companies use to generate shareholder return. Growth companies often focus on driving revenue growth while transformational companies may seek to improve their margins and dividend companies seek to increase shareholder return through dividend payments. Over time, stock market returns should converge to total shareholder return and the metric can be thought of as an expected return.

We applied the TSR model to our fundamental database to determine return drivers for the current constituents of the S&P 500 and Dow Jones Select Dividend (DJSD) indices from 2006-2018. By measuring results annually, we were able to compute averages and standard deviations for each primary TSR component.

The findings are summarized in Exhibit 2 (to the right) and show a few things: first, Dividend and S&P 500 companies have similar TSR (with Dividend TSR slightly ahead); second, dividends account for about 20.4% of S&P 500 TSR and 34.3% of DJSD TSR; finally, the dividend portion of return shows the lowest variability of any of the return components (the points shown on the chart represent the standard deviation of each component). Dividend stocks generate up to a third of expected TSR from dividends, the most predictable of return components, and that ultimately leads to higher risk-adjusted stock returns. Value and growth strategies, on the other hand, generate returns from components that show considerable variability and therefore those strategies also show considerable variability.



3.) Dividend paying stocks generate higher long-term returns than non-payers.

Over long time periods, dividend-paying and dividend-growing stocks have been shown to achieve higher returns with lower volatility than companies with no or reduced dividends. The data, from Ned Davis Research Inc, shows that dividend stocks have performed far better than companies that do not pay dividends or cut their dividends.

We believe this is a direct result from points #1 and 2 above. Dividends are stable, predictable and growing return streams and the least variable component of shareholder return. This leads to lower volatility return streams.

4.) Greater income from the equity portfolio can reduce income pressure on the fixed income portfolio.

Nearly all portfolios have some type of need for income – whether an RMD for an IRA, a spending policy for an endowment or service cost for a pension plan – and many investors rely almost completely on the fixed income portfolio to generate required income. By boosting the yield on the equity portfolio, an allocation to an equity income strategy can help reduce the pressure on the fixed income portfolio to generate income, pressure that typically results in some allocation to credit.

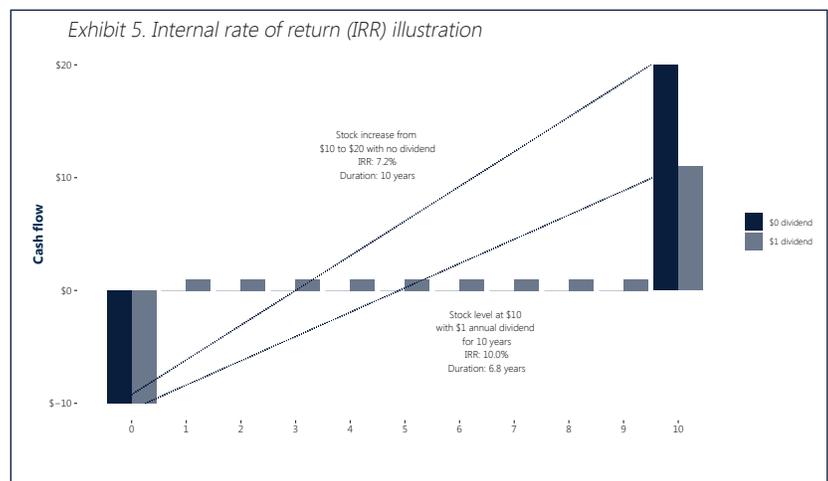
Exhibit 4 (below) is a stylized example of this point. In Scenario 1, the portfolio generates a yield of 2.72% by investing in a portfolio of Equity (S&P 500), Aggregate bond and high yield bond; Scenario 2 generates the same yield but includes a 14% allocation to Dividend stocks carved out of the Equity allocation. The yield is achieved with no allocation to high yield bonds and that helps to improve the credit quality of the fixed income portfolio by one full letter grade compared to Scenario 1.

