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The New Approach to Rising Rates & Inflation

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The first quarter of 2018 has proven to be a challenging environment for many investors trying to navigate the increase in volatility. Understanding the sources of market returns in isolation and catalysts for the volatility is key to understanding where opportunities may lie and how to better prepare for these situations in the future.

First, many expected strong earnings spurred primarily by tax cuts and continued strong economic growth, and this is clearly playing out. However, price/earnings multiples were already becoming a bit rich, leaving probability for some p/e contraction to offset the strong earnings growth. Second, we are seeing more signs of inflation creeping into expectations, with interest rates rising significantly in the first quarter. This has not bode well for fixed income returns, which are typically a safe haven during volatile times. This begs the question, where should one go in an environment like this? Well, one historically well-performing asset in inflationary environments has been commodities, but the range of commodity investment alternatives and historical volatility of the sector can be daunting. This brings us to another option—dividends, which might be considered an investment tracking nominal earnings (and therefore inflation too) without the p/e multiple risk and corresponding volatility experienced by the underlying index. We have been forming this thesis using historical data back to the 70's, and have detailed our findings in a white paper titled *Dividends: The New Asset Class.*

Before we get into how investors can access dividends on a standalone basis in today's market, let's look at some statistics from the first quarter to show how this has been a different investment from equities and fixed income.

Dividends

- Q1 2018 S&P 500 Dividend payments were $109.2 billion, up from $100.9 billion during Q1 2017, corresponding to a year-over-year growth rate of 8.23%.
- Average S&P 500 company's dividend increase during Q1 2018 was 13.9%, compared to 10.4% for Q4 2017 and 10.2% for Q1 2017.

Earnings

- On March 31, 2018, earnings estimate for the S&P Q1 was 17.1%. As of 4/27, 53% of companies had reported with aggregate earnings growth of 23.2%. The percentage of companies that experienced an upside earnings surprise was 79%. (Source: FactSet)

Market Performance

- Q1 S&P 500 price return was -0.76%, largely being characterized by volatility and p/e multiple compression.
- Bloomberg Barclays US Agg Bond Index return was -1.46%, being impacted by rising rates and inflation.

Comparison of 2018 S&P 500 Dividend Futures, S&P 500 Earnings, S&P 500 Price & 10-Yr Treasury Rate
As of 4/30/18

First Quarter Takeaway

Our thesis of dividend growth being significantly correlated to earnings, and therefore being a pure play on earnings, has been well demonstrated in the first quarter. Dividends have aggregately increased in similar fashion to earnings, while the price return of the overall market has been negatively impacted by multiple contraction. Since dividends don't exhibit p/e contractions or expansions, they have proved to be a more direct exposure to earnings than the index, with significantly less volatility. Furthermore, the 10-year rate has been rising from the expectation of rising inflation and the related increasing expectation of Fed tightening, while also exhibited correlation to dividends and earnings. As history has proved before, dividend growth is once again demonstrating a higher correlation to earnings & the 10-yr rate (via inflation) than to index price returns, as illustrated above.

Accessing Dividends as a Standalone Investment Today

Until this year, dividends were only accessible to institutional investors as a standalone investment through the futures and swaps market. This changed in the beginning of 2018 when Metaurus Advisors introduced a new exchange traded fund on the NYSE, ticker IDIV, that allows an investor to purchase a 10-year claim on S&P 500 dividends at its present value, without exposure to the underlying stocks. IDIV expects to pay out monthly distributions that correspond to the actual dividends paid by the S&P 500 index. This fund is a potentially significant development for the market for a few reasons:

1. Dividend growth has historically been correlated (moved similarly in direction) to inflation and rising interest rates, making IDIV a potential substitute for inflation-protected bond funds and a diversifying asset in rising rate environments.
2. Changes in dividend growth have historically been less volatile than the underlying S&P 500 price changes due to dividends not being subject to p/e multiple expansion/contraction, allowing IDIV to potentially offer lower volatility in relation to the S&P 500.
3. Dividend growth has historically been more correlated to earnings growth than the underlying index, making IDIV a potentially better pure play on earnings.
4. IDIV can be used to customize the amount of income a portfolio generates, as it has an approximate distribution rate of 10% per annum.
5. A substantial portion of the monthly distributions is expected to be non-taxable return of capital (please consult your own tax advisor, IDIV issues a schedule k-1).

Given many of these characteristics, IDIV is potentially a substitute to traditional fixed income funds and geared towards investors seeking income with inflation protection and/or those in the distribution phase of their lives. We believe that having access to dividends without the stock price exposure may provide new opportunities for investors and their portfolios, and look forward to providing more innovative solutions to an investment world ripe for disruption.

Disclosures

SEI Investments Distribution Co. (1 Freedom Valley Drive, Oaks, PA, 19456) is the distributor for the Metaurus Advisors LLC funds.

This material must be preceded or accompanied by a prospectus. Carefully consider the Fund's investment objectives, risk factors, charges and expenses before investing. This and additional information can be found in the Fund's prospectus, which may be obtained by calling (866) 395-0079, or by visiting https://www.metaurus.com/Data/Sites/33/media/docs/Metaurus_Prospectus.pdf. Please read the prospectus carefully before investing.

Index returns are for illustrative purposes only and do not represent actual Fund performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

The shares are speculative securities and investing in them involves risk, including possible loss of principal. Other risk considerations are:

- There is no guarantee that an ETF will meet its investment objective.
- The ETFs primarily invest in futures, which can be volatile. Even a small movement in market prices could cause large losses.
- Restrictions on redemptions may affect your ability to withdraw your participation in the ETFs. Because the ETFs have designated maturity dates, new investors may elect not to invest in an ETF as it nears maturity and existing investors may elect to sell their Shares or redeem through an Authorized Participant. As a result, the size of each ETF may decrease as it nears maturity and the impact of fund expenses could increase as a result.
- There is no guarantee that distributions will be made.
- The value of the ETF may decrease due to decreases in actual dividends or share price of the ETF.

An active secondary market for the ETF's shares may not exist. Although IDIV will be listed on an exchange, subject to notice of issuance, it is possible that an active trading market may not develop or be maintained.

Shares are bought and sold at market price (not NAV) and are not individually redeemed from the ETFs other than in large Creation Unit aggregations. Instead, investors must buy or sell shares of an ETF in the secondary market with the assistance of a broker. As with all securities, buying and selling shares of ETFs will result in brokerage commissions and will generate tax consequences. Brokerage commissions will reduce returns.

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The Solactive U.S. Cumulative Dividends Index – Series 2027 (the "Dividends Index", the "Index") is an Index of Solactive AG and is calculated and distributed by Solactive AG. The Index aims to represent the discounted present value of all listed annual S&P 500 Dividend Index Futures contracts out to and including the December 2027 dividend futures expiry. To accomplish this, each S&P 500 Dividend Index Future market price will be discounted by using the computed yield of a specified U.S. Treasury Security with a similar or prior maturity date as the corresponding S&P 500 Dividend Index Future expiry. After expiry of any S&P 500 Dividend Futures contract, such futures contract and its corresponding U.S. Treasury Security will be removed from the Index. The Index is a price only index. The Index is published in USD.

The ETF has no operating history. Therefore, you do not have any performance history to serve as a factor for evaluating an investment in the securities.

IDIV is not sponsored, promoted, or associated with Standard & Poors or its affiliates or with any ETF tracking the S&P 500 Index. IDIVs do not track and are not benchmarked to the S&P 500 Index or the S&P 500 Dividend Points Index.