Federated®

On Point A Series of Industry and Investment Insights

Executive Summary

- A sizeable portion of high-dividend equities' return is in the form of cash. Therefore, dividend-paying stocks may help to cushion a portfolio's downside when the broader market is posting losses.
- Although high-dividend equity portfolios may underperform during strong growth markets, historically, dividend returns have been much more stable than price-only returns.
- An allocation to international dividend-paying stocks offers a powerful combination of potentially higher yields and enhanced portfolio diversification.
- Dividend-paying stocks, when included in hypothetical portfolios of various investor profiles, help to improve returns while generally lowering overall portfolio risk.
- The key to dividend investing is capturing equities with dividend-growth potential to outpace the effects of inflation.

Seeking to Enhance Portfolio Returns with a High-Dividend Equity Strategy

The search for higher returns and lower risk has often left many investors vacillating between different investment styles and vehicles. As illustrated in this paper, one strategy, high-dividend equity investing, has demonstrated consistent outperformance with little added risk, meriting an allocation in a wide range of portfolios. This paper examines how an allocation to high-yielding stocks can potentially boost performance and actually lower risk in certain portfolios. It also looks at factors to consider when determining an allocation to high-yielding stocks and stock portfolios.

High-Dividend Equity: Identifiable Traits

A high-dividend equity strategy involves more than amassing a group of stocks that pay dividends. The key is focusing on companies that generate significant free cash flow and have a history of maintaining or increasing their dividends.

"Companies with healthy dividends typically generate significant free cash flow and have communicated their commitment to using this cash to enhance total return for shareholders," said Walter C. Bean, senior vice president and head of the strategic value investment team for Federated Investors. "Historically, many of these companies have been found in income-producing sectors of the market such as Utilities, Consumer Staples, Telecommunications Services and Energy. It is not unusual for high-yielding securities within these sectors to present valuation advantages such as relatively low price/earnings, price/book value and price/cash flow ratios."

The combination of cash flow and valuation may explain in part why high-dividend equity strategies have offered a positive risk/return differential. "With a substantial portion of the return coming in cash, there has been a significant advantage in terms of achieving better risk-adjusted returns than the overall market," Bean said.

When examining the benefits of high-dividend equity approaches, the Dow Jones U.S. Select Dividend Index is a useful proxy. To be included with the index, a company must have a non-negative, five-year dividend-per-share growth rate, a five-year average dividend-to-earnings-per-share ratio of 60% or less and a three-month average daily trading volume of 200,000 shares or more.[1] Stocks meeting these criteria are ranked by dividend yield, and the top 100 weighted by dividend yield are selected. History is available back to December 31, 1991, and the index is rebalanced annually in December—likewise, for international stocks.

Chart 1 illustrates how the risk/return differential of high-dividend equities and the broader domestic and international markets have played out historically. For the period beginning July 1, 1996, and ending December 31, 2014[2], a high-dividend domestic equity strategy generated an average annualized total return of 10.75%—252 basis points higher than the 8.23% annualized return realized by the S&P 500.[3] At the same time, risk, as measured by standard deviation, was only 30 basis points higher for a high-dividend equity strategy.

[1] Source: Dow Jones Indexes.

There are no guarantees that dividend-paying stocks will continue to pay dividends. In addition, dividend-paying stocks may not experience the same capital appreciation potential as non-dividend-paying stocks.

Similarly, international high-dividend equities delivered a performance edge with little additional risk. For the same period, a high-dividend international equity strategy generated an average annualized total return of 8.25%—366 basis points higher than the 4.59% annualized return of the MSCI EAFE. Standard deviation was just 73 basis points higher.[4]

