Time to Rethink Your Approach to Dividend Stocks?

A focus on "bond proxy" sectors may cause investors to lose out on potential capital appreciation. We think a different strategy may be in order.

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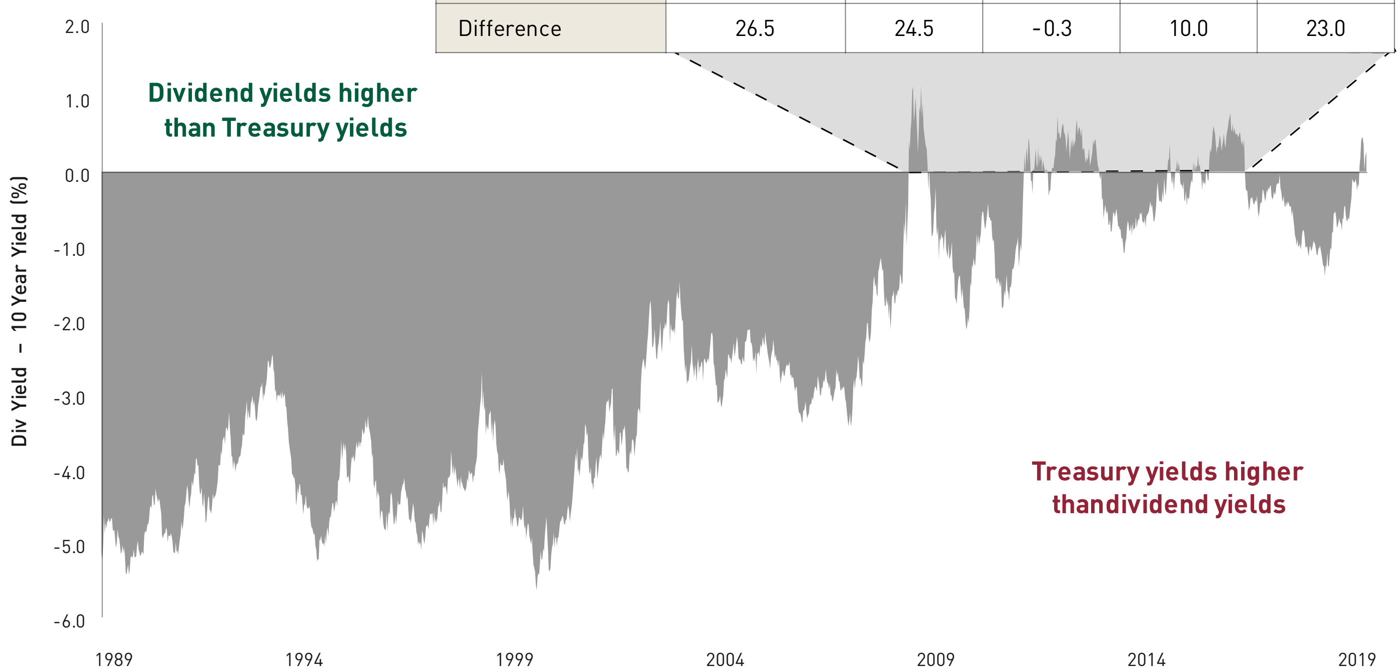
Chart 1. U.S. Dividend Yields Recently Exceeded 10-Year U.S. Treasury Yields

Difference between S&P 500 dividend yield and 10-year U.S. Treasury yield, September 22, 1989–September 30, 2019

	Index Returns over following 12 months				
	12/1/08 - 11/30/09	10/1/11 - 9/30/12	2/1/15 - 1/31/16	10/1/15 - 9/30/16	2/1/16 - 1/31/17
S&P 500	25.4	30.2	-0.7	15.4	20.0
10 year Treasury	-1.1	5.7	-0.4	5.4	-3.0
Difference	26.5	24.5	-0.3	10.0	23.0



Source: Bloomberg. Data as of September 30, 2019.

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Past performance is not a reliable indicator or guarantee of future results.

