AlphaQuant
Engineered for Alpha

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Dividend Investing Strategy Framework

Executive Summary

- The total return that a stock investor can earn is made of two components: price appreciation and dividend income. Over the long-term, reinvested dividends are a key factor to growth and preservation of wealth. Over the three decades between 1990 and 2020, on average, dividends comprised about 50% of total return of the S&P 500.
- Generally, while share prices fluctuate in response and anticipation of market and company-specific events, the dividend component tends to be more stable as companies' decision to pay dividends is based on their long-term expectations of cash flows. This is particularly evident for companies with a long history of paying a dividend.
- Selecting stocks based simply on dividend yield is a risk investors encounter when selecting income stocks. Paradoxically, the very high dividend yield is often a sign of distress and a potential signal of an impending dividend cut or omission.
- In structuring dividend-oriented strategies AQM focuses on the sustainability of dividend growth and its fundamental drivers: established dividend policy as reflected in a long history of increasing dividends; business stability supported by steady earnings; financial strength as evidenced by liquidity and high creditworthiness; and adequate dividend coverage.
- AQM has designed a strategy that balances dividend growth and yield, aiming to generate a dividend yield of approximately 1.5-2x the yield of S&P 500. The strategy is also well-represented across industries and sectors to reduce industry concentration risk and provide enhanced diversification.

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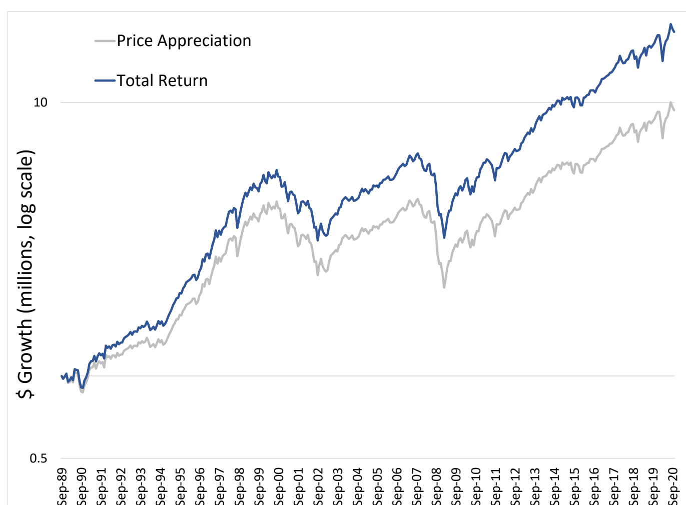
The Importance of Dividends

The total return that a stock investor can earn is made of two components: price appreciation and dividend income. Generally, while share prices fluctuate in response and anticipation of company-specific and market events, the dividend component tends to be more stable as companies' decision to pay dividends is based on their long-term expectations of cash flows. This is particularly true for companies with a long history of paying a dividend.

To understand the importance of dividends to investor returns, Figure 1 graphs the hypothetical growth of $1M invested in October 1989 through September 2020 in the S&P 500. The price appreciation-only index (light grey line) grew from $1M to over $9M which corresponds to a compounded average return of 7.5%. The total return index (dark blue line) grew to over $18M which corresponds to a CAGR of 9.7%.

FIGURE 1. S&P 500: Price vs. Total Return Growth of $1 million (log scale)

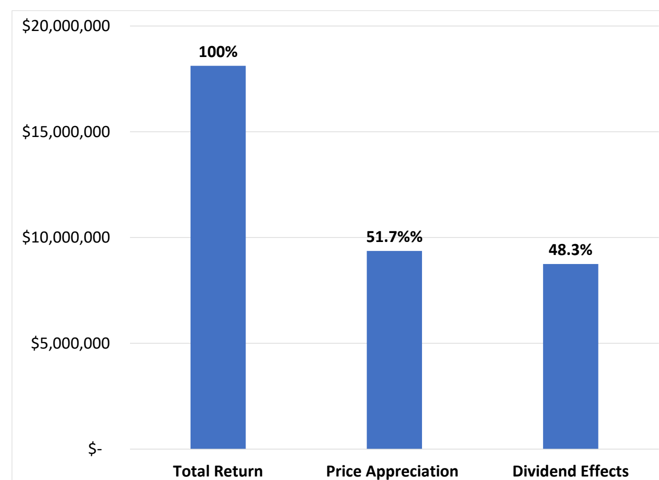


Source: S&P Dow Jones. As of 9/30/2020.

Such a significant growth differential is the result of two important interacting effects: a) dividends directly contribute to total return; b) dividend income reduces overall stock and portfolio volatility and in periods of falling market prices dividends are the only positive contribution to investor returns. Thus, reinvested dividends over the long-term are key factor to growth and preservation of wealth.

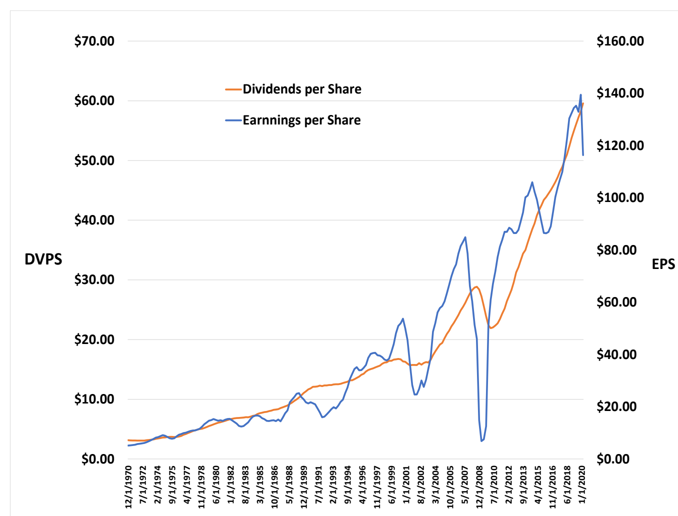
Figure 2 breaks-down the S&P 500 total return in price appreciation and dividend contribution. Over the period under study, dividends comprised almost 50% of total cumulative return.

