ThomasPartners®

Quarterly Observations

Summer 2020

ThomasPartners income strategies seek to provide: Income Every Month | Income Growth | Competitive Total Returns Over Time

Many of us have been facing challenging situations during the more than four months that have elapsed since this global pandemic began to impact our daily lives—whether it be an interruption to income, child care, home schooling, or safeguarding elderly relatives and friends. We hope that you are well and beginning the slow process of resuming the activities that you enjoy.

Are dividends dead (again)?

Recently, a number of highly-publicized dividend cuts resulting from the adverse impacts of the global economic shutdown and shelter-in-place orders enacted to contain the COVID-19 pandemic have brought into question the basic thesis of dividend-oriented investment approaches: Will the dividend be paid?

These pandemic-related containment measures are having an impact on all businesses—favorable if you're making bleach, but devastating if you're flying planes. Many good companies that were otherwise strong, with good business models and experienced management teams, have been forced to reassess their financial strategies in order to survive the extent and duration of the sudden and unpredictable nature of this shutdown. The consumer discretionary and energy sectors have been particularly hard-hit, and numerous companies in these two sectors have either reduced or suspended dividend payments as a way to conserve cash flow.

Give me the facts...

While dividend cuts have been muted since the Financial Crisis, as they are in most normal economic environments, the number of dividend cuts or suspensions announced by S&P 500 Index constituents is now at its highest level since 2009 (See Figure 1 on page 2). And given the pervasiveness of the unprecedented global shutdown, this should not be surprising.

However, to quote Mark Twain, "The report of my death was an exaggeration." In fact, during the first six months of 2020, more companies in the S&P 500 Index actually increased their dividends versus decreasing them[1]. The global economic shutdown is not eliminating dividends from all companies, nor is it eliminating dividend increases. Instead, it has been the pandemic-driven financial strain within certain industries and companies, and in some cases government mandate, that has forced involuntary changes in corporate strategies related to dividends and the resultant attention-grabbing sound bites reported by the financial media.

ThomasPartners details...

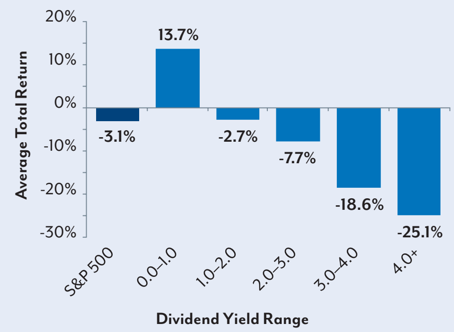
While the ThomasPartners Strategies have not been completely immune from dividend cuts, our portfolio has experienced a number of increases. During the first half of this

Did you know?

After a rough start to the year, the S&P 500 has recovered a substantial portion of the first quarter's losses, driven in large part by a handful of technology companies. However, while the overall index is off about 3% for the year, those stocks with no or low dividend yields have significantly outperformed those with higher dividend yields. As shown in the chart below, those stocks yielding less than 1% have returned nearly 40% more than those stocks yielding more than 4%.

While no strategy performs well all the time, the consistency that dividends, especially growing dividends, provide income investors often outweighs the excitement generated when outsized gains are only enjoyed by a few.

S&P 500 Returns by Dividend Yield Range
January 1, 2020–June 30, 2020



Source: Morningstar. Figures above are year-to-date average total returns for the S&P 500 and Dividend Yields are trailing 12-month yields.

year, 17 stocks in the ThomasPartners portfolios announced dividend increases, versus two announcing dividend decreases[2]. Observe that these 17 increases do not include our foreign holdings, of which three have announced dividend increases on a local-currency basis thus far. We believe that additional dividend increases among our portfolio holdings are likely in the months ahead.

The two stocks that cut their dividends have been sold. This sell discipline confirms our perception that cuts are a "signal" of fundamental challenges within the company that will likely hinder future performance.

This sell discipline also reflects a risk management judgment. We believe that the combination of income (dividends, interest, and rents) and capital gains is a natural form of reward diversification; investments that once offered both but now offer only capital gain potential are inherently riskier, in our opinion.

Of course, a dividend cut is not necessarily a death knell; companies can and do recover from adversity. One need not look any further than the dramatic recovery of banks since the Financial Crisis. Managements frequently argue that dividend cuts will save money that can fuel future growth.

