River Road Asset Management, LLC

**Investment Perspective**

# Why Dividend All-Cap Value?

December 2016

# EXECUTIVE SUMMARY

In this paper, we explore the benefits of dividend investing, and how we believe an all cap, value-oriented approach can assist in creating a diversified portfolio of stocks offering an attractive combination of lower volatility price appreciation and dividend yield.

### *Why Dividends?*

Dividend investing is not a fad. **Historically, dividend-paying stocks have offered consistent long-term outperformance versus non dividend payers with lower risk**. Therefore, we believe dividend-focused strategies present an attractive solution for investors seeking a combination of capital gains, current income, and inflation-protected growth. Furthermore, we believe that demographic trends and prolonged low interest rates will sustain the alpha generation that has made dividend stocks so compelling in decades past.

### *Why All Cap?*

In our opinion, **an all cap approach creates a sustainable competitive advantage**. A broad investment universe not only allows more flexibility for stock selection, but it also provides access to the higher yields and total returns historically available among mid and small cap dividend payers.

### *Why Value?*

At River Road Asset Management (River Road), we believe that a value focus is necessary for successful fundamental equity investing over the long term. While dividend stocks are often construed as value stocks, **many investors focus solely on the yield and lose sight of the value of the underlying asset, increasing the risk of losses in the future**. The Dividend All-Cap Value (DAV) Strategy is designed to balance yield and value in order to seek an attractive total return.

### *Why Dividend All-Cap Value?*

Leveraging River Road's proprietary Absolute Value® investment approach, **we believe the DAV Strategy presents an innovative, timely solution for investors seeking both capital appreciation and current income**. The name 'Dividend All-Cap Value' describes what we believe are three powerful sources of alpha generation.

Dividend stocks have consistently outperformed the broader market over time and we believe this advantage will continue to be supported by an aging population and relatively low interest rates. Additionally, the Strategy's all cap design leverages River Road's core competency in small cap and undiscovered stocks, greatly expanding the investable universe and creating a key competitive advantage. Lastly, value investing is a time-tested method for outperforming the broader market and provides the necessary discipline to help avoid the valuation traps that are common when investors become desperate in their search for yield.

### *Why Now?*

We expect low global growth, high valuations, and rapidly shifting politics to be a recipe for volatility in the years to come. Interest rates may certainly move higher, but are likely to remain low on an absolute basis over this cycle. Over time, dividend stocks have lagged amid sharp market rallies and periods of rapidly increasing interest rates. However, we do not view either of these scenarios as likely in the near future. Lastly, with valuation distortions an increasing challenge in the dividend universe, especially in the more defensive areas, we believe now is the exact time to avoid passive strategies and their rigid rules in favor of an active strategy that allows for timely adjustments to avoid continuing to invest in unattractively valued sectors.

### *Summary*

In conclusion, **we believe that the combination of River Road's highly active Absolute Value® investment approach and the DAV Strategy's thoughtful portfolio design provides a unique competitive advantage and should sustain the historical success of the Strategy for years to come**.

# WHY DIVIDENDS?

***There are numerous styles of dividend investing…***

Over the last 10 to 15 years, numerous styles of dividend strategies have emerged, including **dividend income**, **dividend growth & income**, and **dividend growth**. In a recent paper titled "Dividend Fund Landscape Report," Morningstar laid out a framework defining these three approaches, with each strategy differing in the level of emphasis it places on current yield.

***…and given their strong track record, they are here to stay!***

| | | Dividend-paying S&P 500 Stocks Equal Weighted | Non Dividend-paying S&P 500 Stocks Equal Weighted | S&P 500 Equal Weighted |
|---|---|---|---|---|
| **Trailing 5 YR** | Avg Anlzd Return | 10.18% | 3.77% | 8.64% |
| | Avg Anlzd Std Dev | 16.32 | 24.22 | 17.25 |
| **Trailing 10 YR** | Avg Anlzd Return | 10.16% | 2.98% | 8.44% |
| | Avg Anlzd Std Dev | 16.39 | 24.42 | 17.36 |

Data shown as of December 31, 2016. Source: River Road Asset Management LLC, FactSet Research Systems Inc., and Ned Davis Research Inc.

