White Paper on Dividend Stocks

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The Importance of Dividend-Paying Stocks

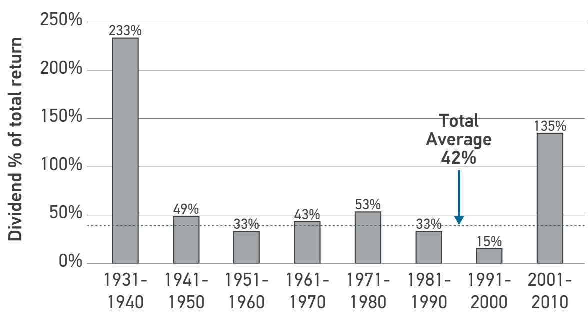
As an increasing number of baby boomers enter their retirement years, the demand for income-yielding investments will only continue to grow. By 2020, a projected 70% of all investment assets will be held by those in or approaching retirement. In an interest rate environment where nominal bond yields have fallen to their lowest levels in 50 years, investors seeking alternatives to bond income have increasingly been drawn to dividend-paying stocks, with nearly half of dividend income being paid to those 65 and older. Strategas Research Partners, Strategy and Policy Report (Nov. 9, 2012).

In the 1990s, when capital growth was the primary focus of investors, dividend-paying stocks were shunned in favor of growth stocks. Companies that allocated their capital through the payment of dividends were thought to have low prospects for earnings growth. This was proven to be a misconception by a 2003 study published in the CFA Institute's Financial Analysts Journal by Robert D. Arnott and Clifford S. Asness, which found that companies with high payout ratios (the percentage of net income paid out in the form of dividends) had achieved higher earnings growth than companies with low payout ratios.

Contribution to Total Returns

It may also come as a surprise that dividends have accounted for an average of over 40% of the total return from stocks since 1931. The following chart displays the contribution of dividends to total return per decade. Another study conducted by Ned Davis Research, which compared the performance of dividend-paying stocks to the performance of non-dividend payers between 1972 and 2005, revealed that dividend stocks actually outperformed the non-dividend stocks by 3% annually during this period.

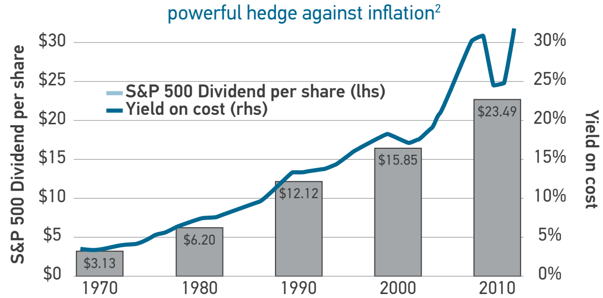
Today, dividends likely make up greater portion of equity returns[1]



Protection Offered

Attributes of dividend-paying stocks include dampened volatility and inflation protection. Dividend payers have up to 30%-33% lower volatility than non-dividend-paying stocks, and in decades of high market turmoil, such as the 1930s and 2000s, these dividend-paying stocks provided a cushion against downside price activity. Dividend payers that consistently grow their dividends can offer better inflation protection than bonds in an inflationary environment. The companies that can increase dividend payouts in periods of rising inflation tend to be those with the ability to pass through increasing costs of commodities by raising product prices. As shown in the following chart, dividend growth per share for the S&P 500 has outpaced inflation over time.

A growing dividend stream may be a powerful hedge against inflation[2]



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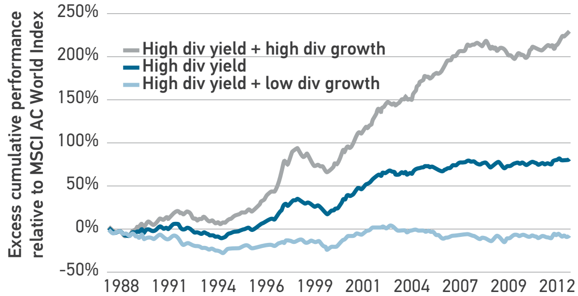
Corporate Environment

Cash generated by corporations can be put to use in a number of ways including (1) reinvestment in the company, (2) mergers and acquisitions, (3) share repurchases, and (4) payment of dividends to shareholders. Cash flow generation and cash reserves are currently at peak levels as companies have been shoring up balance sheets following the financial crisis of 2008 and remain cautious in a period where fiscal policy is in question. Payout ratios, which have historically been above 50%, have dropped to historic lows of approximately 30%. As business confidence is restored, there is the potential for dividend payouts to rise.

Selection of Dividend-Paying Stocks

As with any investment, careful analysis of a company's financials, not to mention stock valuation, is critical in selecting dividend-paying companies. A high yield for a company may appear attractive but can be deceptive. Some of the highest-yielding stocks are issued by companies that tend to have stable and fairly predictable cash flow, such as utilities or telecoms. However, a high yield can also be an indicator that the health of the company is in question or that a dividend cut may be on the horizon. Understanding the actual cash generated by a company is critical because operating earnings figures can be manipulated based on rules of accounting and may not give a true picture of the real cash flow of a company. Selecting companies with a history of dividend growth and the ability to continue raising dividends over time can benefit one's portfolio, as shown in the following chart. Since 1988, companies that have consistently grown their dividends over time have greatly exceeded the cumulative returns of those with simply high yield or lower dividend growth.

Excess Returns Relative to the MSCI AC World Index[3]



Consequences of Tax Policy Changes

Many investors are wondering whether a change in tax policy could affect the demand for income-yielding investments. Could increased tax rates negatively impact the returns of dividend-oriented investments and corporate dividend policies? A study by Copeland Capital Management, LLC on June 30, 2012, in which periods following tax policy changes were analyzed in both 1991 and 1993, found that tax policy changes had minimal impact on stock prices. Further research by WisdomTree suggests a similar outcome, based on factors such as (1) 88% of stocks pay dividends, meaning that there are few alternatives for those seeking yield, and (2) 40% of investments in this country are held in tax-exempt accounts where taxes are not an immediate issue. While tax policy changes could disrupt the near-term performance of income-yielding investments, the adverse impact would likely be short-lived.

In summary, a combination of factors, including demographics, demand for income in a low yield environment, and excess cash on corporate balance sheets, all bode well for continued demand for dividend-paying stocks.

[1] ***Chart provided by PIMCO. As of December 2011. Source: Bloomberg, Jack W. Wilson and Charles P. Jones, Bloomberg. Data through 1990 is derived from An Analysis of the S&P 500 Index and Cowles's Extensions: Price Indexes and Stock Returns, 1870-1999, Journal of Business, 2002, vol. 75 no. 3. Data after 1990 is from Bloomberg. Total return assumes reinvestment of income.***

[2] ***Chart provided by PIMCO. Source: Bloomberg. Data is based on S&P 500 Index. Yield on cost = Annual S&P 500 dividend/S&P 500 Index price (1970 $92.06). Hypothetical example for illustrative purposes only. This illustration is not indicative of past or future performance.***

[3] ***Chart provided by PIMCO. As of June 30, 2012. Source: BofA Merrill Lynch Global Quantitative Strategy. High Div Yield + High Div Growth, High Div Yield, High Div Yield + Low Div Growth data represent subsets of the MSCI AC World Index.***