Denver Investments®
Institutional

Deconstructing Dividends: Six Reasons to Consider Dividend-Paying Stocks

"Dividend-paying stocks historically outperform the market with less risk and low correlation with other investment styles, making them excellent portfolio diversifiers—especially in a rising rate environment."

EXECUTIVE SUMMARY

Research shows that allocating a portion of investable assets to dividend-paying stocks has the potential to enhance a portfolio's overall risk/return profile. Indeed, a close look at this unique subset of stocks reveals that they historically outperform the market with less risk, with a low correlation with other investment styles, thereby making them excellent portfolio diversifiers. Within the small- and mid-cap universes in particular, dividend-paying stocks have compounded money over the past three decades at a rate significantly higher than non dividend payers. For example, in the small-cap universe, dividend payers have compounded money at over 500 basis points higher than non dividend payers, creating more than four times the amount of dollar value.

Why are these stocks often overlooked? One reason might be that Wall Street thrives on companies that need outside capital to grow. Generally, dividend-paying companies rely less on external capital for growth. There is also a commonly held belief that dividend-paying companies' growth must be plateauing if they are giving money back to shareholders – believing that if a company had high return projects to invest in, they would make that choice instead of giving the money back to shareholders. This mis-held belief could not be further from the truth. We believe that companies are saying two powerful things when they pay their first dividend. 1) They are signaling to the market that their future is bright and that growth can be funded internally, and 2) they are going to be disciplined, shareholder-friendly corporate managers.

This paper presents compelling evidence as to why small- and mid-cap dividend-paying stocks should be part of a diversified portfolio.

Evidence includes:

I. Dividend-paying small- and mid-cap companies historically deliver higher returns compared to non-dividend-paying companies.

II. Lower risk profiles relative to non-dividend-paying stocks make small- and mid-cap dividend-paying stocks more attractive from a risk perspective.

III. The ability for dividend-paying small- and mid-cap stocks to participate in up markets while preserving capital in down markets.

IV. Low correlations of dividend-paying small- and mid-cap stocks with other equity classes make them good portfolio diversifiers.

V. Small and mid-cap dividend-paying stocks have shown to be attractive investments in rising rate environments.

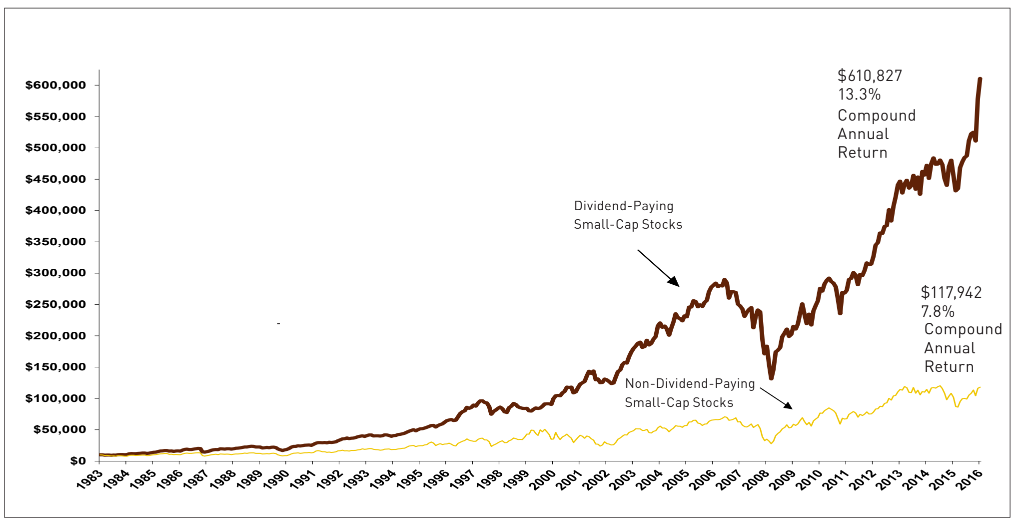
VI. Investing in dividend-paying stocks enables our investment team to potentially amplify the positive impact these stocks have on an investor's portfolio.

