



Deliberate Dividend-Growth Investing for rising income and capital growth

*Investors who examine
the mathematical benefits
of a dividend-growth strategy
may not look at investing
in the same light again.*

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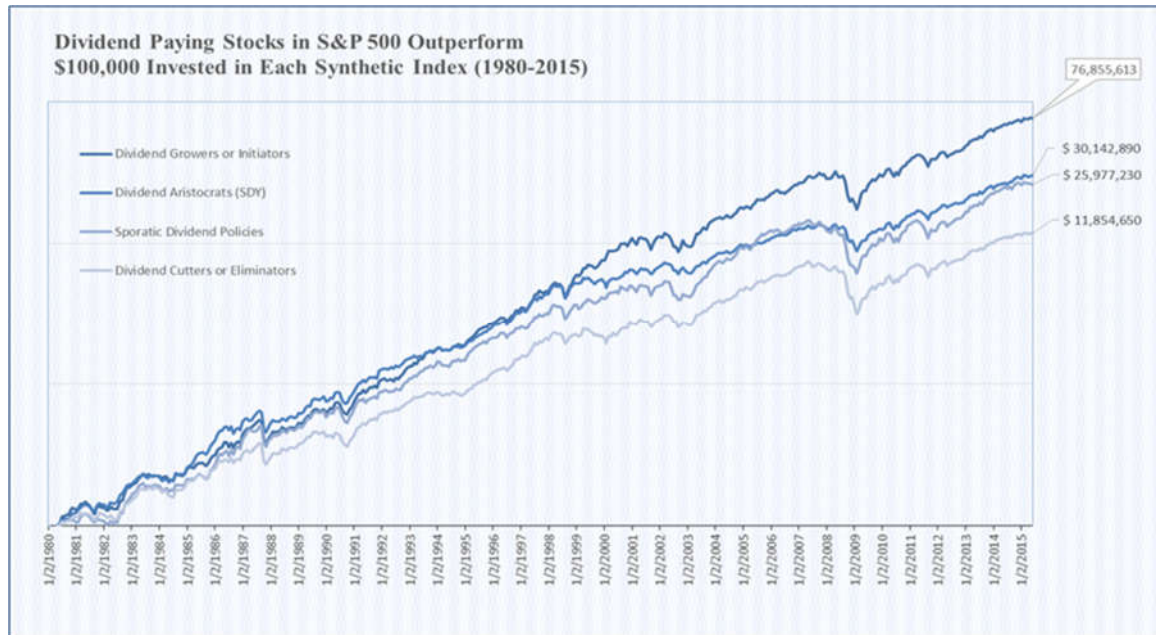
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Executive Summary

Chart 1: Dividend Initiators and Growers in S&P 500 Outperform



There are three long-term investment benefits of a deliberate dividend-growth strategy that is executed with care, prudence and a focus on individual stock selection within a diversified portfolio.

First, the exponential compounding of reinvested dividends, a phenomenon with even greater implications for capital growth than compound interest (a concept Albert Einstein described as “the eighth wonder of the world”) is explored in this paper. Investors who examine the mathematical benefits of a dividend-growth strategy may not look at investing in the same light again.

Second, a detailed example using real estate investment trust Realty Income Corporation (ticker symbol “O”) reveals the impact of long-term dividend growth and reinvestment on achieving a very attractive yield on initial cost that may help meet future income needs, where appropriate. In this example, investors were able to extract a yield on initial cost of nearly 30% on their original investment, helping to provide an important contribution to meet a need for future income.

Third, stocks that have initiated and grown dividends over time have revealed corresponding capital growth over the trailing 35-year period in the study of this paper, while outperforming a cohort of equities that have either had sporadic dividend policies or cut their dividends. The study takes a real-life approach to dividend-growth analysis, reconstituting and rebalancing exposures over time and applying a robust sample set of S&P 500 companies spanning all key sectors.

An examination of the definition of a cash dividend is foundational for this paper and establishes the source of the dividend as tangible cash on a firm's balance sheet, not as accounting-based earnings measures that are subject to a variety of management manipulations and analytical shortcomings. The paper illustrates the difference between high-quality and low-quality dividends through the lens of cash-flow-based financial health and business quality analytical insights, and in doing so, points to the characteristics of dividend-payers that may be best able to help achieve the long-term benefits of a deliberate dividend-growth strategy while minimizing the risks of income deterioration and investor capital erosion.

The paper doesn't overlook the risks of a deliberate dividend-growth strategy either. The best dividend-growth equities over the next 20, 30, or even 40 years may not be the ones that were the best in the past, and that those that have achieved such a consecutive streak of annual increases in the post-World War II era are but a small percentage of the global population of stocks. The pitfalls of selecting low-quality dividend paying equities that may encounter trouble during the depths of the economic cycle are highlighted in the paper, while the hazards of misinterpreting management's dividend "signaling" is also addressed. The paper authoritatively establishes the payment of a dividend as an output of the valuation equation, not a driver behind intrinsic worth, or a selection criteria, an important distinction. The uncertainty regarding the implications of asset flows to yield-sensitive dividend-paying stocks in light of contractionary monetary policy in the US is also considered in this paper.

Readers may not look at a dividend in the same light following the examination that follows.

