EQUITY DIVIDEND PLUS STRATEGY

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ABOUT OUR STRATEGY

The GW&K Equity Dividend Plus Strategy focuses on companies that possess high dividend yield and growth potential to offer a good combination of total return, downside protection and lower volatility. We aim to maintain a portfolio yield twice that of the benchmark. Assessing a company's ability to deliver consistent growth is an essential element of our approach as we want the dividends to be sustainable and to increase in the future. Our investable universe spans large, mid and small cap stocks. This multi-cap approach helps to broaden the investable universe while diversifying away systematic risk.

- **Strategy Assets: $954 MM**
- **GW&K Equity Assets: $5,019 MM**

Assets as of 6/30/16

AARON C. CLARK, CFA

What would you say are the relative advantages to investing in dividend-paying stocks?

Mr. Clark: Number one, returns on dividends are always positive, so that gives investors a good head start, especially in the low-yield environment we live in today. A yield of 3% or 4% gets you about half way to a good total return of 7% to 8%, the historic range of equity returns. It is a nice boost for investors as they set to meet their investment objectives.

Dividends are also a lot less volatile than the stocks themselves. If you look at volatility in the market, it's typically about 15%, but the volatility of the actual dividends per share is much lower – around 4% – which means more stability.

For those reasons alone, I think we're in an era where dividends will continue to grow in importance in equity portfolios. They're a very attractive investment opportunity.

Dividend-paying stocks turned in strong performance during the first half of the year. Were you surprised, given the volatility of the markets?

Mr. Clark: I wasn't surprised at all that dividend stocks performed as well as they did. The markets struggled at the beginning of the year and we had a swift correction. People were looking, and continue to look, for safer alternatives whether its municipal bonds, stable sectors in the equity market, or dividend-paying stocks. In this case, good dividend-paying stocks did what they are supposed to do – provide the downside protection that you would expect.

Are there specific market conditions that particularly benefit this Strategy's performance?

Mr. Clark: Historically, we see the biggest relative outperformance of dividend stocks in down market environments. Downside market protection has been quite strong, so investors fare much better in a down market. Conversely, in up markets the upside participation is usually more limited. That said, there has been as much, if not more, upside participation as downside protection over the past year. That trend has contributed to the increasing appetite for dividend-paying stocks.

The firm's approach to this Strategy has proved to be very successful since it was launched, but have you done anything to tweak it since coming on board?

Mr. Clark: I think we've taken a very disciplined approach and made it even better. There's a bit more of a focus on dividend growth than there has been historically. It's always been an all-cap strategy focusing on higher yielding stocks and with an objective of portfolio yield that's twice that of the S&P 500 Index, so that hasn't changed.

Our approach looks for dividend growth as well, so that's an added nuance compared to how it was managed in the past. I think a lot of times investors look at dividend strategies as a value strategy because they're mostly mature companies that are milking their cash flow and returning it in the form of dividends and share buybacks.

But I tend to view it more as a growth strategy. I want the companies we invest in to be able to invest in their business to grow their earnings and future cash flow, both of which make up the foundation for future dividend sustainability and growth. That is an important focus that sets us apart from other approaches.

Are there other attributes of the Strategy that differentiate it from your competitors?

Mr. Clark: We believe in an all-cap approach. We invest in small, medium, and large capitalization companies. I think most dividend funds are littered with old economy and slow-growing Consumer Staples companies like General Mills, Campbell's Soup or IBM.

Our Strategy is distinctly different from your grandfather's dividend strategy. Besides being all-cap, it's also more concentrated. We typically hold about 40 or so stocks, so we're highly focused. Finally, the Strategy targets a yield that's twice that of the S&P 500, and generally gets close to that. If you look at the yield for this Strategy, it typically ranks in the top decile of its peer universe[1].

You said it's an all-cap strategy. How does it actually break down among small, mid, and large?

Mr. Clark: It's approximately a 50/50 balance between small and mid cap stocks versus large cap stocks, with the cutoff in market cap size between these groups being $10 billion. So if you look at the portfolio, half of it will be comprised of companies that have market caps greater than $10 billion, and the remainder would be smaller companies with market caps of less than $10 billion.

There's been a great deal of on-again, off-again speculation about the possibility of the Fed raising rates before year end. If the Fed should raise rates, how would you reposition your portfolio?

Mr. Clark: Generally speaking, we're not inclined to structure our portfolio based on what the Fed may or may not do. What we're interested in is finding companies that have wide moats around their businesses that are defensible. But that's not enough. We are also looking for companies whose cash flows are growing and sustainable, that have the ability to invest in their business, that are going to grow their business over time, and finally, increase dividend payments. So we are not concerned about macro events impacting the Strategy. What we're focused on is how the higher-yielding stocks have done, are doing, and are likely to do in the future.