ANALYSIS

I. Dividend-paying small- and mid-cap companies historically deliver higher returns compared to non-dividend-paying companies.

According to Ned Davis Research, which has tracked the performance of dividend-paying stocks versus non-dividend-paying stocks as far back as 1983, the historical returns of dividend payers are higher than those of non dividend payers. Although the universe for each study is slightly different, the results are similar. Within the small-cap universe, dividend-paying stocks outperformed non-dividend-paying stocks, on average, over the last 33 years. Those that pay a dividend returned 13.3% annually over the period versus 7.8% for non dividend payers. This incremental return of approximately 500 basis points has led to the creation of more than four times the amount of dollar value.

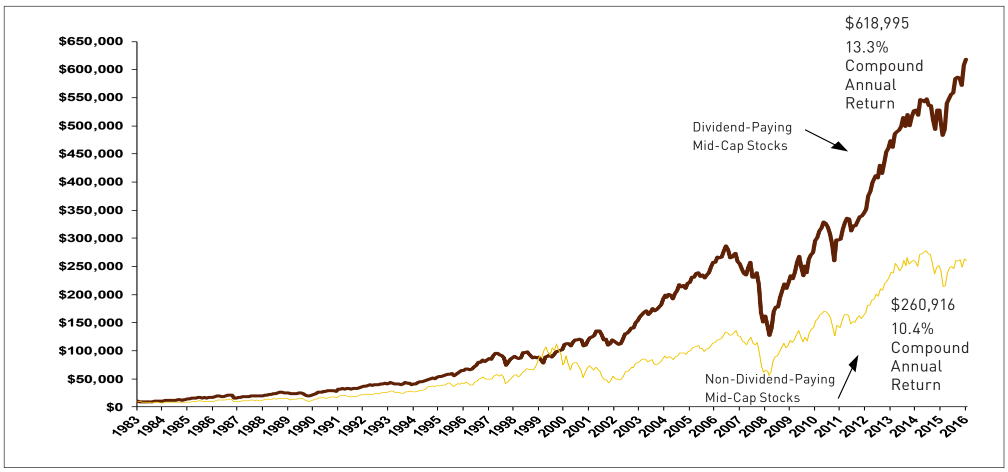
Dividend-Paying Small-Cap Stocks Outperform
Growth of $10,000 Investment
Dividend-Paying vs Non-Dividend-Paying Small-Cap Stocks
1983 to 2016



 Data as of 1/1/1983 through 12/31/2016. Based on equal-weighted arithmetic average of dividend-paying and non-dividend-paying historical Russell 2000® Index stocks. ***Past performance does not guarantee future results.***

Similarly, within the mid-cap universe, dividend payers outperformed non dividend payers during the same period, delivering annual returns of 13.3% and 10.4%, respectively. This means that dividend-paying stocks in this universe have compounded money at a rate of 290 basis points higher than non dividend payers, generating more than two times the amount of dollar value.