The Advantages of Dividend Yield

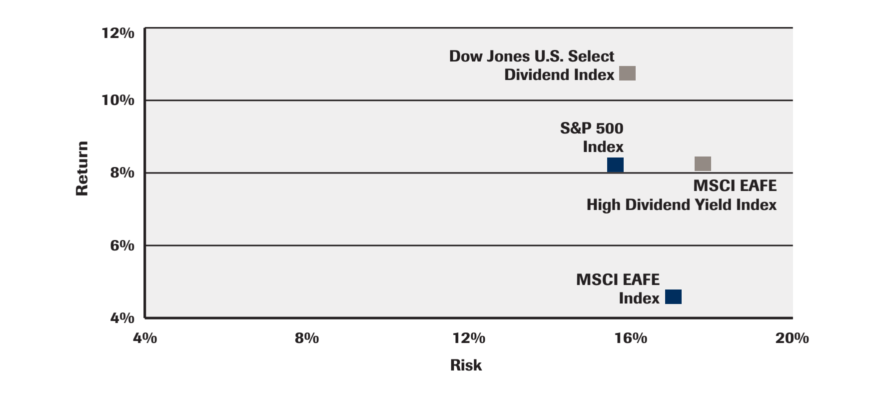
The outperformance of high-dividend equities stems from several advantages offered by dividends and dividend-paying companies. For one, because a sizeable portion of their return is in cash, dividend-paying stocks may help to cushion a portfolio's downside when the broader market is posting losses. As Chart 2 indicates, dividend yield has generated an average positive return of 4.45% in down markets since 1926, which has helped to offset the average loss of -14.06% during these periods.*

The ability of dividends to mitigate a portfolio's downside stems, in part, from their relative stability. Although high-dividend equity portfolios may underperform during strong growth markets, historically, dividend returns have been much more stable than price-only returns, as Chart 3 illustrates. The relative stability is crucial for investors building portfolios to finance retirement, higher education and other long-term goals.

In addition to displaying more stability than price-only returns, dividends continue to offer an important tax advantage for many investors—even with the 2013 tax legislation affecting investment income. This legislation assures no additional tax consequences on dividend income for individuals earning less than $200,000 per year and households earning less than $250,000. For individuals earning $400,000 and above and households earning $450,000 and above, the law lifts the tax rate on dividends (and capital gains) from 15% to 20%.

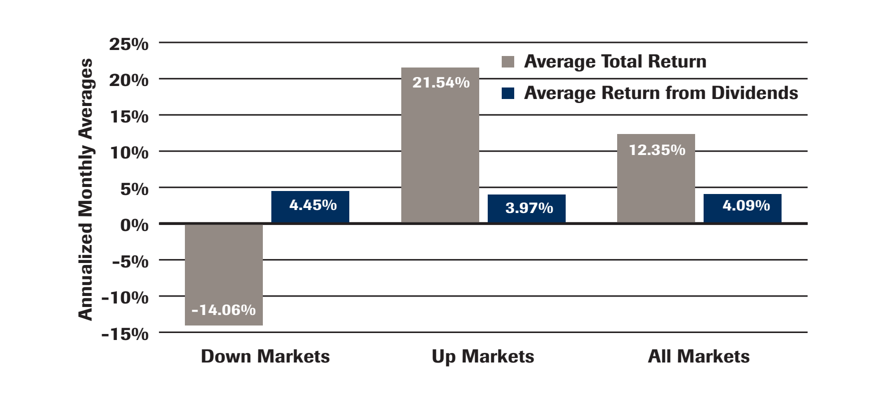
As part of the 2009 Patient Protection and Affordable Health Care Act, there also is a 3.8% tax on unearned income, including dividends, that applies to individuals earning $200,000 and households earning $250,000 and above, for a total of 18.8%. The total tax for individuals and households earning $400,000 and $450,000 and above, respectively, is 23.8%, well below the rate if dividends were taxed as ordinary income.

