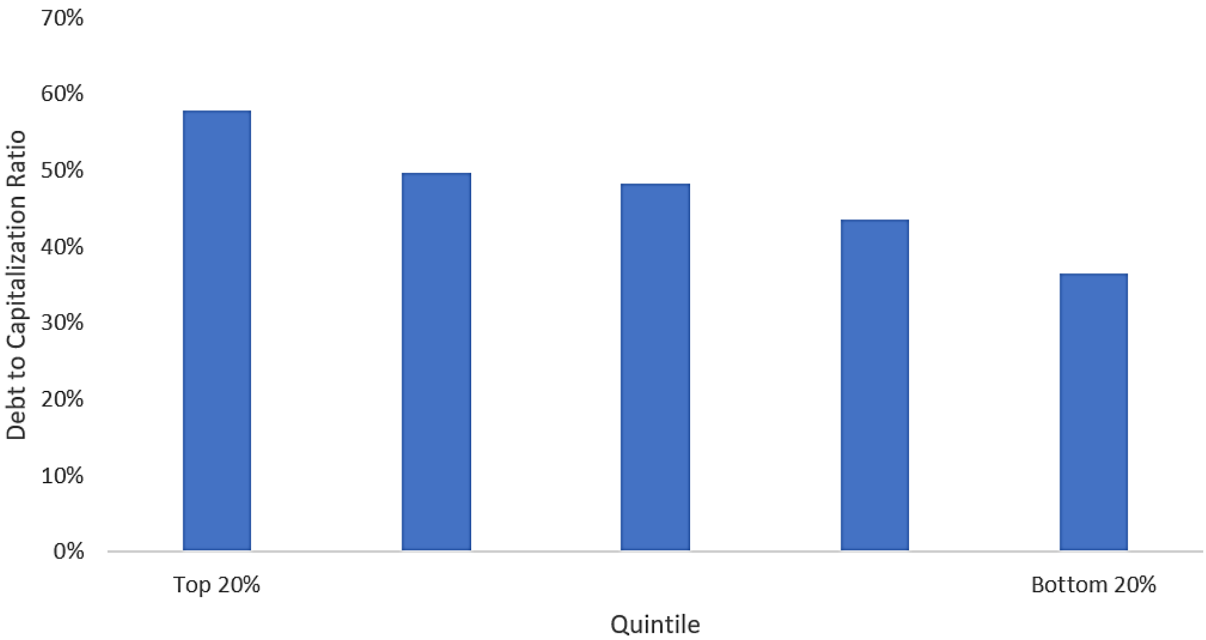
Balancing Yield

The Lead | September 2023

Russell 1000® Value Leverage Ratio by Dividend Yield (excluding financial services)



Grouped by quintile of yield high to low as of July 31, 2023. Financial services sector excluded for comparability purposes. Source: Bloomberg L.P.

On December 1, 2022, Bloomberg's survey of seventeen market strategists forecasted that the S&P 500® Index would end 2023 right around 4,000, a modest 4.0% above 2022. While we are just over halfway through the year, the S&P 500 closed at 4,589 at the end of July, generating over 20% total return. Where do we go from here? We find trying to predict the future can be challenging, so we try to stick to what we know. One important component in generating total returns for clients is the contribution for dividends, regardless of how we end the year. As the Ned Davis Research table to the right highlights, dividend-paying stocks generated over 9.0% total return per year versus just over 4.0% per year from non-dividend paying stocks.

The chart on the top of this page shows the debt/capitalization ratio (a form of leverage ratio) for Russell 1000® Value Index members by dividend yield, bucketed in 20% increments from high to low. We did not include financial services companies for the sake of comparison. For perspective, the top 20% of yielders had a median yield of 5.1% while the bottom 20% had a median yield of 0.7%.

The main takeaway from this chart in our assessment is the increased balance sheet leverage that correlates with higher dividend yield. For many companies, the cost of this leverage is rising with interest rates, potentially placing pressure on cash flows to pay future dividends as interest expense may take a greater share of corporate cash flow.

Portfolio Performance Statistics Analysis Dates: 1973-01-31 - 2023-07-31		
Portfolio	Gain/Annum %	Growth of $100
Dividend Growers & Initiators	10.3	13855.2
All Dividend-Paying Stocks	9.2	8569.8
Dividend Payers w/No Change in Dividends	6.7	2677.8
Dividend Cutters & Eliminators	-0.7	70.7
Non-Dividend Paying Stocks	4.3	830.8
S&P 500 Geometric Equal-Weighted Total Return	7.8	4390.4

Source: Ned Davis Research.