In Brief

- News that the dividend yield on the S&P 500® index now exceeds the yield on 10-year U.S. Treasury notes has brought renewed attention to dividend-paying stocks.
- However, we believe some popular dividend-investment vehicles lean too heavily on "bond proxies," i.e., higher-yielding stocks from a narrow range of sectors with low growth, and therefore, less chance of stock-price appreciation.
- Instead, we think investors may wish to consider a strategy that seeks to identify the most attractive dividend stocks from *all* sectors, potentially enabling them to benefit from dividend income and a greater chance of capital appreciation.

The dividend yield on the S&P 500® Index recently exceeded the yield on the 10-year U.S. Treasury note for the first time since January 2016 (see Chart 1). This uncommon occurrence serves as a reminder that with interest rates at ultra-low levels, dividend-paying equities may present an attractive alternative for income investors.

Moreover, historically when the S&P 500 dividend yield overtook the 10-year U.S. Treasury yield, the subsequent 12-month return was positive with the exception of 2015. The average 12-month return over the five periods depicted in the table that accompanies Chart 1 was approximately 18%. This suggests that not only are dividend paying stocks attractive from an income standpoint, but also that equity markets have the potential for robust positive total returns in the coming year.

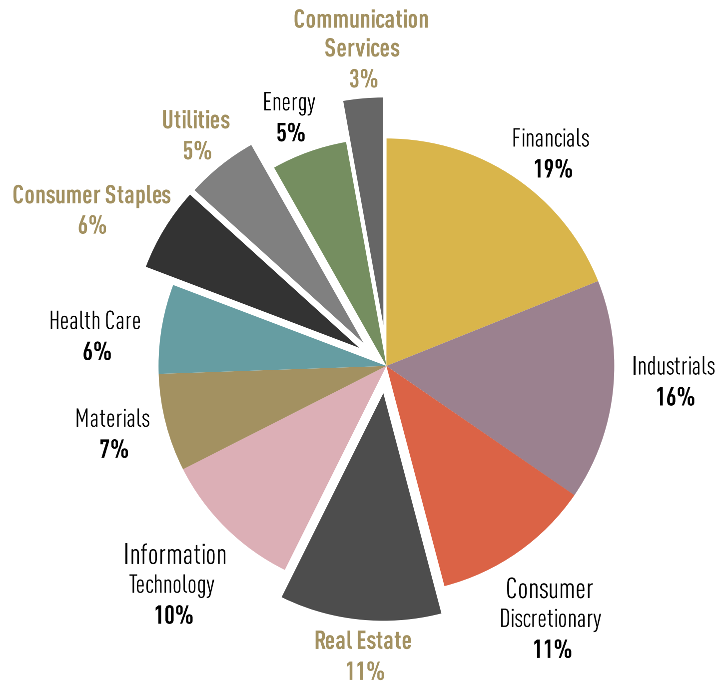
However, we would note that not all dividend-focused strategies are the same. Equity income funds often have an overconcentration in sectors that pay a high dividend yield, but do not offer much potential for capital appreciation. The return profiles of these stocks have prompted investors to label them as "bond proxies." These stocks are commonly found within the utilities, communications services (primarily telecom services), real estate, and consumer staples sectors. While bond proxy sectors are attractive in a low interest rate environment, performance is usually whipsawed when rates rise.

Investors considering a dividend-focused strategy should be wary of major sector biases. In fact, several major dividend income exchange-traded funds (ETFs) exhibit sector biases toward bond proxy sectors. As of October 2, 2019, two of the largest dividend ETFs, SPDR S&P Dividend ETF (SDY) and iShares Select Dividend ETF (DVY), were both overweight in bond proxy sectors relative to the S&P 500, based on FactSet data. The SPDR S&P Dividend ETF had an overweight allocation relative to the S&P 500 to the consumer staples and utilities sectors of approximately 8% and 7% respectively. Meanwhile, the iShares Select Dividend ETF maintained an overweight position relative to the S&P 500 in the utilities sector of roughly 23%.

While there are several large, dividend-paying companies within these bond proxy sectors, we think dividend investors should consider expanding their horizons. For, as Chart 2 shows, the universe of dividend-paying equities is quite broad.

Chart 2. Bond Proxies Represent Only One-Quarter of Dividend-Paying Stocks

Percentage of all dividend-paying stocks in the Russell 1000® Index from each sector, as of June 30, 2019



"Bond Proxies" represent less than 26% of all dividend-paying stocks in the Russell 1000 Index

Source: FactSet. Data as of June 30, 2019. Aggregate total of sector representation reflects rounding of individual percentages. "Bond proxies" refer to sectors (in this case, Real Estate, Communication Services, Consumer Staples, and Utilities) containing mature, slow-growth companies that return a large portion of their earnings to shareholders when paying dividends, resulting in "bond-like" yields for investors.