Contributors

Vincent Rossi, CFP

President and Chief Investment Officer

Intelligent Capitalworks

vince.rossi@icwia.com

Vincent Rossi is the founder of Intelligent Capitalworks, and President and Chief Investment Officer. He leads the investment management and retirement and estate planning for the firm and works exclusively with a select number of client families, their related family members and their philanthropic organizations. Mr. Rossi's career in the financial services industry has been distinguished by a broad foundation of knowledge and experience in the capital markets and wealth management. Prior to founding the firm in 2005, he was a Senior Vice President at Morgan Stanley, where he served as a Wealth Advisor, Portfolio Manager and Trust Officer. He was also a Managing Director at Piper Jaffray, where served as a Wealth Advisor, Portfolio Manager and Senior Investment Management Consultant. Prior to the development of his individual client practice, he served institutional clients, hedging and arbitraging U.S. Government securities for a primary dealer trading directly with the Federal Reserve System. He has also been an individual member of one of the world's largest financial exchanges, The International Monetary Market Division of the Chicago Mercantile Exchange. From 1986 to 2000, Mr. Rossi wrote and taught personal investment management classes for executive programs at Thunderbird School of Global Management, The University of Arizona Extended University, Northern Arizona University and the University of Phoenix. He holds a Master of Science in Financial Services from The American College and a Bachelor of Science in Business Administration from Northern Arizona University.

Brian Nelson, CFA

President of Investment Research

Valuentum Securities, Inc.

brian@valuentum.com

Brian Nelson is the president of equity research and ETF analysis at Valuentum Securities. Before founding Valuentum in early 2011, Mr. Nelson worked as a director at Morningstar, where he was responsible for training and methodology development within the firm's equity and credit research department. Prior to that position, he served as a senior industrials securities analyst covering aerospace, airlines, construction, and environmental services companies. Before joining Morningstar in February 2006, Mr. Nelson worked for a small capitalization fund covering a variety of sectors for an aggressive growth investment management firm in Chicago. He holds a Bachelor's degree in finance and a minor in mathematics, magna cum laude, from Benedictine University. Mr. Nelson has an MBA from the University of Chicago Booth School of Business and also holds the Chartered Financial Analyst (CFA) designation.

Kris Rosemann

Tatiana Dmitrieva

Jessica Bishop

Valuentum Securities, Inc.

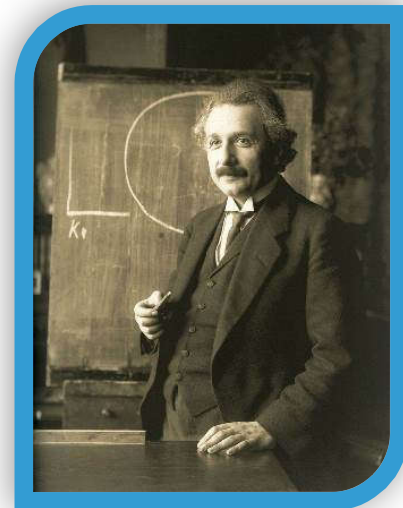
info@valuentum.com

The Exponential Compounding of Reinvested Dividends

“Compound interest is the eighth wonder of the world. He who understands it, earns it...he who doesn’t...pays it.” – attributed to Albert Einstein

A deliberate dividend-growth strategy seeks to capture on what famed theoretical physicist Albert Einstein called the “eighth wonder of the world,” but can capture so much more.

Where compound interest is calculated on the fixed initial principle and accumulated interest from previous periods of a bond or loan, the dividend-growth investor, on the other hand, benefits not only from the reinvestment of dividends into the purchase of new stock, but also on higher dividend payments on the ever-increasing number of shares held, generating a virtuous wealth-building engine for an appreciating equity over long periods of time. If such a strategy is executed with care and prudence, the dividend-growth investor may end up accumulating more shares that pay out a higher dividend, resulting in a fantastic combination and “exponential-type” returns beyond that of compounding interest alone.



Let’s examine Table 1 below that compares the “eighth wonder of the world,” compound interest, to an exponential-type return from reinvesting a growing dividend over time.

Table 1: Compound Interest versus Compound Dividends

Year	Compound Interest			Compound Dividends				
	3% Interest Rate	Interest Earned Annually	Total Value (\$)	Dividends/Share (increases 3% per annum)	Share Price (increases 3% per year)	Dividend Reinvestment (# of new shares)	Total Shares with reinvestment of dividends	Total Value of Shares (\$)
0			100,000		100.00		1,000	100,000
1	3%	3,000	103,000	3.00	103.00	29	1,029	106,000
2	3%	3,090	106,090	3.09	106.09	30	1,059	112,360
3	3%	3,183	109,273	3.18	109.27	31	1,090	119,102
4	3%	3,278	112,551	3.28	112.55	32	1,122	126,248
5	3%	3,377	115,927	3.38	115.93	33	1,154	133,823
10	3%	3,914	134,392	3.91	134.39	38	1,333	179,085
15	3%	4,538	155,797	4.54	155.80	44	1,538	239,656
20	3%	5,261	180,611	5.26	180.61	50	1,776	320,714
25	3%	6,098	209,378	6.10	209.38	58	2,050	429,187
30	3%	7,070	242,726	7.07	242.73	67	2,366	574,349
35	3%	8,196	281,386	8.20	281.39	77	2,732	768,609

The calculations on the left side of Table 1, “Compound Interest,” reveal the annual interest paid on a hypothetical bond with a 3% interest rate, where the interest is added to the principle such that the principal balance advances at an increasing rate. After 35 years, the total value of the bond is \$281,386.