While much attention has been focused on the cumulative long-term outperformance of dividend payers, what is often missed is the consistency of that outperformance – supporting our view that **dividend investing is not a fad**. Since 1972, **dividend stocks have significantly outperformed over rolling five- and 10-year periods**. In fact, in the 414 rolling 10-year observations, the equal-weighted index of non-dividend paying S&P 500 stocks outperformed the dividend payers index only **once**. Not only was the return higher, but the **risk was lower**, with the annualized standard deviation of monthly returns for dividend payers consistently less than for non payers.

***We believe demographics will sustain demand…***

**As the saying goes, "demographics is destiny," and there is reason to believe that demographics will remain favorable for dividend-focused strategies in the future.** As the average life expectancy continues to march higher, Baby Boomers should consider a higher allocation to equities in their retirement funds than did their parents. Additionally, **with interest rates well below the historical norm, they will need to focus that equity investment on dividend strategies** which can provide a vital opportunity for capital gains, current income, and inflation-protected growth.

**We believe that demographics and low interest rates will sustain the alpha generation that has made dividend stocks so attractive in decades past.**

***…and interest rates will likely remain relatively low over this cycle***

Looking at long-term interest rates in the United States, it is clear that investors are discounting the Federal Reserve's tightening bias and expect that interest rates will remain relatively low in the years to come. Even with the recent surge in long-term rates, the 10-year U.S. Treasury yield remains well below the 5.9% average since 1953. This is likely an acknowledgement of the severe headwinds that a steep rise in rates would pose for the federal budget, economic growth, and corporate earnings. By our estimate, **a mere +100 bps increase in the federal government's borrowing cost would increase the $534 B budget deficit by more than $200 B**. Additionally, further monetary tightening would only exacerbate the already stark contrast to the monetary policies of both the European Central Bank and Bank of Japan, fueling further dollar strengthening and ultimately weighing on corporate profits. In the end, it appears that, absent a period of robust economic growth or a sharp upward revision in inflation expectations, the high point of this interest rate cycle will likely be below the long-term average.

# WHY ALL CAP?

***Historically, an all cap approach boosts the size of the investable universe and the yield potential***

| | # of Companies (> 2% Yield) | Wtd Avg Yield |
|---|---|---|
| Mkt Cap < $2 B | 392 | 6.52% |
| $2 B < Mkt Cap < $15 B | 417 | 5.04% |
| Mkt Cap > $15 B | 238 | 4.01% |

Data shown as of December 31, 2016. Universe: U.S. listed equity; TTM yield > 2%; mkt cap > $300 MM. Source: River Road Asset Management LLC and FactSet Research Systems Inc.

There is a very common misperception that the dividend universe is dominated by large cap, multinational companies. In fact, the dividend universe, which we define as equities with a yield greater than 2%, contains three to four times as many small and mid cap stocks as large. We have long noted that the **smaller cap segment of the dividend universe also consistently offers a yield premium**. Additionally, an all cap approach opens significant opportunities among various **high-yielding equities including Master Limited Partnerships** and **Real Estate Investment Trusts**, which we believe can play a significant role for investors in meeting their yield objectives.

**The larger investable universe provides more opportunities to execute against all of our investment objectives <u>without compromise</u>**. In 2008 - 2009, the number of firms in the S&P 500 that grew or initiated a dividend shrank by nearly half. A large cap dividend strategy focused on investing in dividend growth would likely have found this a tough environment in which to populate a diversified portfolio. More recently, tremendous flows into dividend-oriented strategies, both active and passive, have driven the prices higher on a number of large cap dividend stalwarts and left their valuations stretched in the process. Without the flexibility to move into smaller, less impacted stocks, we believe investors will find they suffer unduly when those flows reverse.