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We believe this breadth can be put to work for investors. As we have noted in the past, a focus on just the highest dividend payers has exposed investors to more risk than they may have realized. Instead, we believe a better approach to accessing dividends may be for investors to utilize a diversified approach that focuses on uncovering the most attractive dividend payers wherever they can be found, thereby allowing their portfolios to potentially benefit from both the power of compound interest and the capital appreciation opportunity provided by higher-quality, undervalued dividend paying stocks.

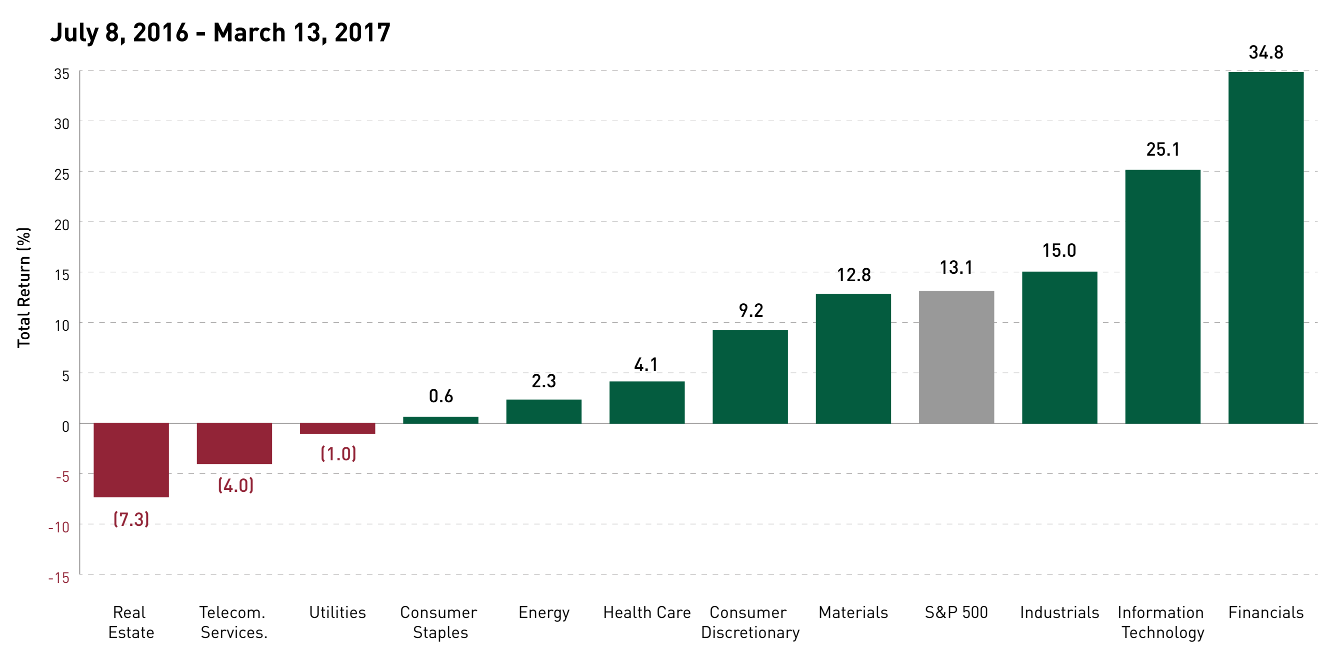
CLOSE-UP

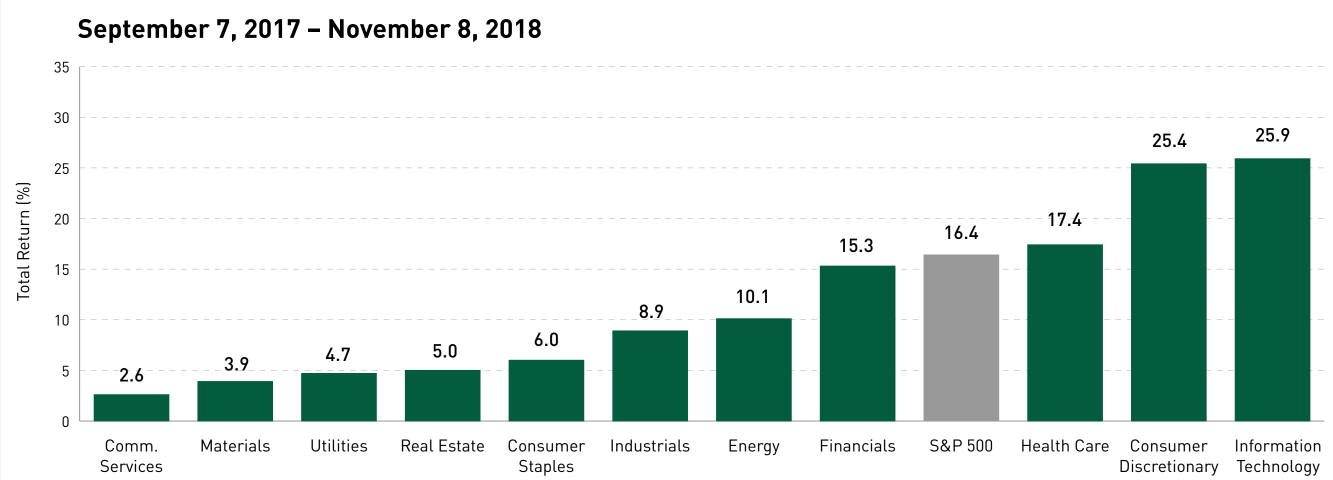
"Bond Proxies" and Rising Rates

Since "bond proxies" are typically low- or no-growth stocks, their dividend payout is often a sizeable portion of their overall total return. So we think it would be no surprise that they tend to underperform when a spike in interest rates makes their dividend yields relatively less attractive. As the accompanying chart highlights, the classic bond proxy sectors were the relative laggards during the two most recent periods of rising rates: July 8, 2016–March 13, 2017, when the broader equity market (as represented by the S&P 500® Index) delivered a return of 13%; and September 7, 2017–November 8, 2018, when the market returned 16%.

"Bond Proxies" Have Underperformed during Periods of Rising Rates

Total return by S&P 500 sector during indicated periods when the yield on the 10-year U.S. Treasury note rose 100 basis points





Source: FactSet. "Bond proxies" refer to sectors (in this case, Real Estate, Communication Services, Consumer Staples, and Utilities) containing mature, slow-growth companies that return a large portion of their earnings to shareholders when paying dividends, resulting in "bond-like" dividend yields for investors.

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Past performance is not a reliable indicator or guarantee of future results.

