Capitalizing on Dividend-Paying Stocks

Evidence-based rules for seeking long-term growth and managing risk
About Post Oak Private Wealth Advisors

Post Oak Private Wealth Advisors is a leading money management and advisory firm based in Houston, Texas. We are highly specialized fee-based managers who serve in a fiduciary role on behalf of our clients.

Our Guiding Beliefs

- Transparency
- Simplicity
- Value

Post Oak offers particular expertise in the areas of advanced risk management strategies, innovative cash flow design and retirement distribution planning.
Accommodative monetary policies by global central banks have created a challenging environment for many investors. Those seeking income must do so in a market where yields on bond investments are at historic lows. Investors seeking capital appreciation often find returns are elusive in the current slow-growth climate, unless they are willing to assume additional risk.

In the search for yield and return, investors often look toward dividend-paying stocks as vehicles to provide both current income and capital appreciation. A suitable dividend investment strategy should consider all factors that influence both growth and yield, while providing some protection from downside risk for periods of market volatility.

Even though investing in quality dividend paying companies is often recognized as a sound compliment to passive index investing, there remains a lack of guidance about an appropriate strategy that should be used in the management of such a portfolio.

This paper will consider the factors that affect the performance of dividend-paying stocks and lay the groundwork for the evidence-based rules that guide the investment strategy of Post Oak's Ultra Blue Chip Dividend Portfolio.
How dividends influence stock performance

Yield

Investors in dividend-paying stocks are often interested in yield. But income generated through dividends is just one side of the equation. Dividends also contribute significantly to the stock market’s total return over long-term periods.

The importance of dividend return often gets ignored because price appreciation garners much more attention during bull market periods. Rightly so, according to the data: dividends accounted for just 19% of the S&P 500’s total return during the bull markets from 1900-2000.

But it’s significant to note that during bear markets or sideways markets, dividends have had a more profound influence, contributing 90% of the S&P 500’s total return during these periods from 1900-2000.

Contrary to conventional wisdom, it’s often not the highest yielding stocks contributing the most to performance. According to research by Kenneth French, dividend stocks considered to be above-average payers (in fourth quintile for yield) outperformed the highest payers (fifth quintile for yield) for total return for the time period 1928-2013.

Average annual total return among dividend-paying stocks 1928-2013

<table>
<thead>
<tr>
<th>Quintile</th>
<th>Total Return</th>
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<tbody>
<tr>
<td>5th Quintile (highest payers)</td>
<td>10.9%</td>
</tr>
<tr>
<td>4th Quintile</td>
<td>11.7%</td>
</tr>
<tr>
<td>3rd Quintile</td>
<td>9.7%</td>
</tr>
<tr>
<td>2nd Quintile</td>
<td>9.9%</td>
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<tr>
<td>1st Quintile</td>
<td>9.1%</td>
</tr>
<tr>
<td>Non-Payers</td>
<td>8.3%</td>
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</table>

Source for chart data: Kenneth R. French and CRSP
Dividend Safety

Consistency in dividend payments or dividend safety is essential to the success of a dividend investment strategy. Sustainability of dividend payments is often more preferable than seeking the highest yield, because companies that pay out a significant share of earnings in dividends are not reinvesting in the business and may not be able to maintain a high share payout for long.

One risk that can come when investing in dividend stocks is the reduction or suspension of dividend payments, if a company decides to halt or scale back the payment of dividends to shareholders due to difficult operating conditions for the business or contraction in the overall economy. History shows us that dividend cuts not only reduce income but also tend to depress the share value of the stock itself.

Strong balance sheets and good underlying economics of the business are key indicators of dividend safety. Companies with low or moderate payout ratios (dividend per share/earnings per share) are better positioned for sustaining the payment of dividends over longer periods, compared with companies that pay out most or all of earnings in the form of dividends.

Dividend Growth

While dividend yield is an important indicator of return potential, companies that have increased payouts consistently showed better performance than companies that maintained stable dividend payouts. Therefore, an integral component of a successful dividend investment strategy is to select stocks that may have slightly lower current yields but also have the potential to grow those yields over time.

