



Christopher G. Huemmer, CFA | Senior Investment Strategist – Equity | ETF Group

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QUALITY = A DIVIDEND BREAKTHROUGH

Investing, like many things in life, is cyclical by nature. Factors, trends, and asset classes move in and out of favor, gaining and losing investors' attentions and dollars. The phasing and amplitudes of cycles can also vary, driven by different forces with different emphases at different times. Sometimes the phasing of short and longer term cycles overlap to create so called super-cycles that push asset prices to extremes. At first glance, recurring investment cycles can appear to follow a predictable path. In fact, each is driven by a unique set of characteristics and circumstances that present investors with an ever-changing mix of opportunities and risks.

For some time now, equity markets have been riding a wave of cyclical demand for dividend stocks and dividend-focused equity products. Not atypically, company managements have both fed and responded to this trend by adjusting their dividend policies to satisfy the surging investor interest. The proliferation of dividend-focused investment products over the last half decade has led many to view this cycle as a replay of dividend-favored markets of years past. Others think today's infatuation with dividends is mainly caused by the Federal Reserve's quantitative easing (QE) programs, which have pushed market interest rates to record lows and cut the yield on investors' bond portfolios. Which view is correct? Does it matter? In this commentary we review why dividends are important, explore what is/is not different about dividends in the current contextual environment, and highlight an evergreen approach to dividend investing that may be useful for income-focused investors.

DIVIDENDS DRIVE EQUITY TOTAL RETURNS

For many, the focus on dividends is tied to the change in demographics taking place in most developed nations. As the baby-boomer generation ages and more individuals approach the spending phase of the retirement lifecycle their need for dependable sources of income has become very dear. In addition, life expectancies in many developed economies are increasing but often retirement ages are not. This means that retirees will need to stretch their fixed-sized nest egg or continue to grow it while also depending on the income it generates. A retirement portfolio that includes dividend paying stocks provides investors with both an income stream and the capital appreciation potential of equity markets.

Institutional investors face their own unique challenges in today's environment. For liability driven investors the extraordinarily low bond yields have created a series of interconnected hurdles that need to be overcome in order to effectively immunize their current and future payment obligations. For example, over a near horizon, the low level of interest rates may force a sponsor to raise their pension contributions in order to maintain a desired funded status. Or, to meet current payouts, entities may target a higher expected return with their existing assets by increasing their fixed income durations or by shifting into higher yielding (i.e. riskier) investments. And while these riskier assets may generate higher expected returns they also will have weaker correlations with the subject liabilities. Looking at the long-term consequences of the

QE programs, any uptick in inflation the programs eventually produce will act as a hidden tax on the corpus of the portfolio (because many of determinants of the funding status – such as wage increases – are indexed to inflation.)

This is only part of the story. The truth of the matter is that dividend investing has long been a crucial component of equity total returns. Academics would argue that, as a whole, dividend income is the sole aspect of equity market return on which to focus (i.e. capital appreciation is zeroed out between market participants as one investor's sell price is another investor's purchase amount.) For non-academic types, a longer perspective shows how crucial dividends are to equity returns. According to Bloomberg data over the past eighty years, dividend income has accounted for at least thirty percent of the total returns earned in six of the eight decades. This is somewhat forgotten due to what occurred in the 1980s and 1990s, which happened to coincide with the shift in the U.S. from defined benefit to defined contribution retirement plans, when strong equity price gains paired with exceptional economic growth for much of the period.

DIVIDENDS CYCLES

Dividends fell out of favor during the 1980s and 1990s due to a unique set of cyclical circumstances: technological advancements created efficiencies that triggered strong growth across many industries, which in turn pushed corporations to focus more on reinvesting profits inside the firm than on paying out dividend income. During the 2000-2010 decade the cycle changed and strong dividend policies returned to favor. Why? Companies had matured, economic and business growth prospects had declined, and tax laws were modified so that dividends were taxed at a lower capital gains rate. Similar to the 1960s and 1970s, the conventional wisdom believed strongly that the pendulum had swung back in favor of dividend paying stocks.

