Executive Summary:

- Dividend-paying stocks have historically outperformed non-dividend paying stocks over many market cycles.[1]
- Dividend-paying stocks have a lower risk profile as these dividends tend to be supported by strong cash flows and outperformed non-dividend paying companies.
- In this current COVID-19 market environment, despite their attractiveness, dividend strategies have underperformed broader market indices. We examine the factors that have contributed to the underperformance.[2]
- We advise investors to be discerning when picking dividend strategies and recommend strategies where the risk of dividend cuts for underlying holdings is low.

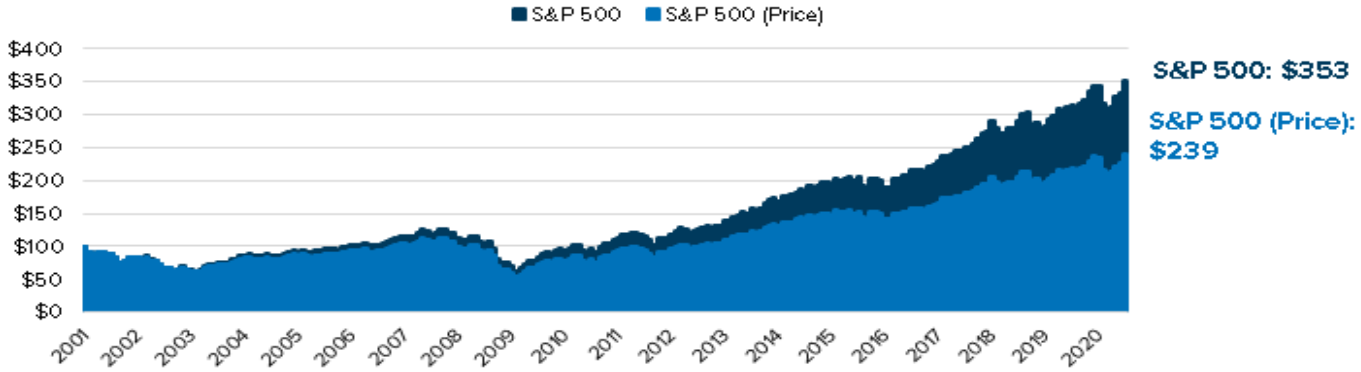
Traditionally, dividends have helped investors to gain reliable income and additional growth from their investment portfolios over time. However, equity-income strategies have been in focus in recent years as investors seek alternatives to low-yielding fixed income instruments, including treasury and investment grade bonds. In this paper, we look at these strategies, examining the historical returns as well as why we believe it makes sense to include them in investment portfolios.

The Power of Dividends and Their Compounding Effect

Historically, dividends have been a key contributor to total returns over the long-term. Our analysis shows that if an investor were to have invested $100 in the S&P 500 Index in 2001, and reinvested all the dividends, the investment would today be valued at more than $350.[3]

EXHIBIT 1:

The Power of Dividends and Compounding Growth of $100 (February 2001 – July 2020)[4]