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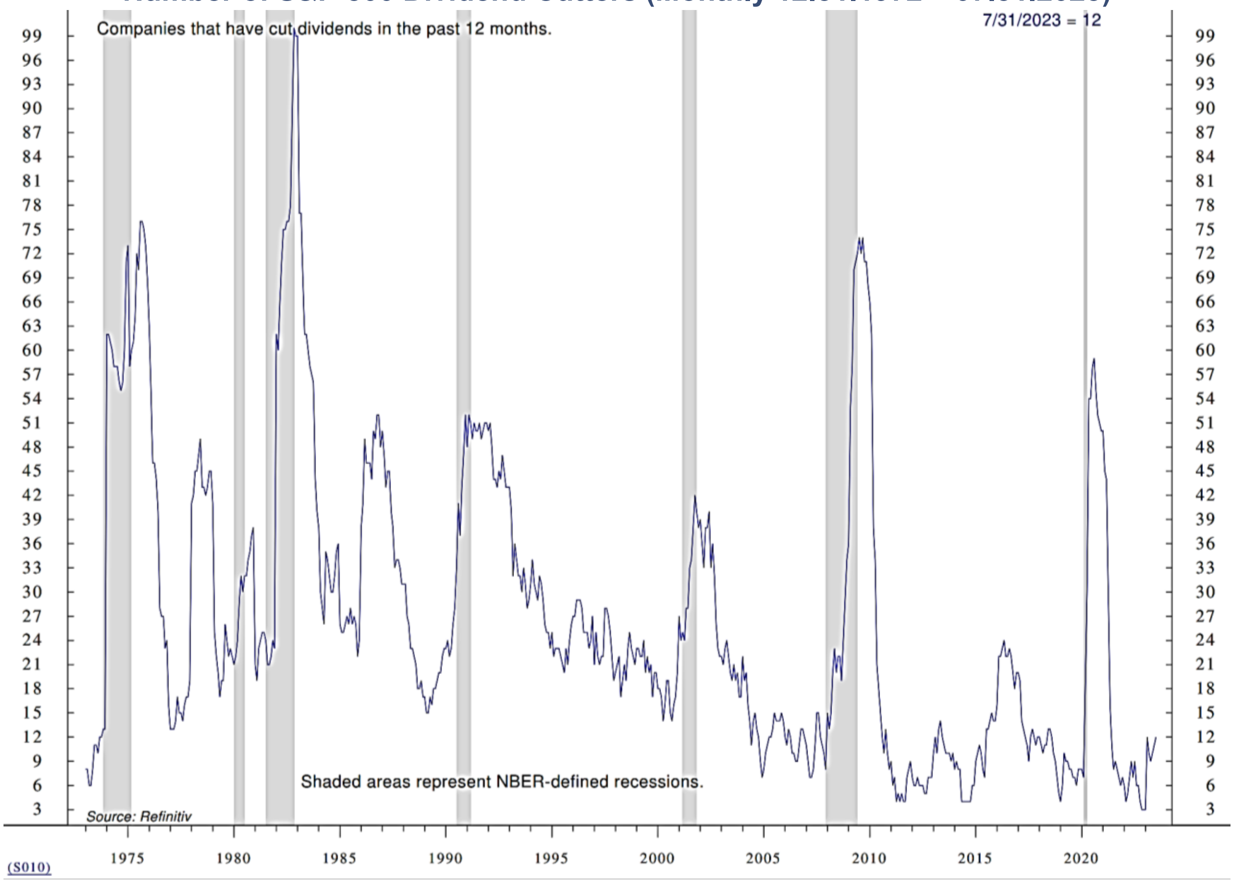
Number of S&P 500 Dividend Cutters (Monthly 12.31.1972 – 07.31.2023)



NBER: National Bureau of Economic Research. Source: Ned Davis Research.

In the past, we have discussed the negative impact of cutting dividends on stock price performance. We show the relative performance of dividend cutters in the table on the first page. In the chart on this page, we note the relatively few dividend cuts recently as the economy experienced its post-COVID-19 boom.

Is there investor complacency over potential dividend cuts? We do not know for sure, but we believe that owning stocks with strong balance sheets has the potential to minimize this risk as we endeavor to generate attractive above-average total returns with below-average risk for clients.