Now let's examine the calculations on the right side of Table 1, "Compound Dividends." In the event a stock paying a 3% dividend raises its dividend 3% each year and its share price advances 3% each year, and assuming dividends received are reinvested into new shares, the total value after 35 years would be \$768,609. Under such assumptions, the compounding effects of reinvested dividends on an appreciating dividend-growth stock are 2.7 times more pronounced than the dynamics of compound interest, generating a portfolio 7.6 times its initial value in 35 years! If Albert Einstein thought so much of compound interest, what might he have said about dividend-growth investing?

The mathematical outcome of the dividend-growth process is impressive in the theoretical tabular format as displayed in Table 1, but there are a few caveats worth noting, of course. The coveted S&P High Yield Dividend Aristocrats Index (available for direct investment using an exchange-traded fund, ticker symbol SDY),¹ comprises equities that "have followed a managed-dividends policy of consistently increasing dividends every year for at least 20 consecutive years." As of April 2016, there were only 109 holdings out of ~1,500 possible stocks in the S&P 1500 Composite Index (or about 7% of the total) that met the criteria. In this context, for a stock to experience a meaningful dividend increase in each consecutive year for the next 20 years (or the 35 year duration of the study for this paper), even at a modest pace of 3%, it represents no small feat for even the strongest business models. This particular accomplishment is more difficult for a stock that may already be yielding a comparatively high 3%, as is the hypothetical equity in the example at the beginning of the period in Table I.

In light of historical annual stock returns that have compounded in the high-single-digits from 1928-2015,² equity share price increases of 3% per year as assumed in Table 1 can be considered reasonable, but even such modest expected annual capital appreciation results in a share price that is 2.8 times higher than at the beginning of the period, an increase that incidentally matches all of the benefits of the compound interest example by itself. On a simple return basis, it is worth noting Table 1 assumes an annual equity return of 6%, consisting of 3 percentage points of dividend yield plus 3 percentage points of capital appreciation per year.

The bar is set high for any dividend-growth stock to pull its own weight over the long haul within a deliberate dividend-growth strategy. In this context, we believe careful individual stock-selection remains paramount to harnessing the long-term benefits of the compounding effects of reinvested dividends in a portfolio setting. The cases of two real estate investment trusts (REIT), for example, illustrate this point. Realty Income Corporation (ticker symbol "O") has paid out 550+ consecutive monthly dividends since its founding in 1969, with 75+ consecutive quarterly dividend increases, amounting to cumulative dividend growth of nearly 170% and equivalent to compound average annual dividend growth of approximately 5%.³ On the other hand, American Capital Agency (ticker symbol "AGNC"), once a favorite among dividend-growth investors, had paid out cumulative dividends greater than its initial public offering price,⁴ but unlike Realty Income Corporation, the REIT ended up cutting its dividend a number of times during the past few years, thwarting the efforts of dividend-growth investors with a long-term horizon. Stock selection will always matter within any dividend-growth investing strategy.

Earning an Attractive Yield on Original Cost

The number of feasible options income investors have to choose from continues to shrink in the age of ultra-low interest rates in the United States and negative interest rate policy (NIRP) across much of the rest of the world. Investment capital has flocked toward dividend-paying equities as investors take advantage of their growing income characteristics, and while the jury is still out on the long-term impact of such asset flows, a deliberate dividend-growth strategy may mitigate several unforeseen risks when targeting rising investment income.

We've discussed the potential of generating better long-term returns as one key benefit of a deliberate dividend-growth strategy relative to the concept of compounding interest in Table 1 on page 4, but achieving an attractive income yield on original cost is yet another benefit that can result over a long-duration dividend-growth investing process. The yield-on-cost for a stock is the current annual dividend rate of the stock divided by the original cost basis of the stock.

Referring again to Table 1, the dividend payment per share in the example advanced to \$8.20 by year 35. Comparing this payout to the original cost basis, or initial purchase price of \$100 per share, results in a yield on original cost of 8.2%, a measure far greater than the 3% dividend yield at initial investment. Steady dividend increases of a modest 3% per year have translated into what many income investors may accept as a welcome level of yield, especially one under present market conditions where certificates of deposit, for example, are at much lower yields.

The previous Realty Income Corporation example offers an excellent example of the increase to yield on original cost that results from continual dividend growth. As shown in Table 2 on page 7, an investor who purchased one thousand shares of Realty Income on October 18, 1994, would have received annual income of \$900 on that original investment of \$8,000 in 1994, translating into an original annual dividend yield of 11.3% ($\$900/\$8,000$)⁵. Successive dividend increases, however, would push annual dividend income on the original investment up to \$2,388 from \$900 by 2016, resulting in a current yield on original 1994 cost of 29.9% as of March 31, 2016. Said differently, an investor who allocated \$8,000 of his or her portfolio to shares of Realty Income Corporation on October 18, 1994, would now be enjoying a cash flow yield equivalent to 29.9% on initial cost ($\$2,388/\$8,000$).⁵

More spectacularly, however, those investors who decided to reinvest dividends received from their Realty Income Corporation shares back into more shares would have an even larger income stream today. As Chart 2, "Comparison of \$100 Invested in Realty Income," reveals on page 9, these investors would have also achieved significantly better long-term performance than both the broader market and industry-specific REIT indices.⁶ Thanks to the exponential compounding of dividends, a \$100 investment in Realty Income in 1994 would now be worth more than \$2,700, an increase of 27-fold. Very few equities have managed to deliver 27 times their initial cost over the past couple decades.

