EquityCompass

**Investment Commentary**

# High-Dividend Portfolio (HDP)
## *A Cash Flow Alternative*


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*Senior Managing Director*
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- A lower for longer interest rate environment has driven an investor quest for yield. The result has been significant corporate debt issuances at near historically low spreads.
- At best, this represents lower risk adjusted returns on high-yield corporate bond allocations than investors may have originally anticipated. At worst, the value of high-yield corporate bond allocations could be negatively impacted by a widening gap in spreads that often occur during recessionary periods.
- The **High-Dividend Portfolio (HDP)** was developed as a strategy with these risks in mind. It is designed to represent an attractive cash flow generation alternative to high-yield corporate bond allocations within a diversified investment portfolio.

With long-term interest rates nearing all-time lows and corporate debt levels above that of the past two recessions, **we have identified a diversified portfolio of stocks that provides a cash flow alternative to high-yield corporate bonds.**

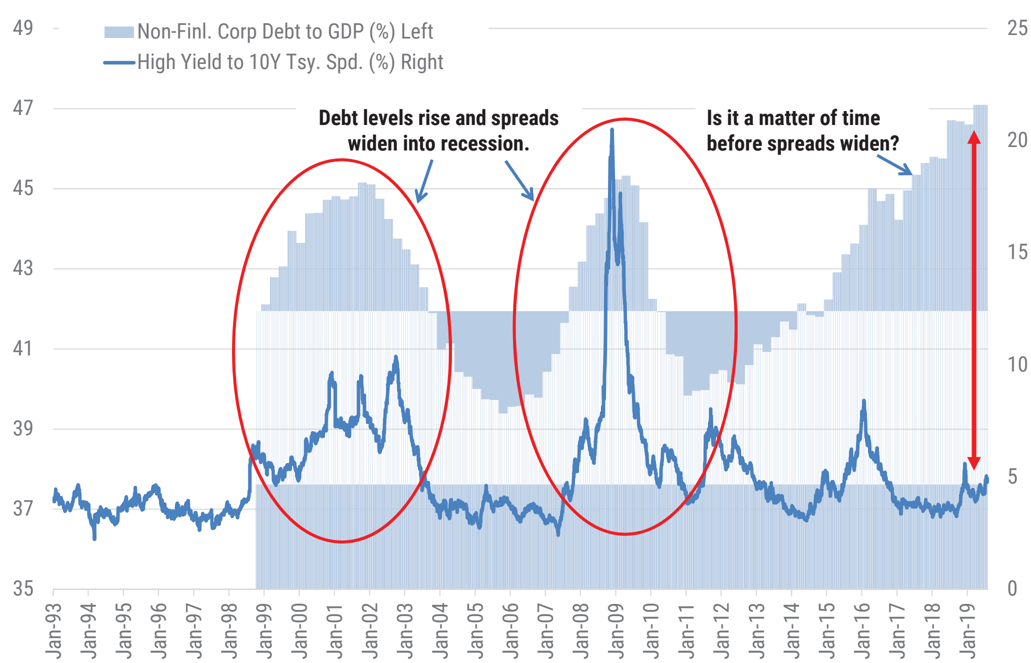
## Introducing the EquityCompass High-Dividend Portfolio (HDP)

- Seeks to generate a dividend yield similar to a high-yield corporate bond portfolio, while maintaining a higher concentration in investment grade companies
- Objective is to provide a supplemental strategy to complement, not replace, core income-oriented investments
- Recommended allocation similar to that of high-yield corporate bonds within a diversified portfolio
- Goal is to provide investors with: (1) a net cash flow yield in excess of 4% (net of fees) with dividend growth covering inflation, and (2) capital appreciation potential

## Debt Levels and Yield Spreads

**Figure 1**

January 1993—August 2019 | Source: Bloomberg Finance L.P., Ned Davis Research, EquityCompass



## The Origin

Over the past several years, investors have migrated to high-yield corporate bonds to gain adequate cash flow/income in what continues to be a historically low interest rate environment. This has resulted in significant corporate debt issuances at relatively low spreads to "risk free" U.S. Treasury rates.