But history suggests that dividend cuts signal problems that usually present themselves in reduced, not increased, future growth. Self-directed investors are sometimes reluctant to sell stocks that have depreciated in value due to a dividend cut; perhaps hopeful for a potential price recovery and to avoid declaring the original purchase a "mistake". However, again relying on history as illustrated in the chart below (See Figure 2), the stocks of companies that have cut or eliminated their dividends have significantly underperformed the stocks of companies that have maintained or grown theirs.

As demonstrated over this period, the stock market has not favored companies that cut dividends. As such, investors have historically been wise to sell stocks that cut dividends and reinvest the proceeds in stocks that can maintain dividend growth. It's this practical evidence that has shaped our sell discipline.

Fighting fear...

With the fear of negative stock price volatility in the forefront of most investor's thinking; combined with traditional equity valuation tools now challenged in how to deal with negative GDP, near-zero interest rates, extremely negative earnings, and no forward guidance, one risk management approach is simply to avoid the equity markets all together... go to the sidelines...at least for a time.

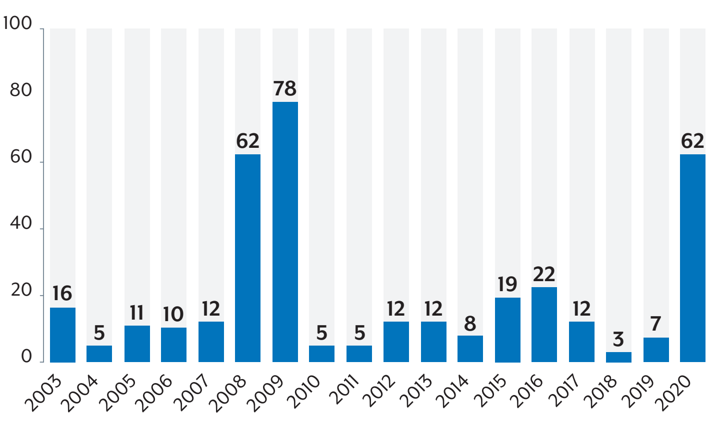
The assumption behind this approach seems to be that in the near-term markets will continue to be abnormally volatile, and to the downside. While seemingly riskless, the fundamental tactic here is effectively market timing. But market timing has rarely, if ever, enjoyed much repeatable success. Further, for those investors who equate progress to the regular production of capital gains, this creates the additional decision of when to reenter the market. You see, there is no ability to generate capital gains, and thus no progress, from the sidelines. Further, the price of "going to the sidelines" has rarely been more costly than it is now, with the rate on 30-day Treasury Bills at just 0.13%[3].

The investor's challenge in the near term therefore is defined by the need to span the time gap between today's negative personal bias and market uncertainties, and tomorrow's eventual global economic recovery, while still making progress towards one's goals in such an environment.

Making progress amid uncertainty...

One alternative (and we think, better) approach to making progress that avoids market timing involves the ownership of dividend-paying common stocks. Dividends provide an always-positive cash payout. If consumed, dividends avoid selling principal at what may be an inopportune time. If

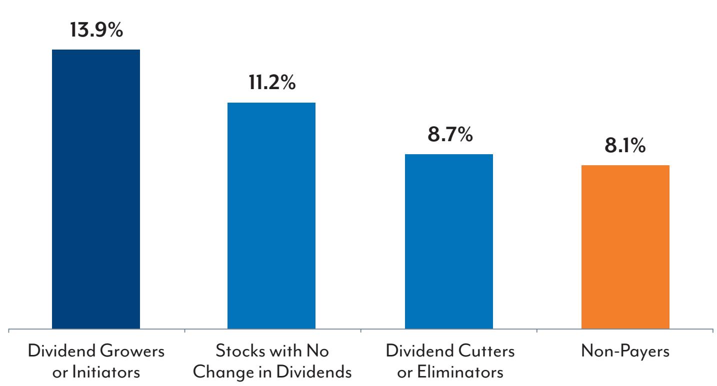
Figure 1: Dividends Reduced or Suspended by S&P 500 Stocks



Source: S&P Global Indices. Data as of June 30, 2020.