**River Road's all cap approach creates a sustainable competitive advantage that allows more flexibility for stock selection and the ability to tap into the higher yields and greater total returns historically available among mid and small cap dividend payers.**

***Most importantly, an all cap approach also historically enhances the <u>expected total return</u>***

In November 2016, Financial Analysts Journal published an article titled "What Difference Do Dividends Make?" Given the extensive academic literature and market experience demonstrating the value added by dividend stocks, it was unsurprising that their conclusions were very positive. However, the authors dug a bit deeper than past investigations, showing that not only have dividend-paying companies offered high returns at lower risk, but also that **small cap and mid cap dividend payers offered higher risk-adjusted returns than their large cap peers**. This supports our belief that dividend managers gain a clear advantage by adding an all cap tilt to a strategy.

# WHY VALUE?

***We believe a fundamental, value-driven strategy is key to identifying opportunity…***

Put simply, **value investing works**. Numerous academic studies conducted over decades past support the assertion that value is one of the few factors that drive outperformance over time. Not only does a fundamental-driven, value discipline make sense in broader application, but we believe it is especially vital in a dividend strategy. First, a fundamental approach supports dividend investors in their most important effort – **identifying companies that can not only sustain, but also grow, their dividend payments**. Sometimes a company has a high yield because the stock trades down as investors anticipate that the current dividend cannot be sustained. Secondly, in today's low rate environment, investors are desperately searching for yield and without value as a guide, they are all too prone to overpay. A value discipline not only allows for an initial margin of safety, but it also supports the other, and perhaps more important, component of total return, capital gains. **Few stocks can provide an adequate total return through yield alone**.

***…and providing the impetus to move on***

Not only does a fundamentally-driven value strategy help identify attractive opportunities to buy, but it **also serves as an important gauge of when it is time to move on**. One of the unique issues faced by dividend investors is the risk that they will rest on their laurels with big winners, especially if the gains are long term, held in place by their "yield on cost." **While it can be great fun to look at the dividend payment received as a percentage of cost, this sort of thinking can be a trap**. From a financial standpoint, the only numbers that matter are the current yield and the expected total return going forward. Holding on to an overvalued security not only introduces higher risk, but it also makes it less likely that the expected capital gains will be sufficient to produce an attractive total return.

**At River Road, we believe that a value discipline is necessary for successful fundamental investing. While dividend stocks are often construed as value stocks, many investors mistakenly focus solely on the yield and lose sight of the value of the underlying asset, creating risk of losses in the future. The DAV Strategy is designed to balance yield and value in order to seek an attractive total return.**

# WHY DIVIDEND ALL-CAP VALUE?

### *Dividend All Cap Value leverages River Road's Absolute Value® philosophy…*

**The DAV Strategy leverages River Road's Absolute Value® philosophy and is specifically designed to take advantage of three powerful sources of alpha generation – dividends, all cap and value**. Not only does this philosophy tend to steer us away from 'dividend traps' – firms that have a high, and likely unsustainable yield – but it also requires that we acknowledge when a stock is overvalued and sell the position despite the fact that the yield is attractive. Our value discipline is a key component, helping provide an opportunity to get the capital gains necessary to meet our total return objective. Our philosophy is to seek yield where we believe it can grow and where it is cheap and sell when the yield is threatened or the stock becomes expensive, thus creating the opportunity for outperformance.

### *…to achieve historically superior risk-adjusted results*

Dividend-focused investing is fraught with dividend traps and investors can find themselves lured into one, investing in a stock with an unusually high yield only to find that the payment cannot be sustained. **We believe that our investment philosophy and processes help us identify and avoid these traps** – a key role of active dividend managers and one that is difficult to replicate with the types of simple rules that often underpin passive, index-based strategies. **When a holding does not perform as expected, the loss control aspect of our sell discipline takes over**, pushing the portfolio managers to address the issue and reduce the position. We believe this is why the Strategy has proven itself not only against the Russell 3000 Value benchmark, but against the FTSE High Dividend Index as well.