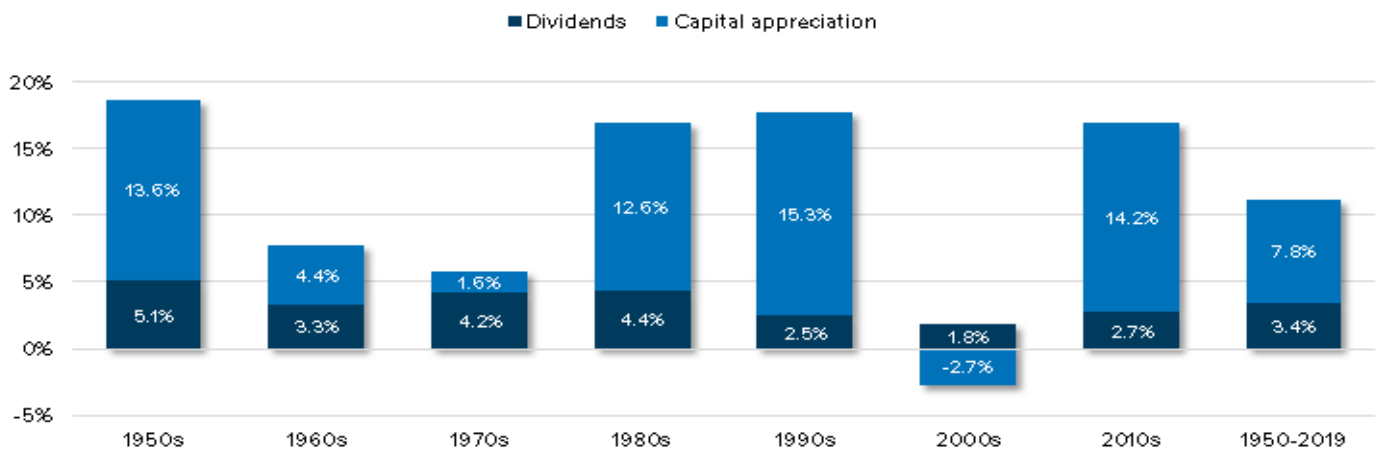


Source: eVestment Analytics

Looking at average stock performance over a longer time frame provides a more granular perspective. Dividends were significant contributors to total return until the late 80s and were de-emphasized in the late 1990s. In the lost decade of 2000s, dividends were mostly the sole saving grace.[5] After the dot-com bubble burst, investors tended to once again turn their attention back to dividends.

EXHIBIT 2:

S&P 500 Total Return: Dividends vs. Capital Appreciation[6]

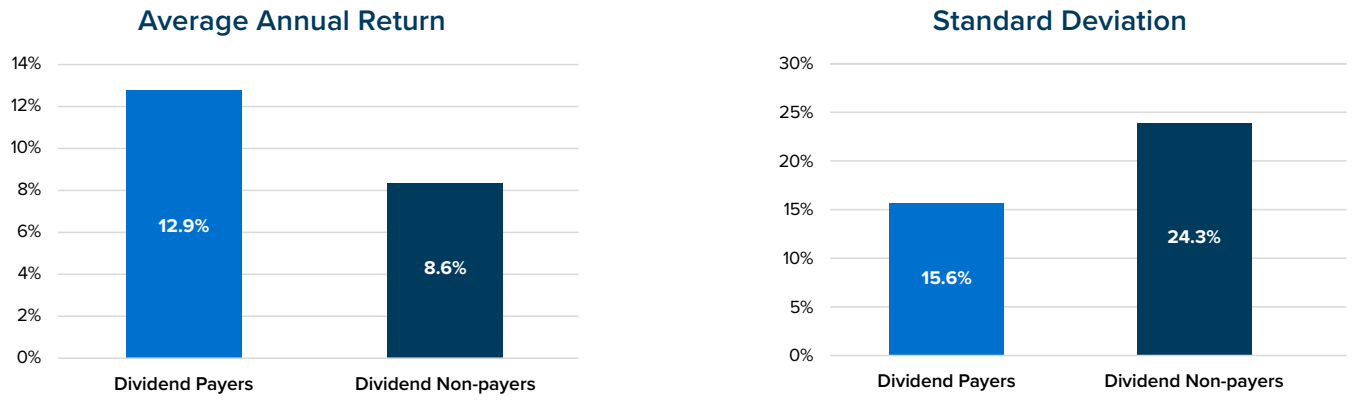


Source: JPMorgan Market Insights: Guide to the Markets®

Industry research shows that companies that pay dividends not only experience higher returns than non-payers but also tend to have significantly lower volatility.[7] While some investors may think of dividend payers as stodgy companies in slow-growth businesses, in reality dividend payers can be found across a broad range of sectors and industries. Dividends can force fiscal discipline for management teams, who otherwise may have a tendency to use cash for potentially dilutive acquisitions.

EXHIBIT 3:

Average Annual Return & Volatility by Dividend Policy for Stocks in the S&P 500 Index[8] - Period: March 31, 1972 to December 31, 2019