Figure 2: Dividend Policy Matters

Historical Total Returns of Stocks by Dividend Policy (1980–2019)



Source: Ned Davis Research. S&P Capital IQ Compustat. S&P Dow Jones Indices. Copyright 2020 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved. See NDR Disclaimer at www.ndr.com/copyright.html. For data vendor disclaimers refer to www.ndr.com/vendorinfo/. Starting in Q1 2019, this chart has been updated to reflect a new data source and independent calculation methodology by a third party. As such, the composition of the four categories is different than in prior quarters and has affected the trend in returns from prior quarters. The 'Dividend Growers' and 'Non-Payers' groups' returns are now generally lower than under the previous calculation methodology. The 'No Change' and 'Dividend Cutters' groups' returns are now generally higher than under the previous calculation. The 'Dividend Cutters' group showing the largest change in returns. Please see additional explanatory notes and disclosures at the end of this document for calculation methodology. Past performance does not guarantee future results.

reinvested, dividends can serve to increase the number of shares owned in an investor's portfolio. This additional path to reward has the potential to make progress even when the outlook for market prices is cloudy, at best.

More shares wins...

The significance of this dividend-driven approach in this period of unprecedented uncertainty is profound.

By employing a dividend-driven strategy, the investor can steadily increase the number of shares owned (or, if dividends are regularly consumed, at least hold onto the number of shares owned) during periods that may be uncertain. In this manner, the investor's portfolio will have the opportunity to experience the compounding effect of dividend reinvestment, and make some form of progress, all without having to time the markets, in general, or to time the volatile price movements of individual stocks, in particular.

The universally poor expectations for economic growth around the world offer opportunities for long-term investors, as expectations are so low that it may not be that difficult to exceed them. Companies that are being ascribed very low growth expectations could do very well when the virus fears finally subside.

The companies that survive may also enjoy greater market shares due to the demise of former competitors who were dependent on easily available capital and/or poorly managed.

This is the silver lining of any bear market and, particularly, this bear market. As market prices went down in the March freefall, dividends yields went up...a lot. Within just three months from the close of 2019, the yield on the ThomasPartners Dividend Growth Non K-1 Strategy had risen more than 25% to 3.86%[4].

This is a compelling circumstance. By owning dividend-paying stocks through an investment in ThomasPartners Strategies, investors who were seeking to achieve distributable income levels sufficient to satisfy the "4% Rule" (popularized by William Bengen in 1994)[5] were nearly to their goal. It is also a circumstance that defines a hidden opportunity cost. If share prices mount a rally, as they recently have, the opportunity to buy dividends at cheap prices drops proportionately—paying more tomorrow to get less.

Of course, like all investments, dividend-paying stocks are not without risk; dividend payments thought to be previously reliable can be eliminated or reduced, as some have. But dividends cannot go negative; a volatile market will never take back yesterday's dividend, as it so easily takes back yesterday's price appreciation that was simply the result of a momentary electronic stock quotation.

Research Insights

As the nearby piece narrates, the first half of 2020 will not soon be forgotten. Whether it was the human impact of the COVID-19 pandemic, the subsequent economic toll, or the unprecedented Federal Reserve and fiscal responses, investors were tested in their resolve to "stay the course".

While dividend-focused investment approaches[6] provided substantially better downside protection vs. the broad U.S. equity market during the prior two recessionary periods[7], the same approaches have not provided the same result in the current recession. So what was different this time?

The current recession, induced by the global economic shut-down implemented to contain the virus, has characteristics very different from the 2008–2009 Great Financial Crisis and the 2001 recession. In both prior recessions, excesses gradually manifested themselves in the economy over time. In both periods, businesses slashed technology spending to conserve cash.

Different this time was the lack of visibility into the extent and speed with which containment measures were implemented to control the global pandemic. Within a month's time, entire industries (travel, store-front retailers, and sit-down restaurants) saw revenues going to zero. This sent ripple effects throughout other industries (energy and banks). Different this time was that technology spending increased, being viewed as the key to corporate survival and shelter-in-place living; providing the ability to work and live virtually in an economy that was all but "closed for business".

Coming into the pandemic our dividend equity portfolio was positioned for the continued cyclical growth the economy had been delivering. As our primary goals seek to provide our clients with an income stream that is both meaningful and growing, our portfolio construction and trading methodology will be different from investment managers who are attempting to outperform a benchmark's total return and have little, if any, regard for maintaining or growing portfolio income.

Our trading activity has been implemented with an income-aware approach, attempting to reduce dependence of the portfolio's dividend stream on cyclical revenues in this environment, and attempt to maintain, if not grow, the portfolio's year-over-year income.