Many people think of dividend investment strategies as best suited for risk-averse retirees. Would you agree with that? Are there others who should consider this Strategy?

Mr. Clark: Well, I definitely think our Strategy has a much broader appeal than just retirees. We've looked at how a younger investor can fund future liabilities by putting a certain amount of money into a strategy like ours that seeks to generate a high dividend and that will be increased by 4-5% each year as has been the case in our Strategy. Let's look at funding a child's college education for example. Letting an initial investment grow and reinvesting dividends during an 18 year period, the portfolio would grow enough to fund college tuition costs during years 19 through 22 without having to draw down portfolio principal.

The point is, in the low yield environment we find ourselves in, more investors should take another look at dividend strategies to help them achieve their objectives beyond just an income generator during retirement. The slogan should be, "not just for retirees anymore."

You said the portfolio is pretty evenly split between small and mid-cap, and large-cap, but where on the market spectrum are you finding the most opportunities today?

Mr. Clark: It's fairly balanced, but maybe a slight edge to the smaller cap market segment today. From a valuation standpoint, many of those companies have lagged over the past couple of years relative to large cap, but the last few additions to the portfolio have been more on the smaller to mid cap size. Also, over the past few years we have been finding higher dividend yield and faster dividend growth rates in some of the smaller and mid-cap companies.

Are there any sectors that look especially attractive these days among dividend stocks?

Mr. Clark: Technology is an interesting one. We've done some work looking at the volatility of earnings for Technology stocks versus Consumer Staples stocks that shows the volatility for Technology companies has actually come down to the point where their earnings are now less volatile than Consumer Staples.

You can find Technology stocks today that are trading anywhere from 10, 12 or 14 times earnings, depending on which company you look at, compared to 22 or 24 times earnings for names in the Consumer Staples sector. You are essentially getting more bang for your buck with much lower volatility than in the past. Many other fundamental metrics overwhelmingly favor the Technology group as well, like a lower payout ratio, and faster dividend growth, earnings growth and revenue growth.

So we think there's room for a lot more dividend growth in Technology than there is in some of the Consumer Staples names. This is not a consensus view for investors or dividend strategy investment managers.

At what point do you cut a dividend stock loose from a portfolio? How do you make that determination?

Mr. Clark: Yield is a big driver. When we get to the point where the yield is at or below the S&P 500, that is certainly a trigger for reducing our position. At the same time, we'll look at the growth potential of the dividend, and if it's one where we feel confident that there's a continuation and sustainability of the dividend, we may give it more slack.

Another important driver is the general investment thesis of the company. If, for some reason, our thesis about the cash flows or a company's capital allocation policies change, where instead of paying it back to shareholders through dividends or share buybacks they decide to go on an acquisition binge or do something different with the capital that doesn't position it for dividend growth anymore, that would certainly be a reason to sell the company.

What do you look for in a dividend stock? Is it different if you're looking at a mid-cap, a large-cap, or a small-cap?

Mr. Clark: Far and away the primary objective is yield. But targeting high-yielding companies exclusively is very susceptible to value traps, or what I like to call slowly melting ice cube type of companies. Those are companies that are in mature businesses, not growing, oftentimes shrinking, trying to cost-cut their way to prosperity, and just milking the cash flows and paying it back to shareholders in the form of a dividend.

We look for companies that have a good set of assets, a good moat around their business that give us confidence that the cash flows over time will grow, and have opportunities to reinvest in their business to drive that future growth and create earnings power to sustain and grow the dividend. We apply that discipline to small, medium, and large cap companies. It doesn't matter what the market cap is.

Can you provide an example of a dividend stock that illustrates your Strategy's approach?

Mr. Clark: A good example would be a leading movie theatre chain. This is a smaller cap company with a yield of 4.3% currently, meeting our high-yield criteria, and they have a lot of reinvestment opportunities in the business. What they're doing is converting their asset base, or their theaters, to luxury seating. They're ripping out their traditional seating and transitioning to leather recliners. And with that comes better concessions. They can justify serving more than just popcorn, sugary drinks and snacks; they can serve beer and wine and provide better food offerings.

The movie-goer will pay a premium for the seating and will also tend to spend more on the concessions, which is a very high-margin business. And the landlord kicks in up to 50% of the improvement costs.

This company has had really high returns on invested capital on these investments, in the range of 30% to 50%, so it's really a great strategy for them. They're growing earnings and they sometimes pay special dividends.

Is there a global play when investing in dividend stocks?

Mr. Clark: Yes I think so, in industries that are more global in nature, like pharmaceuticals for example. Some U.S. pharmaceutical companies have a lower dividend yield than their European counterparts, but they are in the same business, selling globally, yet they are just domiciled in different countries.