We are especially pleased with our risk-adjusted returns as the Strategy tends to shine when the market is in decline. Breaking down rolling five-year returns monthly since inception and comparing results to the Russell 3000 Value return in down, normal, and strong markets, **the DAV Strategy has consistently outperformed in down and normal markets**. In fact, DAV has yet to post a negative five-year annualized return since inception (gross and net of fees). Interestingly, the Strategy has also managed to outperform modestly (gross of fees) when the index return was strong (>10% annualized). This is exactly the sort of risk/reward we believe should be expected from a well-managed dividend strategy.

| Five-year Index Return | Down Market < 0% | Normal Market 0 to 10% | Strong Market > 10% |
|---|---|---|---|
| DAV Composite Avg Return (Gross) | 3.84% | 7.49% | 15.47% |
| DAV Composite Avg Return (Net) | 3.12% | 6.75% | 14.69% |
| Russell 3000 Value Avg Return | -1.65% | 3.61% | 15.42% |
| # of months of outperformance (Gross) | 33 | 32 | 19 |
| DAV outperformance (Gross) | 100% | 100% | 54% |

Annualized rolling five-year performance data shown gross and net of fees. DAV Strategy inception: October 1, 2003. Outperformance and count data shown gross of fees. Data shown as of December 31, 2016. Source: River Road Asset Management LLC, FactSet Research Systems Inc. and Russell Investment Group. Past performance is no guarantee of future results. Please see appendix for additional disclosures.

### *Passive dividend strategies still struggle to catch on…*

According to Morningstar, it is estimated that passive strategies have reached approximately **37%** share in the broader market. However, passive dividend strategies have grown from 2% market share in 2007 to only **18%** in 2016. **Despite the tidal shift toward passive in the industry and ample supply of passive dividend vehicles, it appears that investors continue to favor active solutions in the space**. One would think that passive strategies would be able to replicate the key characteristics that make dividend investing attractive, but the market suggests otherwise.

### *…perhaps because they failed investors so severely in 2009!*

While passive dividend strategies have performed well as interest rates have declined in recent years, one should recall that heavy exposure to Financials led many to significantly underperform in Q1 2009. Amid massive losses and federal bailouts it was clear that dividend payments for many firms were going to be substantially cut or eliminated, yet **passive dividend strategies remained locked into these positions because of the rules governing their construction**. Despite the relative long-term safety of dividend investing in general, passive dividend strategies largely failed to deliver when they were needed most! Looking at the 11 U.S. dividend ETFs that existed at that time and have more than $1 B in assets today, only one outperformed as the S&P 500 declined -24.6% from December 31, 2008 to the March 9, 2009 bottom. **<u>In fact, six of these ETFs underperformed by more than -1,000 bps in this short period!</u>**

**U.S. Dividend ETF Performance**

| | | Performance 12/31/2008 to 3/9/2009 | Relative Performance vs. S&P 500 |
|---|---|---|---|
| | ***S&P 500*** | ***-24.63%*** | |
| VIG | Vanguard Dividend Appreciation ETF | -23.89% | +0.74% |
| FVD | First Trust Value Line Dividend Index Fund | -28.79% | -4.16% |
| DLN | WisdomTree LargeCap Dividend Fund | -30.13% | -5.50% |
| VYM | Vanguard High Dividend Yield ETF | -31.73% | -7.10% |
| SDY | SPDR S&P Dividend ETF | -32.66% | -8.03% |
| DON | WisdomTree MidCap Dividend Fund | -34.88% | -10.25% |
| DVY | iShares Select Dividend ETF | -36.38% | -11.75% |
| DHS | WisdomTree High Dividend Fund | -38.96% | -14.33% |
| FDL | First Trust Morningstar Dividend Leaders Index Fund | -40.41% | -15.78% |
| DES | WisdomTree SmallCap Dividend Fund | -42.62% | -17.99% |
| PEY | PowerShares High Yield Equity Dividend Achievers Portfolio ETF | -47.30% | -22.67% |

Source: River Road Asset Management LLC, etfdb.com, and FactSet Research Systems Inc.

