Power of Dividends:

Knowing Is Half the Battle

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Learning Objectives

Presentation Overview

How to Analyze Dividend Stocks

- What are dividends
- Benefits of dividends
- Dividend strategies

Three Pillars of Dividend Investing

- Valuation metrics
  - Dividend yield, price-earnings (P/E) ratio
- Growth trends
  - Margins, earnings
  - Dividend consistency -> history / growth
- Financial strength / quality
  - Dividend sustainability
  - Payout ratios, interest coverage ratio

Framework: Sell Considerations

  - Change regarding the growth, consistency or sustainability of the dividend

Dividends Matter to Me

Growing Up With Dividend Income

United Parcel Service (UPS):

- Father worked at UPS for 25+ years
- First dividend payment $25
- UPS went public in 1999
- Dividend payments grew more substantial
- Dividend income to fund living expenses
  - Summer vacations
  - Parents continue to enjoy benefits of dividends

Dividend Benefits and Strategies

Introduction to Three Pillars of Dividend Investing

Dividend Valuation Metrics

Growth Trends -> Dividend Consistency

Financial Strength -> Dividend Sustainability

Framework: Sell Considerations

What Are Dividends

Dividends are a distribution of cash from a company to its shareholders

Balance Sheet (A = L + OE)

Assets	**Equity**
Cash	Retained Earnings
-Dividends	-Dividends

"Do you know the only thing that gives me pleasure? It's to see my dividends coming in."

–John D. Rockefeller

Benefits of Dividend Investing

1. **Passive Income**:
   - Dividends provide a steady flow of passive income, which you can choose to spend or reinvest
2. **Higher Growth Potential**:
   - Dividend-paying stocks have historically delivered higher long-term returns than non-dividend-payers
3. **Inflation Protection**:
   - Unlike bonds paying fixed income, many companies increase their dividend payout each year
4. **Continued Ownership While Collecting Profits**:
   - Owning shares in a firm that doesn't pay dividends is frustrating in that profits are locked in the stock
5. **Less Volatility Than Other Stocks**:
   - Dividend payers tend to be large, financially strong companies with more mature businesses
   - Cushion against market risk
6. **Dividends May Provide Clear Signal of Corporate Financial Health**:
   - Straightforward and effective tool to identify quality, well-run companies
   - Enhance earnings transparency of a company / apply a level of financial discipline on management
   - Can signal management's confidence in current and future growth prospects

Dividend Strategies: Two Main Approaches

Today's Focus

1 Dividend Growth

- Look for growing dividend
- Usually better quality, less risk, lower absolute yield when compared to high-yield approach

2 High Dividend Yield

- Seek high-yielding stocks
- Usually lower quality, more risk

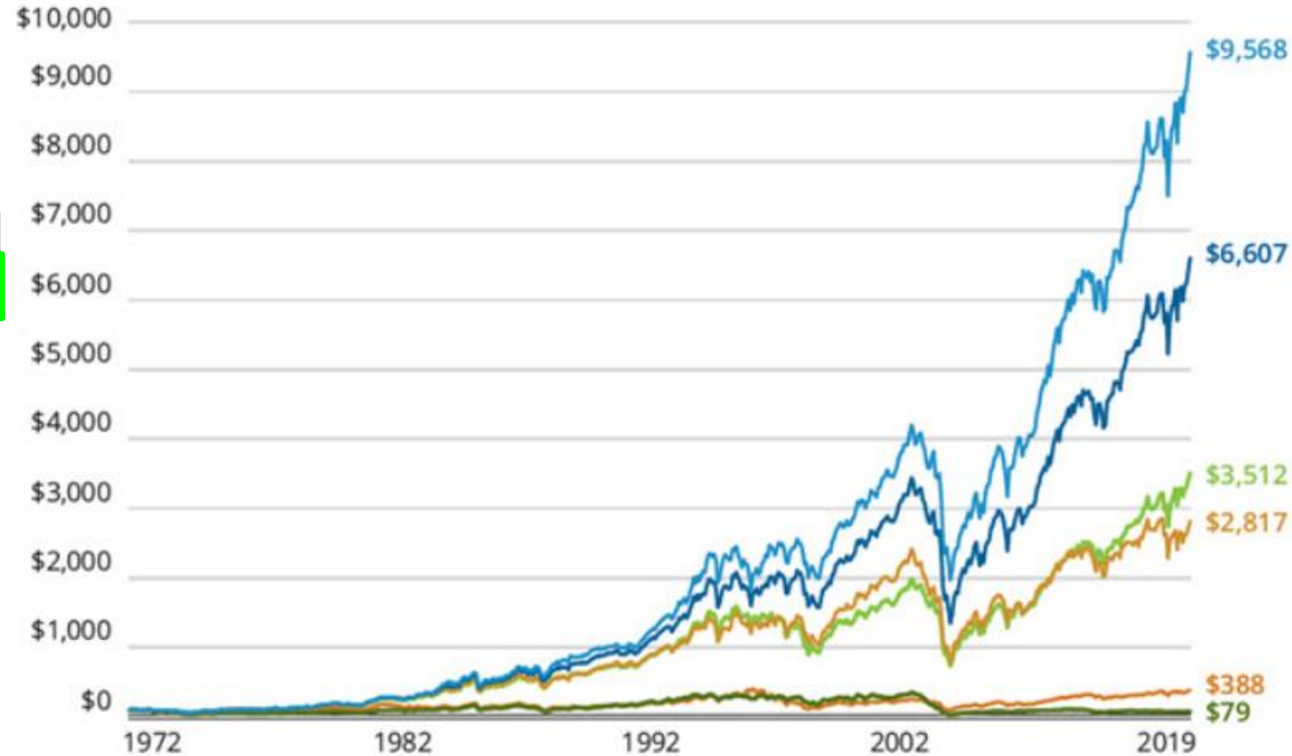
Dividend strategies add to total return over time

