Dividends: Mapping the Journey to Normal

Josh Peters, CFA
Director of Equity-Income Strategy
Editor, Morningstar DividendInvestor
About Morningstar DividendInvestor

► Launched in January 2005

► Josh Peters, CFA is Morningstar’s director of equity-income strategy, founding editor of DividendInvestor, and manager of its model portfolios

► Released companion book in 2008: The Ultimate Dividend Playbook

► Received over 1,100 dividends thus far from our recommended holdings—all of which reflect actual, trades in real money, Morningstar-funded brokerage accounts
Overview: Thinking About a “Normal” Equity Market

► What’s *probably* normal?
  ► Low economic growth
  ► Low inflation (excluding financial asset values, of course ...)
  ► High profit margins and cash generation

► What’s *not* normal?
  ► Interest rates (much too low)
  ► Dividend payout ratios (also too low)

► Who are dividends for?
  ► Everyone with an interest in risk-adjusted total return!
Primary Headwind: Rising Interest Rates

10-Year Treasury Yields

<table>
<thead>
<tr>
<th>Year</th>
<th>S&amp;P 500</th>
<th>DJDVY</th>
<th>Staples</th>
<th>Utilities</th>
<th>Telecoms</th>
<th>MLPs*</th>
<th>REITs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1946</td>
<td>18.6%</td>
<td>10.5%</td>
<td>11.3%</td>
<td>2.8%</td>
<td>10.7%</td>
<td>20.9%</td>
<td>12.3%</td>
</tr>
<tr>
<td>1951</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1956</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1961</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1966</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1971</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1976</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1981</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1986</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2016</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Average Rate Cycle, 1993-2011

<table>
<thead>
<tr>
<th></th>
<th>S&amp;P 500</th>
<th>DJDVY</th>
<th>Staples</th>
<th>Utilities</th>
<th>Telecoms</th>
<th>MLPs*</th>
<th>REITs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Absolute Performance</td>
<td>18.6%</td>
<td>10.5%</td>
<td>11.3%</td>
<td>2.8%</td>
<td>10.7%</td>
<td>20.9%</td>
<td>12.3%</td>
</tr>
<tr>
<td>Relative Performance</td>
<td>-8.1%</td>
<td>-7.3%</td>
<td>-15.8%</td>
<td>-7.9%</td>
<td>-0.4%</td>
<td>-6.3%</td>
<td></td>
</tr>
</tbody>
</table>

Rate Cycle, 7/2012 - 9/2013

<table>
<thead>
<tr>
<th></th>
<th>S&amp;P 500</th>
<th>DJDVY</th>
<th>Staples</th>
<th>Utilities</th>
<th>Telecoms</th>
<th>MLPs*</th>
<th>REITs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Absolute Performance</td>
<td>38.3%</td>
<td>31.6%</td>
<td>25.2%</td>
<td>6.7%</td>
<td>6.2%</td>
<td>27.7%</td>
<td>3.3%</td>
</tr>
<tr>
<td>Relative Performance</td>
<td>-6.8%</td>
<td>-13.2%</td>
<td>-31.7%</td>
<td>-32.1%</td>
<td>-10.6%</td>
<td>-35.1%</td>
<td></td>
</tr>
</tbody>
</table>

Tailwind: Dividend Payout Ratios

► Median payout ratio, 1946-1994: 53%  Current payout ratio: 35%

► ~50% upside for total dividend payments based on mean reversion

S&P 500 Index: Dividend Payout Ratio

The U.S. investor base is aging, which all but guarantees an increased preference for income and reduced tolerance for risk.

Source: Moody’s Economy.com via FreeLunch.com, U.S. Census Bureau, Morningstar analysis
Tailwind: Scarcity

Data shows percent of S&P 500 market value in categories shown above as of Nov. 11, 2014. Source: Morningstar
Tailwind: Long-Term Outperformance

High-Yield Equity Outperformance: 10-Year Rolling Total Returns

Our Evaluation Process

► Current dividend **yields** generally 3% or higher
  ► Willing to pay fair prices—not a traditional “value” strategy

► **Economic moats**: narrow or wide
  ► Protects dividend income from the effects of competition
  ► Encourages dividend growth as retained earnings are deployed at high returns within the company’s moat

► **Strong finances**
  ► Manageable leverage, healthy payout ratios, durable profits

► **Management devotion to dividends**
  ► No arbitrary test of time, but clear commitment to growth
Our Results: Income Leads to Outperformance

Cumulative Total Return: DividendInvestor Portfolios vs. S&P 500

Our Best Ideas Today (yields as of Nov. 12)

► **Chevron** (CVX; 3.6% yield)
  ▶ Heavy spending will pivot to rising output and free cash flow

► **General Electric** (GE; 3.3% yield)
  ▶ Rapidly repositioning toward infrastructure, away from GECS

► **General Mills** (GIS; 3.2% yield)
  ▶ Long-term advantages intact through industry slowdown

► **Magellan Midstream Partners** MMP (MMP; 3.1% yield)
  ▶ Highly attractive assets, great management & balance sheet

► **Philip Morris International** (PM; 4.6% yield)
  ▶ Uniquely suited to provide high income and high growth
Summary

► Rising interest rates will be a headwind, though mainly in terms of relative performance

► Payout ratios have a lot of room to rise, but already-generous companies are still the best picks for long-term income generation

► Demographic tailwinds and scarcity of high-payout, low-risk businesses suggests continued outperformance over long time horizons

► Among individual dividend payers, seek economic moats, strong finances, dedicated management teams, and reasonable valuations

► Questions?

Disclosure: Josh Peters owns the following stocks in his personal portfolio: AEP, APU, CLX, CVX, EMR, GE, GIS, GSK, HCN, JNJ, KO, KRFT, MCD, MMP, NGG, O, PAYX, PEG, PG, PM, RCI, RDS.B, SE, SEP, SO, UL, UPS, WFC, XEL.