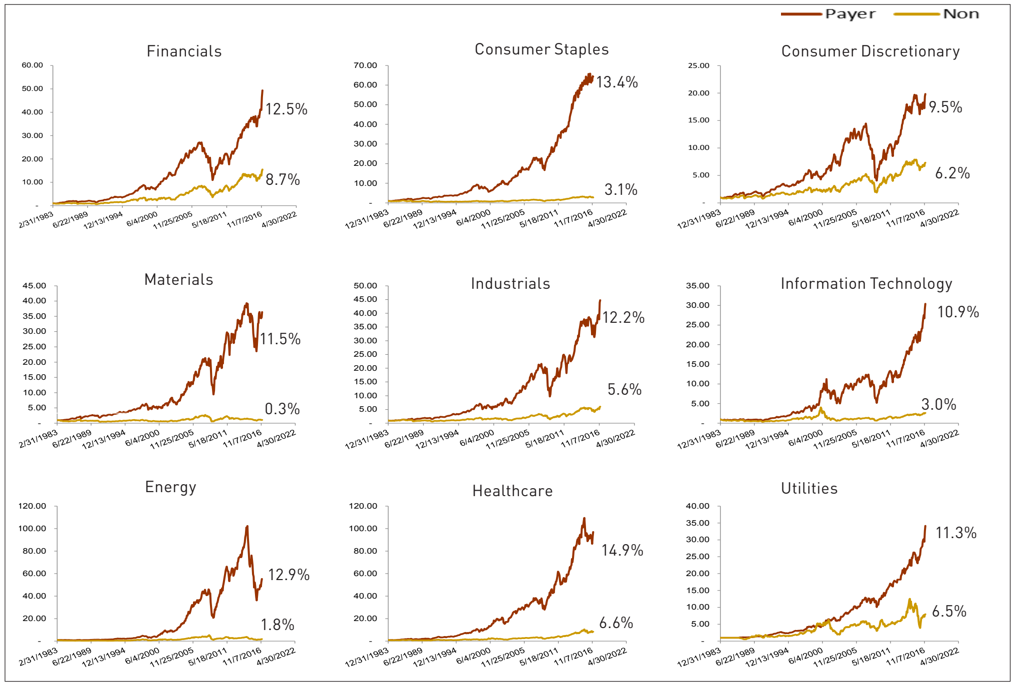
Dividend-Paying Mid-Cap Stocks Outperform
Growth of $10,000 Investment
Dividend-Paying vs Non-Dividend-Paying Mid-Cap Stocks
1983 to 2016



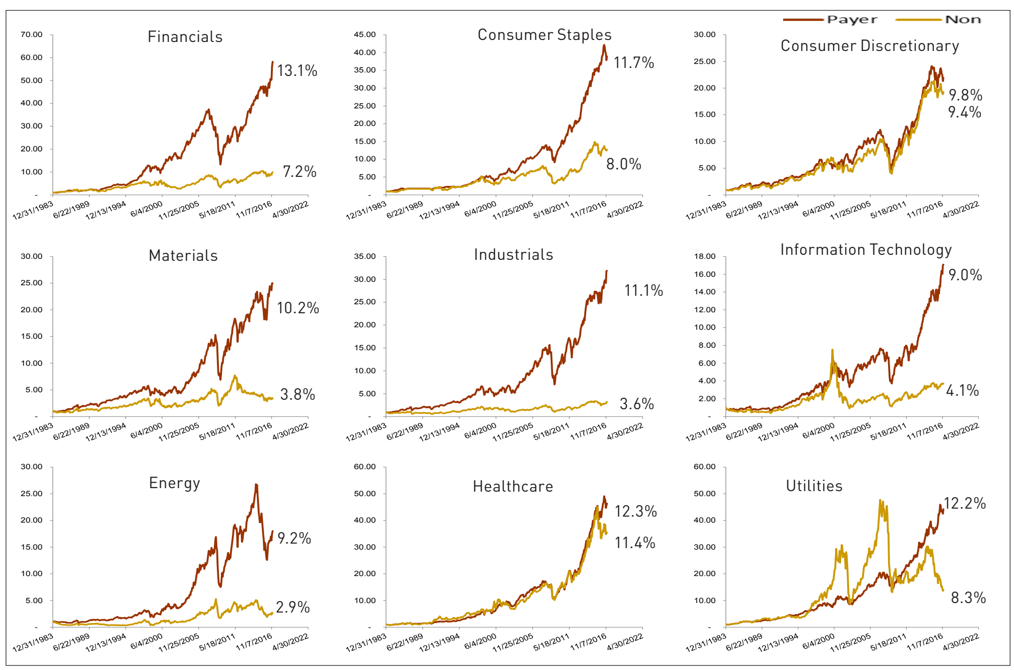
© Copyright Ned Davis Research, Inc., All Rights Reserved. Data as of 1/1/1983 through 12/31/2016. Based on equal-weighted arithmetic average of dividend-paying and non-dividend-paying historical Russell Midcap® Index stocks. ***Past performance does not guarantee future results.***

Importantly, as the charts on the next page show, this phenomenon is not limited to high-yielding sectors only. Compound annual growth rates for small- and mid-cap dividend-paying stocks are higher than those of non-dividend-paying stocks in every sector. The risk level for dividend-paying stocks, as defined by standard deviation, is also lower in every sector.

