CAPITAL IDEAS

REGIONS INVESTMENT MANAGEMENT

November 2016

It Pays to Collect Dividends

Executive Summary

▲ Dividend income makes up a significant portion of total return over long time periods.

▲ We believe there are a myriad of reasons to be a dividend investor. Dividend investors typically benefit from a Quality bias, paying a significant dividend reduces the agency problem and dividend growth is a leading indicator of earnings growth.

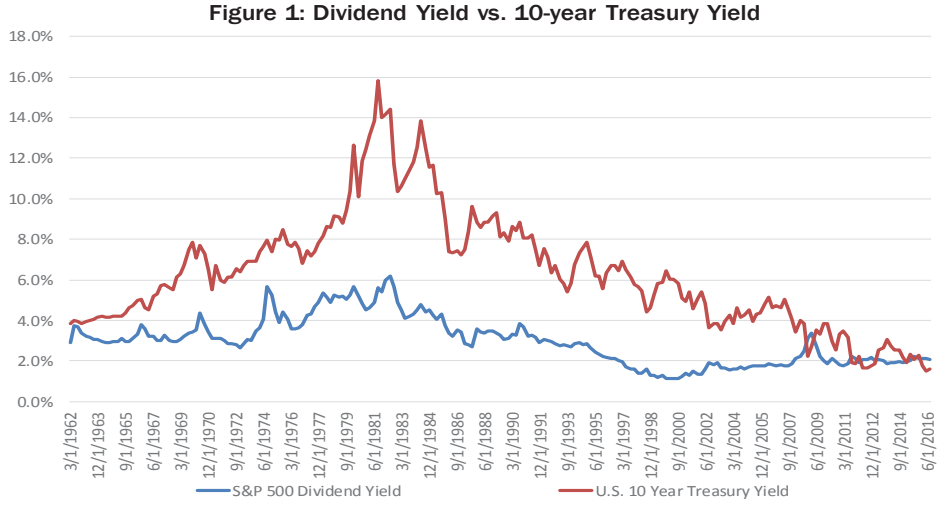
▲ RIM's Equity Income strategy's consistent long-term approach and team has led to positive stock selection over a full business cycle.

▲ Over the last ten years, RIM's Equity Income strategy is in the fifth percentile of its peer group.[1]

Introduction

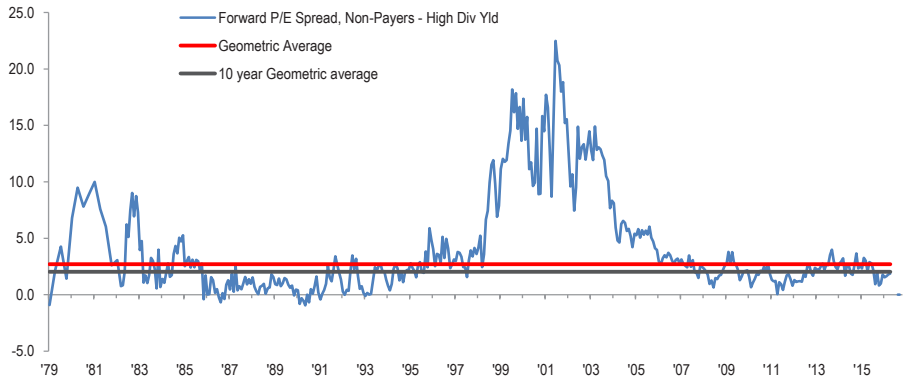
The last couple of years have been characterized by a low growth environment with loose monetary policy and extremely low inflation. The impacts of low inflation and the Federal Reserve's quantitative easing policy have driven US treasury yields on the 10 year bond near historic lows averaging roughly 2% over the last two years, with US GDP averaging only 1.7%. In this low yield and slow growth environment, investors have increasingly focused on dividends as the average dividend yield for the S&P 500 over this period was 2.24%. It is rare for the dividend yield of the S&P 500 to exceed the 10-year Treasury yield (see Figure1). Interest rates and economic growth have been at historically low rates over the last couple of years. The implications of this low rate and slow growth environment would be that valuations of income generating investments are at historically high levels. Our research on long-term valuation of stocks that pay a significant dividend suggest that this is not the case. Going back to 1979, we used forward price to earnings valuation multiples to appraise the valuation of the median non-dividend payer relative to the median of high dividend payers over this time period. These multiples were subtracted to provide a valuation spread (median of non-payers forward price to earnings - median high dividend payers forward price to earnings). Explained another way a higher spread would indicate that High Dividend payers are at a higher valuation discount over this time period. The valuation spread of these two groups is above its average since 1979, but below its 10 year average spread (Figure 2). The forward price to earnings valuation

