Searching for Yield as Dividend Growth May Slow

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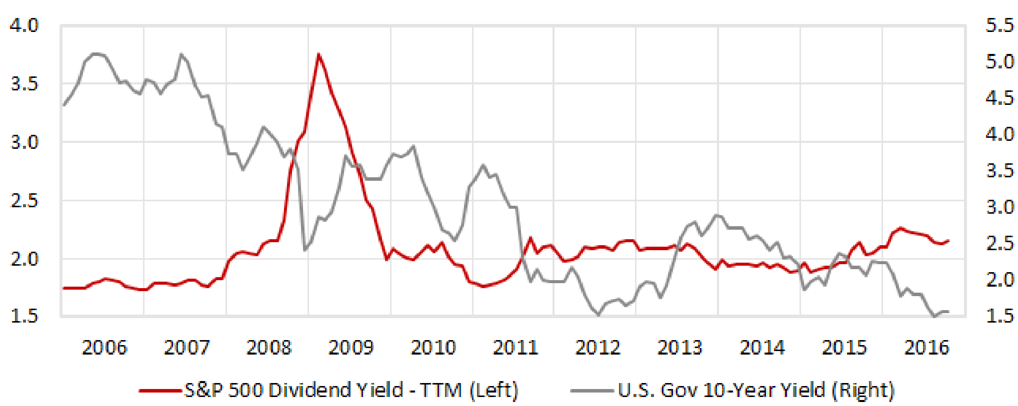
Thoughts to Ponder in a Good Year so Far

2016 has been a good year so far for stocks offering attractive dividend yields, as investors continue to search for reliable cash returns in an environment of historically low interest rates. Year to date, the Dow Jones Select Dividend Index has seen total returns in low double-digit territory, outperforming the S&P 500's total return by a wide margin.

For much of this year, the S&P 500's dividend yield (currently 2.1% as of 9/12/16) has exceeded the 10-year Treasury bond yield. This is a rare event. Post World War II, that had not occurred until the carnage of the Great Recession produced a cross-over in 2009 and then again in 2012. The chart below tracks this monthly data back to January 2006.

TTM S&P 500 Dividend Yield vs. U.S. Gov 10-Year Yield



Source: FactSet as of September 12, 2016

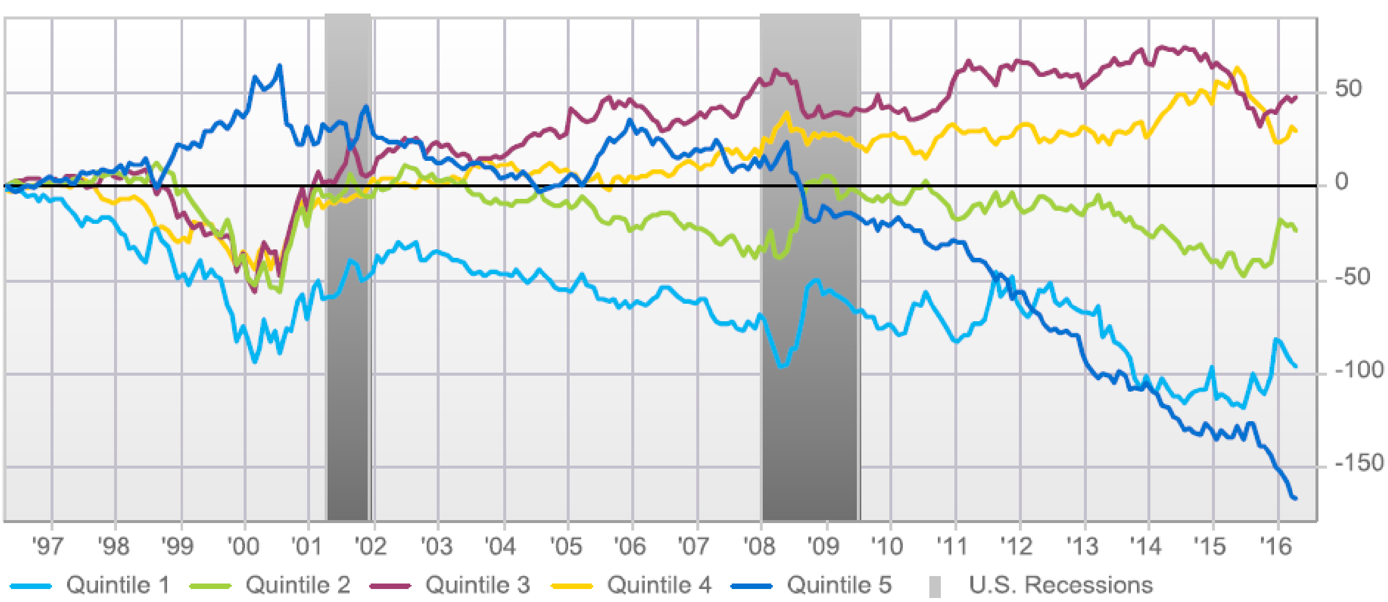
Dividend Growth Expectations

Institutional and retail investors' desire for cash returns has not been lost on big corporations. Management teams often stress the importance of returning cash to shareholders through dividends and ongoing share repurchases on quarterly earnings conference calls. In this economy where top line sales growth has been sluggish in many sectors, companies have lacked plentiful new investment opportunities. Forgoing capital investment activities has led to increasing cash levels on corporate balance sheets and has supported the growth of increasing distributions to shareholders.