Class	Quality	Yield	Scenario 1	Scenario 2
Equity	---	1.86%	40.0%	26.0%
Dividend	---	3.40%	0.0%	14.0%
Aggregate bond	AA	2.91%	50.0%	60.0%
High yield bond	BB-	5.20%	10.0%	0.0%
Portfolio yield	---	---	2.7%	2.7%
Fixed income average credit quality	---	---	A	AA

5.) Periodic income stream boosts IRR and helps to de-risk an investment.

Dividend paying stocks can generate higher internal rate of return (IRR) than non-paying stocks. Higher IRR reflects a return that is earned more quickly than a lower IRR investment. This helps to 'de-risk' the investment because at least a portion of the expected return is earned at any given point in time. In some ways, the high dividend investment can be thought to have lower duration than a non-paying investment and receiving a payoff in the distant future is inherently riskier than receiving one in the near future.

Exhibit 5 (to the right) compares returns on two hypothetical investments: a non-dividend paying stock that is bought for \$10 at time 0 and sold for \$20 at time 10 (dark blue bars) and a stock that is purchased for \$10 at time 0 and sold for \$10 at time 10 with a \$1 annual dividend in the intervening periods. The non-dividend paying stock doubled over the 10 periods, resulting in \$10 of return, an IRR of 7.2% (since there were no cash flows, the time-weighted return was also 7.2%). The dividend paying stock meanwhile, didn't increase at all over the 10 periods but did receive cash flow each period so also received \$10 of return. Because some of the return was earned early on in the life of the investment, the IRR of 10.0% is much higher than the non-dividend alternative. Also, because some of the return was earned early in the investment, the overall investment is less risky.



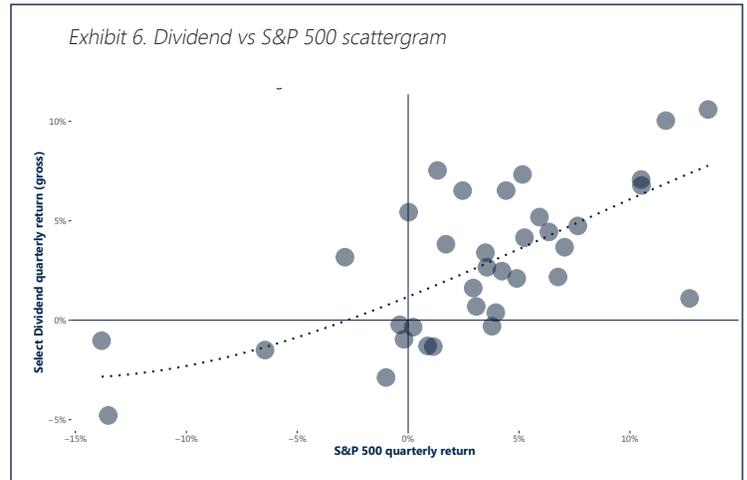
6.) Dividend stocks exhibit lower volatility and lower correlation compared to broader equity markets, especially in down markets.

High dividend strategies have historically shown low correlation to, and lower volatility than, broad market indices, especially in down markets. This occurs because of the defensive nature of dividend-paying companies, due to interest-rate sensitivity from the dividend yield and idiosyncratic exposures, such as energy, that can respond to non-market factors.

Downside correlation is typically low for a couple of reasons. Interest rates often fall in reaction to increases in risk and make dividend yields more attractive as they added diversification during these higher risk periods. Energy companies respond favorably to increases

in oil prices, which often move higher as geopolitical risk increases. As energy companies are typically well represented in high dividend portfolios, dividend portfolios can provide diversification against those risks as well.