Figure 1: Dividend Yield vs. 10-year Treasury Yield



Source: Strategas

Figure 2: Forward Price to Earnings spreads of Non Dividend Payers vs High Dividend Payers



Source: J.P. Morgan Quantitative & Derivative Strategy Research

1. Equity Income Strategy versus eVestment US Large Cap Value Equity Peer Universe September 30, 2016

spreads do not indicate stretched or historically expensive valuations for the High Dividend payer group.

Investors' emphasis on dividends has varied over time with the rate of economic growth, interest rates and equity market returns. As you can see in Figure 3, dividends' impact on total return has varied from decade to decade based on equity market performance. Over the long term, compounded dividends account for a significant portion of total return. From 1930 through 2015, dividend income has accounted for 34% of total return. The major impacts of compounded dividend income on total return would argue for dividend investing always being a top priority for investors over the long-term. A Dividends' contribution to total return is not only a long-term phenomenon. In a more recent time frame, dividends have accounted for an even larger share of total return. In fact, over the last 25 years, dividends accounted for 45% of total return. The difference between price and total return can be seen in Figure 4.

Figure 3: Dividend contribution

Dividend Contribution to Total Return

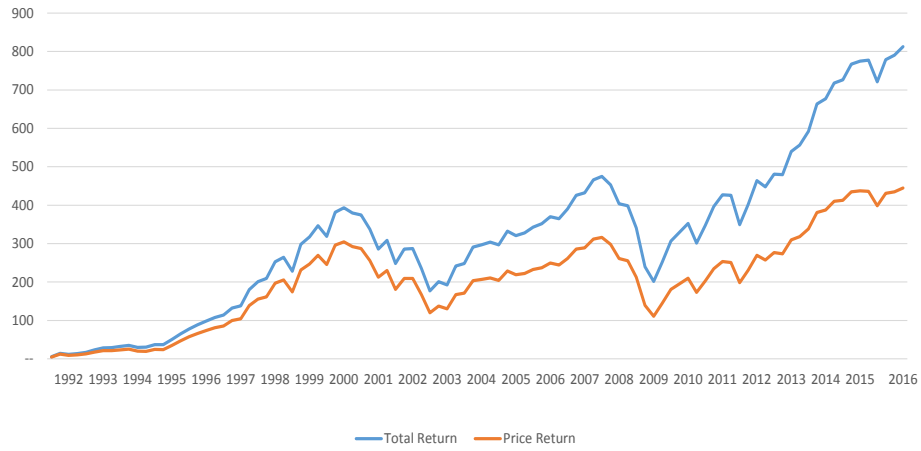
	Price Pct. Change	Dividend Contribution	Total Return	Dividends Pct of TR	Avg Payout Ratio
1930s	-41.9%	56.0%	14.1%	NA	90.1
1940s	34.5%	100.1%	134.6%	74.4	59.4
1950s	257.3%	180.3%	437.7%	41.2	54.6
1960s	53.7%	54.2%	107.9%	50.2	56.0
1970s	17.2%	59.1%	76.4%	77.4	45.5
1980s	227.4%	143.1%	370.5%	38.6	48.6
1990s	315.7%	115.7%	431.5%	26.8	47.6
2000s	-24.1%	15.0%	-9.1%	NA	35.3
2010s	91.2%	29.5%	120.8%	24.4	34.5
Average	**103.5%**	**83.7%**	**187.1%**	**47.6**	**52.4**

Source Strategas & Standard and Poor's

Importance of Dividend Growth

One important factor in dividend investing is dividend growth. Unlike a bond payment that may be fixed, companies that pay dividends can grow those dividends over time. Dividend growth can help ward off the negative impacts of inflation on real rates of return. In addition, there is academic evidence that supports the idea that companies that are raising their dividends are signaling positive earnings prospects for the company.[2] Proprietary research has found the dividend growth factor has led to superior total return over long periods of time. Utilizing the S&P 500 going back 20 years, we grouped stocks into deciles based on dividend growth to measure their performance over time. The first and second deciles had the highest dividend growth while the ninth and tenth quintiles had the lowest dividend growth. The weighted average total return of the first and second deciles was 8.3% versus the weighted average total return of the ninth and tenth deciles of 3.9% over the last twenty years. This historical analysis indicates that focusing on companies that are growing their dividend can help income growth and relative performance over long periods of time.