In fact, corporate debt as a percent of U.S. gross domestic product (GDP) is now higher than it was during the Financial crisis. Further, while the spread between high-yield corporate bond yields and the 10-year U.S. Treasury bond has increased somewhat off its recent low it remains close to its 25-year low (**Figure 1**). **In our view, the increased demand for high-yield corporate debt at such low spreads has increased the inherent risk in this asset class.**

We are not forecasting pending doom in the high-yield corporate debt market. But, we are cognizant that high debt levels trading at relatively low spreads can be indicative of heightened investment risk.

During the most recent recessions, high-yield bond spreads increased significantly (decreasing the value of the bonds) as corporate debt levels spiked—appropriately reflecting building risk within corporate debt and the economy.

However, high-yield bond spreads are currently very low despite high debt levels. One could argue that corporate credit quality (and resulting spreads) is benefitting from the positive impact low interest rates have had on debt service coverage ratios. But, this is highly vulnerable to rising rates. Is it different this time or has monetary policy simply masked building risk?

We don't know the answer yet. But, we do believe it is prudent to have other options available in order to adequately diversify. Thus, **our search began for cash flow alternatives to high-yielding corporate bond allocations within diversified investment portfolios.**

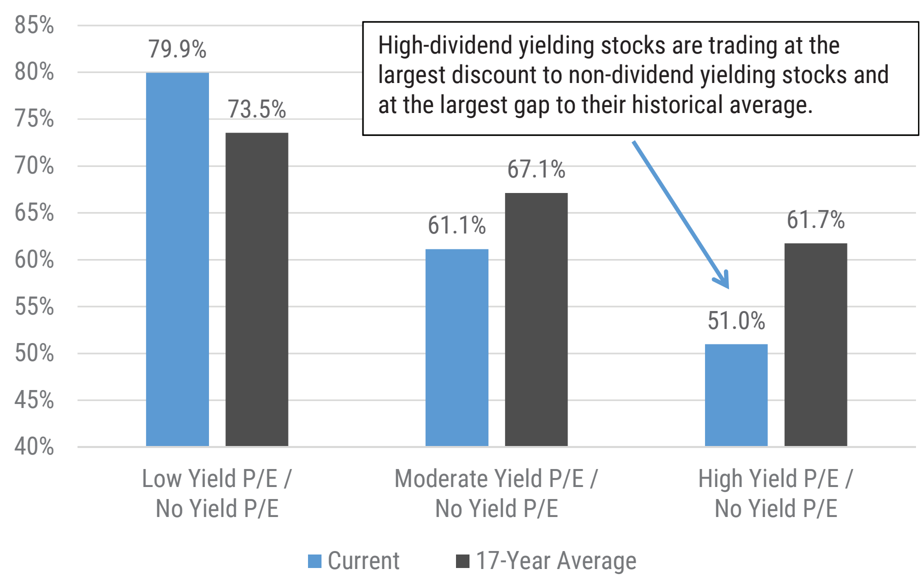
## The Search

During our search, we noted a valuation gap has developed between non-dividend and high-yielding dividend-paying stocks over the past several years as growth has significantly and consistently outperformed value in the equity markets. **High-dividend yielding stocks currently trade at just 51% of the non-dividend paying price-to-earnings (P/E) multiple versus the 17-year average of 62%** (**Figure 2**).