Dividends Outperform Across Sectors: Small-Cap



Dividends Outperform Across Sectors: Mid-Cap



Source: Factset, Clarifi. Internal calculations. Equal-weighted holdings, rebalanced monthly, 12/31/83 through 12/31/2016. ***Past performance does not guarantee future results.***

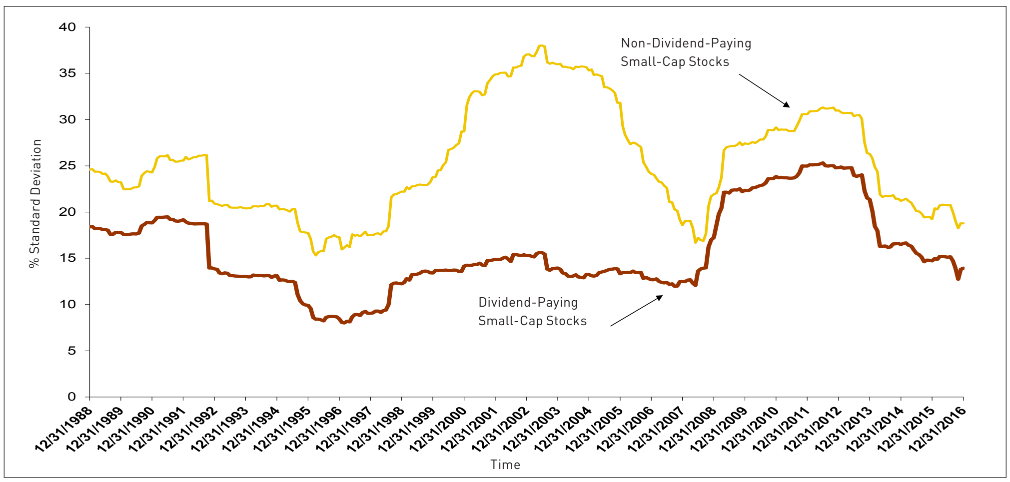
Conclusion: Based on the charts, small- and mid-cap dividend-paying stocks outperform non-dividend-paying stocks in every economic sector.

II. Lower risk profiles relative to non-dividend-paying stocks (as measured by standard deviation) make small- and mid-cap dividend-paying stocks more attractive from a risk perspective.

Modern portfolio theory states that, to achieve higher returns, an investor must take on more risk. However, the analysis of small- and mid-cap dividend strategies has shown otherwise. Using monthly return data from Ned Davis Research, we've charted the rolling five-year standard deviation of dividend-paying and non-dividend-paying small- and mid-cap stocks from 1983 through 2016. As you can see, dividend-paying stocks exhibit significantly lower risk than non-dividend-paying stocks.

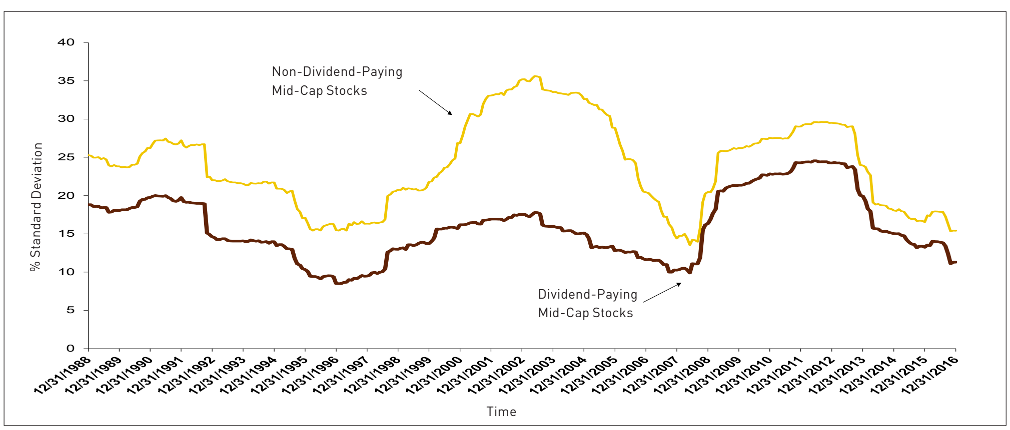
Attractive Risk Profile: Dividend-Paying Small-Cap Stocks