An analysis of 40 years of stock data of S&P 500 companies by Ned Davis Research showed companies that consistently raised their dividend payments each year returned 9.4% on an average annual basis. Companies that paid dividends but did not increase them returned around 7% on an average annual basis over the same period.

Putting the pieces together

A quality dividend investment strategy will consider each factor that influences the performance of dividend paying companies and apply a series of buy and sell rules around these factors to guide the management of the dividend stock portfolio.

The following rules were developed around these factors for the Post Oak Ultra Blue Chip Dividend Portfolio.
The Quality Rule

*Invest only in stocks with track records of dividend increases of 25 years or more.*

Companies that are managed for stability, profitability and growth have greater potential for long-term success and the ability to reward investors by sharing earnings from the business.

**Analytic evidence:**

The S&P Dividend Aristocrats Index, comprised of stock of companies that have consistently increased dividends every year for at least 20 years, has outperformed the S&P 500 Index over the last 10 years by nearly 3% per year.

### Historical Performance: S&P 500 Dividend Aristocrats and S&P 500 Index (total return)

Source for chart: S&P Dow Jones Indices
The Bargain Rule

*Rank stocks by their dividend yield.*

Invest in companies that pay relatively high dividends in order to seek to maximize your cash flow from your investments.

**Analytic evidence**

Higher yielding dividend stocks outperformed lower yielding dividend stocks by 1.7% per year from 1928-2003.

**Hypothetical growth of $1M from January 1928-December 2013**

THE SAFETY RULE

Rank stocks by their payout ratios.

When a company pays out most of its net income in the form of dividends, less income is left to reinvest in the business. That can leave investors vulnerable to a reduction or suspension in dividend payments should the business experience a downturn.

Companies that can balance dividend payments with business reinvestment are in better position to maintain consistent dividends over long periods. Payout ratio can help determine how much a company is paying in dividends relative to its income. For example, a payout ratio of 10 means for every dollar of net income 10% is paid to shareholders in the form of dividends.

Analytic evidence:

Dividend stocks with low payout ratios outperformed those with high payout ratios by 8.2% per year from 1990-2006.

The Growth Rule

*Rank stocks by their long-term revenue growth.*

If a business has maintained a high growth rate for dividends over several years, they are likely to continue to do so. The more a business's revenue grows, the more profitable your investment will become.

**Analytic evidence:**

Dividend stocks that have grown their payouts have outperformed those that have maintained stable payouts by 2.4% per year from 1972-2013.

**S&P 500 Index hypothetical performance of $100 invested in each of the five strategies, 1972-2013**

The Peace-of-Mind Rule

*Rank stocks by their long-term volatility.*

Contrary to popular wisdom, stocks with lower volatility have a history of outperforming higher volatility stocks in all business cycles. Between 1968 and 2008, a portfolio of low volatility stocks has offered high average annual returns and relatively small drawdowns. This runs counter to the prevailing belief in finance that higher risks are generally rewarded with higher returns.

**Analytic evidence:**
The S&P Low Volatility Index outperformed the S&P 500 Index by 2.0% per year for the 20-year period ended September 30, 2011.

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**Relative performance of the S&P 500 Low Volatility Index and the S&P 500 Index**

The Overpriced Rule

Sell stocks when their normalized price/earnings (P/E) ratio is over 40.

It makes sense to sell a stock when its price is greater than its worth, as measured by earnings. Selling stocks when they reach levels of overvaluation allows profits to be reinvested in other businesses that pay high dividends and offer similarly attractive opportunities.

Analytic evidence:
Stocks in the lowest decile for P/E outperformed the highest decile stocks by 9.0% per year from 1975-2010.

Average annualized rates of return, 1975-2010

The Survival-of-the-Fittest Rule

*Sell a stock when the dividend payment is reduced or eliminated.*

If a company reduces the dividend it pays to shareholders, it is paying less over time and not more—the opposite of what should happen. At this point, prudent investors recognize that the business has lost its margin of safety and the stock should be sold to reinvest in the proceeds into other businesses that offer better opportunities for return.