In addition, the high-yielding dividend paying stocks are the only subset within the S&P 500 currently trading at a discount to their historical

### Relative P/E of Dividend Payers to Non-Dividend Payers — Figure 2

Data as of 8/31/2019 | Source: Bloomberg Finance L.P., EquityCompass



## P/E Multiple Subsets By Dividend Yield

**Figure 3**

Source: Bloomberg Finance L.P., EquityCompass | Indices are unmanaged, do not reflect fees and expenses, and it is not possible to invest directly in an index.

| | P/E Ratio | | | | | Relative P/E Ratio | |
|---|---|---|---|---|---|---|---|
| S&P 500 Stocks (SPX) Market-Cap Weighted | High Yield | Moderate Yield | Low Yield | No Yield | All Stocks | High Yield P/E / Low Yield P/E | High Yield P/E / No Yield P/E |
| **Current** (as of 7/31/19) | **12.78** | 15.34 | 20.05 | 25.08 | 19.51 | **63.8%** | **51.0%** |
| **Average** (17-Year) | **12.88** | 14.01 | 15.34 | 20.87 | 17.78 | **84.0%** | **61.7%** |
| **Discount/Premium** | **-0.10** | **1.33** | **4.71** | **4.22** | **1.73** | **-20.2%** | **-10.8%** |

High Yield = Yield > 2X SPX Yield
Moderate Yield = 1X - 2X SPX Yield
Low Yield = < 1X SPX Yield

average (12.8x versus 12.9x). All other no-, low-, and moderate-dividend yielding subsets are trading at noticeable premiums to their historical averages (**Figure 3**).

This underperformance is occurring despite extraordinarily low interest rates, which may provide a unique opportunity for stock dividends as a cash flow alternative to high-yield corporate bonds. Currently, investors can achieve similar yields on these investments. However, dividend stocks could offer the added potential benefit of stock price appreciation given relatively attractive valuations. Bonds may not have the same upside potential due to the significant drop in longer term interest rates and tight spreads.

### The Solution

HDP is comprised of high-dividend paying stocks domiciled in the U.S. and developed international markets. It seeks to generate a high level of current income with dividend growth sufficient to cover inflation and a yield competitive with U.S. high-yield bond benchmarks. **Within a diversified portfolio, it is a supplemental income-focused strategy with a recommended allocation similar to high-yield corporate bonds.**

Most importantly, **HDP produces a yield similar to high-yield corporate bond funds while maintaining a higher level of investment grade securities.** For example, when we compare and contrast HDP against a high-yield corporate bond index like the iBoxx USD Liquid High Yield Index (IBOXHY), we note that both portfolios have a similar yield of approximately 5.8%–5.9%. However, HDP accomplishes this with over 85% of its weighted holdings achieving investment grade status versus just over 4% for IBOXHY (**Figure 4**). Other credit quality measures, such as portfolio debt/EBITDA ratios also seem to support the view that HDP is of higher credit quality.

**To be clear, the risk in comparing a stock portfolio to debt instruments lies in the fact that equity holders are subordinate to bond holders.** As such, in times of significant stress dividends could be cut in order to shore up debt payment obligations. However, our illustration not only compares the current yields between high-dividend stocks and high-yield corporate bonds, but it also focuses on the wide disparity of investment grade ratings between portfolio constituents.

### The Construction

HDP has been constructed in an effort to provide a higher than average yield from a portfolio of common/preferred equities with sufficient dividend growth to offset modest inflation.

The portfolio represents an opportunity that is not readily available for investors desiring a strategy that combines both high yield and diversification. For example, HDP's current dividend yield of 5.8% is lower than strategies highly concentrated in stocks such as Business Development Companies and Master Limited Partnerships (which can carry yields in the 8.0% range). However, the yield is much higher than the average broadly diversified dividend strategy, which yield more in the 3.0%+ range. In other words, **the portfolio seeks to balance concentration risk and yield in order to derive an above average cash flow stream from equities.**