Figure 4: Price Return vs Total Return of the S&P 500 Index



Source: Factset Research Systems

Agency Cost

Another advantage of dividend investing is the reduction in agency cost[3]. While there are no legal repercussions or covenants that enforce the payments of dividends, companies that cut dividends often suffer from a capital appreciation perspective. Cutting a dividend often leads to multiple compression and stock underperformance as investors seeking a stable dividend may liquidate their positions. Weak stock performance can be a threat to management as shareholders become disgruntled, and distressed multiples may lead to a takeover by an activist investor, possibly putting management's employment at stake. For companies that pay dividends, meeting and even growing a dividend are typically a major priority for management. Dividends can be a substantial financial obligation that forces managers to run an efficient capital structure. The need to meet dividend payments removes excess capital from management's disposal and allocates it back to the shareholder. This can be beneficial for investors seeking income and it can be beneficial from a total return perspective as well. Excess capital is reduced as it is paid to shareholders, thereby lowering the probability that management will seek to make an acquisition. At times there can be conflicts of interest between managers and shareholders. Managers may seek to grow their empire through

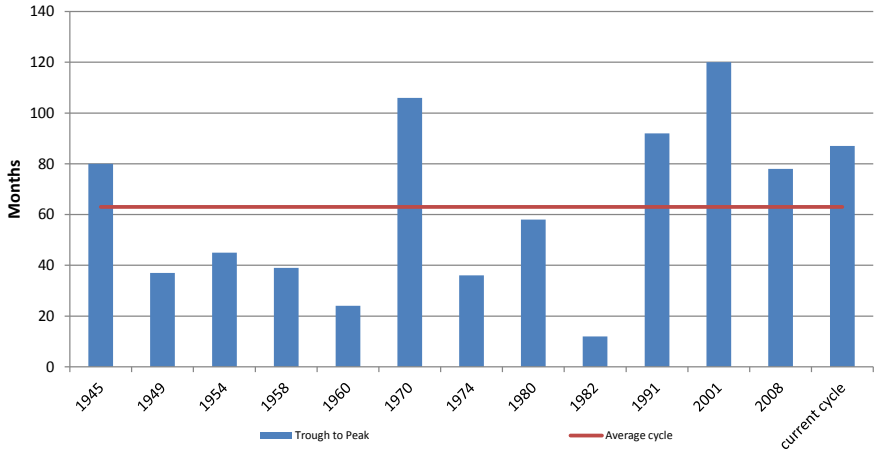
2. Doron Nissim and Amir Ziv, "Dividend Changes and Future Profitability" The Journal of Finance VolLVI, NO. 6, December 2001
3. Agency Cost- cost associated with the fact that all public companies and larger private companies are managed by non-owner, which results in conflicts of interest between managers and equity owners. Jensen and Meckling (1976)

acquisitions that may expand the size of their company and remuneration, but may not result in a positive return on capital. Investing in companies that pay dividends can result in more efficient capital structure and reduce the likelihood of projects that do not provide a positive return on capital.[4]

Quality Bias

Returning capital to shareholders through dividends is a characteristic of quality investing. If an investor has a portfolio with a concentration in dividend paying stocks, they are likely to have a quality bias. Having a quality bias is beneficial. Quality investing can have different meanings. Typically, quality investing is associated with a tendency to return capital to investors through dividends, earnings stability, consistent earnings growth, above average cash flow generation, lower volatility, and lower levels of leverage. Investing in quality companies has shown to provide superior risk adjusted returns over long time periods.[5] In fact, Regions Investment Management's proprietary quality scores show that the highest quality stocks ranked A and B outperform the lowest quality stock ranked D and F. Plus, the A and B stocks have a much lower beta, which results in even better risk adjusted performance or Alpha relative to the low quality D and F stocks (Figure 5). Portfolios that have a quality bias usually exhibit strong downside protection. Strong downside protection is beneficial when markets are weak and investors are increasing their aversion to risk. Focusing on quality investing late in a business cycle when the odds of a slowdown are higher can be an effective strategy. According to NBER (National Bureau of Economic Research), post World War II trough to peak of an economic expansion average 63 months or slightly more than five years (Figure 6). June of 2009 was the trough of the financial crisis so our current economic expansion has lasted over seven years. The length of this expansion may indicate that this economic cycle is in its later stages. Dividend investing typically leads to a quality bias that may provide downside protection in the event of a slowdown and bear market.