Table 2: The Exponential Growth of Rising Dividends Over Time ⁵

The Magic of Rising Dividends Over Time							The Cumulative Dividend Effect	
1k Shares Purchased	Original Investment	Investment Value as of 3/31/2016	Original Annual Dividend Income	Current Annual Dividend Income ⁽¹⁾	Original Yield	Current Yield on Cost at 3/31/2016	Dividends Received Through 3/31/2016	% of Original Investment Received in Dividends
10/18/94	\$8,000	\$62,510	\$900	\$2,388	11.3%	29.9%	\$31,157	389%
12/31/94	\$8,563	\$62,510	\$900	\$2,388	10.5%	27.9%	\$30,857	360%
12/31/95	\$11,250	\$62,510	\$930	\$2,388	8.3%	21.2%	\$29,945	266%
12/31/96	\$11,938	\$62,510	\$945	\$2,388	7.9%	20.0%	\$28,899	242%
12/31/97	\$12,719	\$62,510	\$960	\$2,388	7.5%	18.8%	\$27,952	220%
12/31/98	\$12,438	\$62,510	\$1,020	\$2,388	8.2%	19.2%	\$26,970	217%
12/31/99	\$10,313	\$62,510	\$1,080	\$2,388	10.5%	23.2%	\$25,927	251%
12/31/00	\$12,438	\$62,510	\$1,110	\$2,388	8.9%	19.2%	\$24,836	200%
12/31/01	\$14,700	\$62,510	\$1,140	\$2,388	7.8%	16.2%	\$23,715	161%
12/31/02	\$17,500	\$62,510	\$1,170	\$2,388	6.7%	13.6%	\$22,564	129%
12/31/03	\$20,000	\$62,510	\$1,200	\$2,388	6.0%	11.9%	\$21,382	107%
12/31/04	\$25,290	\$62,510	\$1,320	\$2,388	5.2%	9.4%	\$20,141	80%
12/31/05	\$21,620	\$62,510	\$1,395	\$2,388	6.5%	11.0%	\$18,795	87%
12/31/06	\$27,700	\$62,510	\$1,518	\$2,388	5.5%	8.6%	\$17,358	63%
12/31/07	\$27,020	\$62,510	\$1,641	\$2,388	6.1%	8.8%	\$15,797	58%
12/31/08	\$23,150	\$62,510	\$1,701	\$2,388	7.3%	10.3%	\$14,135	61%
12/31/09	\$25,910	\$62,510	\$1,716	\$2,388	6.6%	9.2%	\$12,428	48%
12/31/10	\$34,200	\$62,510	\$1,731	\$2,388	5.1%	7.0%	\$10,707	31%
12/31/11	\$34,960	\$62,510	\$1,746	\$2,388	5.0%	6.8%	\$8,970	26%
12/31/12	\$40,210	\$62,510	\$1,821	\$2,388	4.5%	5.9%	\$7,199	18%
12/31/13	\$37,330	\$62,510	\$2,186	\$2,388	5.9%	6.4%	\$5,051	14%
12/31/14	\$47,710	\$62,510	\$2,201	\$2,388	4.6%	5.0%	\$2,859	6%
12/31/15	\$51,630	\$62,510	\$2,292	\$2,388	4.4%	4.6%	\$588	1%
3/31/16	\$62,510	\$62,510	\$2,388	\$2,388	3.8%	3.8%		

⁽¹⁾ Current annual dividend income based on annualized dividend per share of \$2.388

Image Source: Realty Income (used with permission, Jonathan Pong CFA)

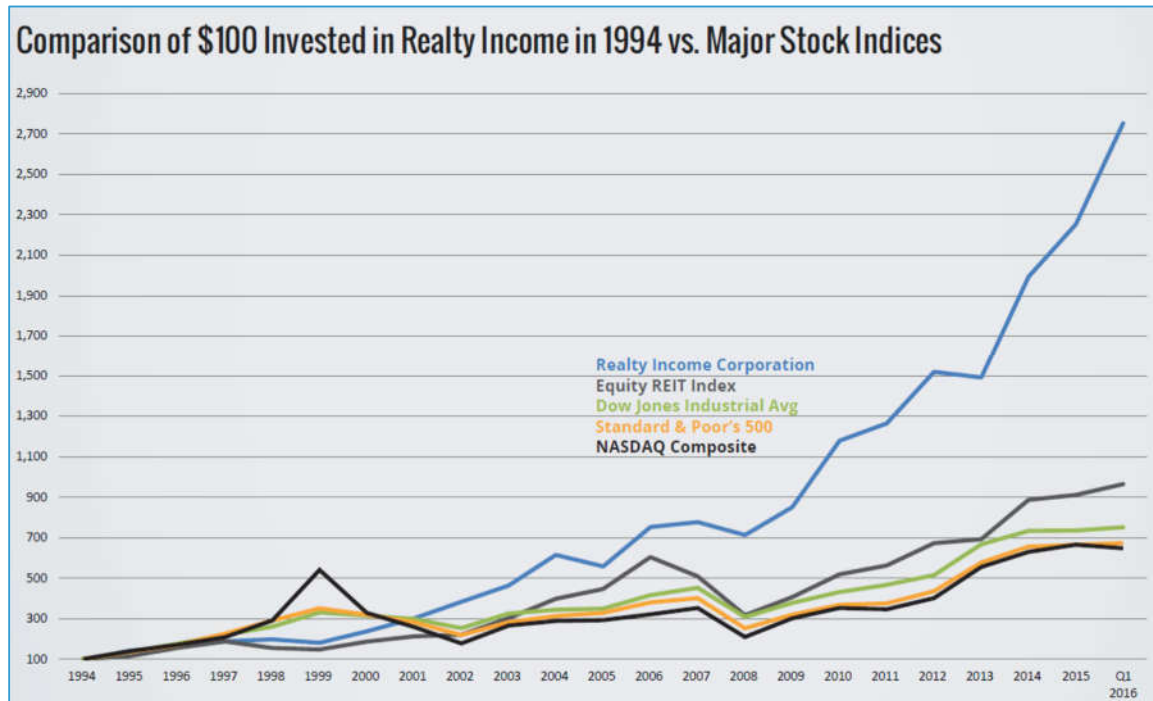
Chart 2: Comparison of \$100 Invested in Realty Income⁶