## Yield and Investment Grade Comparison

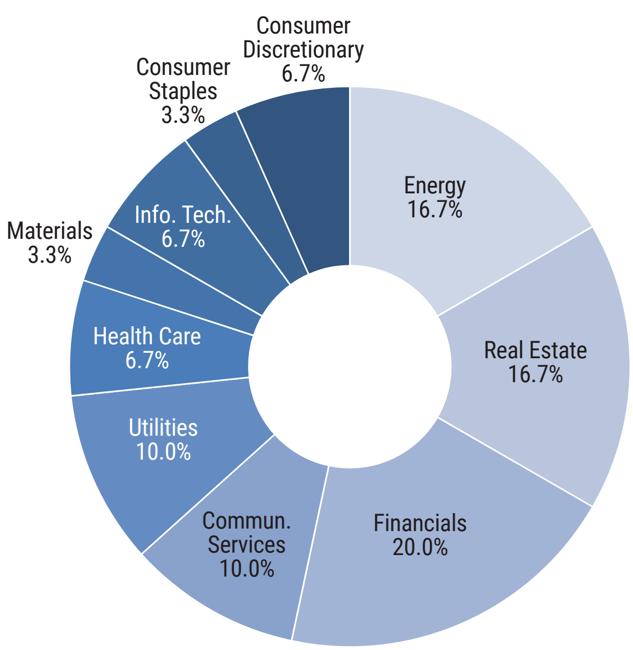
**Figure 4**

Data as of 8/31/2019 | Source: Bloomberg Finance L.P., EquityCompass

| | | IBOXHY | | HDP | |
|---|---|---|---|---|---|
| | Bond Rating | Weight | Avg. YTM | Weight | Avg. Dvd Yld. |
| Investment Grade | AAA | | | | |
| | AA | | | 9.24% | 5.27% |
| | A | | | 27.05% | 5.40% |
| | BBB | 4.52% | 4.69% | 49.60% | 6.13% |
| Non Invest. Grade | BB | 53.01% | 4.64% | 12.62% | 6.58% |
| | B | 33.75% | 7.37% | | |
| | CCC | 2.52% | 19.82% | | |
| | NR/Cash | 6.21% | 4.65% | 0.00% | 0.00% |
| | **Avg. YTM/Avg. Dvd. Yield** | | **5.95%** | | **5.82%** |
| | **Total Investment Grade** | **4.52%** | 5.65% | **85.89%** | 5.91% |
| | Total BB or lower | 95.48% | 6.01% | 12.62% | 6.58% |
| | Total B or lower | 42.47% | 7.71% | 0.00% | |
| | Total CCC or lower | 8.73% | 9.03% | 0.00% | |
| | **Debt to EBITDA** | **5.94** | | **4.86** | |
| | **Debt to Assets** | **0.50** | | **0.31** | |
| | **Debt to Total Capital** | **0.69** | | **0.47** | |

**To achieve the positive yield spread, the portfolio assumes more risk (i.e., higher dividend payout ratios) and may not be suitable for all investors.** However, we attempt to mitigate this risk by assessing a company's willingness and ability to pay current dividends. **The median dividend growth of the companies within the portfolio was 5.3% in 2018, with 4.0%–5.0% growth expected in 2019 and 2020.** In general, the companies in the portfolio have had stable, if not increasing, dividends for more than 13 years.

Portfolio construction is comprised of 30 primarily large cap stocks with an average market cap in excess of $80 billion that represent 10 distinct industry sectors. This can provide greater diversification than concentrated strategies generating yields in the 8% range.




| | |
|---|---|
| Number of Holdings | 30 |
| Avg. Market Cap. (USD Billions) | $87,827.1 |
| Weighted Avg. Dividend Yield | 5.82% |
| Price / Earnings (2020 Est.) | 14.8x |
| Price / Earnings (2021 Est.) | 13.9x |

The **High-Dividend Portfolio (HDP)** represents the third leg of the EquityCompass dividend income-focused suite and is intended to complement the existing Select Quality Growth and Income (SQLT) and the Quality Dividend (QDIV) portfolios. The three portfolios are differentiated by distinct objectives:

- **Select Quality Growth and Income** – Capital appreciation and income
- **Quality Dividend Portfolio** – Asset preservation, current income and growth in income
- **High-Dividend Portfolio** – High current income generation with possibility of growth

The High-Dividend Portfolio will be managed by the core competencies of the existing members of our dividend-focused team.