Figure 6: Duration of Economic Cycles



Source: National Bureau of Economic Research

Figure 5: Quality Score

RANK	ANNUALIZED RETURNS	STANDARD DEVIATION	SHARPE RATIO (1)	ALPHA (2)
A	13.96%	15.91	0.63	3.73%
B	13.39%	16.18	0.58	2.74%
C	12.54%	18.23	0.47	0.41%
D	12.29%	20.98	0.40	-0.74%
F	9.08%	25.68	0.20	-3.85%

Source: Regions Investment Management, FactSet Research Systems, Strategas
(1) Sharpe Ratio =(Return – 3 month Treasury) / Standard Deviation
(2) Alpha is the excess return over that described by Beta. Beta is the tendency of security's returns to respond to swings in the market.
Back-tested from December 31, 1984- December 31, 2015.
Rebalance quarterly. Assumes no transaction costs.

Why Choose the Equity Income Opportunity Portfolio

Companies that pay a significant dividend have benefited from investors' preference for income oriented investments in this very low interest rate environment. Dividends have been in favor but we remain very optimistic about Equity Income's near and long-term outlook. In the near-term, the potential for higher volatility may result in a preference toward quality investing. A preference toward quality would be beneficial to the Equity Income strategy. In the fourth quarter, the Federal Reserve may boost rates and the uncertainty of the U.S. presidential election looms. Early in 2017, additional details regarding the economic impact of Britain exiting the European Union are likely to be more evident. These events could result in higher levels of equity market volatility in the near-term. Tighter monetary conditions domestically and the economic impacts of the geo-political situation in the Eurozone may increase volatility, but the biggest reason to be optimistic about the prospects of Equity Income is the aged business cycle.

The duration of the economic cycle favors the Equity Income strategy. Historically, Equity Income's best relative performance has occurred in

4. Jensen, Michael C., 1986, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, American Economic Review 76, 323-329.
5. Clifford S. Asness,Andrea Frazzini, Lasse H Pedersen "Quality Minus Junk", CFA Digest January 2014, Vol 44, No 1.

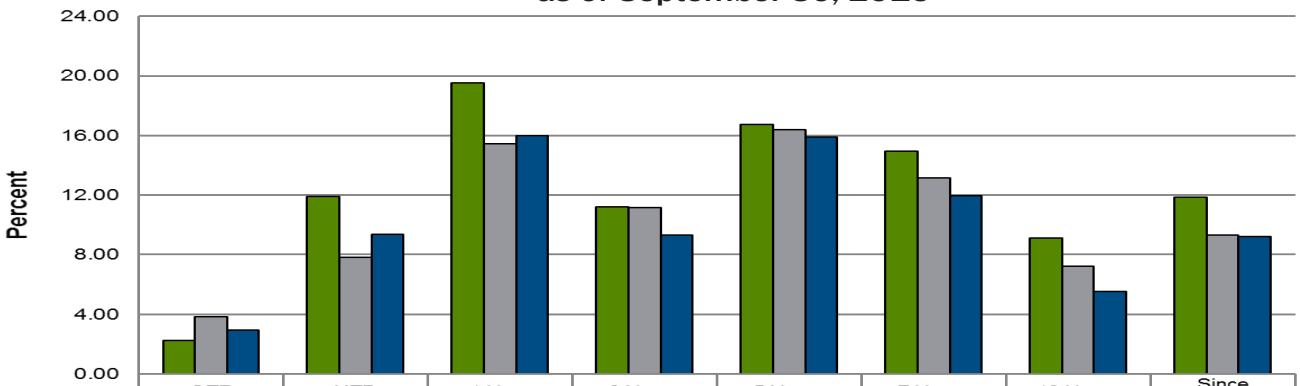
the back half of an economic cycle. The duration of this current economic expansion would suggest the economic cycle is in its late expansion phase. The current business cycle is well past the average duration of an economic cycle post World War II. As the duration of this cycle extends the probability of a slowdown increases. In the event of a slowdown, Equity Income investors may benefit on relative basis. Over the last ten years, Equity Income has had superior downside protection relative to 90% of its peers.[6]

We believe Equity Income's emphasis on investing in companies that pay significant dividends make it an optimal investment vehicle for individual and institutional investors with income needs. Thus, we also believe the long-term benefits of investing in Equity Income exceeds its obvious ability to generate higher levels of income. Prioritizing investments in companies with favorable fundamental outlooks, strong free cash flow generation, committed to paying a significant dividend and growing it over time has many benefits other than income generation. Paying a significant dividend puts additional pressure on management to run a disciplined capital structure while avoiding excessive risk with company capital or splurge on expensive acquisitions that do not have clear synergies for the company. In addition, paying a significant dividend allows capital to flow back to shareholders so that they can determine the best way to allocate it.