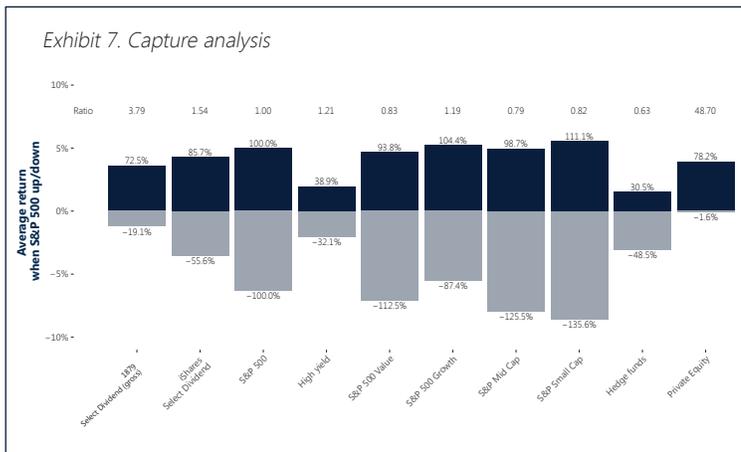
Exhibit 6 (to the right) shows the quarterly returns of the 1879 Select Dividend Strategy versus the S&P 500 from 2011-2019. The correlation of the Strategy to the benchmark is only about 67%; in negative market months, the strategy correlation is even lower at 42%. Figures for the Dow Jones Select Dividend index are slightly higher than our strategy but show the same trend nonetheless with an overall correlation of 84% and a conditional correlation of 75%.



Volatility, too, is lower for dividend strategies. Our dividend strategy shows an annualized standard deviation of 7.4% compared to 12.0% for the S&P 500. A similar phenomenon is observed on the downside. In negative S&P months, S&P volatility is 20.8%; in those months, our dividend strategy has a standard deviation of 8.5% (figures for the DJSD index are similar with an overall standard deviation of 9.9% and a downside deviation of 14.2%). High yields, diversified exposure and defensive characteristics help to make Dividend strategies an ideal source of diversification in both up and down markets.

7.) Dividend strategies exhibit favorable capture statistics versus other asset classes.

Capture statistics measure how an investment performs in up and down market environments (with the S&P 500 usually representing 'the market'). Favorable capture occurs when an investment participates in a higher percentage of up market moves than it does in down market moves. This is similar to point #6 above but rather than assessing capture over individual time periods, returns are aggregated over a range. Up capture is the average return for up market periods; down capture is the average return during down market periods and the ratio measures the percentage of up capture over the percentage of down capture. For example, consider Exhibit 7 (to the left). The S&P Small Cap index is up an average of 111.1% of the broader S&P 500 in up S&P 500 quarters. The same index is down 135.6% of the S&P 500 in down quarters. Its capture ratio of 0.82 indicating that it captures more of the downside than the up.



Dividend stocks exhibit more favorable capture ratios than many other investment styles and asset classes, including hedge funds (we measured these statistics from March 2011 through June 2019). The Dow Jones Select Dividend index shows a capture ratio of 1.54 while the 1879 Advisors Select Dividend (gross), capturing 72% of the upside and only 19.1% of the downside, shows a ratio of 3.79. Hedge funds showed a disappointing capture ratio of only 0.63. Private equity investments, measured by the Cambridge Private Equity Index, showed the most favorable ratio but it should be noted that those returns include unrealized gains and losses where fund managers are responsible for valuing investments.

8.) Dividend strategies have historically exhibited high alpha values.

As we've shown in the points above, dividend strategies have historically exhibited low correlation and volatility relative to broad markets so it stands to reason that they also have low betas. As a reminder, beta can be calculated by multiplying the correlation of two assets by their relative standard deviation (ie the standard deviation of one asset divided by the standard deviation of its benchmark). Using the figures from exhibits above, our dividend strategy has a correlation to the S&P 500 of about 67% and the standard deviations of the strategy and the S&P are 7.4% and 12.0%, respectively. The beta is therefore 67% * (7.4% / 12.0%) or .407. At the same time, we showed dividend strategies have historically earned the same (or greater) returns than the overall market.