Chart 1: High-Dividend Domestic and International Equity Outperformed Their Non-Dividend-Paying Counterparts



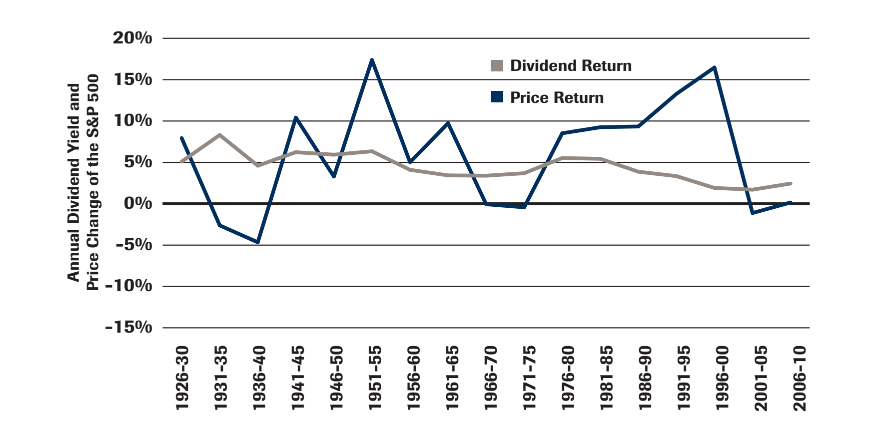
Source: Morningstar, Inc. 7/1/96-12/31/14.

Chart 2: Dividends Have Supported Returns in All Markets — S&P 500, 1926 to 2014



**Source: Morningstar, Inc. 1/1/26-12/31/14.*

Chart 3: Dividend Returns Have Been Much More Stable Than Price-Only Returns — S&P 500, 1926 to 2010 in 5-Year Periods



Source: Standard & Poor's. 1/1/26-12/31/10.

These charts are for illustrative purposes only and are not representative of the performance of any particular investment.

Past performance is no guarantee of future results.

Determining High-Dividend Equity Allocations

Many investors understand the benefits of a high-dividend equity strategy but are uncertain about how to allocate their portfolios to capitalize on it. An appropriate allocation depends on an investor's goals, risk tolerance and time horizon. Although past performance does not guarantee future results, historical returns may shed light on the potential advantages of high-dividend equities within aggressive, moderate and conservative portfolios.

Each of the hypothetical allocations that follow illustrate how high-dividend equities—which include allocations to international high-dividend equities—have enhanced average annual total return and generally reduced volatility over the time period from July 1, 1996 through December 31, 2014.[2] There's a clear message here for investors: High-dividend equities may have appeal that goes beyond occupying a small slice of a conservative portfolio. A high level of reinvested dividends typically cushions a portfolio during down markets and contributes significantly to long-term total return—factors that are important to almost all investors.

Aggressive Portfolio

High-dividend equities may help aggressive investors deal with one of their most vexing challenges—mitigating the potential downside of a portfolio weighted mostly to stocks. Changing the equity allocation from 50% stocks of the S&P 500 and 30% international stocks to 25% stocks of the S&P 500, 25% domestic dividend-paying stocks, 15% international stocks and 15% international dividend-paying stocks improved the annualized total return by 130 basis points and reduced risk as the Aggressive Portfolio illustrates in Chart 4.

Moderate Portfolio

As illustrated in Chart 5, a portfolio crafted for a moderate risk tolerance does not have to settle for middle-of-the-road returns. Allocating 30% of the portfolio to high-dividend domestic and international dividend payers improved annualized total return by 93 basis points while also reducing risk. In this case, the return exceeded that of the aggressive portfolio that did not include high-dividend equities—with considerably lower risk.

Conservative Portfolio

High-dividend equities traditionally have been associated with conservative portfolios designed to pursue growth with reduced risk. Allocating half of the stock portion of a conservative portfolio to high-dividend domestic and international equities, as Chart 6 illustrates, may help an investor pursue these dual objectives.

It's interesting to note that the returns of the conservative portfolio with high-dividend equities exceed those of the aggressive portfolio that did not include high-dividend equities—but with significantly less risk. The relatively low standard deviation of the revised conservative portfolio stems from an 80% allocation to a combination of bonds and high-dividend domestic and international equities, investments that historically have offered lower downside risk.