Source: Ned Davis Research and Hartford Funds: Data as of February 2020

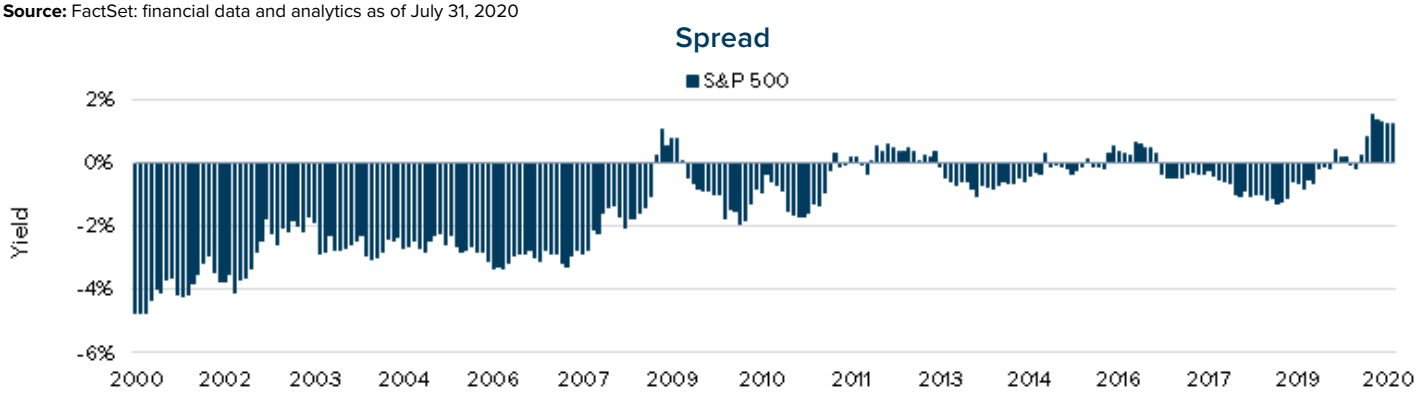
Generally, the conventional thinking for many income investors was to invest in the treasury or corporate bond market for stability. U.S. Treasury bonds can be a safe haven in times of crisis but after over three decades of a bull market, the yields on these bonds have declined substantially. With global central banks cutting interest rates close to all-time lows, and pumping trillions of dollars in liquidity, U.S. treasury yields are close to all-time lows.

There have been very few instances when the dividend yield on the S&P 500 Index was higher than 10-year US treasury bonds. With that being said, this current environment is one of those instances.

EXHIBIT 4:

Equity Income vs. Bond Yield - For the 20 year period ending July 31, 2020 [9]

Source: FactSet: financial data and analytics as of July 31, 2020



Source: FactSet: financial data and analytics as of July 31, 2020

Investment grade corporate bonds are not necessarily that attractive either Bonds of some of the better-rated companies provide even lower yields than that of US treasury bonds. As an example, Microsoft's bond maturing in 2027 yields only 79 bps (as of July 31, 2020).[10]

EXHIBIT 5:

Yield on Microsoft Bond[11]

Yield on Microsoft Corporate Bond: 3.3% February 6, 2027 (bps)-For 3 Year Period Ending July 31, 2020

Source: FactSet: financial data and analytics

Why Did Dividend Strategies Underperform During the COVID-19 Sell Off?

Over the past 20 years, the S&P 500 has experienced three bear markets with drawdowns greater than 30%.[12] Dot-com tech meltdown in 2001, financial crisis of 2008 and the current COVID-19 related global sell-off.

Dividend strategies outperformed broader markets during both 2001 and 2008 sell-offs. However, during the current crisis, most dividend indices underperformed. As an example, the S&P 500 Dividend Aristocrats index has underperformed the broader S&P 500 Index by almost 6 percentage points, year-to-date.

EXHIBIT 6:

Cumulative Excess Return of Dividend Indices Against S&P 500 Index[3]

Drawdowns Total Return	S&P 500 Index	S&P 500 Dividend Aristocrats	S&P High Dividend Aristocrats	Dow Jones U.S. Dividend 100	Dow Jones U.S. Select Dividend
Sep 1, 2000 – Oct 9, 2002	-47.4%	4.7%	15.5%	7.8%	6.8%
Oct 9, 2007 – Mar 9, 2009	-55.3%	-47.2%	-52.9%	-48.6%	-60.3%
Feb 19, 2020 – Mar 23, 2020	-33.8%	-35.2%	-36.2%	-32.6%	-40.6%

Source: S&P Global Research

There are a Few Reasons For the Underperformance of Dividend Strategies So Far In This Current Crisis.

First, most dividend paying strategies are underweight in the Information Technology sector. The technology sector was a strong performer during the bull market and is so far outperforming during the current downturn. In our opinion, big tech companies are likely to remain unscathed and may even emerge stronger than ever – as they benefit from work-from-home, play-from-home and deliver-to-home tailwinds. As the table [Exhibit 7] shows, most dividend indices are significantly underweight in the technology sector when compared to S&P 500, thereby hurting returns.[13]

EXHIBIT 7:

Average Sector Exposure of Dividend Indices Relative to S&P 500[14] December 31, 1999 – April 30, 2020