As always, thank you for your interest and trust managing your investments.

Charles J. Wittmann, CFA®, Executive Director, joined Sterling Capital Management in 2014 and has investment experience since 1995. Chip is Co-Portfolio Manager of the Equity Income strategy. Prior to joining Sterling, he worked for Thompson Siegel & Walmsley as a portfolio manager and (generalist) analyst. Prior to TS&W, he was a founding portfolio manager and analyst with Shockoe Capital, an equity long/short hedge fund. Chip received his B.A. in Economics from Davidson College and his M.B.A. from Duke University's Fuqua School of Business. Chip earned the Certificate in ESG Investing, which is developed, administered and awarded by the CFA Society of the United Kingdom. He holds the Chartered Financial Analyst® designation.

Important Information

Disclosures

Past performance is not indicative of future results. Any type of investing involves risk and there are no guarantees that these methods will be successful. Economic charts are provided for illustrative purposes only. The information provided herein is subject to market conditions and is therefore expected to fluctuate.

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The volatility of an index varies greatly. All indices are unmanaged and investments cannot be made directly in an index.

Dividend-focused strategies may underperform strategies that do not limit their investment to dividend-paying stocks. Stocks held strategy may reduce or stop paying dividends, affecting the strategy's ability to generate income.

The Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000® companies with lower price-to-book ratios and lower expected growth values. The Russell 1000® Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics.

The S&P 500® Index is a readily available, carefully constructed, market-value-weighted benchmark of common stock performance. Currently, the S&P 500 Composite includes 500 of the largest stocks (in terms of stock market value) in the United States and covers approximately 80% of available market capitalization.

Dividend Policies: Dividend Paying vs. Non-Paying: Each stock's dividend policy is determined by its indicated annual dividend. We classify a stock as a dividend-paying stock if the company indicates that it is going to be paying a dividend within the year. A stock is classified as a non-payer if the stock's indicated annual dividend is zero. Prior to July 2000, the indicated annual dividends were updated on a quarterly basis. Since July 2000, the indicated annual dividends are updated on a daily basis, so the most up-to-date information is used. The index returns are calculated using monthly equal-weighted averages of the total returns of all dividend-paying (or non-paying) stocks. A stock's return is only included during the period it is a component of the underlying index. The dividend figure used to categorize the stock is the company's indicated annual dividend, which may be different from the actual dividends paid in a particular month.

Dividend Growing, No-Change-in-Dividend, and Dividend Cutting: Each dividend-paying stock is further classified into one of the three categories based on changes to their dividend policy over the previous 12 months. Dividend Growers and Initiators include stocks that increased their dividend anytime in the last 12 months. Once an increase occurs, it remains classified as a grower for 12 months or until another change in dividend policy. No-Change stocks are those that maintained their existing indicated annual dividend for the last 12 months (i.e., companies that have a static, non-zero dividend). Dividend Cutters and Eliminators are companies that have lowered or eliminated their dividend anytime in the last 12 months. Once a decrease occurs, it remains classified as a cutter for 12 months or until another change in dividend policy. (Source: Ned Davis Research).

The **Chartered Financial Analyst® (CFA)** charter is a graduate-level investment credential awarded by CFA Institute — the largest global association of investment professionals. To earn the CFA charter, candidates must: 1) pass three sequential, six-hour examinations; 2) have at least four years of qualified professional investment experience; 3) join CFA Institute as members; and 4) commit to abide by, and annually reaffirm, their adherence to the CFA Institute Code of Ethics and Standards of Professional Conduct.

Since we began publishing The Lead in 2015, our primary purpose has been to communicate our investment philosophy and process as an investment advisor in the context of changing markets. In creating portfolios that differ from our benchmarks by focusing on characteristics that have a long term history of attractive relative returns according to Ned Davis Research, the portfolios are different from the benchmarks and as a result there can be periods where results differ including below benchmark performance. Since strategies are oriented toward the long term characteristics, if those characteristics are out of favor over a period of time, the given strategy's performance could be challenged in terms of relative performance. While Sterling believes active professional investment management that employs a consistent process with a long term orientation and aligned with client interests offers benefits, management fees to support the active approach can be higher than certain alternatives. When hiring an investment manager we believe it is important to monitor the investment risks taken including sector concentrations, portfolio turnover, and the impacts of dividend policy changes.

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