Dividend Growth May Be a Key to Outperformance

- Returns of S&P 500 Index Stocks by Dividend Policy: Growth of $100 (1972–2019)

Average Annual Returns & Beta by Dividend Policy
(3/31/72 – 12/31/19)

	Returns	Beta
Dividend Growers & Initiators	12.87%	0.92
Dividend Payers	12.79%	0.98
Equal-Weighted S&P 500 Index	12.29%	1.00
No Change in Dividend Policy	11.85%	1.13
Dividend Non-Payers	8.57%	1.13
Dividend Cutters & Eliminators	10.88%	1.23



Dividend growers and initiators have historically provided greater total return with less volatility relative to companies that either maintained or cut their dividends

Data Sources: Ned Davis Research and Hartford Funds, 2/20 "The Power of Dividends: Past, Present, and Future" from https://www.hartfordfunds.com/market-perspectives/the-power-of-dividends.html. Past performance does not guarantee future results. For illustrative purposed only. The data does not take into account fees and charges associated with actual investments.

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Step One: What Does the Company Do?

Determining What a Company Does

- Download and read most recent 10-K
- Read the last few conference call transcripts
  - What are company trends, opportunities and threats?
- What are the company's business segments?
  - Understand each segment's percentage of revenue and earnings
  - Which segments are growing or slowing?
  - Look at geographic concentration
- Who does the company compete with?
- Who are the company's customers and suppliers?

Basic Materials
Consumer Cyclical
Financial Services
Real Estate

Communication Services
Energy
Industrials
Technology

Consumer Defensive
Healthcare
Utilities

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Three Pillars of Dividend Investing

1 Valuation / Attractiveness

Stock prices tend to **fluctuate between high** and **low extreme valuation levels**, these relationships can be used to determine a stock's value range

Characteristics Analyzed:

- Dividend yield
- Trailing price-earnings ratio
- Forward price-earnings ratio

2 Growth Trends

A company's success is driven by its ability to **generate sales** and **convert revenue into earnings** and **cash flow**

Characteristics Analyzed:

- Revenue
- Gross margins
- Operating margins
- Net profit margins
- Earnings
- Earnings per share
- Dividend history
  - Consistency
- Dividend growth

3 Financial Strength / Quality

Understand company's underlying financials and its ability to **generate cash flow, pay its obligations** and **return capital to shareholders**

Characteristics Analyzed:

- Earnings payout ratio
- Free-cash-flow payout ratio
- Leverage ratio
- Interest coverage ratio
- Operating cash flow
- Free cash flow
- Returned capital
  - Share buybacks & dividends

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Three Pillars of Dividend Investing: Valuation

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Dividend Yield: Main valuation metric

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Main Valuation Metric: Dividend Yield

