

Dividend Equity Strategy

Conceptual Framework

Executive Summary

- ▶ A stock investor's total return is comprised of two components: price appreciation and dividend income. Over the long term, reinvested dividends are a key factor to growth and preservation of wealth. Over the eight decades between 1930 and 2010, on average, dividends comprised more than 50% of the total return of the S&P 500 Index.
- ▶ Generally, while share prices fluctuate in response and anticipation of market and company-specific events, the dividend component tends to be more stable as companies decide to pay dividends based on their long-term expectations of cash flows. This is particularly true for companies with a long history of paying dividends.
- ▶ The main mistake investors make when selecting income stocks is to focus mostly on dividend yield. Paradoxically, the very high dividend yield is often a sign of distress and a potential signal of an impending dividend cut or omission.
- ▶ In structuring and managing dividend-oriented portfolios, we focus on the sustainability of dividend growth and its fundamental drivers: an established dividend policy reflected in a long history of increasing dividends; business stability supported by steady earnings; financial strength as evidenced by liquidity and high creditworthiness; and adequate dividend coverage.
- ▶ As a result of our process, which balances dividend growth and yield, the Alpha Quant Dividend Strategy is designed to generate a dividend yield of approximately 1.5 to 2 times that of the S&P 500. The portfolio is also well-represented across industries and sectors to reduce industry concentration risk and provide enhanced diversification.



Massimo Santicchia

Co-Founder and Chief Investment Officer

Alpha Quant Advisors

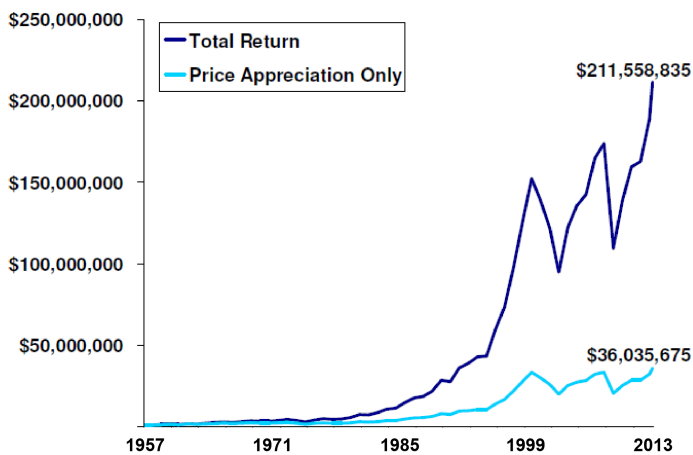
Massimo.Santicchia@AlphaQuantAdvisors.com

The Importance of Dividends

A stock investor’s total return is comprised of two components: price appreciation and dividend income. Generally, while share prices fluctuate in response and anticipation of company-specific and market events, the dividend component tends to be more stable as companies decide to pay dividends based on their long-term expectations of cash flows. This is particularly true for companies with a long history of paying dividends.

To understand the importance of dividends to investors, **Chart 1** illustrates the growth of \$1 million invested from March 1957 through April 2013 in the S&P 500 Index. The price appreciation-only index (light blue line) grew from \$1 million to more than \$36 million, which corresponds to a compound average return of 6.6%. The total return index (dark blue line) grew to more than \$211 million, which corresponds to a compound annual growth rate of 10%.

Chart 1: Growth of \$1 Million Invested in the S&P 500



Sources: S&P Dow Jones Indexes, Alpha Quant Advisors

Such a significant growth differential is the result of two important interacting effects: (1) dividends directly contributing to total return, and (2) dividends reducing overall stock and portfolio volatility and, in periods of falling market prices, the only contribution to investor returns. Thus, reinvested dividends over the long term are key factors to growth and preservation of wealth. **Chart 2** breaks-down the S&P 500 total return in price appreciation and dividend contribution by decade. Over the eight decades between 1930 and 2010, on average, dividends comprised more than 50% of the total returns.