Rolling 5 Year Standard Deviation—Dividend-Paying Small-Cap Stocks versus Non-Dividend-Paying Small-Cap Stocks



Attractive Risk Profile: Dividend-Paying Mid-Cap Stocks

Rolling 5 Year Standard Deviation—Dividend-Paying Mid-Cap Stocks versus Non-Dividend-Paying Mid-Cap Stocks



Source: Ned Davis, Frank Russell Company. Data as of 1/1/1983 through 12/31/2016. **Past performance does not guarantee future results.**

Conclusion: Small- and mid-cap dividend-paying stocks are less risky than small- and mid-cap non-dividend-paying stocks.

III. The ability for dividend-paying small- and mid-cap stocks to participate in up markets while protecting capital in down markets.

A common misconception is that owning dividend-paying stocks is a defensive strategy and only leads to outperformance in down markets. Since 1983, the average performance of small-cap dividend payers in up markets surpassed that of its core benchmark by 2.1%, while mid-cap dividend payers were flat with their benchmark. In down markets, both small- and mid-cap dividend-paying stocks offered protection relative to the benchmark, outperforming by 6.2% and 4.6%, respectively. Compared to value benchmarks for the same time period, the relative performance also looks strong. Small-cap dividend payers outperformed by 1.0% in up markets and by 3.3% in down markets. Mid-cap dividend payers outperformed by 0.9% in up markets and 0.3% in down markets.

Relative Outperformance of Dividend-Paying Stocks Compared to Core Benchmarks

	Russell 2000® Index	Russell 2500® Index	Russell Midcap® Index
Average Performance in Up Markets	2.1%	1.2%	0.3%
Average Performance in Down Markets	6.2%	5.1%	4.6%

Relative Outperformance of Dividend-Paying Stocks Compared to Value Benchmarks

	Russell 2000® Index	Russell 2500® Value Index	Russell Midcap® Value Index*
Average Performance in Up Markets	1.0%	2.3%	0.9%
Average Performance in Down Markets	3.3%	2.2%	0.3%

*Denotes that the benchmark was established in 1986. All other data from 1/1/1983 through 12/31/16. Data source: Ned Davis. **Past performance does not guarantee future results.**

Conclusion: Based on these charts, small- and mid-cap dividend-paying stocks outperform in up and down markets.

IV. Low correlations of dividend-paying small- and mid-cap stocks relative to other equity classes make them good portfolio diversifiers.

In this section, we look at the correlation of small- and mid-cap dividend-paying stocks to the nine common style indices. The following tables show that the correlations between most of the indices and the small- and mid-cap dividend payers are attractive from a portfolio construction perspective. For example, combining the Russell 1000® Growth Index with a small- or mid-cap dividend-paying portfolio could provide positive diversification benefits.

Correlation with Dividend-Paying Small-Cap Stocks	1983-2016
Russell 1000® Index	0.79
Russell 1000® Growth Index	0.70
Russell 1000® Value Index	0.83
Russell Midcap® Index	0.86
Russell Midcap® Growth Index	0.73
Russell Midcap® Value Index	0.89
Russell 2000® Index	0.91
Russell 2000® Growth Index	0.81
Russell 2000® Value Index	0.97

Correlation with Dividend-Paying Mid-Cap Stocks	1983-2016
Russell 1000® Index	0.90
Russell 1000® Growth Index	0.80
Russell 1000® Value Index	0.94
Russell Midcap® Index	0.94
Russell Midcap® Growth Index	0.79
Russell Midcap® Value Index	0.99
Russell 2000® Index	0.85
Russell 2000® Growth Index	0.78
Russell 2000® Value Index	0.91

Source: Ned Davis. Both mid-value and mid-growth indices began in 1986.