- Dividend yield indicates what an investor pays for a given level of dividends

$$\textbf{Dividend Yield} = \frac{\text{Annual indicated dividend per share}}{\text{Stock price per share}}$$

- Stock price and dividend yield are inversely related

Holding Dividend Steady:

If stock price goes up ↑, yield goes down ↓

If stock price goes down ↓, yield goes up ↑

- To help determine stock's valuation: compare its current dividend yield to its historical average yield and market yield

Buy signal (undervalued): Dividend yield > five-year average yield

Sell signal (overvalued): Dividend yield < five-year average low yield

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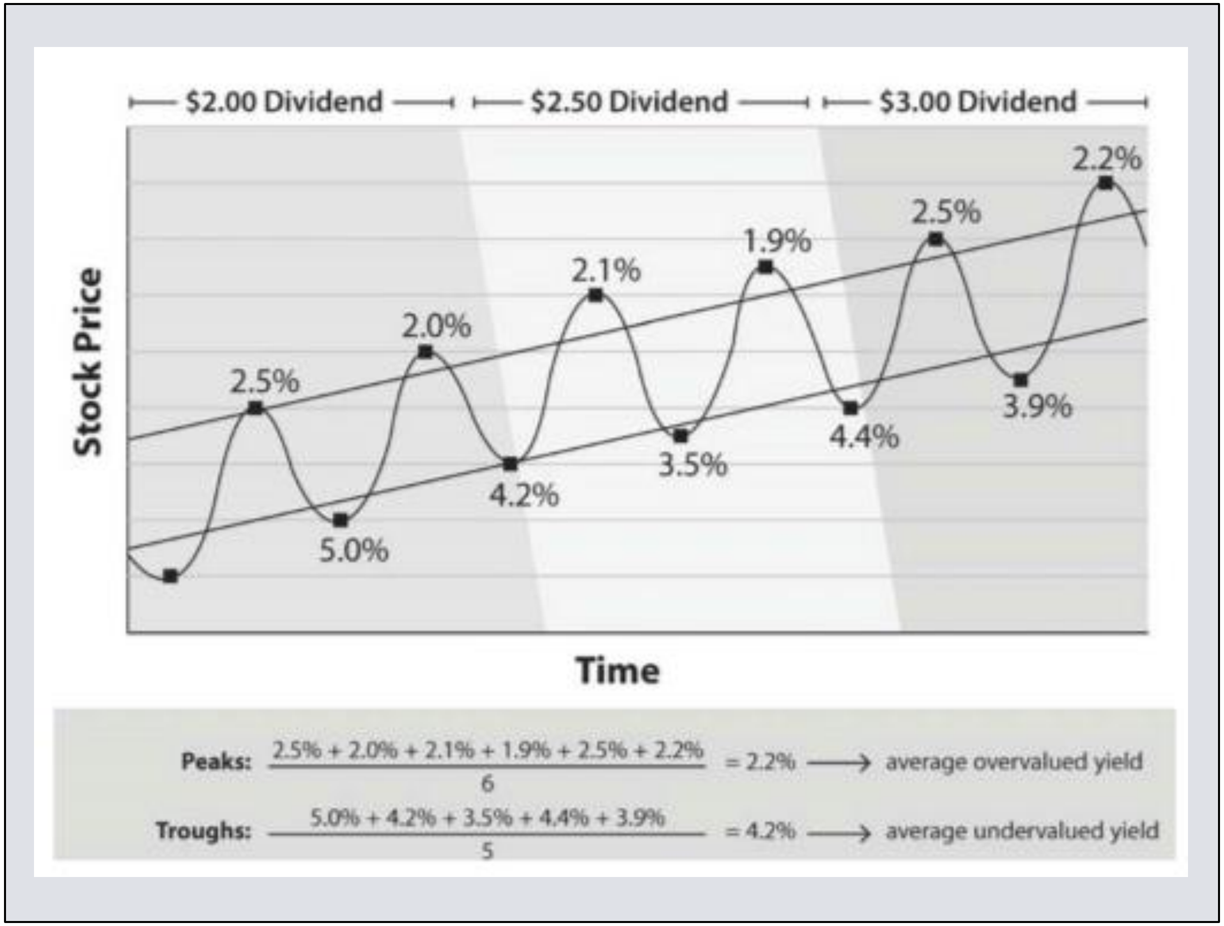
1 Dividend Yield: Over/Undervalued Band*

- Historical Yield Peaks and Troughs Buy/Sell Example



*Note: Example based on concept from "Dividends Don't Lie" by Geraldine Weiss and Janet Lowe.