A Note about Risk: The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. While growth stocks are subject to the daily ups and downs of the stock market, their long-term potential as well as their volatility can be substantial. Value investing involves the risk that the market may not recognize that securities are undervalued, and they may not appreciate as anticipated. Smaller companies tend to be more volatile and less liquid than larger companies. Small cap companies may also have more limited product lines, markets, or financial resources and typically experience a higher risk of failure than large cap companies. The value of an investment in fixed-income securities will change as interest rates fluctuate and in response to market movements. As interest rates fall, the prices of debt securities tend to rise. As rates rise, prices tend to fall.

No investing strategy can overcome all market volatility or guarantee future results.

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Forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

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Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes.

Dividend yield is equal to the dividend divided by the stock price. Dividend yield is one measure of a stock's value. A high dividend yield may indicate that a stock is relatively inexpensive.

Dividend policy: A stock is classified as a dividend payer if it paid a cash dividend any time during the previous 12 months, a dividend grower if it initiated or raised its cash dividend at any time during the previous 12 months, and non-dividend payer if it did not pay a cash dividend at any time during the previous 12 months.

Exchange Traded Fund (ETF) is a security that tracks an index, a commodity or a basket of assets like an index fund, but trades like a stock on an exchange. ETFs experience price changes throughout the day as they are bought and sold.

Yield is the annual interest received from a bond and is typically expressed as a percentage of the bond's market price.

The **Russell 1000® Index** measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 92% of the total market capitalization of the Russell 3000 Index.

The **S&P 500® Index** is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

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