

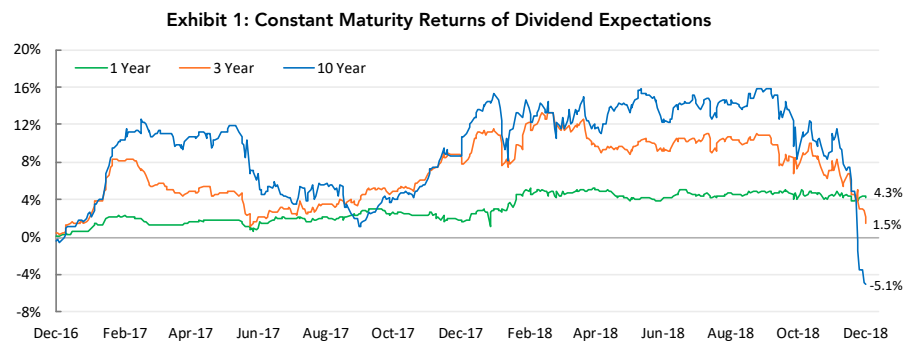


Isolated Dividends can be considered “short-term equity claims” which provide lower volatility and low beta exposure relative to the underlying S&P 500 Index. Here’s how:

1. Isolated Dividends as “Short-Term Equity Claims”

Isolated dividends with claims of ten years or less (also known as “dividend claims” or “strips”) are the “short term equity claims” in the term structure of equity returns studied by many academic practitioners. The truncated return horizon for a strip of dividends presents an opportunity for a closer focus on the two primary drivers of dividend growth; nominal corporate earnings and dividend payout ratios. By contrast, the perpetual nature of common stocks and associated returns requires an investor to incorporate views on not only these two variables, but on numerous other variables that can be highly volatile including P/E multiples, long term earnings potential, and long term discount rates.

The differences in volatility between short and long term “equity claims” can similarly be observed in the fixed income market with different maturity bonds, where the longer maturity bond (higher duration) exhibits more volatility to changes in interest rates than a short term bond (all else equal). Therefore, similar to a bond as it nears maturity, dividend expectations become less volatile as they near expiry (Exhibit 1).

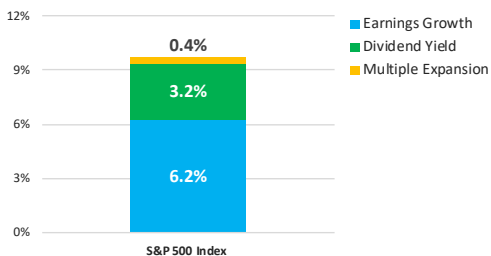


Data Source: Bloomberg

2. No P/E Multiple Volatility

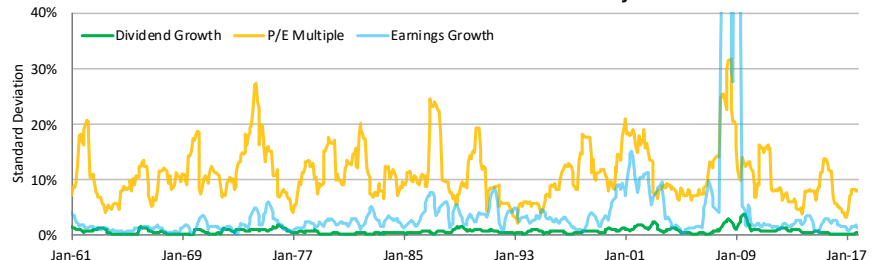
Returns for the S&P 500 can be attributed to 3 sources: Earnings growth, dividends, and P/E multiple expansion and contraction (Exhibit 2). Since dividends are paid directly from corporate earnings, they exhibit very similar characteristics in growth and correlation, while avoiding the volatility from changes in the P/E valuation (Exhibit 3). Therefore, isolated dividends are considered by many academics to be “short-term equity claims” and potentially the most direct way to take a view on corporate earnings over defined time horizons.

Exhibit 2: S&P 500 Sources of Returns (1957-2018)



Data Source: Bloomberg

Exhibit 3: S&P 500 Sources of Volatility

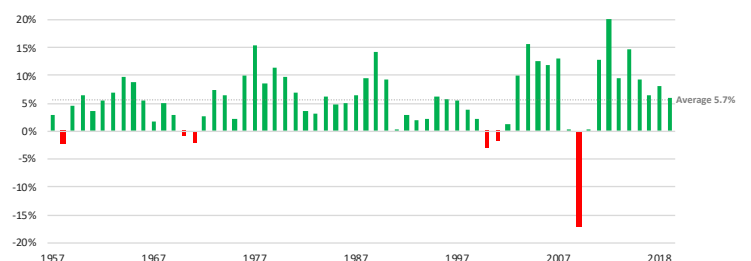


Data Source: Robert Shiller

3. Dividend Cuts are Infrequent

Corporations are typically reluctant to cut dividends as it sends a signal of poor health to shareholders, making dividends “sticky” while growing with an upward bias relative to corporate earnings. Due to this paradigm, S&P 500 dividend growth has only been negative in 6 of the last 60 years while averaging 5.7% per annum (Exhibit 4). The ability for corporate management to control dividend policy allows for dividend growth to be actively managed, thus reducing its volatility historically relative to earnings and price growth.