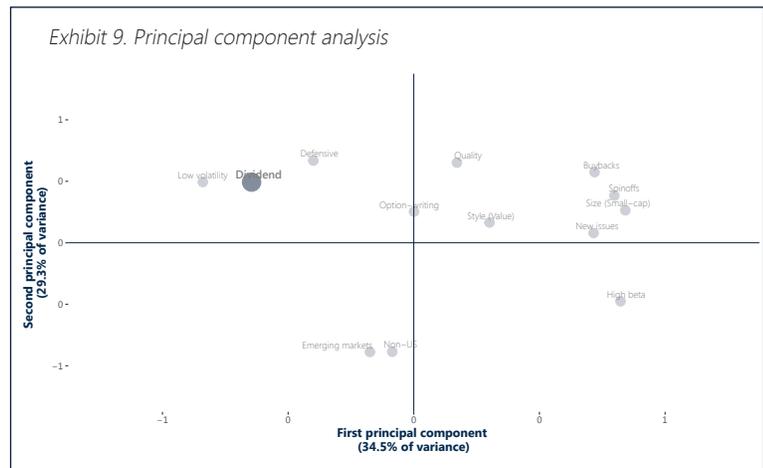
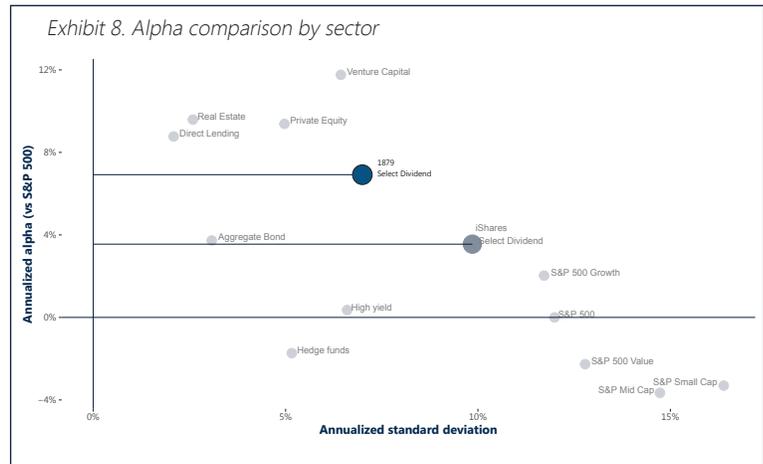
Alpha represents the excess risk-adjusted return of an investment. It is commonly calculated by subtracting the return on one investment by the risk-adjusted return on a benchmark. Since launching in 2011, the 1879 Select Dividend Strategy has generated

an average annual return of 11.5% compared to the S&P 500 of 12.0%. Using these figures to compute alpha: $11.5\% - (12.0\% * .407 \text{ beta}) = 6.6\%$. About half of that relates to the excess dividend yield on the strategy versus the S&P (about 2.82%), the remainder is due to idiosyncrasies of dividend stocks versus broader markets. As seen in Exhibit 8 (to the right), dividend strategies bridge the alpha gap between public and private markets. Our dividend strategy has generated alpha near to private market levels and even broader dividend indices such as the DJSD index have been sources of cheap, liquid alpha.

9.) Dividend is a unique factor that can complement or supplement traditional value and defensive investments.

In recent years, investors have expanded their horizons beyond the simple two-dimensional size/style orthodoxy and embraced a range of new approaches to find diversification. Smart-beta, factor investing and alternative investments are all intended to add unique sources of diversification to portfolios.

To identify unique market factors, we used principal component analysis (PCA) to analyze beta-adjusted excess returns for a variety of style and smart-beta ETFs including size, style, quality, momentum, dividend and others. PCA is a technique that seeks to transform data into uncorrelated factors that explain the variance of the data. The resulting factors, or principal components, can be thought of as core factors and for market-related data, the first principal component is usually 'the market'. As is clear in Exhibit 9 (to the right), dividend is a unique factor with similarities to defensive and low volatility suggesting that allocations to dividend strategies can help to improve portfolio diversification.



Dividends are often overlooked by investors yet they offer numerous benefits. Investors should consider increasing dividend allocations to boost income, improve diversification during up and down markets and earn alpha.

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