Chart 4: Hypothetical Aggressive Portfolios[5]

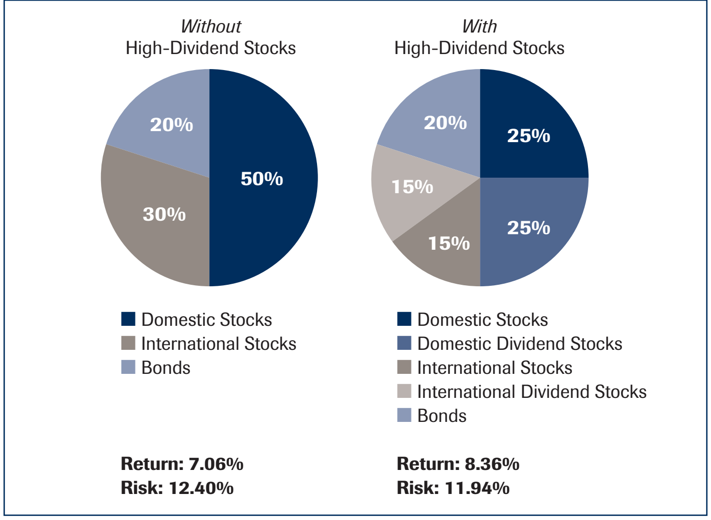


Chart 5: Hypothetical Moderate Portfolio[5]

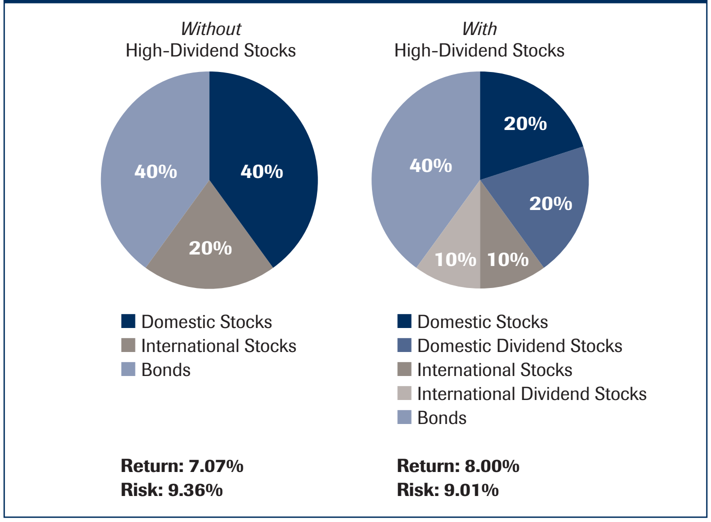
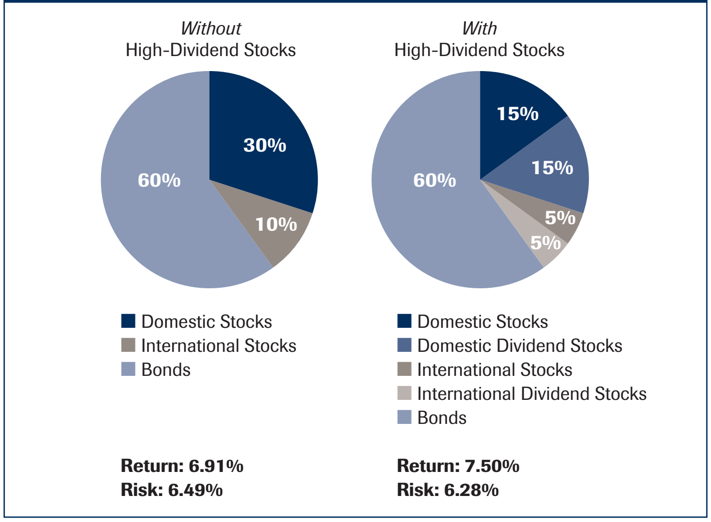


Chart 6: Hypothetical Conservative Portfolio[5]



Past performance is no guarantee of future results.

These charts are for illustrative purposes only and are not indicative of any particular investment.Charts are for a select time period. Other time periods may not result in the same favorable returns.

Dividend Growth and Inflation

The risk and return associated with the aggressive, moderate and conservative portfolios assume all dividends are reinvested to enhance total return. But many investors instead rely on cash dividends to supplement other sources of income. When constructing portfolios for these investors, it's important to consider not only risk and return but also how the portfolio's potential for income compares with historical trends in inflation.

