GW&K INVESTMENT MANAGEMENT

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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: $915 MM**
- **GW&K Domestic Equity Assets: $5,336 MM**

Assets as of 3/31/20

AARON C. CLARK, CFA

The year began upbeat despite an impeachment trial, unrest in the Middle East and various other macroeconomic uncertainties. Then the global outbreak, COVID-19, brought business activity to a virtual halt and took stocks into bear market territory in record time. With all this uncertainty, is there a particular reason why investors should look at dividend stocks?

Mr. Clark: Absolutely. The economy has clearly entered a recession and, in response, interest rates are now even lower. So, we believe, unquestionably, that dividend growth stocks are the best solution for providing high and growing income in a yield-starved world. Many dividend paying stocks actually generate a growing stream of tax-advantaged income regardless of what is occurring in the macroeconomic environment. The share prices may move around due to events like those mentioned, but the dividend income those businesses generate is far more stable. This is one reason why we strongly believe dividend paying stocks deserve a key place in the portfolios of income-oriented investors.

Aren't there other equally attractive income generating opportunities for investors?

Mr. Clark: Prior to the downturn related to COVID-19, the dichotomy in sentiment among income generating asset classes had been striking. Take municipal bonds, for instance. Inflows into that asset class were running at all-time highs, driving muni spreads-to-Treasuries to historically narrow levels. Similarly, demand for taxable bonds was also extremely robust. Many recent bond offerings were oversubscribed multiple times as investors tripped over themselves to get yield. The pandemic flipped this on its head and now we are seeing record level outflows across all asset classes. What's particularly interesting is that high yielding dividend stocks, which are normally downside protectors in a weak market, have been the worst performers. When we look at these stocks, the highest yielders have lagged by one of the largest amounts on record, approximately 1,500 basis points (as of 3/31/20). This underperformance suggests that high yield dividend stocks have been ignored. In contrast to other income-oriented asset classes, we believe dividend stocks are still extremely attractive and see this as a tremendous investment opportunity.

Not all dividend stocks are created equal. You've said you look for stocks with more than just high yields. What other factors are important to you when evaluating a potential dividend stock?

Mr. Clark: It's very easy to create a portfolio of high yield dividend stocks. Anyone can run a screen of the 40-50 highest yielding stocks and you'd be well on your way to having a high yielding dividend stock portfolio. The problem with that approach, however, is that many of these high yielders are in a slow, but inevitable, secular decline. We call these stocks "slowly melting ice cubes." Eventually, the dividend paid by these companies will become unsustainable and will need to be cut.

We invest in companies that have a wide moat around their business with sustainable competitive advantages and the opportunity to reinvest in their business. These investments back into the business solidify the moat and create opportunities for future growth. This creates a positive feedback loop: as cash generation becomes more sustainable it allows for ongoing reinvestment. This, in turn, improves dividend coverage and positions the company well for future dividend growth.

There are any number of dividend investing strategies out there. What sets your strategy apart from the competition?

Mr. Clark: First, our Strategy is truly a high yielding strategy. Its 4.0% yield is nearly two times that of the S&P 500, and we typically rank in the top 10-20% of all dividend strategies based on yield in the eVestment database. In addition to the high yield, we also focus on dividend growth, so our clients are not only getting high current income, but also income growth each year.

Another differentiator is our all cap focus. This not only broadens our opportunity set of dividend growth stocks, it also smooths out returns since it is not unusual for one market cap segment to outperform another. For example, small cap stocks are trailing large cap stocks by approximately 1,700 basis points for the trailing 12 months ending 3/31/20. As a result, our small cap exposure has been a drag on relative performance, but when these stocks catch up, as they inevitably will, this will be a positive.

Conventional wisdom has it that investing in dividend stocks -- whether small, mid or large cap -- is both boring and less risky. Is that true?

Mr. Clark: If risk is defined as volatility, then we believe dividend stocks are less risky. The volatility of our portfolio (as measured by 3-year standard deviation) is 10.4% versus 13.6% for the S&P 500 benchmark. However, what we tend to view as risk is the permanent loss of capital, which usually occurs if a business is impaired. Historically, our Strategy has protected on the downside, meaning it has gone down less than the overall market during periods of weakness. Given that returns from dividends are always positive, we believe this, too, makes dividend stocks less risky. To the extent they are more *"boring"* than the average stock, that seems very apt for clients seeking income generation with some capital appreciation and moderate risk.

How long do you typically hold a dividend stock? What's the turnover in your strategy?

Mr. Clark: We take a long-term view with all of our investments. We typically ask ourselves, *is this a type of business we can own forever?* Not because it is likely we will, but rather because that is the hurdle we apply to ensure we are investing in a company that we will be comfortable owning through various economic cycles. This long-term view is reflected in our annual turnover which is typically less than 20%. That means we own companies on average for 5 years. Our trailing 12 month turnover for 2019 was 12%.

What are some warning signs you look for when deciding whether to cut a holding?

Mr. Clark: We have an unconventional view on this. We do not set price targets on our holdings. We don't like to go into an investment with one foot out the door already, which is what a target price forces you to do. We don't want to be anchored to a price target to force a decision. Instead, we monitor the competitive advantages of the company to see if those are still sustainable and being reinforced.

If it appears the moat around the business is eroding, or its growth opportunities are more limited than we initially expected, this would weigh heavily in any sell decision. Similarly, if the dividend yield becomes too low or we become concerned about the sustainability of the dividend, this could also be a trigger to sell.

You're overweight real estate. What do you find attractive about REITs?