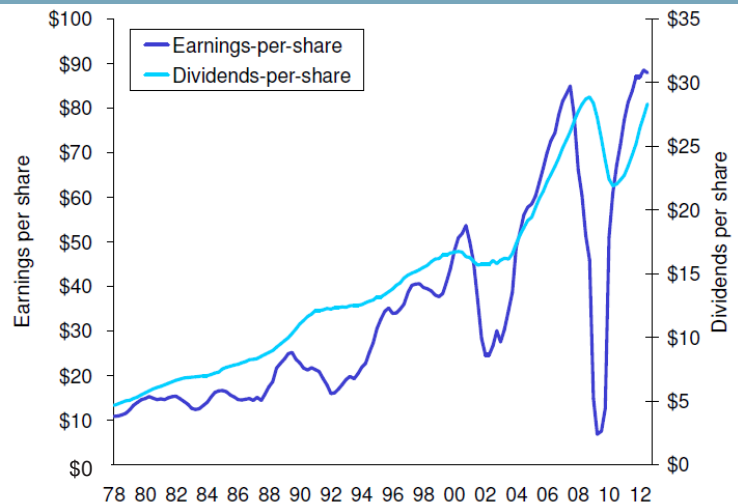
Chart 2: Contribution of Dividends to Total Return

Decade	Price Appreciation	Dividend Contribution	Total Return	Dividends as a % of Total Return
1930s	-41.9%	56.0%	14.1%	NM
1940s	34.8%	100.3%	135.0%	74.3%
1950s	256.7%	180.0%	436.7%	41.2%
1960s	53.7%	54.2%	107.9%	50.2%
1970s	17.2%	59.1%	76.4%	77.4%
1980s	227.4%	143.1%	370.5%	38.6%
1990s	315.7%	116.7%	432.4%	27.0%
2000s	-24.1%	15.0%	-9.1%	NM
Average	104.9%	90.6%	195.5%	51.5%

Source: Strategas Research Partners, as of 2012

Chart 2 shows dividend contribution to the total return is not the same in every decade. Specifically, during periods of low growth and/or high inflation like in the 1940s and 1970s, dividends accounted for more than 70% of the total returns. The lowest contribution was in the 1990s, a decade characterized by the “tech bubble,” which was a pronounced and unsustainable market rise attributed to increased speculation in technology stocks. Investors paid for the excesses of the late 1990s through the prolonged 2000-2002 bear market when the NASDAQ lost more than 90% of its value. In the subsequent decade, which encompasses the two major bear markets of 2000-2002 and 2008, dividends provided the only positive return from stocks to investors. The inherent stability of dividends contrasts with the cyclical nature of earnings, which drives stock prices (see **Chart 3**). This dividend persistence can mitigate the negative impact of recessions and bear markets on investors’ wealth.

Chart 3: Earnings and Dividends – S&P 500



Sources: S&P Dow Jones Indexes, Alpha Quant Advisors

Designing a Dividend Strategy

The main mistake investors make when selecting income stocks is to focus mostly on dividend yield. Paradoxically, a very high dividend yield is often a sign of distress and a potential signal of an impending dividend cut or omission. We believe investors should focus on the sustainability of dividend growth and its fundamental drivers. First of all, companies with a long history of increasing dividends are more likely to continue providing such in the future. Commitment to pay a dividend imparts discipline to the capital-allocation process by forcing management to only invest in projects with expected positive payoffs. Thus, steadily growing dividends are a sign of a well-managed company with confidence in its future growth.

A long history of paying dividends does not guarantee future dividend growth, though. A number of causes may adversely impact companies' future dividends. For example, during business-cycle downturns, reduced cash flows may force companies to cut their dividend to preserve cash. Increasing government regulation on certain industries may also impact companies' profitability and, therefore, limit dividend distributions. In some cases, to retain dividend-seeking investors, some companies stretch their finances to maintain their dividend to the point where their financial flexibility, growth options and their dividend are compromised. The dividend coverage defined as earnings-to-dividend ratio measures how well earnings "cover" the dividend and, thus, provides one metric to evaluate dividend sustainability.