"Inflation is the enemy of income investors," noted Federated's Bean. "There are portfolio managers who create income-oriented portfolios by making them bond-like. But the problem with this approach is that there is little likelihood of an increase in the income stream. By investing in stocks with the potential for growth in dividends, the income stream may move higher, which benefits investors who expect their need for income to rise over time."

Balancing Risk and Return

A high level of dividend income can provide a distinct advantage when fixed-income yields are low, the outlook for inflation is uncertain and the broader equity market is volatile. While a specific allocation depends on individual circumstances, high-dividend equities can be an important part of a wide range of portfolios. With increasing numbers of investors looking to enhance returns while financing retirement, higher education and other long-term goals, interest in high-dividend equity investing—both domestic and international—is likely to remain strong in the years ahead.

Thinking Globally Can Pay Dividends

While many U.S. companies have been more likely to spend a greater proportion of their income on capital expenditures, acquisitions and share repurchases, companies overseas typically pay out a higher percentage of their net income as dividends. It's simply how most of them allocate their cash flows, and it's what their shareholders demand.

Here are three reasons why dividend-seeking investors may want to expand their horizons by including an allocation to international dividend-paying stocks:

- **Potentially More Attractive Yields**—Currently the S&P 500 yields 2.0%.* In comparison, international markets provide dividend yields ranging from 2.8% to 4.4% in countries such as the United Kingdom, Canada, Australia, Switzerland and Norway.*
- **Strong Performance**—As is true of their U.S. counterparts, international stocks that initiate and pay growing dividends have historically outperformed their non-dividend-paying and dividend-cutting counterparts as well as those offering no dividend growth.
- **Enhanced Diversification**—Non-U.S. dividend funds also deliver an added layer of diversification through exposure to an expanded range of countries, currencies and economies.

Of course, when it comes to international markets, there are both countries and companies prudent investors will generally avoid. But given an overall "culture of dividends" that exists overseas, investors may benefit by combining the power of international investing with a dividend focus.

**Source: Bloomberg. As of 3/31/15.*

[2] *Use of the timeframe was based on the availability of performance and standard deviation data based on the MSCI EAFE High Dividend Yield Index's inception date of 10/31/1996. Data for the four-month period prior to the index launch date is back-tested data (i.e., calculations of how the index might have performed over that time period had the index existed.)*

[3] *Source: Morningstar, Inc. High-dividend equity is represented by the total return of the Dow Jones U.S. Select Dividend Index; the broader market by the S&P 500, an unmanaged index of 500 stocks designed to measure the performance of the broad domestic economy through changes in the aggregate value of 500 stocks in all major industries. Investments cannot be made directly in any index. Chart covers the time period beginning July 1, 1996 and ending Dec. 31, 2014.*

[4] *Source: Morningstar, Inc. The broad international market is represented by the MSCI EAFE Index, a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada. International high-dividend equity is represented by the MSCI EAFE High Dividend Yield NR USD Index, which is based on MSCI EAFE, its parent index, and includes large- and mid-cap representation across developed markets countries around the world, excluding the U.S. and Canada. The index is designed to reflect the performance of equities in the parent index (excluding REITs) with higher-than-average dividend yields that are both sustainable and persistent.*

[5] *Sources: Standard & Poor's; Dow Jones; Barclays and Morningstar, Inc. For the period beginning July 1, 1996 and ending Dec. 31, 2014. Domestic stocks are represented by the total return of the S&P 500, domestic dividend stocks by the Dow Jones U.S. Select Dividend Index, international stocks by the MSCI EAFE Index, international dividend stocks by the MSCI EAFE High Dividend-Yield Index, bonds by the Barclays Aggregate Bond Index. Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices. Asset allocation does not ensure a profit or protect against loss. Risk is measured by standard deviation.*

International investing involves special risks including currency risk, increased volatility, political risks and differences in auditing and other financial standards.

Actual investments cannot be made in an index.

G42080-03 (4/15)
Federated Investment Counseling