DIVIDENDS IN THE CURRENT ENVIRONMENT

When the financial crisis left the U.S. and European economies in recession, the Federal Reserve undertook an unprecedented plan to spur growth and drive the economy into recovery. One of the Fed's key actions was to create an artificially low interest rate environment, using policy rate cuts and a series of aggressive bond purchases (quantitative easing programs). Besides diminishing the risk of fresh financial shocks, these monetary programs worked through investment sentiment and valuation channels to rally prices on risk assets, domestically and globally. While the ultra-low interest rates have helped many firms refinance or borrow inexpensively they have also clobbered multitudes of investors needing income. Their subsequent scramble to find alternative sources of yield has taken on an almost existential quality. Many, many investors have been forced to travel well beyond traditional fixed income sectors to explore new, higher yielding asset classes, such as junk bonds, emerging markets debt and dividend paying equities. The unique circumstances driving these shifts in investor behavior have created a situation for dividend stocks that is the flip-side of the 1980s and 1990s – when dividends were scorned. Today, the cyclical and existential enthusiasm for dividend income is so strong that company production and investor demand can't be satisfied.

However, there is plenty of evidence that dividends should not be viewed as part of a normal cycle or some super-cycle driven by extenuating monetary policies. Over the past 35 years many research studies have detailed the benefits of investing in dividend payers – including papers written by Benjamin Graham, Gene Fama, and Ken French. While some of these luminaries



view dividend investing akin to capturing the value premium associated with equity investing, in today's market environment dividends have taken on greater importance.

WHAT'S NEXT FOR DIVIDEND STOCKS?

Appropriately, some investors are a bit wary. How long will the Fed's QE programs last? What will happen to dividend paying stock valuations when interest rates normalize? Will they normalize? These and other key questions continue to hang over the heads of investors in all asset classes, not just those investing in dividend paying stocks.

The extraordinary incursions by central bankers into the economy and financial markets have altered traditional frameworks used by investors to determine when and how to allocate funds to different asset classes. Whether they realize it or not, investors have already incorporated their expected effects and consequences of the central banks' policy actions into their investment thinking and decisions. Importantly, these investor behaviors are exactly what the Fed had hoped to engender through its monetary programs. So, investors needing income are challenged to look with fresh eyes and in different places for the best income-focused investment options.

In this environment, portfolios focused on dividend paying stocks offer several advantages to other high-yielding asset classes. Stocks offer a level of pricing transparency and liquidity that high-yield bonds and emerging markets debt cannot match. Dividend paying stocks also provide a better long-term hedge to inflation than debt instruments. Additionally, studies have shown that corporate dividend policies have typically taken taxes and interest rate increases into account. This means that, if and when interest rates do start to rise, dividend yields will sustain their attractiveness better than fixed coupon debt instruments.

The challenge today for investors is finding income-focused products and solutions that can deliver attractive yields without sacrificing or compromising portfolio integrity and risk management. This is especially the case when evaluating traditional dividend-based strategies, where investors have long tolerated stock concentrations, sector overweights, and low Beta exposures in the name of accessing yield. This is particularly unhelpful to investors who want or need both yield and growth, or are looking for a Core alternative that can deliver some of the stock market's upside along with a steady income. These investors need a dividend portfolio option that breaks through the cyclical trends to offer a true evergreen approach to equity exposure.

QUALITY STRENGTHENS DIVIDEND INVESTING

"Quality" is the quintessential nebulous term. While generally connoting a range of positive attributes, the word can mean different things to different audiences. In the context of dividend payers, "quality" stocks are companies that give investors a high degree of confidence that a company's dividend is well covered and management has the ability to grow the dividend over time.

