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HOW TO INVEST IN DIVIDEND EQUITIES NOW

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THE RIGHT STRATEGY CAN MAKE A DIFFERENCE AS COMPANIES CUT THEIR DIVIDENDS.

Companies globally are slashing dividend payments as they face a combination of declining revenues and regulatory measures discouraging dividend payments. Not surprisingly, companies are now prioritizing liquidity and solvency over returning capital to shareholders. We think investors can alleviate this problem with an investment approach that addresses two key aspects of dividend investing that can help maintain healthy dividend yields, even in this environment.

DIVIDEND OUTLOOK: DIFFICULT BUT NOT DIRE

The sharp drop in economic activity has significantly worsened the cash flows of several companies, making it difficult for them to sustain dividend payments. Further, regulators have been encouraging companies, in particular banks, to curtail dividends and support the broader economy and restricting companies benefitting from government liquidity programs from paying dividends. As a result, investors are bracing for dividend cuts, with dividend futures as of April indicating cuts of 20% for companies in the S&P 500 Index and 40% for companies in the Eurostoxx 50 Index by the end of 2020.

The degree of dividend cuts is likely to differ across sectors, regions and companies, depending on their sensitivity to economic decline and the regulatory measures. The challenge is that companies that have historically been reliable dividend payers over the years — such as those in the energy, financial, consumer discretionary, and industrials sectors — are particularly susceptible to the deterioration in the underlying business prospects and/or the impact of regulatory measures. These sectors contributed half of the income received from MSCI World Index prior to the onset of the coronavirus crisis. Since then, a large majority of companies that have cut their dividends within the MSCI World Index are concentrated in those sectors.

This may sound altogether dire for investors looking to dividend strategies for both income and total returns. However, we believe that dividends can be a steady source of investor return, even during times of stress. A thoughtful approach to portfolio design can help dividend investors navigate the current environment and achieve their income and return objectives.

For investors looking to maintain a healthy level of dividend income, we have two key recommendations: 1) diversify the source of dividends across sectors, regions and individual companies and 2) integrate a view of company's ability to sustain and grow dividends by looking at its quality.

DIVIDEND DIVERSIFICATION

Traditionally, in order to achieve income objectives, dividend strategies have focused on the high income payers. High-dividend payers tend to be concentrated in mature industries, so certain sectors and regions tend to have higher payouts than others. This results in significant concentration of sector and regional bets that adds to the risks but not necessarily to the returns.

Relying heavily on one or two sectors for dividends can expose investors to significant risks. This was the case during the 2008 global financial crisis, when financial companies cut dividends by about 60%. In the current environment as well, two-thirds of dividend yield for high income payers comes from four sectors where dividends are most at risk and have significantly underperformed.

We believe that there is no need to take significant sector biases in a dividend strategy as higher dividend yield relative to that of the cap–weighted index can be achieved through an efficient dividend strategy that sources its income from all sectors. Dividend payers exist across sectors and a more balanced approach to dividend investing can help avoid the unintended risks of sector biases that may be helpful in the short term but are uncompensated over the long run.

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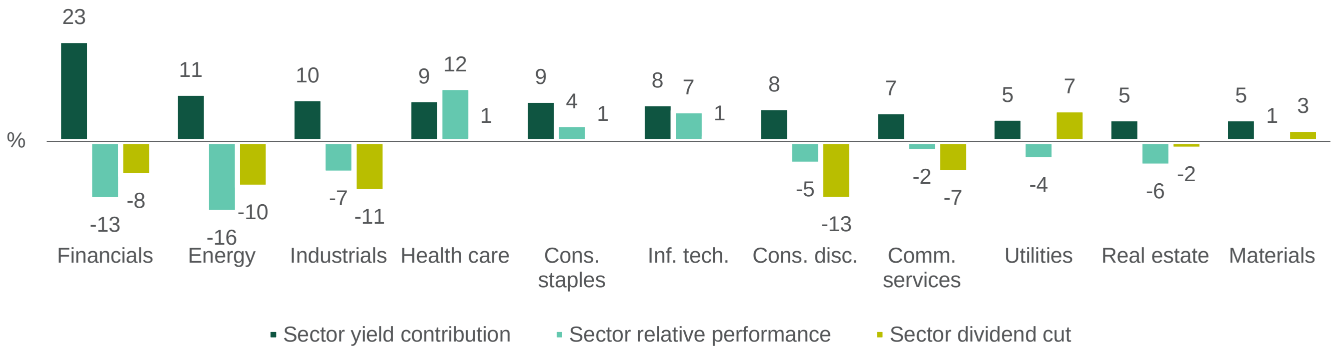
EXHIBIT 1: SECTOR CONCENTRATION IN DIVIDEND PAYERS

Relying heavily on high yield sectors such as financials, energy , industrials and consumer discretionary has proven detrimental to yield and performance.



SOURCE: Northern Trust Asset Management, dividend payers in MSCI World Index, dividend contribution as of April 30, 2020, performance and dividend cuts (indicated annual dividend) from January 31, 2020 to April 30, 2020.

In a similar manner, dependence on specific regions for dividends can prove destabilizing. On a global basis, dividends have historically remained stable. However, there can be significant regional variations. In 2015, emerging markets and Europe ex-U.K. dividends declined by 10% and U.K. dividends fell 22%. However, higher dividends in North America and Asia counterbalanced these declines, resulting in only a 2% decline in global dividends for the year.