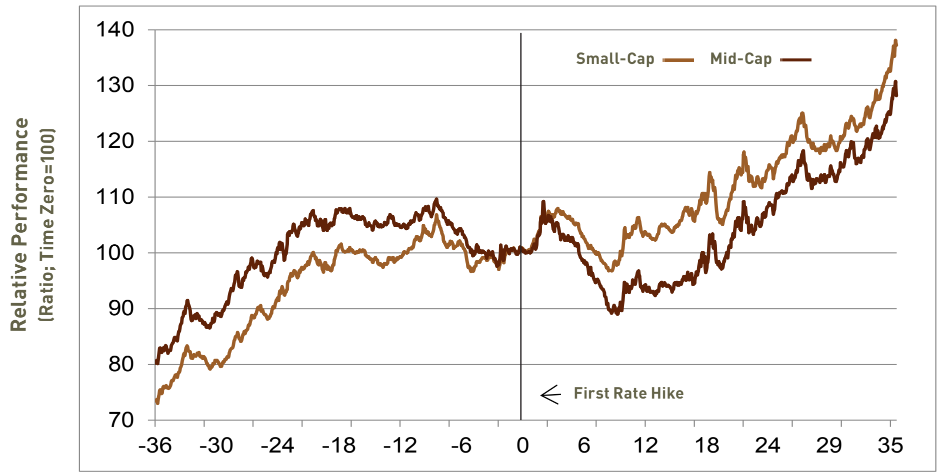
Additionally, small- and mid-cap dividend-paying stocks have delivered higher returns while exhibiting less risk than nearly all other common style indices (from 1983 – 2016), further strengthening the case for why small- and mid-cap dividend-paying stocks should be part of a diversified portfolio.

Conclusion: Adding small- and mid-cap dividend-paying stocks to a portfolio should be a good source of diversification.

V. Dividend Payers Outperform Before and After Rate Hikes

There may be concern in the market on how dividend payers may perform given that we look to be starting an interest rate tightening cycle. Counter to what many may perceive, dividend-paying small-cap stocks have outperformed in most periods leading up to the first tightening, as well as the one-, two- and three-year periods subsequent to the beginning of the tightening cycle. Dividend-paying mid-cap stocks generally underperformed in the year leading up to the first tightening, as well as the year following, but showed tremendous outperformance of the second and third years post-tightening.

Monthly Relative Outperformance of Dividend Payers



Months Before/After Tightening Cycles

Small-Cap Dividend Payers
Months Prior | Months Post

Event Date	-36 Months	-24 Months	-12 Months	-6 Months	6 Months	12 Months	24 Months	36 Months
1987-09-04	44.45	20.90	6.87	4.86	14.61	21.04	24.49	26.62
1994-02-04	15.49	26.72	2.95	-3.35	10.34	4.46	1.72	14.62
1999-06-30	39.24	4.64	-6.07	-8.06	-24.92	-23.81	23.85	102.09
2004-06-30	45.29	-5.70	-0.45	3.77	5.33	11.02	7.90	5.41
Median	41.84	12.77	1.25	0.21	7.83	7.74	15.88	20.62
Average	36.12	11.64	0.83	-0.69	1.34	3.18	14.49	37.19
% Positive	100.00	75.00	50.00	50.00	75.00	75.00	100.00	100.00

Mid-Cap Dividend Payers
Months Prior | Months Post

Event Date	-36 Months	-24 Months	-12 Months	-6 Months	6 Months	12 Months	24 Months	36 Months
1987-09-04	34.80	1.77	-10.29	-3.92	8.13	9.32	6.01	4.64
1994-02-04	-1.99	6.91	-3.44	-5.93	4.98	-4.62	-9.17	-0.19
1999-06-30	-0.47	-17.10	-15.83	-12.08	-28.54	-36.28	29.71	106.50
2004-06-30	65.73	5.66	9.21	6.24	5.95	5.22	4.07	1.70
Median	17.16	3.72	-6.87	-4.93	5.46	0.30	5.04	3.17
Average	24.52	-0.69	-5.09	-3.93	-2.37	-6.59	7.66	28.16
% Positive	50.00	75.00	25.00	25.00	75.00	50.00	75.00	75.00

Source: NedDavis.