Image Source: Realty Income (used with permission, Jonathan Pong CFA)

Time-Tested Better Returns from Dividend Growers and Initiators

The study of S&P 500 companies from 1980-2015 revealed significant return outperformance of the companies that were aggregated into the “Dividend Growers or Initiators” index and better performance of the “Dividend Aristocrats (SDY)” index relative to the indices, “Sporadic Dividend Policies” and “Dividend Cutters or Eliminators.” There are several reasons for the outperformance of the dividend payers’ indices relative to those indices that contained holdings that may have disappointed income investors in the past.

One structural driver of the return outperformance of dividend growers and initiators is the dividend as a component of the return, itself. The study accounted for the dividend as a return of capital and a reduction to a stock’s cost basis, and as such, the returns of dividend growers and initiators benefited from a natural tailwind as their respective denominators in the return calculation were reduced with each dividend paid. This captures in some respect the long-term benefits of reinvesting dividends in substance, but replicating real-life conditions via reconstitution and rebalancing mitigated the compounding dynamic in the study to a degree. Those companies that paid the most dividends cumulatively over the measurement period benefited from very low initial cost bases at the beginning of the study.

The quality of businesses in the “Dividend Growers or Initiators” and “Dividend Aristocrats (SDY)” buckets tend to be better than those that grace the indices, “Sporadic Dividend Policies” and “Dividend Cutters or Eliminators,” and such a dichotomy began to surface following the Crash of 1987 where those that either cut or eliminated their dividends began a prolonged period of underperformance. The data revealed a similar dynamic during the Financial Crisis of

2007-2009, where the dividend growers and initiators and Dividend Aristocrats categories “held up” better and recovered faster than the two categories that held companies that have disappointed income investors in the past. We believe that in both instances of crises, the dividend acted as a “cushion,” offering embedded support to the stock prices of the more consistent and robust dividend payers during adverse conditions.

In the 35-year study contained in this paper, the value of the “Dividend Growers or Initiators” index advanced to 76,855,613 compared to a starting value of 100,000, a compound annual growth rate of ~20.9%. The “Dividend Aristocrats (SDY)” index advanced to 30,142,890, reflecting a compound annual growth rate of ~17.7%.

Defining A Cash Dividend

Understanding the long-term strategy of deliberate dividend-growth investing, with all of its benefits and risks, begins with an understanding of a cash dividend. A cash dividend is a transfer of cash from the company’s coffers to the shareholders, whether paid monthly, quarterly, semi-annually, annually or on a special basis, from the cash position of the company’s balance sheet. Because shareholders already own the company’s cash, a cash dividend is neither a positive driver of a company’s intrinsic value (worth), nor does the payment of a cash dividend represent a transfer of value to shareholders, but instead a transfer of cash already implicitly owned by the shareholder.

Where traditional definitions of a cash dividend imply that the dividend is sourced directly from earnings, we think such a definition falls short of acknowledging accrual accounting and the cash-flow mismatches that are inherent to the operations of any enterprise. Companies can pay out dividends from excess cash on the balance sheet if earnings falter, but absolute cash shortfalls (regardless of earnings) limit the payment of any dividend entirely, squarely placing the emphasis of dividend analysis on an entity’s cash flow. Defining a dividend in the context of earnings also omits the large number of equities traded on public exchanges that operate within the business models of real estate investment trusts (REITs) and master limited partnerships (MLPs), which pay out dividends and distributions, respectively, that are far greater than their reported accounting earnings. REITs typically rely on the industry definition of funds from operations (FFO) as a measure of dividend coverage while master limited partnerships rely on the industry definition of distributable cash flow (DCF) as a measure of distribution coverage.