Sector Overweight/ Underweight	S&P 500 Dividend Aristocrats	S&P High Dividend Aristocrats	Down Jones U.S. Dividend 100	Down Jones U.S. Select Dividend
Communication Services	-1.5%	-1.5%	-0.3%	-1.1%
Consumer Discretionary	4.9%	-2.05%	-2.4%	-2.5%
Consumer Staples	13.3%	6.1%	12.3%	-0.3%
Energy	-6.8%	-7.1%	1.3%	-3.1%
Financials	-1.4%	5.8%	-5.5%	6.9%
Health Care	-1.2%	-6.3%	-3.3%	-10.2%
Industrials	4.6%	2.7%	2.3%	-0.4%
Information Technology	-17.5%	-16.9%	-10.3%	-17.6%
Materials	6.3%	5.5%	1.9%	5.5%
Real Estate	-0.9%	4.3%	-2.9%	-2.9%
Utilities	-0.4%	13.2%	4.5%	23.2%

Source: S&P Global

Second, the current sell-off is most likely driven by simultaneous shocks of the pandemic and the oil market collapse, which seems to have resulted in large energy companies looking for ways to preserve cash.

Third, atypical underperformance of the characteristically defensive utilities sector is driving current underperformance of dividend strategies.[15]

Dividend Cuts Are On The Rise

Last, we believe the relative decline of dividend strategies suggests that investors seem to be anticipating significant dividend cuts or complete suspension of dividends, more so than during the previous two recessions.

While central banks' quick actions seem to have helped stabilize the financial markets, the steep drop in the global economy has put tremendous pressure on companies' cash flows. As a result, we are starting to see some companies either suspend dividends outright or reduce their dividend payments.

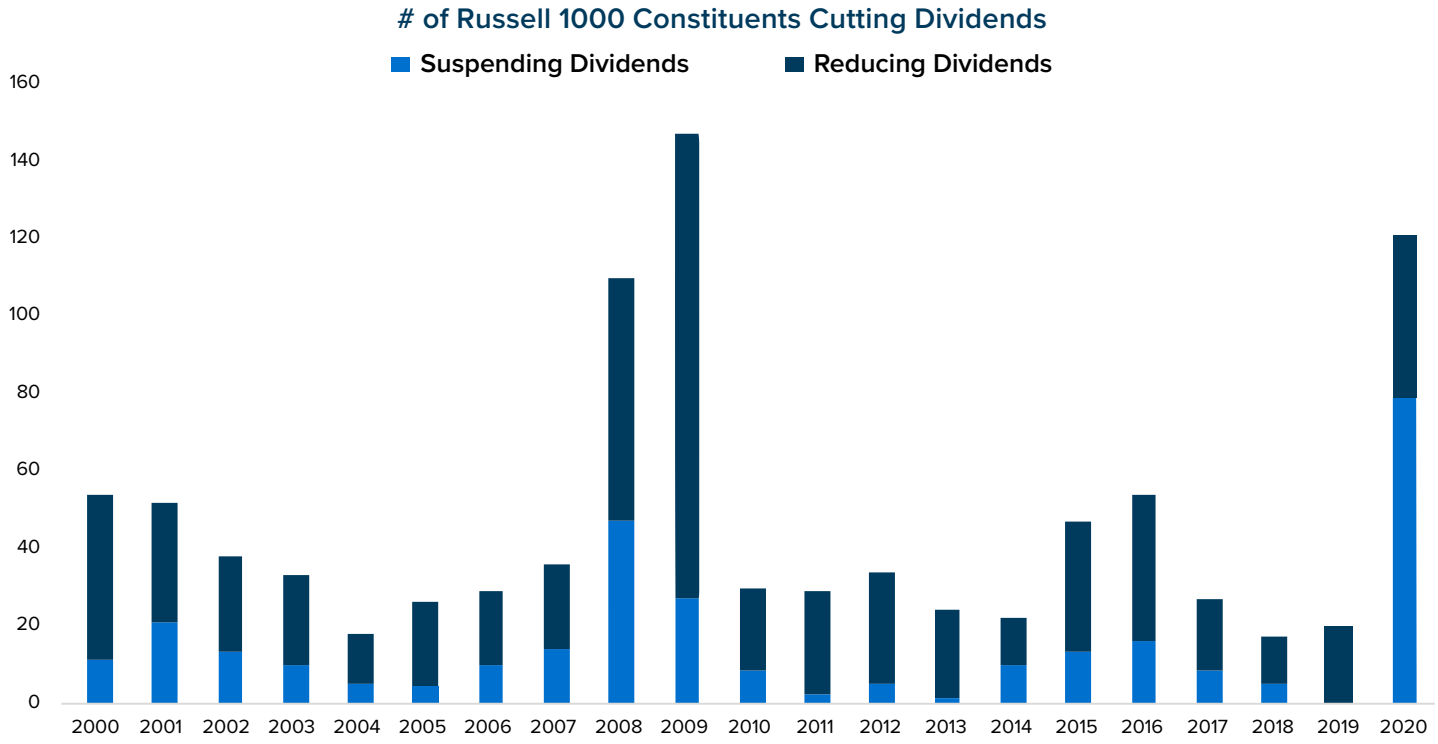
According to Morgan Stanley research, while the number of dividend reductions so far is still relatively small, the number of firms cancelling dividends altogether is already higher than in 2008.[16]