While corporations have increased dividends at or near double-digit rates in recent years, expectations are that dividend growth will slow to less than 5% over the next twelve months, according to FactSet analyst compilations. While dividend growth may cool, it is important to note that companies have been much quicker to suspend or cut stock buybacks rather than dividends when earnings are pressured. Thus share repurchases will likely provide the initial cushion or shock absorber if corporate free cash flow should narrow.

We believe simply seeking the highest yields available can be a losing long-term strategy. Many investors found this out last year when the price of energy related Master Limited Partnerships (MLPs) collapsed along with the price of oil. An analysis of dividend payout ratios (the ratio of aggregate dividends paid to total net income) can be helpful in avoiding yields that appear too good to be true. A recent FactSet study on payout ratios (below) noted that over the past 20 years, companies in Quintile 3, which had an average payout ratio of 34.9%, were the best performers outperforming the S&P 500 Total Return Index by 47.9% on an excess cumulative weighted total return basis. Companies in Quintile 4, with an average payout ratio of 23.4%, were the second best performers. Notably, companies with the highest and the lowest payout ratios were the worst performers and underperformed the S&P 500 Total Return Index. Often, companies on the extreme high end of payouts may use increasing leverage (debt) to support their dividends and companies on the low end may not have the level of recurring, stable free cash flow to support an attractive and growing dividend.

Returns of Dividend Paying Stocks Grouped by Payout Ratio



Source: FactSet Dividend Quarterly (June 22, 2016). Quintiles are grouped by dividend payout ratio with Quintile 1 representing the highest payout ratio and Quintile 5 representing the lowest (but not zero) payout ratio.

Truxton Trust Equity Income

At Truxton Trust, we are strong believers in investing in high quality stocks offering attractive dividend yields that are likely to provide a *growing* income stream to investors over time. An important element in raising investors' overall annual returns will likely come from the reinvestment of dividends over an extended period of time. Reinvestment of dividends added roughly 200 basis points (2%) to annualized returns over the last 20 years.[1] This well-known and powerful financial phenomenon is known as compounding.

Truxton Trust has an active approach to investing in dividend stocks through our Truxton Trust Equity Income portfolio. The Portfolio is currently comprised of 37 individual large cap stocks and has a current yield of more than 3%, which exceeds the S&P 500 yield of about 2.1%. In a typical Truxton Trust Wealth Management account, Equity Income is targeted to represent about 22% of our total equity exposure. Factors we look for when adding a new stock are a demonstrated commitment to dividend growth and/or a commitment by management to specific dividend hikes in the future. This is not a portfolio where we try to take big bets in any individual names but rather we emphasize stock diversification by targeting a full position at about 2.5% and our largest individual stock position is less than 4%. So far in 2016, we have added four stocks to the portfolio and removed two.

Sector Diversification

Likewise, we are not trying to over expose our clients to any particular industry sector. While our largest single sector exposure is currently to utilities at about 15% of the portfolio, that is about half of the exposure of the popular iShares Select Dividend ETF (ticker: DVY). As markets have recovered from 2008, it seems it has been either feast or famine for utilities from a relative performance standpoint. Over the past eight years (2009-2016), the utilities sector has been among the three worst performing industry sectors. However, for two years (2011 and 2014) the utilities sector was the best performing industry in terms of capital appreciation.

After appearing as though 2016 would be a similar top year for utilities, the sector has cooled somewhat in the second half of this year after a torrid first half in which the Utilities Select Sector SPDR ETF (ticker: XLU) increased 21.2% (12/31/15 - 6/30/16). In the second half of the year, as the overall market has improved, XLU has declined about 6% (6/30/16 - 9/12/16). The high yielding telecom sector has outperformed utilities in the second half and both are up more than 13.5%, more than doubling the S&P 500 performance year to date as of 9/12/16. The Truxton Trust Equity Income portfolio currently has nine stocks in the utilities and telecom groups in total. The recent experience of these sectors likely is a function of long-term interest rates continuing their descent this year rather than improving company fundamentals.

Dividends do not necessarily reduce risk and should not be evaluated in isolation, or relied upon as a guaranteed cash flow. In 2007 and 2008, many large and venerable financial institutions with attractive

[1] *Source: S&P Dow Jones Indices (August 31, 1996 to August 31, 2016)*

and seemingly bullet proof dividends failed or were pushed to the brink of failure. Concentrations to a "yieldy" sector can expose investors to meaningful losses. Similar to compounding, diversification is a well-known and important part of a prudent long-term investment process.

Dividend Growth Over Time

As the Federal Reserve stands ready to nudge interest rates higher, potentially this year, investor appetites for dividend stocks could wane somewhat as valuations become extended and as fixed income instruments eventually begin to offer the potential for higher returns. As we at Truxton Trust ponder that possibility, a lever we could pull is an incremental shift away from large cap value toward other equity styles (mid-cap, small-cap, etc.) just as we shifted toward large cap value in late May of 2015. Regardless of any tactical decision, high quality dividend payers with the potential for dividend growth over time will remain a central feature of our equity allocation. We expect a portfolio of well diversified, high-quality dividend paying companies with the capacity to increase dividends over time to deliver attractive risk adjusted returns over a variety of market cycles, even those where interest rates may be trending higher. ■