**Analytic evidence:**

Stocks that reduced or eliminated dividends had a 0% return from 1972-2013.

**S&P 500 Index risk and return, 1972, 2013**

The Balance Rule

*Buy the highest-ranked stock of which you own the least.*

When you reinvest portfolio assets, spread your investments over different business and invest more in under-represented stocks.

**Analytic evidence:**

90% of the benefits of diversification come from owning just 12-18 stocks.

Protection against market corrections

These rules help us construct a portfolio with the potential to deliver higher dividends and less risk than the overall market. But we believe it’s important to further shield our clients against catastrophic losses, such as those experienced by many investors in 2008.

<table>
<thead>
<tr>
<th>There have been 25 bear markets since 1929. (Defined as 20%+ loss)</th>
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<tr>
<td>That is one bear market every 3.4 years.</td>
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<tr>
<td>The average bear market lasted 10 months and declined 35.4%.</td>
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To manage this risk, we advocate the use of a protective hedge designed to significantly limit downside risk in falling markets. A protective hedge is mathematically designed to limit risk to a pre-determined level.

By hedging against the risk of severe market declines, our investment strategies allow clients to participate in most of the upside of the equity markets while helping to protect their portfolios against devastating losses that occasionally come with investing.
Putting the Rules into Practice

These rules work together in a single strategy that can help investors seek long-term growth from dividend-paying stocks. This strategy seeks to provide investors with a sufficient source of income and provide a degree of protection from the inevitable market downturns.

A portfolio managed with these eight rules will generally have these characteristics:

- **Hold blue-chip stocks** – Focus on established, recognizable names.
- **Limited concentration** – Hold generally no more than 20-30 companies in the portfolio.
- **Diversify across industries** – Avoid the highest yielding stocks to temper overemphasis on certain sectors.
- **Hedge against catastrophic losses** – Using protective hedging instruments helps preserve portfolio values against declines.

About the Post Oak Ultra Blue Chip Dividend Portfolio

The Portfolio seeks to generate total return through long-term capital appreciation coupled with lower volatility and a growing stream of dividend income.

Following the evidence-based rules highlighted in this report, we construct a portfolio comprised predominantly of large-capitalization, U.S.-domiciled, multinational companies. These companies are global leaders in structurally attractive industries. They benefit from increasing global market share, ongoing product introduction and innovation, and productivity enhancements. In addition, their financial strength allows them to make profitable investments at any point during the economic cycle.

We believe these businesses are most capable of generating superior growth in earnings, dividends, and cash flow over time, leading to greater capital appreciation. Investing in high quality companies using these criteria in one cohesive portfolio also produces two additional advantages for our clients—low portfolio turnover and a higher likelihood of capital preservation.
Past performance does not guarantee future results. There is no guarantee that any investment strategy or account will be profitable or will not incur loss.

Investors should consider the investment objectives, risks, charges and expenses that make up this investment strategy carefully before investing. Investing involves risk, including the possible loss of principal. Share price, principal value, and return on investments will vary, and you may have a gain or a loss when you sell your investment.

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Market index performance is provided by a third-party source deemed to be reliable. Indexes are unmanaged and have been provided for comparison purposes only. No fees or expenses have been reflected. Individuals cannot invest directly in an index.

The S&P 500 Index is an unmanaged, market capitalization-weighted index of 500 stocks of leading large cap U.S. companies in leading industries; gives a broad look at the U.S. equities market and those companies’ stock price performance.

The S&P High Yield Dividend Aristocrats Index is designed to measure the performance of companies within the S&P Composite 1500 that have followed a managed-dividends policy of consistently increasing dividends every year for at least 20 years.

The S&P 500 Low Volatility Index measures the performance of the 100 least volatile stock in the S&P 500. The index benchmarks low volatility or low variance strategies for the U.S. stock market. Constituents are weighted relative to the inverse of their corresponding volatility, with the least volatile stocks receiving the highest weights.

Contact Us

For more information about this strategy or the Ultra Blue Chip Dividend Portfolio, please contact a Post Oak representative.

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