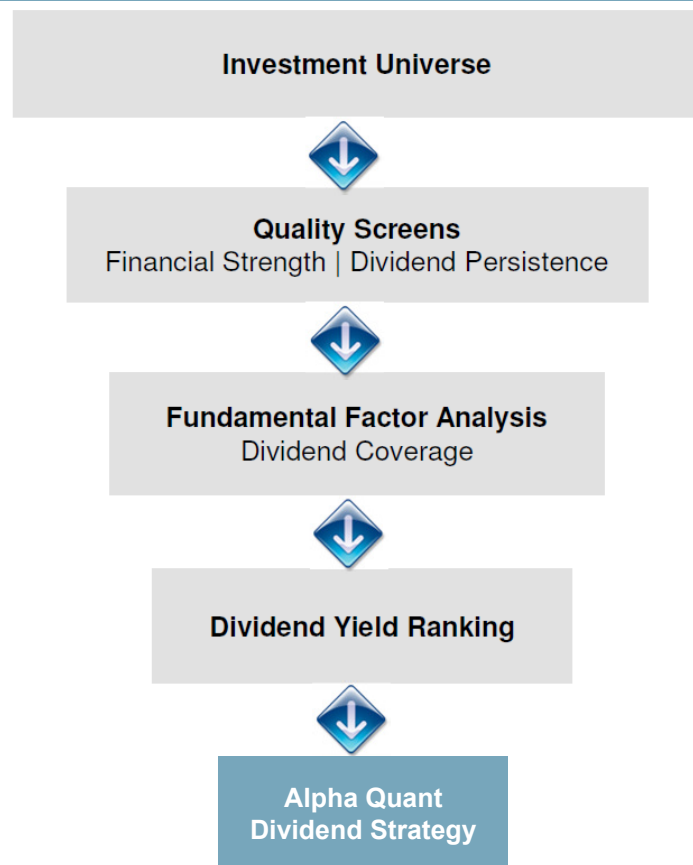
Understanding the need to pay debt obligations before dividends reminds us of the discretionary nature of dividends and highlights the importance of evaluating companies' financial strength and creditworthiness in conjunction with their dividend growth and policy. Companies with strong financials and high creditworthiness are more likely to have far greater access to sources of low-cost, short-term credit and to respond to an unanticipated decline in cash flows by increasing their short-term borrowing. Access to capital markets during periods of distress allow these companies to endure challenging economic environments and be more likely to maintain their dividend.

So far, we have identified the fundamental drivers of dividend growth: an established dividend policy reflected in a long history of increasing dividends; business stability supported by steady earnings; financial strength as evidenced by liquidity and high creditworthiness; and adequate dividend coverage.

Chart 4 illustrates the investment-process flow leading to the final portfolio selection. The sequence reflects our fundamental thinking:

1. Select financially strong stocks with a proven record of dividend growth and earnings, and
2. Select stocks with an attractive combination of dividend coverage and yield.

Chart 4: Investment Process Flow



Source: Alpha Quant Advisors

As a result of our process, which balances dividend growth and yield, the Alpha Quant Dividend Strategy is designed to generate a dividend yield of approximately 1.5 to 2 times that of the S&P 500.

The portfolio is also well-represented across industries and sectors to reduce industry-concentration risk and provide enhanced diversification.



Massimo Santicchia is a co-founder and chief investment officer of Alpha Quant Advisors, LLC. Mr. Santicchia develops and manages equity strategies and funds and oversees all aspects of Alpha Quant's investment process. Previously, he also served as chief investment officer of Cypress Capital Group and Cypress Trust Co. He has more than 18 years of investment experience, including at S&P Investment Advisory Services LLC as developer and portfolio manager of the four JNL/S&P funds. He also co-managed the JNL/S&P Managed and Disciplined funds. Prior positions include: consultant with the investment banking divisions of Goldman Sachs and Credit Suisse First Boston and international equity analyst at Nicholas-Applegate Capital Management. Mr. Santicchia holds a B.A. in Economics and Political Science from the University of Perugia, Italy; an MBA from the U.S. International University, San Diego; and an M.S., Investment Management, from Pace University, New York.

Important Notes

This does not constitute an offer or solicitation in any jurisdiction where to any person to whom it would be unauthorized or unlawful to do so. Opinions expressed are current opinions as of the date appearing in this material only. This information should not be considered investment advice or a recommendation to buy or sell any particular security. While every effort has been made to verify the information contained herein, we make no representations as to its accuracy. The information in this material and specific securities mentioned are not representative of all securities purchased, sold or recommended for advisory clients. Actual portfolio holdings will vary for each client and there is no guarantee that a particular client's account will hold any, or all, of the securities identified. It should not be assumed that any of the securities or recommendations made in the future will be profitable or will equal the performance of the listed securities. Past performance does not predict future results. All investment strategies have the potential for profit or loss. There are no assurances that a portfolio will match or outperform any particular benchmark. Asset allocation and diversification do not assure or guarantee better performance and cannot eliminate the risk of investment losses.

Copyright ©2018 Alpha Quant Advisors, LLC. All rights reserved.