Conclusion: Based on the above chart, small and mid-cap dividend-paying stocks have shown strong outperformance after the beginning of an interest rate tightening cycle.

VI. Investing in dividend-paying stocks enables the team to potentially amplify the positive impact these investments have on an investor's portfolio.

The Value investment team is solely focused on finding undervalued stocks that pay dividends in its small-, smid- and mid-cap dividend portfolios. While this paper has focused on the virtues of small- and mid-cap dividend-paying stocks, smid-cap dividend-paying stocks generally have the same attractive risk-return profiles as dividend-paying small- and mid-cap stocks.

The main tenets to the team's investment philosophy are as follows:

- Stock prices follow free cash flow and returns on capital over time.
- Superior risk-adjusted performance is best achieved by investing in high-quality, dividend-paying companies that are trading at a meaningful discount to intrinsic value.
- A combination of quantitative screening and independent fundamental analysis increases research efficiency and provides an information advantage.
- A team decision-making approach provides diverse, in-depth perspectives, bringing the team's best ideas into each client's portfolio.

Regarding its investments in dividend-paying companies, the team believes that returning capital to shareholders in the form of a dividend sends a clear and powerful message about a company's future prospects and performance. Specifically, the team looks for high-quality companies with management teams that have a high level of shareholder orientation and that earmark capital for shareholder return through dividends. The team also looks for dividend-paying companies that can grow dividends while still investing internally in value-creating projects.

The team brings a combined 145 years of investment experience to the table and a wealth of informational diversity. Because team members have a variety of professional, educational, and geographical backgrounds, breadth of knowledge is deep and varying viewpoints are common. This ensures that current and prospective investments are examined from multiple angles and that decisions are made with confidence.

Portfolio Management

- 145 years of combined experience
- 7 Chartered Financial Analysts on the team
- Wide-ranging professional, educational and geographical backgrounds

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Summary

Small- and mid-cap companies that pay dividends offer attractive risk/return potential. Ironically, because of common misperceptions, these stocks are often missing from investors' portfolios. By providing evidence that demonstrates the many virtues of these stocks, we hope to have dispelled the myths about dividend-paying companies and presented a compelling case for why small- and mid-cap dividend-paying stocks can enhance the risk/return profile of a portfolio.

RISKS: Diversification does not eliminate the risk of experiencing investment losses.

Investing in small- and mid-cap funds generally will be more volatile and loss of principal could be greater than investing in large-cap funds.

Dividends are not guaranteed. A company's future abilities to pay dividends may be limited and a company may cease paying dividends at any time.

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The investment process used by Denver Investments may not achieve the desired results.

INDEX DESCRIPTIONS:
All indices are unmanaged and index performance figures do not reflect any fees, expenses or taxes. Investors cannot invest directly in an index.

The Russell 1000® Index measures the performance of the 1,000 largest companies in the Russell 3000® Index, which represents approximately 92% of the total market capitalization of the Russell 3000® Index.

The Russell 1000® Growth Index measures the performance of those Russell 1000 companies with higher price/book ratios and higher forecasted growth values.

The Russell 1000® Value Index measures the performance of those Russell 1000 companies with lower price/book ratios and lower forecasted growth values.

The Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000® Index, which represent approximately 25% of the total market capitalization of the Russell 1000® Index.

The Russell Midcap® Growth Index measures the performance of those Russell Midcap companies with higher price/book ratios and higher forecasted growth values. The stocks are also members of the Russell 1000® Growth Index.

The Russell Midcap® Value Index measures the performance of those Russell Midcap companies with lower price/book ratios and lower forecasted growth values. The stocks are also members of the Russell 1000® Value Index.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000® Index.

The Russell 2000® Growth Index measures the performance of those Russell 2000 companies with higher price/book ratios and higher forecasted growth values.

The Russell 2000® Value Index measures the performance of those Russell 2000 companies with lower price/book ratios and lower forecasted growth values.

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