We've capitalized on this yield differential by investing in GlaxoSmithKline in the UK for instance. The dividend yield at approximately 5.25% is a good 150-200 basis points higher than many of its U.S. competitors, which is an anomaly. So, again, same business, developing similar products, selling them to similar markets, but the attitude toward dividends in Europe is somewhat different. They tend to have higher payout ratios, and are more inclined to pay higher dividends than some U.S. companies. We definitely look for these yield arbitrage opportunities.

Are there risks associated with dividend investing?

Mr. Clark: Dividend cuts are clearly a risk. The market overall has seen the highest number of dividend cuts this year since the financial crisis in 2009. That's something we focus on. That's why I think targeting high-yield companies alone, without regard to future cash flow and opportunities to reinvest for the future, can be a dangerous strategy. Past experience suggests that many of those companies may reach a point when they can no longer service the dividend and they'll have to cut it. That's why it is so important to understand the business, its fundamentals, its cash flow and what their plans are for the future.

And then there is opportunity cost risk. If the market is up 40% some year, our Strategy will likely not be up nearly as much, so in theory, you are leaving some money on the table, for arguably a short period of time, in return for less volatility, more stability, and most importantly, much lower drawdowns in down markets, which is very powerful for long-term compounding of returns.

Frankly, we worry a lot less about beating the benchmark, even though of course we pay attention to it, and more about dividend growth and creating a growing stream of income over time. Our preferred metrics for looking at performance is the annualized income this Strategy throws off over time, because that's what we have the most control over.

Do you find there are some overarching misconceptions about dividend stocks out there when you speak to investors? In other words, is there an expectation on

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their part that it might be unrealistic?

Mr. Clark: I think sometimes there is. You might call it the "recency effect." That's where investors tend to be influenced by whatever they've read most recently, or by whatever is happening most recently, to the point that they extrapolate that near-term trend into a longer-term expectation.

Here's an example. Dividend strategies have performed quite well partly because they have attracted strong assets flows in this low-yield environment, and partly because there are some good companies doing good things – paying good dividends and growing their businesses. Our Strategy was up 14% for the first half of the year, and while that's a great rate of return for equities in any given year, I certainly wouldn't want investors to extrapolate that type of half-year performance into an expectation that it will continue at that pace.

So, this isn't something that's going to continue indefinitely, in terms of paying out dividends at near-record levels?

Mr. Clark: I am unwavering in my belief that dividend strategies are a great way to compound wealth over time, in a good risk-adjusted return manner. I also think that dividend-paying companies as an asset class are still undervalued and that there is still a long runway for the cycle.

What is the "Plus" in the GW&K Equity Dividend Plus Strategy name?

Mr. Clark: The "plus" refers to the flexibility we have to invest in other parts of the capital structure beyond just common stocks. What we do is not easy. We want high-yielding dividend stocks that can also grow their dividends. That's a rare combination. So at the higher-yield end of the spectrum we've added perpetual preferred securities to enhance the yield and balance the portfolio. I call it a barbell approach. In the event we can't find companies with high yield and dividend growth, I can synthetically create that by buying some securities with lower yields and higher growth and balance that with those that have high yield and lower growth. This helps the overall portfolio meet the objectives.

An example might be Goldman Sachs or Citibank, two current holdings, which issued perpetual preferred shares that yielded around 6.5%. The downside is, those dividends won't grow – they are a fixed rate. But there is also much less volatility in that type of security and you get an attractive return of 6.5%, not too far off the long-term returns for equities overall.

How have dividend investing strategies actually evolved over the years?

Mr. Clark: I think the growth aspect of dividend investing has become a bit more acceptable. In the past it was really all about utility companies who tended to pay out their cash flow in the form of a dividend. Growth of dividends tended not to be a consideration. That's changing.

Another change that has been slow in developing is the idea of a multi-cap approach to dividend investing. More often when people talk about dividend strategies, they think of big, old, lumbering large cap companies that pay dividends. The perception has been that because small cap companies are oftentimes younger, they can't afford to pay dividends because they need to invest in their business and grow. But that's simply not the case.

As time goes on, these are views that will grow in acceptance, but right now, it not only gives us a much broader range of investible opportunities -- a distinct investment advantage -- it also allows us an opportunity to differentiate ourselves from our competition in the marketplace.

In the end, we see it as far more than just screening for companies with high yields. The sweet spot for us is finding the ones we think have a good business, good returns on capital, a defensible moat, and a clear vision that will allow the company not only to continue paying dividends, but increase their dividends over time.

Disclosures

[1]Peer universe represents the eVestment U.S. Dividend Focused Equity.

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