# WHY NOW?

***We expect low global growth, high valuations, and rapidly shifting politics to be a recipe for volatility***

Between the change of leadership in the United States, key elections throughout Europe, the Brexit negotiations, and conflict throughout the Middle East, there are ample opportunities for event risk that could shake Wall Street's complacency in the months to come. Coupled with below-trend growth across much of the globe and relatively expensive markets, it is little surprise that we expect volatility to be elevated. Fortunately, **dividend stocks in general, and DAV in particular, have historically outperformed in such periods**.

***Interest rates may move higher, but are likely to remain low***

Interest rate concerns have been front and center for income-oriented investors since the first discussions of tapering of the Fed's quantitative easing program in 2013. In 2015, the federal funds rate was increased for the first time since it was taken to zero in 2008. Despite these concerns and the increase in short-term rates, the yield on 10-year U.S. Treasury has remained at relatively low levels over the past two years. **The U.S. is largely alone in its tightening stance** and yields on sovereign debt have slipped into negative territory in numerous markets. To the extent that Donald Trump and Congress try to ignite economic growth with increased deficit spending there will be upward pressure on interest rates. However, the cost of servicing the nearly $20 T in federal debt is already staggering. **Unless they want to fuel a vicious cycle of higher deficits and higher interest rates, they will likely rely more heavily on reducing regulations, revenue-neutral corporate tax reform, and other pro-growth approaches**.

***Dividend stocks have lagged amid sharp market rallies and rapid interest rate increases***

We noted above the strong long-term track record of dividend payers versus non-dividend payers. This provides great support for the attractiveness of dividend-based strategies, but it is fair to note that this record does not always hold over shorter periods. In nearly 10% of the rolling five-year periods since 1972, non-dividend paying stocks in the S&P 500 outpaced the dividend payers. The occurrences of this underperformance were episodic in nature including the late 1970s, the internet bubble, and a short span ending in 2007. This supports our assertion that dividend stocks should be expected to struggle in periods characterized by rapid increases in interest rate expectations or overzealous equity markets. **However, we do not view either of those scenarios as likely in the near future**.

***With valuation distortions in the dividend universe, now is the exact time to avoid passive strategies***

**Market pundits have finally noticed that the persistence of low interest rates has led to distortions in the dividend universe as investors struggle to replace lost bond income**. We long ago noted we were concerned about broader valuations in REITs, MLPs, and Health Care, and more recently Utilities and Consumer Staples. The concern is that individual investors have focused on yield with little consideration for the premium they are paying for the underlying stock and quantitative strategies have chased and amplified this momentum. Within the DAV universe, not only have Consumer Staples and Utilities joined Health Care among the most expensive sectors, but the median yield in the two sectors is now well below that of the broader universe – this is not a particularly attractive combination. **Our Absolute Value® philosophy generally prompts us to sell such situations and look for attractive opportunities elsewhere**. Unlike many passive strategies, an active strategy can make such adjustments promptly, and avoid continuing to invest heavily in these sectors despite the increasingly obvious dislocation. Even if the Consumer Staples and Utilities sectors do not experience significant mean reversion in the near term, the likely return investors should expect in these low growth sectors over the next five to 10 years is now quite unattractive.

**Dividend All-Cap Value Universe Summary Statistics**

| | | Median | | | |
|---|---|---|---|---|---|
| GICS Sector | # | Yield - TTM | P/E[1] | Dividend Growth | 2016 Total Return |
| Real Estate | 168 | 4.2% | 26.2x | 5.0% | 19.1% |
| Consumer Staples | 49 | 2.9% | 23.0x | 3.9% | 17.2% |
| Health Care | 33 | 3.1% | 22.2x | 2.1% | -1.7% |
| Utilities | 80 | 3.3% | 20.9x | 4.5% | 20.0% |
| Industrials | 84 | 2.7% | 20.6x | 3.9% | 35.2% |
| Information Technology | 61 | 2.7% | 19.4x | 1.3% | 23.0% |
| Materials | 66 | 3.3% | 19.1x | 0.3% | 61.2% |
| Financials | 214 | 3.1% | 18.1x | 3.4% | 33.4% |
| Consumer Discretionary | 114 | 3.3% | 16.6x | 3.8% | 13.9% |
| Telecommunication Services | 33 | 3.9% | 15.5x | 0.0% | 11.3% |
| Energy | 142 | 5.9% | 12.7x | 1.3% | 28.9% |
| **Total** | **1,044** | **3.5%** | **19.5x** | **3.4%** | **26.4%** |