**Christopher M. Mutascio**
*Senior Managing Director*

Chris Mutascio will be the lead Portfolio Manager for the High-Dividend Portfolio (HDP) with a focus on leveraging credit expertise gained through three decades of experience as a national bank examiner and large-cap bank stock analyst. Chris joined EquityCompass in May 2018 as a Managing Director and senior member of our portfolio management team. He joined EquityCompass from Stifel, Nicolaus & Company, Incorporated, where his most recent role was Associate Director of Stifel's U.S. Equity Research department. Prior to his position with Stifel Equity Research, Mr. Mutascio was senior bank analyst with KBW and a director of large cap traditional bank research for Credit Suisse. Previously he spent seven years with Legg Mason, where he was a managing director and the company's senior bank analyst. Mr. Mutascio began his career as a federal bank regulator with the Office of the Comptroller of the Currency, where he worked for six years, rising to the level of national bank examiner.

Mr. Mutascio has an M.B.A. from Loyola University Maryland and an undergraduate degree from Gettysburg College.

**Michael S. Scherer**
*Senior Portfolio Manager*

Mike Scherer will act as HDP Co-Manager and brings a wealth of portfolio manager experience given his roles as lead Portfolio Manager on Select Quality Growth and Income (SQLT) and Co-Manager for the Quality Dividend Portfolio (QDIV). Mike is a senior member of the team responsible for developing and researching EquityCompass' quantitative portfolio strategies. He has written extensively on market strategy and works closely with Stifel financial advisors educating them on EquityCompass investment portfolios and products.

Mike has been involved in quantitative model maintenance and portfolio construction for the EquityCompass portfolios and quantitative models since the beginning. He joined the Legg Mason equity marketing department in 2000 and arrived at Stifel as part of the acquisition of Legg Mason's Capital Markets Group in December 2005.

Mr. Scherer has an M.B.A. in Finance from Loyola University Maryland and a B.A. from the College of William & Mary with a concentration in government.

**Larry Baker, CFA**
*Senior Portfolio Advisor*

Larry Baker brings a consistent and reliable process of identifying companies that demonstrate the willingness and ability to pay annual dividends given his successful leadership of the Quality Dividend Portfolio (QDIV) from 2010–2018. Larry joined EquityCompass in 2010. He has more than 35 years of investment experience, including 15 years at Legg Mason, where he was a Managing Director and a securities analyst in the Industrials sector. Prior to joining Legg Mason, he was a Vice President and securities analyst at Dillon, Read & Co. Mr. Baker began his career as a securities analyst with E. F. Hutton, where he spent 10 years. Mr. Baker received a B.S. from the United States Military Academy and a Master's in Finance from the Sloan School of Management at the Massachusetts Institute of Technology.

# Portfolios & Products

## EquityCompass strategies have been available on the Stifel platform since 2006

Strategies are based on fundamental, technical, and behavioral insights evolving from the empirical research conducted by EquityCompass professionals since 2001.

We follow a rules-based investment process for portfolio construction and risk control strategies overseen by the Chief Investment Officer, while Senior Portfolio Managers focus on quantitative and qualitative research for stock selection appropriate to the various investment strategies.

EquityCompass is committed to providing full transparency on investment decision-making so that financial advisors and investors can assess risk and return potential.