FIGURE 2 Contribution of Dividends to Total Return



Source: Dow Jones. As of 9/30/2020.

FIGURE 3. Earnings and Dividends – S&P 500



Source: S&P Dow Jones. As of 9/30/2020.

The inherent stability of dividends throughout the business cycle and the ever-changing economic backdrop contrasts with the cyclicality of earnings which drives stock prices (see Figure 3).

This dividend persistence can mitigate the negative impact of recessions and bear markets on investors' wealth and help to build more resilient portfolios.

Designing a Dividend Strategy

Selecting stocks based simply on dividend yield is a risk investors encounter when selecting income stocks. Paradoxically, the very high dividend yield is often a sign of distress and a potential signal of an impending dividend cut or omission. AQM believes that a dividend strategy should focus on the sustainability of dividend growth and its fundamental drivers. Based on AQM research, companies with long history of increasing dividends are more likely to continue to do so in the future. Commitment to pay a dividend imparts discipline to company management's capital allocation process. Thus steadily growing dividends may be a sign of a well-managed company with confidence in its future growth.

A long history of paying dividends does not guarantee future dividend growth, though. Several events may adversely impact companies' future dividends. For example, during business cycle downturns reduced cash flows may force companies to cut the dividend in order to preserve cash. Increasing government regulation on certain industries may impact companies' profitability and therefore limit dividend distributions.

In some cases, in order to retain dividend-seeking investors, some companies stretch their finances to maintain their dividend to the point where their financial flexibility, their growth options - and their dividend - are compromised. To address these risks, AQM incorporates additional factors in its dividend strategy.

Dividend coverage, defined as earnings-to-dividend ratio, measures how well earnings "cover" the dividend and thus provides one metric to evaluate dividends' sustainability.

The recognition that debt obligations need to be paid before dividends reminds us of the discretionary nature of dividends and highlights the importance of evaluating companies' financial strength and creditworthiness in conjunction with their dividend growth and policy.

Companies with strong financials and high creditworthiness are more likely to have far greater access to sources of low-cost short-term credit and to respond to an unanticipated decline in cash flows by increasing their short-term borrowing. Access to capital markets during periods of distress allow these companies to endure challenging economic environments and are better positioned to maintain their dividend.

Thus far we have identified the fundamental drivers of sustainable dividend growth: an established dividend policy reflected in a long history of increasing dividends; business stability supported by steady earnings; financial strength as evidenced by liquidity and high creditworthiness; and adequate dividend coverage. Figure 4 illustrates the portfolio selection process flow to support this dividend strategy.

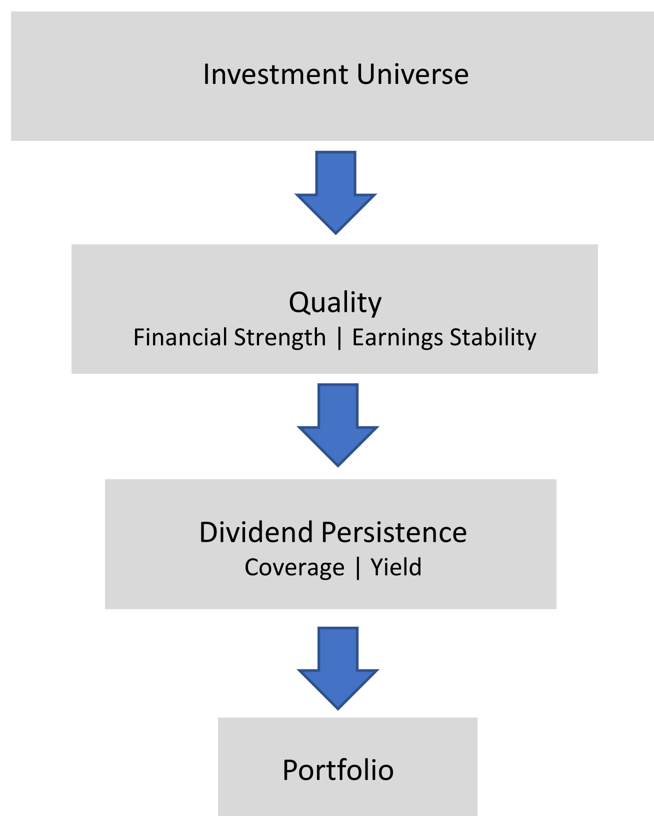
The sequence reflects the fundamental thinking:

1) Select financially strong stocks with a proven record of dividend growth and earnings;

2) Select stocks with an attractive combination of dividend coverage and yield;

3) Apply a sector-relative method to achieve adequate diversification.

FIGURE 4. Strategy Process



Source: Alpha Quant Models

Through a process that balances dividend growth and yield, the resultant strategy is designed to generate a dividend yield of approximately 1.5-2x the yield of the S&P 500. The strategy is also well-represented across industries and sectors to reduce industry concentration risk and provide enhanced diversification.

Massimo Santicchia is a Co-Founder and Managing Member of Alpha Quant Models LLC. Massimo has over 20 years of investment experience including: CIO at Alpha Quant Advisors, CIO at Cypress Trust Company, and VP of Investment Strategy at S&P Investment Advisory Services LLC. His expertise encompasses fundamental, quantitative analysis, portfolio management and investment strategy development.

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