Performance is shown gross of fees as of December 31, 2016. DAV investable universe is all stocks trading on the NYSE, NASDAQ, or NYSE Amex with at least a 2% TTM dividend yield and $300 MM market capitalization. All universe data is equal-weighted and rebalanced monthly; stocks classified monthly. TTM yield represents dividends paid over the trailing 12-month period. [1]Includes negative earnings. Source: River Road Asset Management LLC and FactSet Research Systems Inc. Past performance is no guarantee of future results. Please see appendix for additional disclosures.

# CONCLUSION

Built upon River Road's proprietary Absolute Value® investment approach, we believe the DAV Strategy presents an innovative, timely solution for investors seeking both capital appreciation and current income. The name 'Dividend All-Cap Value' describes what we believe are three powerful sources of alpha generation.

Dividend stocks have consistently outperformed the broader market over time and we believe this advantage will continue to be supported by an aging population and relatively low interest rates. Additionally, the Strategy's all cap design leverages River Road's core competency in small cap and undiscovered stocks, greatly expanding the investable universe and creating a key competitive advantage. Lastly, value investing is a time-tested method for outperforming the broader market and provides the necessary discipline to help avoid the valuation traps that are common when investors become desperate in their search for yield.

In conclusion, **we believe that the combination of River Road's highly active Absolute Value® investment approach and the DAV Strategy's thoughtful portfolio design provides a unique competitive advantage and should sustain the historical success of the Strategy for years to come**.

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The U.S. dollar is the currency used to express performance and performance includes the reinvestment of income. Inception Date DAV: October 1, 2003. The composite contains fully discretionary accounts that seek to provide long term capital appreciation and high current income by investing primarily in a diversified, all cap basket of income producing equity securities that trade at a discount to our assessed valuation as determined using RRAM's proprietary Absolute Value® approach. The composite is primarily invested in dividend-paying common stocks. The composite may also be invested in a broad range of foreign stocks, publicly traded partnerships, convertible preferred stocks, Real Estate Investment Trusts ("REITS"), investment companies, and royalty income trusts. RRAM employs a value-driven, bottom-up approach. The official benchmark for the composite is the Russell 3000 Value.

As of December 31, 2016, net of fees returns for the Dividend All-Cap Value Composite are as follows for the month, QTD, YTD, 1 year, 3 year, 5 year, 10 year, and Inception to Date periods: 2.08%, 6.68%, 20.75%, 20.75%, 8.35%, 13.10%, 7.48%, and 11.06%. As of December 31, 2016, returns for the Russell 3000 Value are as follows for the month, QTD, YTD, 1 year, 3 year, 5 year, 10 year, and Inception to Date periods: 2.63%, 7.24%, 18.40%, 18.40%, 8.55%, 14.81%, 5.76%, and 8.81%.

Performance presented prior to April 1, 2005 occurred while the original members of the Portfolio Management Team were affiliated with a prior firm and those Portfolio Management Team members were the only individuals primarily responsible for selecting the securities to buy and sell. A review of this track record for compliance with portability requirements of the GIPS® standards was conducted by Ashland Partners & Company.

Sector, Industry Group, Industry, or Sub-industry group levels are provided from the Global Industry Classification Standard ("GICS"), developed and exclusively owned by MSCI, Inc. ("MSCI") and Standard & Poor's Financial Services LLC ("S&P"), unless otherwise stated that they have been reclassified or classified by RRAM. Reclassifications/classifications by RRAM are not supported by S&P or MSCI. All GICS data is provided "As Is" with no warranties. RRAM does classify securities that are not automatically classified by MSCI and S&P.



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