*For updated performance and portfolio statistics, contact a Stifel Financial Advisor.*

**Portfolios & Products**

- Core Retirement Portfolio
- Core Investment Portfolio
- Core Balanced Portfolio
- Global Leaders Portfolio
- High-Dividend Portfolio
- Quality Dividend Portfolio
- Select Quality Growth & Income
- Equity Risk Management Strategy

| Investment Portfolios & Products | Inception | Description |
|---|---|---|
| **Balanced** | | |
| **Core Retirement Portfolio (CRP)** | November 2015 | Comprehensive stock/bond portfolio that seeks to provide reliable income and capital appreciation to fund lifetime retirement withdrawals. |
| **Core Investment Portfolio (CIP)**<br>**Core Investment Portfolio — Tax Advantaged (MCIP)** | February 2018 | Comprehensive stock/bond portfolio that seeks to provide long-term capital appreciation while helping to mitigate risk from bear market drawdowns. With MCIP, the fixed income component, 25% of the total portfolio is allocated to municipal strategies and tax-advantaged investments. |
| **Global Asset Allocation** | | |
| **Core Balanced Portfolio (CBAL)**<br>**Core Balanced Portfolio — Tax Advantaged (MCBAL)** | June 2009<br>December 2009 | Stock/bond strategy that seeks to effectively capture market returns while minimizing volatility. With MCBAL, the fixed income component is allocated to municipal strategies and tax-advantaged investments. |
| **Global Equity** | | |
| **Global Leaders Portfolio (GLP)** | July 2014 | Focused portfolio of leading global companies positioned to benefit from the unprecedented growth in worldwide consumer demand. |
| **U.S. Equity** | | |
| **Quality Dividend (QDIV)** | January 2006 | Diversified strategy of high-quality, high-yielding stocks that integrates quantitative and qualitative approaches. |
| **High-Dividend Portfolio (HDP)** | September 2017 | Diversified strategy of common and preferred stocks that seek to generate a high level of current income with dividend growth to cover inflation and a yield that is competitive with U.S. high-yield bond benchmarks |
| **Select Quality Growth & Income (SQLT)** | January 2006 | Sector balanced strategy investing in high-quality, underpriced stocks that we believe have favorable value and price momentum characteristics. |
| **Alternative Strategies** | | |
| **Equity Risk Management Strategy (ERMS)** | June 2009 | Rules-based tactical asset allocation strategy designed to help reduce portfolio risk without curtailing the upside. |

## About EquityCompass

EquityCompass Investment Management, LLC ("EquityCompass") is a Baltimore-based SEC registered investment adviser offering a broad range of portfolio strategies and custom plans for individuals, financial intermediaries, and institutional clients in the U.S. and Europe. Formally organized in 2008, EquityCompass provides portfolio strategies with respect to total assets over $4.0 billion as of August 31, 2019. EquityCompass is a wholly owned subsidiary of Stifel Financial Corp.

The EquityCompass team of professionals represents deep industry experience in security analysis, capital markets, and portfolio management. We are committed to a consistent investment process that relies on enduring principles, sound empirical reasoning, and the recognition of a dynamic investment environment with a global reach.

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The S&P 500 index is a broad market index that tracks the performance of 500 stocks from major industries of the U.S. economy. The Markit iBoxx USD Liquid High Yield Index consists of liquid USD high yield bonds, selected to provide a balanced representation of the broad USD high yield corporate bond universe. The index is used as a basis for tradable products, including ETFs. Indices are unmanaged, do not reflect fees and expenses, and it is not possible to invest directly in an index. Diversification (or asset allocation) does not ensure a profit or protect against loss. Any projections, targets, or estimates in this report are forward looking statements and are based on EquityCompass research, analysis, and assumptions made by the Adviser. Changes in market conditions or a company's financial condition may impact a company's ability to continue to pay dividends. Companies may also choose to discontinue dividend payments.

*Total assets combines both Assets Under Management and Assets Under Advisement as of August 31, 2019. Assets Under Management represents the aggregate fair value of all discretionary and non-discretionary assets, including fee paying and non-fee paying portfolios. Assets Under Advisement represent advisory-only assets where the firm provides a model portfolio and does not have trading authority over the assets.

PAST PERFORMANCE CANNOT AND SHOULD NOT BE VIEWED AS AN INDICATOR OF FUTURE PERFORMANCE.

Additional Information Available Upon Request



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