Mr. Clark: We have a bottom-up approach driven by fundamental research on individual companies so this is by no means is a top-down call on real estate. However, the sector is a natural place for us to look given that many companies here have attractive yields. In certain instances, the assets these companies own are truly mission-critical facilities for their tenants. That means moving out would impair their operations for a period of time, giving the REITs that own these assets a great deal of negotiating leverage with their tenants. What we also find interesting is that the sector is extremely diversified, as are our holdings. We have exposure to a whole host of different businesses, each with various end-market demand drivers such as industrial properties, casinos, data centers and cell towers. This sector is normally a downside protector, but during the recent downturn this has not proven to be the case. We believe that many REITs have extremely attractive risk-reward profiles and dividends right now.

You're underweight in Communication Services and Information Technology. What gives you pause about these sectors?

Mr. Clark: Again, this is not a top-down sector call, but rather driven by the fact that these two sectors, especially Information Technology, typically do not have a lot of companies with dividend yields.

Your top holding is NextEra Energy. What do you like about this stock?

Mr. Clark: This company meets many of the criteria we look for in an investment. The company has a wide moat around its two main businesses. It has a market leading position as a regulated utility in Florida and has delivered some of the lowest customer rates in the country. This, in turn, has led to strong relationships with regulators.

Their second business is in unregulated, but contracted, renewable energy generation. Their first mover advantage in renewable energy generation allows them to enjoy some of the best wind and solar locations in the country. This leadership in renewables puts them on the cutting edge of green initiatives, which appeal to a broader array of investors in a world where ESG investing is continuing to take on added importance. These sustainable competitive advantages have allowed them to be a model of consistency as far as their ability to deliver financial results. A good example of this is their dividend, which has grown at an 11.5% rate over the past five years. We expect this double-digit growth to continue.

What risks are you most conscious of in 2020? How significant an effect do you anticipate COVID-19 will have on the markets and specifically dividend stocks?

Mr. Clark: The biggest risk by far is COVID-19. This was truly a Black Swan event and nobody knows how long it will last. We are very likely in a recession right now which may be one of the deepest in history, but could snap back relatively quickly too. Therefore, while we expect the hit to the economy to be sharp, we anticipate it will be short lived. We are likely to see continued volatility as the markets will be unable to quantify these risks. However, this economic climate will likely be good for dividend stocks, which hold up better during periods of uncertainty.

Our top focus is the ability of these companies to sustain and grow the dividend. The dividend payout ratio on the portfolio is approximately 50% of free cash flow, so there is sufficient buffer to withstand the earnings contraction we expect. We have also taken action to eliminate a few holdings where we think the dividend is no longer safe due to the rapidly changing circumstances.

In an attempt to manage the effects of the COVID-19 on the markets, the Fed has aggressively cut rates and has signaled it may take other aggressive action. How has the pandemic effected your portfolio up until this point?

Mr. Clark: While we always focus on dividend sustainability, given the magnitude of the impact to earnings from parts of the economy being shut down, we are placing added emphasis on this. We have exited a few holdings where we thought the dividend was at risk and have replaced those with new holdings that should have a greater margin of safety to cover the dividend during this uncertain environment.

How have stock buybacks impacted dividend payouts? Do you think stock buyback activity will decline in 2020?

Mr. Clark: We seek out companies that have a balanced approach to capital allocation. Ideally, we'd like to see a company that is able to use its internally generated excess cash flow to invest in the business, engage in M&A (if it makes sense), have a growing dividend policy and allocate some capital to a share buyback. We think buyback activity will be cut sharply due to the recession and subsequent decline in earnings as companies scramble to protect liquidity. Excess cash flow will not be as robust so we are focusing on companies that have the flexibility to be able to continue to pay the dividend.

The Equity Dividend Plus Strategy returned a very respectable 26.1% last year, but still lagged the benchmark by a little over 5%. To what do you attribute this difference?

Mr. Clark: Our Strategy is designed to provide a high and growing income stream to our clients and to supplement that with some capital appreciation. Given this focus, the Equity Dividend Plus Strategy tends to appreciate, but lag broader equity indexes in a strong rally, but also hold up better during periods of market weakness. Since it is not designed to outperform the overall market, we are not surprised that it did not keep pace, especially in a year that the market returned over 30%. The biggest difference was Information Technology, a sector we are typically underweight due to the lack of yield, and the 49% return from this sector last year weighed on results.

S&P 500 companies paid out a record number of dividends in 2019, even if at a slower pace than 2018. What do you see ahead for dividend stocks for the next 12 months?

Mr. Clark: We never look at any investment in twelve month increments, but we think dividend paying stocks, as an asset class, are still very attractive longer term and that they should be more competitive with overall market returns going forward. The returns on the S&P 500 have been above long-term averages for the past 5 and 10 years. It would not be surprising to see some mean-reversion toward lower returns.

One valuation metric we look at is the Case Shiller P/E ratio which is a trailing 10-year P/E that smooths out economic cycles. The current reading before the recent decline in the market was 32 times, near its 100-year high excluding the tech bubble, and the history of this data would suggest that future returns for the market over the next 10 years will be in the 0-5% range. But we're also cognizant of the fact that real interest rates are at extremely low levels which could distort the signaling power of the Shiller P/E compared to history. Regardless, with a present yield of 4.0%, the Equity Dividend Plus Strategy offers a great starting point for future returns, which is why we believe dividend stocks should be more competitive in the coming years.

In closing, what kind of investor would you say the Equity Dividend Plus Strategy is best suited for?

Mr. Clark: The beauty of the Equity Dividend Plus Strategy is that it's well suited for anyone looking to generate high current income. In fact, we believe this is the best way to generate income among all the yield alternatives. With the 10-year Treasury yield breaking below 1%, and $14 trillion of negative yielding sovereign debt globally, the 4.0%+ yield is extremely attractive. Furthermore, the income will grow over time as dividends are increased. Dividend strategies are not just for retirees anymore. Anyone can benefit from them.