Because of the various ways companies present the health of their dividends and the investor confusion that often results (some disclosures being helpful in the context of traditional free cash flow and others being misleading in the context of the misnomer distributable cash flow), a conscious effort has been made in this paper to clearly define a dividend as a payment from the cash position on the balance sheet, and therefore, a discussion follows on the ways a company can bolster such a cash position. Financially speaking, a company’s cash position on the balance sheet can traditionally be enhanced in three distinctive ways, all emanating from activity on the cash flow statement: through operating, investing, and financing means. Increased net income and positive working capital contributions, for example, can drive increases in cash flow from

operating activities. Business divestitures can bolster a company's reported cash flow from investing activities, while equity and/or debt issuance can bolster cash flow from financing activities. Each source of cash flow generation impacts the cash balance on the balance sheet, and therefore has implications on the quality and sustainability of an entity's dividend, itself a financing cash outflow of the company.

Not All Dividends Are Created Equal

Why does a discussion about a dividend's financial foundation matter?

The risks to the long-term health of a dividend sourced entirely from a company's traditional free cash flow, defined as cash flow from operations less all capital spending, are far less, in our view, than a dividend or distribution that is funded in part or entirely by external capital financing support (borrowings, asset sales, new stock issuance, etc.). A company paying a dividend from cash flow generated from continuing operations is self-sufficient, paying the dividend via organic means without the assistance of external capital, while a company financing dividend payments that are dependent on external capital market conditions for new equity and debt issuance to sustain the payout, can never be guaranteed. During the past year to the date of the publishing of this paper, for example, we have witnessed dividend cuts at the following widely-held industry bellwethers whose capital-intensive business models, weak traditional free cash flow generation, and capital-market dependency proved too much to bear and dividend cuts ensued: Kinder Morgan (KMI),⁷ BHP Billiton (BHP),⁸ and ConocoPhillips (COP).⁹

The dividend cuts, in the three recent high-profile cases above, can nullify the benefits of dividend-growth investing over the long haul by decreasing the portfolio's income stream and increasing the potential for permanent capital impairment if the reasons behind the dividend cut are irreversible over the long haul. It is critical that any deliberate dividend-growth strategy considers the quality of each individual dividend as a primary consideration, with emphasis on financial statement analysis across the portfolio holdings. In the case of a financially-engineered dividend, for example, where the dividend is sourced primarily from the financing section of the cash flow statement instead of from traditional free cash flow generation, the risks over the long run are far greater, in our view, than those of net cash and free-cash-flow-rich entities that can comfortably cover a payout via organic, traditional free cash flow many times over.

Particularly in times of loose credit, the distinction between low- and high-quality dividends may be unwittingly overlooked as happened during the early part of this decade, but capital-market dislocations such as those in the Financial Crisis of 2008-2009, or the external shocks from the collapse in crude oil prices during late 2014 through 2015, re-focused investors' attention on the importance of companies that generate enough cash from ongoing operations to fund dividend payments. Dividend-paying entities that are dependent on accessing the capital markets to fund dividend payments may face significantly greater challenges in sustaining a payout over the long haul than those companies that generate enough cash from ongoing operations to fund dividend payments, and which may care very little if the capital markets remain open at all. Because investors targeting the benefits of dividend growth in the long run may be investing through several market cycles, with each cycle of multi-year duration, the strongest dividend

payers, or the companies that are able to sustain or even grow the dividend payout during the most difficult times, are of most value to a dividend-growth investment strategy.

A discussion of the analytical underpinnings of the difference between a financially-engineered dividend (a low-quality dividend), one sourced primarily from financing activities, and an organically-derived dividend (high quality), one sourced from free cash flow, is beyond the scope of this paper, but we seek to reinforce a widely-accepted view that *not all dividends are created equal*. We believe that a collection of low-quality dividend payers within a dividend-growth strategy, even in a diversified portfolio, comes with unique, firm-specific and potential market risks that may not be easily diversified away compared to a portfolio of dividend-paying companies with strong future free cash flow forecasts, resilient business models and impressive net cash positions. Said differently, a dividend-growth stock portfolio full of businesses that are free cash flow negative, that pay out dividends far in excess of earnings, and that are buried under significant debt-like obligations, may not perform as desired over the long haul.

If the individual stocks of a dividend-growth portfolio are not chosen with care, prudence and quality in mind, with due consideration of their individual financial situation and capital-market risks, the desired benefits of such a strategy may not materialize over the long haul and the risks may very well outweigh any rewards. In particular, a portfolio consisting of unhealthy dividend payers may eventually encounter trouble, given the long duration, often multi-decade horizon, of a dividend and capital growth strategy, particularly during the depths of economic cycles, where lending markets tighten and incremental capital is often not readily available to support such payouts. Individual stock selection within a dividend-growth strategy is a key aspect of the strategy itself and could mark the difference between achieving goals and falling short of them.

The Dividend “Value” Trap

The signaling aspects of the dividend alone can't be trusted at face value.

It is generally accepted that one of the most convincing symptoms of a resilient company is one that has a strong, organic and growing dividend payment that rewards its shareholders for the value-creating endeavors pursued by the executive team. This is not always true. In the same spirit of explaining how some dividends don't make the cut financially, it is important to note that not all dividends have strong business models supporting them, even if accounting earnings and the dividend payout itself may be growing. What's worse for investors seeking to identify individual equities in pursuing the long-term benefits of dividend growth is that management teams have in some cases used the dividend and promises of future growth in it as a way to “distract” investors from the company's deteriorating core fundamental operating performance.