1 Dividend Yield Example: HUBBELL (HUBB)

- Dividend growth and stock price drive change in yield over time:

Dividend Growth > Stock Price Growth ∴ Yield Up

Stock Price Growth > Dividend Growth ∴ Yield Down

Current Yield: 3.2%

Five-Year Avg.:
- High 3.0%
- Average 2.5%
- Low 2.1%

	2012	2013	2014	2015	2016	2017	2018	2019
Dividend Growth %	10.1%	11.4%	12.1%	12.1%	10.8%	9.8%	8.9%	6.1%
Stock Price Growth %	30.7%	(0.6%)	(4.6%)	13.0%	16.0%	(27.2%)	50.3%	(23.3%)

1

Valuation Metric: Price-Earnings (P/E) Ratio

$$\textbf{P/E Ratio} = \frac{\text{Stock price}}{\text{Earnings per share}}$$

Trailing 12 months <u>or</u>
Forward-looking earnings

Price-Earnings (P/E) Ratio

- Compare to historical average
- Compare to market
- Higher the value, the higher the price for a given level of earnings
- Value investor -> seeks lower P/E
- Growth investor -> less concerned about P/E
- Forward looking
- Difficult to interpret with cyclical stocks
  - Normalized earnings are an alternative
- Not meaningful if earnings are negative

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P/E Ratio Example: HUBBELL (HUBB)

	2015	2016	2017	2018	2019	Current
Avg. Price:	$98.68	$101.11	$124.14	$120.46	$122.70	$113.59
Avg. EPS Dil.:	$4.77	$5.24	$5.42	$6.43	$7.30	$7.36
Hubbell Avg. P/E:	20.7x	19.3x	22.9x	18.7x	16.8x	15.4x
Avg. P/E Industry:	20.7x	19.6x	21.2x	19.4x	21.0x	16.8x

HUBBELL

Current P/E: **15.4x**

Five-Year Avg. P/E (HUBB): **19.7x**

Five-Year Avg. P/E (Industry): **20.4x**

Source: *AAII* Stock Investor Pro/*Refinitiv*. Data as of 5/15/2020.

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Dividend Benefits and Strategies

Introduction to Three Pillars of Dividend Investing

Dividend Valuation Metrics

Growth Trends -> Dividend Consistency

Financial Strength -> Dividend Sustainability

Framework: Sell Considerations

Three Pillars of Dividend Investing: Growth Trends

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- Dividend history
  - (Consistency)
- Dividend growth

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Growth: Does, and can, the company grow its dividend?

2

Growth Trends: Margins & Earnings

Profitability

- Does the company make money?
- Analyze historical trends of company
- Analyze overall corporate/industry profitability to the best of your ability

Margin Growth

- Gross margin, operating margin, profit margin
- Higher margins are better (industry specific)
- Expanding margins signal competitive advantage
- Listen to management: Sometimes declining margins can mean business model is changing

Earnings Growth

- Historical, expected, earnings surprise
- Dividends can't grow without earnings growth
- Look at historical and expected earnings growth — pay attention to business cycle
- Consistently missing earnings estimates is bad

2

Margins & Earnings Growth: HUBBELL (HUBB)

HUBBELL	2015	2016	2017	2018	2019	5-Yr Avg
Operating Margin:	14.6%	14.0%	13.9%	12.4%	13.3%	**13.6%**
Operating Margin (Ind.):	5.2%	6.5%	5.3%	6.0%	6.1%	**5.8%**
Net Profit Margin:	8.2%	8.3%	6.6%	8.0%	8.7%	**8.0%**
EPS Growth Year-Over-Year:	(13.0%)	10.0%	3.4%	18.5%	13.6%	**5.9%***
Dividend Growth Year-Over-Year:	12.1%	12.1%	10.8%	9.8%	8.9%	**10.9%***

Operating margin = operating income / sales. Net profit margin = net income / sales. *5-yr compound annual growth rate (CAGR).

Expanding margins signal competitive advantage

Source: *AAII* Stock Investor Pro/*Refinitiv*. Data as of 5/15/2020.