Over the last decade many strategies have attempted to distill quality through a variety of approaches. Some target a single factor related to the dividend paid while others incorporate multi-pronged methodologies. A better approach is to attempt to identify quality using quantifiable metrics focusing on the company paying the dividend — measuring management

efficiency, profitability, and cash flow by looking at the firm's financial statements. This methodology provides a more forward-looking way to judge which dividend paying firms should be considered of good or lesser quality. Through this lens we are able to identify stocks that pay a strong dividend (through its Yield) and that are backed by a solid company base (through its Quality score). This intersection of Yield and Quality is the foundation of our portfolio construction process. Our research has shown that this strategy is more effective than focusing on historical dividend-paying trends and can be applied to both U.S. and International stocks.

Viewing stocks on the basis of both Yield and Quality may provide benefits beyond these strong alpha drivers. It also affords flexibility to consider risk in the context of the investment strategy. Specifically, it attempts to mitigate sector concentrations relative to the benchmark, as well as biases in Beta and other risk factors, which can cause the performance of many traditional dividend strategies to deviate significantly from the overall market. Simply put, our dividend investing approach aims to only take on the biases it is designed to target – Yield and Quality – while attempting to keep everything else in line with the benchmark.

In addition to mitigating risk, we believe this approach has the ability to turn a risk constraint into a feature that may add value to certain investors. Understanding that not all investors have the same risk tolerance for market volatility, additional strategies have been created that target a Beta less than or greater than that of the market. Through this unique set of controls, investors do not have to sacrifice either of the alpha drivers when choosing between the strategies. Each flavor – Defensive, Basic, or Dynamic – offers a distinct portfolio of securities that provides a similar level of quality, yield, and risk mitigation.

This dual focus on maximizing return potential while limiting unhelpful deviations from the benchmark may potentially make for more predictable and successful performance outcomes. In the current challenging environment, as well as in more typical economic periods, a dividend investment strategy focused on Quality and Yield may provide investors with a dependable stream of income and the potential for capital appreciation over time, without undue risk exposures.

Before investing, carefully consider the FlexShares investment objectives, risks, charges and expenses. This and other information is in the prospectus, a copy of which may be obtained by visiting www.flexshares.com. Read the prospectus carefully before you invest.

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An investment in FlexShares is subject to investment risk, including the possible loss of principal amount invested. Fund returns may not match the return of its respective index. The Funds may invest in emerging and foreign markets, derivatives and concentrated sectors. In addition, the Funds may be subject to asset class risk, small cap stock risk, value investing risk, non-diversification risk, fluctuation of yield, income risk, interest rate/maturity risk, currency risk, passive investment risk, inflation protected security risk, market risk and manager risk. For a complete description of risks associated with each Fund, please refer to the prospectus.

Alpha is a measure of performance on a risk-adjusted basis. Alpha takes a fund's volatility (price risk) and compares the risk-adjusted performance to its benchmark index. A fund's excess return relative to the benchmark's return is its alpha.

Beta is a statistical measure of the volatility, or sensitivity, of rates of return on a portfolio or security compared to a market index. The beta for an ETF measures the expected change in return of the ETF relative to the return of a designated index. By definition, the beta of the Standard & Poor's (S&P) 500 Index is 1.00. Accordingly, a fund with a 1.10 beta is expected to perform 10% better than the S&P 500 Index in rising markets and 10% worse in falling markets.

For an equity security, dividend yield is calculated using the (expected) annual dividend divided by the most recent closing price. To calculate annual dividend, we utilize the most recent dividend payment and multiply that payment by the expected frequency over a year. For example, if the most recent dividend for a company is \$2.50 and dividends are expected to be paid quarterly (4 dividend payments/year), the annual expected dividend would be calculated as $\$2.50 \times 4$ dividend payments/year, or \$10.

Credit Quality, also referred to as a "bond rating," is one of the principal criteria for judging the investment quality of a fixed income security. Credit quality informs investors of a security's creditworthiness or risk of default.