Fortunately, there are tools available to the dividend-growth investor to assess business-model resilience through the course of the economic cycle. To be clear, the age-old test of whether a company generates “value” for shareholders won't specifically rest in the dividend payment, or even its earnings per share for that matter. Evaluations of the variability of certain profit measures over longer periods of time and core fundamental operating performance of the entity, as measured by a company's return on invested capital (ROIC) compared to a company's

estimated cost of capital, can provide valuable insights. For strong companies with resilient revenue models, return on invested capital (earnings before interest divided by average invested capital) is often comfortably above the company's cost of capital, on average, through the course of the economic cycle, translating into solid ongoing economic value generation.

Traditional earnings-per-share focused analysis may be unable to discern the difference between low-quality bottom-line support, as in the case of share buybacks or transient dynamics such as low tax rates or abnormal one-time charges, which are often removed in reporting ongoing operating earnings. By comparison, a focus on return on invested capital measures the company's innate ability to apply its net operating assets to drive operating earnings, irrespective of how it finances such operations. Unlike traditional measures of return on equity (ROE), which can be artificially inflated due to incremental leverage, or return on assets (ROA), which may unfairly punish a company with significant financial flexibility in the form of an outsize net cash balance, return on invested capital acts as a pure measure to assess the quality of the underlying operations of the business.

It is not purely by chance that strong corporate economic-value creators, or those that generate return on invested capital far in excess of their estimated cost of capital, tend to also throw off copious amounts of traditional free cash flow, and some even have enormous net cash positions on the balance sheet to continue to apply to future dividend growth in the event troubled times occur. Economic-value generating and cash-rich entities are often in a much better position to grow the cash dividend over the long run than "value-destroying" entities with cash shortfalls, either on a negative free cash flow basis or in the presence of a net debt position. Equities with cyclical tendencies, uncomfortably high debt loads, and that are tied to commodity markets while paying out abnormally burdensome dividend payments won't make the cut for a long-term dividend-growth strategy in most cases.

A discussion of the impact of a cash dividend on valuation is a rather important topic, particularly in light of modern-day confusion on the issue. In the same way that a dividend may not be genuinely reflective of the earnings, free-cash-flow, or return-generating capacity of a company, the dividend itself is also not a driver within the equity valuation framework, despite academic models applying dividend discount frameworks. In the context of an enterprise discounted cash flow model, in particular, a focus on earnings before interest, the net capital intensity of the firm, the company's net balance sheet position (net cash or net debt) and the value of other non-operating assets remains core to estimating value (intrinsic worth). A dividend is an output of the enterprise valuation model context, not a driver behind valuation, as in the case of revenue or gross margin or inventory turns, for example.

Said plainly, what a company removes from its cash position on the balance sheet and transitions to shareholders in the form of a cash dividend payment results in a tangible reduction to the company's intrinsic value, as the cash position on the balance sheet is reduced. In other words, what shareholders once owned on the company's balance sheet prior to the cash dividend payment, they now own themselves, a net-neutral proposition absent tax consequences. That a stock's share price is reduced on the exchange when it goes "ex-dividend"

reveals this particular “value-adjustment” phenomenon, though a discussion of the important differences between the concepts of price and value are beyond the scope of this paper.

The haphazard application of dividend discount models in estimating intrinsic worth may prove hazardous to investors seeking a conservative value bent to any long-term dividend-growth strategy. In extreme instances, for example, when a dividend and/or distribution exceeds the company’s traditional free cash flow generation capacity, as measured by cash flow from operations less all capital expenditures, and/or the earnings power of the entity, as in the case of the financially-engineered distributions of MLPs, the potential for the perpetuation of an equity valuation “bubble” materializes. The latest instance of such a “bubble” occurred during the latter part of 2015 within the energy master limited partnership arena, which is well-known for paying out distributions far in excess of internally-generated earnings and traditional free cash flow. When investors “price” equities on the dividend or distribution payment instead of on core operating fundamentals, as in the case of enterprise free cash flow, a price-to-fair value disconnect can occur, exposing dividend-growth investors to risk of permanent capital impairment.

A deliberate dividend-growth strategy is one that focuses on strong, high-ROIC business models that have organically-derived dividend payouts backed by strong expected free cash flow generation and solid net cash positions on the balance sheet. Such a combination of favorable individual security fundamentals helps to insulate a dividend-growth portfolio from the possibility of investor income erosion during weak economic periods and permanent capital impairment in the event of artificial equity mispricings, both risks that could derail the very benefits of such a strategy over the long haul. Adding a discounted cash-flow valuation overlay that aids in identifying underpriced dividend-paying opportunities while identifying overpriced exposures, and/or a technical overlay that considers information contained in the market price, may offer additional risk insulation to a portfolio pursuing such a dividend-growth strategy.

Study Guidelines and Parameters

We studied the 35-year dividend histories of the companies in the S&P 500 Index as of June 2015. The companies in the Index were assigned to one of 17 sub-categories and then to five primary categories of dividend payment histories as shown in Table 3 on the next page. The five primary categories are: “Dividend Growers or Initiators,” “Dividend Aristocrats (those held in both of the exchange-traded funds SDY and SPY at the time of the study),” “Sporadic Dividend Policies,” “Dividend Cutters or Eliminators, and “Does Not Pay (DNP).”