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Growth Trends: Consistency & Growth

Dividend Consistency

- Record of paying and increasing dividends
- Has the company ever cut its dividend? Why?
- Long-time dividend payers have done well
- Companies that recently implemented a dividend could also be committed to paying it (it's just less "sticky")
- Bottom line: Consistency shows commitment, but doesn't guarantee it

Walgreens Boots Alliance

44 Years

PEPSICO

48 Years

Medtronic

42 Years

Dividend Growth

- Analyze historical dividend growth
- Prefer growth above inflation
- Prefer increasing rate of growth, but consider economic conditions and earnings
- Dividend growth can't outpace earnings growth over the long term
- Dividend growth will boost dividend yield (holding price steady)

UNITEDHEALTH GROUP

	2014	2015	2016	2017	2018	2019
Dividend Growth	33.5%	33.5%	26.7%	21.1%	20.0%	20.0%

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Three Pillars of Dividend Investing: Financial Strength

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Sustainability: Can the company sustain its dividend payment in the future?

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3 Financial Strength and Dividend Sustainability

Financial Strength / Quality

- Understand company's underlying financials
  - Ability to generate cash flow
  - Pay its obligations
  - Return capital to shareholders
- Ties into dividend sustainability
  - Can the company support the dividend?
  - Good times and bad times

Dividend Sustainability

- **Payout ratio**: earnings & free cash flow
- **Financial strength**: high leverage is bad (generally!)
- **Long-term earnings growth**: dividends derived from earnings
- **Long-term competitive advantage**:
  - No demand = no profitability
  - Analyze margins
  - Non-quantitative aspects (SWOT analysis, etc.)

Seeking "sticky" dividends. Can a company sustain its dividend?

3

Dividend Sustainability: Payout Ratios

$$\text{Earnings Payout Ratio} = \frac{\text{Dividends per share}}{\text{Earnings per share}}$$

$$\text{Free-Cash-Flow (FCF) Payout Ratio} = \frac{\text{Dividends per share}}{\text{FCF per share}}$$

FCF = (cash from operations – capital expenditures)
This calculation is a “pre-dividend” calculation

Payout Ratios

- Generally lower is better -> shows room to grow
- High payout ratio (>100%) is not sustainable over the long term
- Important to compare to industry and historical average
- Check to see if company reports “target” payout ratio
- Free cash flow is less easily manipulated by management
- Sometimes payout ratio can be affected by “one-time” items

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Payout Ratios Example: HUBBELL (HUBB)

HUBBELL	2015	2016	2017	2018	2019	5-Yr Avg
Earnings Payout Ratio:	46.7%	47.9%	63.3%	46.9%	45.8%	50.1%
Free Cash Flow per Share:	$4.40	$5.96	$5.46	$7.71	$9.15	$6.54
Free-Cash-Flow Payout Ratio:	50.9%	42.3%	51.3%	40.0%	36.7%	44.2%

Rising free cash flow per share

Source: *AAII* Stock Investor Pro/*Refinitiv*. Data as of 5/15/2020.

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Dividend Sustainability: Payout Ratios

Sector Median Payout Ratios for All Dividend-Paying Stocks

Sector	Payout Ratio 12 Mo (%)	# of Stocks
Basic Materials	37.3	110
Consumer Cyclicals	35.6	209
Energy	84.7	131
Financials	37.6	667
Healthcare	30.6	61
Industrials	29.4	235
Non-Cyclicals	50.9	78
Technology	39.0	117
Telecom Servs	55.8	19
Utilities	62.2	71
Basic Materials	37.3	110

Source: *AAII* Stock Investor Pro/*Refinitiv*. Data as of 11/4/2019.

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Financial Strength: Interest Coverage Ratio

$$\textbf{Interest Coverage Ratio} = \frac{\text{Earnings before interest and taxes (EBIT)}}{\text{Interest expense}}$$

Interest Coverage Ratio

- Measures company's ability to meet its debt obligations
- Higher ratio is better
- Increasing debt is not *always* bad
  - Important that the company can pay its current obligations
  - Is company using the debt effectively?
  - Companies with more significant capital needs are more likely to carry more debt as a % of total capital

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Interest Coverage Ratio: HUBBELL (HUBB)

HUBBELL	2015	2016	2017	2018	2019
Interest coverage:	14.5x	10.9x	6.0x	7.8x	8.5x
Interest coverage (Ind.):	9.4x	8.9x	6.2x	6.2x	5.6x
LT debt to capital:	25.5%	38.3%	37.7%	49.4%	43.6%
LT debt to capital (Ind.):	12.8%	15.8%	15.7%	14.8%	14.8%

Large acquisition in 2018 resulted in debt increasing.
Ability to meet debt obligations also increased.