Although selling myriad holdings adversely impacted by the pandemic may have propped up short term portfolio values, income would have been substantially and adversely impacted, as well. We believe that providing durable income (currently 25 times more than cash rates)[8], income that grows, while at the same time offering the potential for capital appreciation over the long term, will remain a theme for all seasons. Dividend investing has been successful over time, just not in each and every sub-set of time.

Our disciplined approach to managing your assets consistent with our three goals of monthly income, income growth, and competitive total returns over time remains firmly in place. We continue to focus on companies that pay attractive dividends and have the financial capacity to grow those payouts over time, along with fixed income instruments that offer a return over and above that of Treasuries. We view these disciplines as vital to helping you to achieve your retirement goals in the years ahead.

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If it looks like a duck...

Market bottoms are always a surprise and usually occur before the economy bottoms. However, the sudden turnaround and unusual magnitude of this most recent rally is less likely a prediction of a swift return to normalcy than it is an indication of the extreme and overdone risk-avoiding mentality that surfaced with a vengeance in mid-March.

Just because the recent rally looks and acts like the real thing—a bounce off a bottom—there is still downside risk. In fact, there is always downside risk; stock market prices are fundamentally volatile.

It is this that defines the investor's dilemma: Should the recent rally inspire investors to re-embrace risk, specifically the risk of volatility, or should it inspire investors to avoid it?

ThomasPartners' dividend-driven style, providing two paths to reward, does not assume that markets can go only in one direction, up or down; rather, it has elements that can provide progress in each possibility.

The reward path of dividends offers portfolio purchasing power protection when markets are in decline. And when bear markets reverse, a consistent commitment to equities (and reluctance to "spend" principal) retains the portfolio's recovery potential and allows a healthy participation in advancing equity prices, the capital appreciation reward path.

For investors who believe, as we do, that two paths to financial reward can be better than just one, the current environment offers a unique opportunity to buy compelling dividend income streams at unusually attractive prices.

Dividend Increases

Four U.S.-based companies in the ThomasPartners portfolios increased their cash dividend payments in the second quarter of 2020*

Company	Ticker	Increase declaration date	Annual dividend	Percent increase
Johnson & Johnson	JNJ	4/14/2020	$4.04	**6.32%**
The Procter & Gamble Co	PG	4/14/2020	$3.16	**6.01%**
Kinder Morgan Inc	KMI	4/22/2020	$1.05	**5.00%**
International Business Machines Corp	IBM	4/28/2020	$6.52	**0.62%**

*Data source: Bloomberg as of 6/30/2020.

We appreciate your investment in the ThomasPartners Strategies. Please contact your Investment Professional if your investment objectives or circumstances have changed such that a review of your ThomasPartners strategy account(s) might be necessary, or if you have any specific questions about how your account is managed.

Past performance is no guarantee of future results; the value of investments and the income derived from them can go down as well as up. Future returns and the achievement of stated goals are not guaranteed, and a loss of principal may occur.

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Please refer to the ThomasPartners Strategies Disclosure Brochure for additional information.

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Indexes are unmanaged, do not include fees, and cannot be invested in directly.

Dividend Policy Matters Chart:

Each dividend-paying company 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 or 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: S&P Capital IQ Compustat. Dow Jones S&P Indices.

Sources:

[1] S&P Global Indices. Data as of June 30, 2020.

[2] Charles Schwab Investment Management, Inc. Data as of June 30, 2020.

[3] U.S. Department of the Treasury. Data as of June 30, 2020.

[4] Charles Schwab Investment Management, Inc. Data as of March 31, 2020.

[5] William Bengen, "Determining Withdrawal Rates Using Historical", pg. 172, Journal of Financial Planning, October 1994.

[6] Represented by the S&P 500 Dividend Aristocrats Index.

[7] Selected periods cover calendar years of recessions defined by The National Bureau of Economic Research (NBER). Index returns from Morningstar. 2001: S&P Dividend Aristocrats Index (+10.8%) / S&P 500 Index (-11.9%); 2008–2009 (Cumulative Return): S&P Dividend Aristocrats (-1.1%) / S&P 500 Index (-20.3%); 2020 (Jan–Jun): S&P Dividend Aristocrats Index (-9.7%) / S&P 500 Index (-3.1%).

[8] Charles Schwab Investment Management, Inc., U.S. Department of the Treasury. ThomasPartners Dividend Growth Strategy Non K-1 yield versus the 4-week Treasury Bill Rate. Data as of June 30, 2020.