The most prominent example of the subjectivity in assigning equities to each category may be in one of the largest and best-performing equities in the study, Apple. The iPhone maker eliminated its dividend in 1995, but more recently Apple implemented a capital-return policy and has since initiated and raised its dividend in the past few years.¹⁰ Because Apple initiated its dividend subsequent to the beginning of the study, eliminated its dividend, and then initiated it again, Apple is assigned to the category: “Initiator + Eliminator + Initiator.” Apple is then rolled into the primary category, “Sporadic Dividend Policies,” due to its dividend history over the 35-year duration of the study.

Table 3: Assigning the 17 Sub-Categories to Five Primary Categories

Dividend Growers or Initiators
Initiator + grower
Grower
Initiator
Dividend Aristocrats
S&P 500 constituents in the SDY
Sporadic Dividend Policies
Bankruptcy + initiator
Initiator + eliminator
Initiator + eliminator + initiator
Eliminator + initiator + cutter
Eliminator + initiator
Initiator + eliminator
Initiator + corporate event
Initiator + sporadic
Initiator + eliminator + initiator + cutter
Corporate event
Dividend Cutters or Eliminators
Initiator + cutter
Cutter
Eliminator
Does Not Pay (DNP)
Does not pay a dividend

There are a number of other nuances that readers should note. Assigning companies to categories was performed on the basis of the snapshot of the characteristics of S&P 500 companies at a specific point in time (June 2015), so an equity that had only begun paying its dividend in recent years would be included in the “Dividend Growers or Initiators” bucket for its entire price history, even if it may not have paid a dividend for much of its corporate life. Some notable examples that reflect this nuance would be Amgen (AMGN) and Gilead (GILD), which were included in the “Dividend Growers or Initiators” primary category as they started paying a dividend during the past few years, but the study considered their overall contribution to the performance of their assigned category since corporate inception.

In calculating the performance of each category (synthetic index), historical pricing data was retrieved on the basis of adjusted-close prices for each company in each sub-category (and therefore, primary category).¹¹ The adjusted-close price simulates a return of capital to the shareholder, reducing the owner’s cost basis, translating into a lower denominator within any return calculation for a dividend payer. We believe the adjusted-close prices are most appropriate in capturing the total return dynamics of both dividend payers and non-dividend payers within the study (an apples-to-apples basis). Using unadjusted pricing numbers, for example, would not give credit for the payment of the dividend in the return calculation as previous prices would not be adjusted lower with subsequent dividend payments.

The starting date for each synthetic index is either January 1980 or occurs at the first available pricing data point of a company within the particular synthetic index (i.e., January 1990 for the “Does Not Pay (DNP)” synthetic index). Companies were equal-weighted at each reconstitution and rebalancing date, or at the time that each new company was (or companies were) phased into the synthetic index based upon their first available pricing data (when they first started trading as a public company). For example, in the case of the “Does Not Pay (DNP)” synthetic index, Jacobs Engineering (JEC) was the first addition in January 1990. For the next two months until Fiserv (FISV), Lab Corp (LH), Electronic Arts (EA), Cerner (CERN) and Celgene (CELG) were introduced to the index March 1990, changes in the share price of Jacobs account for changes in the price of the index. In March 1990, however, the index was then reconstituted with six companies and rebalanced appropriately such that each company then accounted for one-sixth of the synthetic index value at that time.

This reconstitution and rebalancing process was continued for each company within each synthetic index until all companies were phased into their assigned index, and each index was calculated through the end of the study after all companies were incorporated. We believe capturing the entire trading history of companies from 1980 to the end of the study (phasing companies into their respective synthetic index as pricing information became available) was more robust than an arbitrary reconstitution or rebalancing on an annual basis, which may omit key monthly information on securities within each respective synthetic index. In the case of annual reconstitution or rebalancing, multi-month delays in incorporating new companies to the indices might have resulted in the overemphasis of older-dated companies, particularly in the early stages of creating the synthetic indexes.

The reconstitution and rebalancing framework used in the study implicitly simulates risk-mitigation techniques that are most likely to occur within the dividend-growth management process. Where the reinvestment of dividends in a strongly appreciating stock may drive some individual stocks to outsize weightings in a portfolio setting if left alone, the study’s reconstitution and equal-weight rebalancing makes the returns more reflective of what investors might have been able to achieve from investing while attempting to maintain well-balanced diversification of a stock portfolio. We assumed that very few managers would let individual stocks run to extreme exposures, making reconstitution and rebalancing iterations an appropriate component of the return calculations. The absence of any rebalancing framework in long-duration studies is unrealistic and may result in return outcomes more reflective of risk-seeking behavior than prudence and care.

Observations from the Study

A deliberate dividend-growth strategy over the 35-year study period offered the prospect of exponentially compounded returns from long-term dividend reinvestment and the potential for generating an attractive yield on initial cost for long-term savers. Additionally, the study revealed a dividend-growth strategy may create an opportunity for capital growth and relative return outperformance from investment in dividend payers if such a strategy is executed with prudence and care. A dividend-growth investment strategy may potentially meet the needs of a great number of investors, assuming such an approach is a good fit for their personal goals and risk tolerances.

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About the Authors

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Promenade Corporate Center
16427 N Scottsdale Rd, Suite 350
Scottsdale, AZ 85254

Arizona: (480) 951-2900
Toll-Free: (866) 617-2900

To schedule a meeting with us, please call Monique Pressley at (480) 248-2223.