Exhibit 4: Annual S&P 500 Dividend Growth (1957-2018)



Data Source: Bloomberg

4. Growth Controlled by Management

Dividends are ultimately an asset that can be managed by business leaders, and has developed into a strong communication tool for firms. This tends to provide changes in dividends that are muted compared to changes in corporate earnings, thus smoothing the growth and reducing the volatility, as demonstrated in exhibit 5. **This has delivered growth similar to earnings over time, but the reduction in volatility has allowed for better risk adjusted returns.**

The reduction in volatility can also be observed given the cyclical nature of both earnings and dividends. As illustrated in exhibit 6, dividends are clearly correlated but less volatile than earnings. This also indicates that **during times of economic uncertainty, dividends should be less exposed to downward changes in earnings estimates, unlike equities.**

Exhibit 5: Growth of S&P 500 Dividends, Earnings, and Price (1871 - 2018)

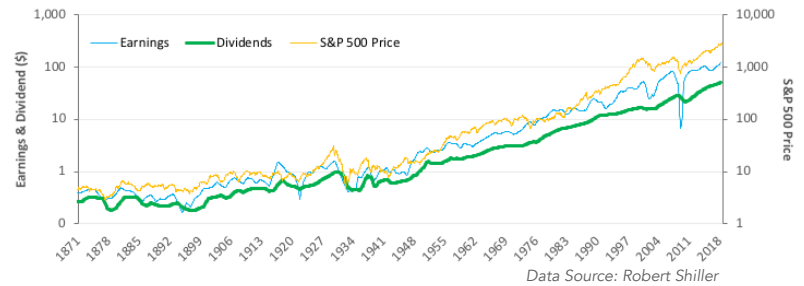
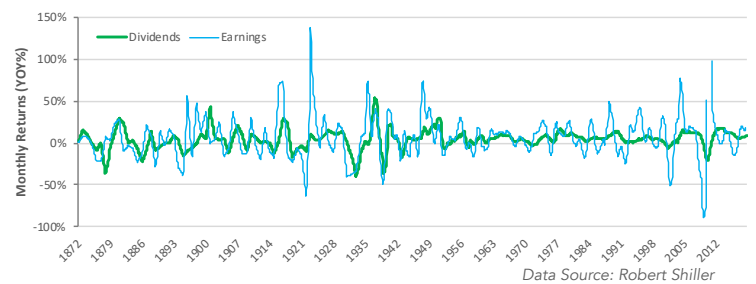


Exhibit 6: Cyclical Returns of Dividends and Earnings (1871 - 2018)



Conclusion: Dividend Expectations as a Low Volatility Equity Strategy

Given the characteristics that make isolated dividends less volatile than their underlying stocks, we can observe how dividend expectations have reacted to above average market volatility. For a proxy, SOIDIV27 reflects the current value of dividend expectations for 2018 through 2027 (10 years).

Leading academic authors have estimated dividend growth expectations to reflect a beta between 0.3 and 0.5 relative to the S&P 500, which translates into a 30-50% upside and downside capture ratio. Dividend expectations during the periods in Exhibit 7 & 8 have proven no different.

Exhibit 7: February 2018 Correction (1/29 - 6/30)

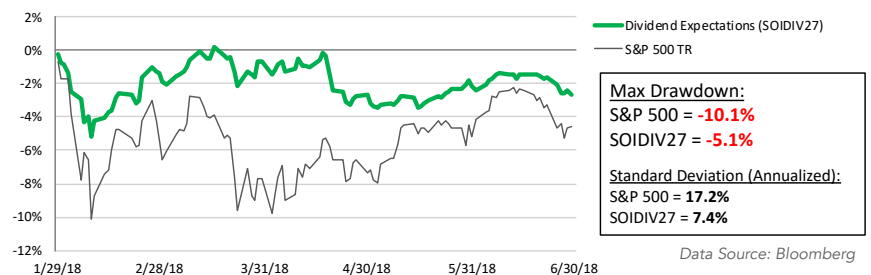
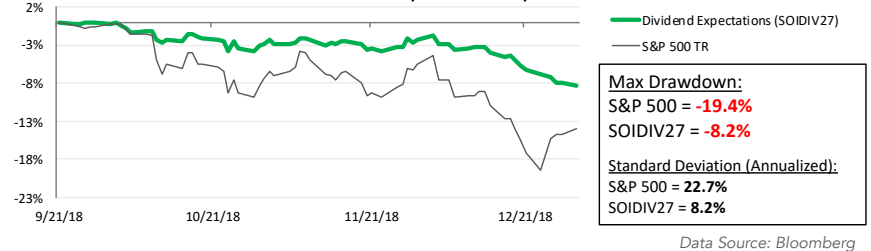


Exhibit 8: 4Q 2018 Correction (9/21 - 12/31)



Dividend Expectations are Underpriced Relative to Historically Realized Dividends

The term structure of dividend growth for the S&P 500 is currently downward sloping, reflecting a greater discount of implied growth for each longer dated dividend strip, relative to the historical average of realized dividends. This discount can be considered the "dividend risk premium" that investors demand to compensate them for the risk that the market's expectation of dividends will come to be realized. If an investor believes the market's expectation of dividends is accurate, or even better too low, then an opportunity is present.

Currently, the market's expectation of S&P 500 dividend growth for the next 9 years is 1.50% per annum, which is 440 basis points below the historical mean, and 90 basis points below the historically worst 10-year period of dividend growth (Exhibit 9). Mean reversion would suggest an opportunity is present to capture a positive dividend risk premium.

Exhibit 9: Term Structure of Dividend Growth Rates