Most of the dividend suspensions and cuts appear to have come from industries that are most impacted by the current crisis: Consumer services (Hotels, Restaurants), Transportation (Airlines & Travel), Oil & Gas, and Capital Goods.

EXHIBIT 8:

Rising Dividend Cuts[17]

June 4, 2020



Source: Morgan Stanley Research

Anchor Capital's Dividend Income Strategy

While a major portion of an investor's return can come from dividends, investing in stocks with absolute high dividends may not be the best strategy. The reason is two-fold: one, companies that grow dividends faster than their earnings tend to reach a point where the dividends are not sustained by earnings, and investors can see through this. Second, these companies may miss investments in growth opportunities in the quest to pay higher dividends.

However, at Anchor, we have observed that companies, which pay sustainable dividends, tend to outperform their benchmark over the long term. We believe dividend payments force companies to make more responsible financial decisions. We put a lot of emphasis on obtaining dividend income from companies that can afford to not only pay dividends but also grow them – at least in line with earnings growth. We also expect the companies in our portfolio to grow their earnings faster than GDP, over the long-term.

This approach is evident throughout all of Anchor's strategies. Anchor's Dividend Income strategy, in particular, comprised only of dividend yielding stocks, takes this investment approach to its fullest extent. Anchor's preference for dividend yielding stocks is one of the many ways we strive to provide our clients with downside protection during periods of market volatility and generate competitive long-term returns.

Anchor's Dividend Income strategy is also differentiated in terms of high exposure to small and mid-cap stocks. We firmly believe we have an edge in picking small and mid-cap stocks, and have built a reputation through performance over more than three decades. Furthermore, Anchor's Dividend strategy selects dividend paying stocks across sectors rather than focusing on just the highest dividend paying sectors. This can help reduce the overall risk in the portfolio.

EXHIBIT 9:

Anchor Dividend Income Strategy - Investment Process

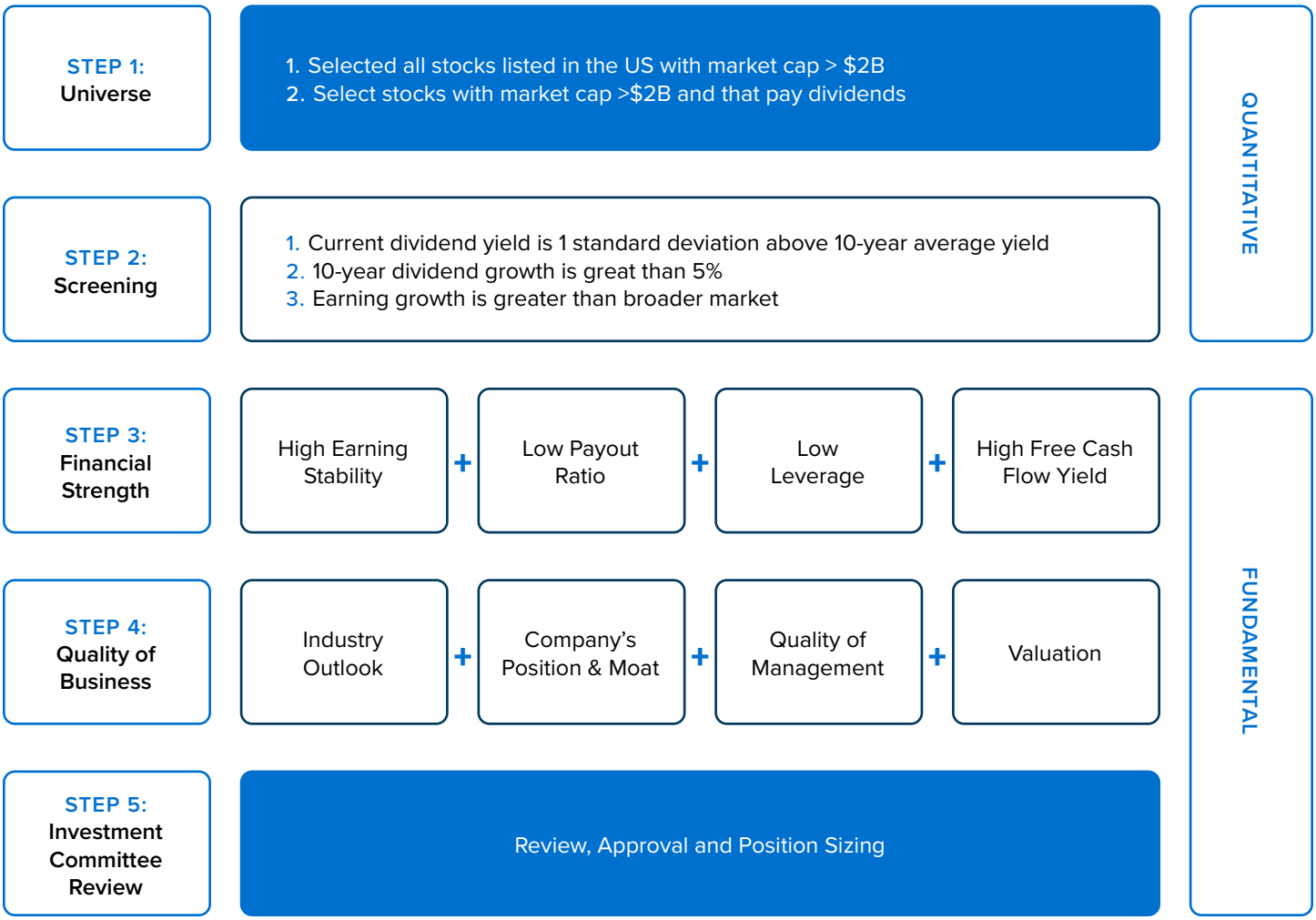


EXHIBIT 10:

Anchor Dividend Income Portfolio Characteristics[18]

as of July 31, 2020

	Dividend Income	Russell 1000 Value
Market Cap (Weighted average) - $ billion	$110.8 B	$119.0 B
Dividend Yield	3.2%	2.7%
Dividend Payout Ratio	58.5%	66.0%
EPS Growth (3-year historical)	20.5%	15.3%
Dividend growth	13.3%	13.0%

Source: FactSet financial data and analytics

Summary:

As we have seen, dividends can be an important component of total return over the long-term, with dividend paying stocks having outperformed non-dividend paying stocks over the long-term.[19] Dividend strategies can be especially attractive right now, in a low interest rate environment. At the same time, not all dividend-paying stocks are the same. We believe our focus on finding high quality companies that can grow dividends over time provides a compelling investment opportunity.

1. FactSet financial data and analytics
   The information used in this presentation is based on a hypothetical account created by the source. The returns presented are exclusive of fees and are gross returns. The performance results are based upon a hypothetical model and may have inherent limitations. Hypothetical performance does not involve financial risk, and no hypothetical trading record can completely account for the impact of financial risks associated with actual market conditions. There are numerous other factors related to the markets in general, or to the implementation of any specific trading strategy, which cannot be fully accounted for, and all of which can adversely affect actual trading results. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. The hypothetical results do not represent actual recommendations or trading by Anchor and should not be considered as indicative of the skills of the investment adviser. During the period shown, the Adviser was not managing client accounts according to the strategy depicted.
2. Ibid.
3. Factset financial data and analytics
4. eVestment Analytics as of 2/2001-7/2020
5. FactSet financial data and analytics
6. JP Morgan: "Guide to the Markets" Q2 2020
7. Hartford Funds: 2020 Insight: The power of dividends
8. Ned Davis Research and Hartford Funds: Data as of February 2020
9. FactSet financial data and analytics
10. FactSet financial data and analytics
11. Ibid.
12. FactSet financial data and analytics
13. S&P Global: https://www.spglobal.com/en/research-insights/articles/why-did-dividend-indices-underperform-during-the-coronavirus-sell-off
14. Ibid.
15. FactSet financial data and analytics
16. Morgan Stanley Research: Rising Dividend Risk – How do stocks reach to a cut?April, 2020
17. Ibid.
18. FactSet financial data and analytics
19. Ibid

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