Historically, Europe tends to have higher yields than other regions, so a number of dividend strategies are significantly overweight to Europe. For global dividend strategies, reliance on the European region for dividends had resulted in underperformance over last decade as European equities lagged U.S. equities. In this environment as well, dividends cuts have been deepest in Europe on account of local regulatory measures and the economic deterioration.

Over the long run, it is evident that the regional bias has added to the risks but not to the returns. In summary, a high income portfolio that avoids unintended sector and regional biases and diversifies its sources of income is essential to avoid the adverse impact of dividend concentration in the portfolio. The lower the concentration to the source of income, the lesser the dividends are at risk.

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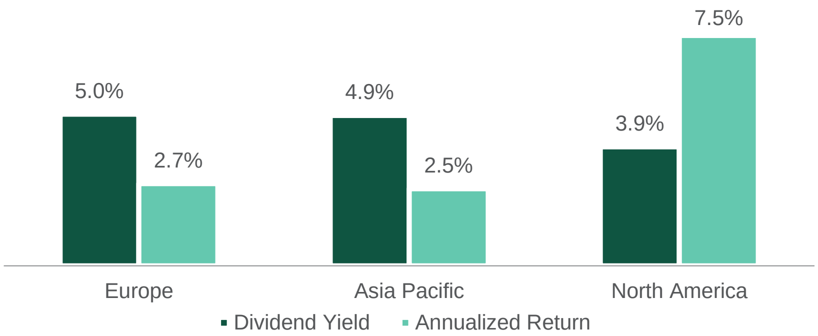
EXHIBIT 2: EUROPE: HIGH YIELD BUT LOWER RETURNS

European high dividend-paying stocks have higher yield but have lagged in return over the last 10 years.



SOURCE: Factset, MSCI. March 2010 to March 2020, MSCI World Index.

For companies in the top decile of dividend yield, their one-year forward dividend yield is 75% lower than their one-year trailing dividend yield, indicating that a number of them are yield traps.

QUALITY: KEY TO DIVIDEND SUSTAINABILITY

Successful dividend investing has always been about identifying companies who can consistently pay and grow dividends over the long-term. In other words, seeking out dividend payers without considering future ability to maintain them is akin to buying high yield debt without considering its default likelihood.

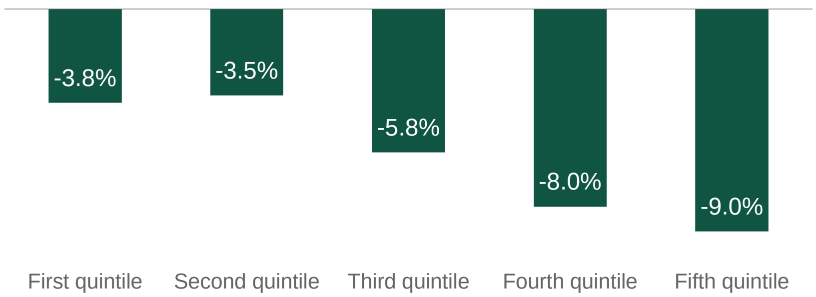
Many times, higher yield is the result of a price decline. Seemingly cheap high-yielding stocks may be yield traps, as their attractive yield is the result of markets pricing in their impaired fundamentals such as lower sales, profits and cash flows. It has been observed that such price declines generally precede dividend cuts. For example, for companies in the top decile of dividend yield, their one-year forward dividend yield is 75% lower than their one-year trailing dividend yield, indicating that a number of them are yield traps.

We believe that investors should take a holistic view to judge sustainability of dividends and avoid yield traps. They should focus on high quality companies, looking at companies' management efficiency, profitability, and cash flows to help determine financial sustainability.

In comparison to peers, high quality companies tend to be more profitable, have more conservative balance sheets and generate higher cash flows, all which are important to protecting a company's dividend relative to peers during times of stress.

EXHIBIT 3: QUALITY AND DIVIDEND CUTS

The highest quality companies (first and second quintiles) have cut dividends less severely than the lower quality companies.



SOURCE: Northern Trust Asset Management, FactSet, January 31, 2020 to April 30, 2020 Average dividend per share reduction sorted in quality quintiles for MSCI World Index. Dividend per share for an equally weighted portfolio in each quintile.

When investing in any strategy, we feel it is essential to focus on the areas where investors are getting paid to take risks, and avoid taking risks where investors are not getting paid.

CONCLUSION: DESIGN IN DIVIDEND STRATEGIES MATTERS

Dividend investing has been popular for decades, and has only become more so in recent times as yields from fixed income markets have continued their secular decline and economic growth expectations have shrunk. However, not every dividend strategy will meet the investor's expectations, as we are in an environment that will separate the wheat from the chaff, when it comes to dividend payers.

In our dividend strategies, we diversify income sources and avoid heavy reliance on certain sectors or regions. We focus on high quality companies because our research shows their dividends tend to be relatively more sustainable during times of stress. When investing in any strategy, we feel it is essential to focus on the areas where investors are getting paid to take risks, and avoid taking risks where investors are not getting paid. This philosophy applies particularly well to high-dividend yielding strategies.

PUT OUR EXPERTISE TO WORK FOR YOU

For more information, please contact your Northern Trust Relationship Manager or the NTAM Investment Institute Portfolio Construction Experts at (855) 645-8303 or NorthernSolutionsGroup@ntrs.com