Source: *AAII* Stock Investor Pro/*Refinitiv*. Data as of 5/15/2020.

Hubbell Inc. Company Summary

Company Summary:

Hubbell Incorporated (HUBB), a global electrical equipment company

- An intelligent play on industrial infrastructure spending, particularly from improvements made to the U.S. power grid
- Growth drivers include:
  - Transition to renewables
  - Technology adoption like smart meters

Bullish Factors

- Well positioned as utilities invest to upgrade and modernize an aging U.S. power grid infrastructure
- Aclara acquisition extends capabilities into smart automation technologies valued by utility customers

Bearish Factors

- Slowing demand and price erosion in legacy lighting business due to rapid adoption of LED technology
- Raw materials pricing and competitive rivalry has pressured margins

Select Dividend Investing Screening Characteristics:	Yes/No:	Hubbell Inc.
• Current yield greater than 5-year avg.:	Yes	3.2% > 2.5%
• At least 7 consecutive yrs. of annual div. increases:	Yes	12 years
• 5-year dividend growth rate > 3%:	Yes	10.9%
• 5-year sales growth rate > 3%:	Yes	6.4%
• 5-year EPS dil. cont. > 3%:	Yes	5.9%
• Op. margin 12m >= Indus. op. margin 12m:	Yes	13.2% > 6.2%
• Earnings payout ratio 12m <= 50%:	Yes	46.3%
• Times interest earned 12m >= 2x:	Yes	8.8x
• LT debt to capital Q1 <= 50%:	Yes	45.5%

Source: *AAII* Stock Investor Pro/*Refinitiv* and Morningstar. Data as of 5/15/2020.

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Excessively high yield	• Can signal a dividend cut
Yield below benchmark yield	• Market and company's historical range • Example: yield below five-year average low
Lack of dividend increase	• Case-by-case basis • Growth consistently less than inflation
Continuing poor fundamentals	• Shrinking revenue and/or lower margins • Negative free cash flow
Interest coverage ratio	• Below 2.0x
Better dividend growth opportunities available	• Example: higher dividend growth and/or more attractive yield

Think: Change regarding the growth, consistency or sustainability of the dividend → SELL

Key Takeaways

Learning Objectives	Key Takeaways

How to Analyze Dividend Stocks

- What are dividends
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- Dividend strategies

→ Passive income, higher growth potential, inflation protection and less volatility than other stocks

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- Valuation metrics
  - Dividend yield
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→ Stock prices tend to **fluctuate between high** and **low extreme valuation levels**, these relationships can be used to determine a stock's value range

- Growth trends
  - Margins
  - Earnings
  - Dividend consistency -> history / growth

→ A company's success is driven by its ability to **generate sales** and **convert revenue into earnings** and **cash flow**

- Financial strength / quality
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  - Payout ratios
  - Interest coverage ratio

→ Understand company's underlying financials and its ability to **generate cash flow, pay its obligations** and **return capital to shareholders**

Framework: Sell Considerations

- Change regarding the growth, consistency or sustainability of the dividend

→ Excessively high yield, yield below benchmark yield, lack of dividend increase and continuing poor fundamentals are potential sell considerations

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- Model portfolio with real capital investment
- 24 curated dividend-paying growth stocks
- Alert members of portfolio additions / deletions
- Monthly *Dividend Investing* newsletter
- Weekly email / commentary
- DI Ideas
- Dividend article archive
- Website: www.aaiidividendinvesting.com

Provide the education and tools necessary to analyze, research and manage a successful dividend portfolio

Upcoming Webinars:

Alliance for Investor Education Panel: Investing Mistakes to Avoid in the Next 6-12 Months
Wednesday, May 27, 2020, 7:30 p.m. CDT

Kevin Carter: The Future of Emerging Markets & the Digital Revolution
EMQQ's Founder of Emerging Markets Internet & Ecommerce ETF
Wednesday, June 3, 2020, 7:30 p.m. CDT

Wayne Thorp: Investing Like a Stock Superstar
AAII Senior Financial Analyst
Wednesday, June 10, 2020, 7:30 p.m. CDT