The Equity Income strategy has a consistent long-term process that has generated significant alpha with top decile results over the last 3, 7, and 10-year time periods relative to its value peer group.[7] The process focuses on companies with sustainable competitive advantages, that have strong balance sheets, are consistent earnings and free cash flow generators and emphasizes dividend growth. An invariable commitment to the Equity Income process has resulted in a strategy with lower degrees of volatility and beta. In fact, the Equity Income strategy's volatility and beta are both at the bottom quartile of its peer group and below its index on both metrics. Equity Income's below index beta and stock price volatility offer downside market protection in the top decile of its peer group over the last five and ten-year time periods. The processes' focus on companies that can grow their dividend, resulting in the strategy being invested in areas like the Information Technology sector with no significant sector bet on defensive high yielding sectors. The dividend growth aspect of the process has enabled good upside market capture in the middle of its peer group on five and seven-year time horizons. The Equity Income strategy does not just provide dividend factor exposure. The process emphasizes deep fundamental analysis as well as a focus on companies with strong balance sheets and a proclivity toward dividend growth. Equity Income has exhibited results near the top of its peer group over an entire business cycle with its performance ranking in the top 5% and 7% of its peer group over the last ten years and since inception, respectively.[8]

A spike in rates would be a negative for dividend yielding stocks. Interest rates are likely to move higher as the Federal Reserve considers a December rate hike, and potentially more rate hikes in 2017. We believe the odds of a spike in interest rates are low due to few signs of a significant uptick in global growth. Rates are unlikely to move materially higher without an

Figure 7: Equity Income Strategy's Trailing Performance as of September 30, 2016



	QTR	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Since Inception
EIOP	2.27	11.93	19.51	11.20	16.72	14.97	9.13	11.84
S&P 500	3.85	7.84	15.43	11.16	16.37	13.17	7.24	9.30
S&P 500 Value	2.94	9.36	15.98	9.34	15.87	11.97	5.53	9.20
EIOP Percentile Universe Rank	81	11	7	9	20	2	5	7
S&P 500 Value Percentile Universe Rank	70	33	27	41	37	52	83	77
No. of Observations in eA US large cap value equity universe	390	390	390	379	355	336	302	237

Inception Date is 3.31.2003.
Past performance is no guarantee of future results. Please read in conjunction with disclosures on the last page. Model performance results do not reflect the deduction of advisory and custody fees, and are net of all other expenses.

Source: FactSet & eVestment Alliance

6. Equity Income Strategy's Downside Market Capture versus eVestment US Large Cap Value Equity Peers Universe September 30, 2016
7. Equity Income Strategy versus eVestment US Large Cap Value Equity Peer Universe September 30, 2016
8. Equity Income Strategy versus eVestment US Large Cap Value Equity Peer Universe September 30, 2016

uptick in inflation and growth. The backdrop of slow global growth will likely result in the Federal Reserve raising rates at a measured pace. In a slow growth environment, dividends should remain in favor and account for a large portion of total return.

The aging demographic in the U.S. and globally will result in an increasing and constant need for income bearing investments. This should favor stocks that pay significant dividends, especially in a low growth environment. We believe stocks that pay significant dividends may have a more stable investor base to support income needs for the aging demographic. In addition, the need for income by the aging demographic should provide a higher floor from a valuations perspective for these defensive areas that have low earnings growth, but significant dividend yields and low earnings volatility.

Conclusion

In conclusion, dividends encompass a significant portion of total return for the broader market over short and long-term time horizons. Dividend growth is an important aspect of dividend investing, that has led to outperformance in the large capitalization area of the equity markets. Investors focus on dividend investing is a pragmatic strategy, but it also provides additional benefits such as lowering agency cost and increasing exposure to quality investing. Companies that pay a significant dividend are more likely to run a disciplined capital structure to enable the company to meet their dividend obligations thereby reducing agency cost. Additional exposure to quality investing is beneficial because it has been shown to provide superior risk adjusted returns over long-time periods.

About the Author

Stephen Daniels joined the firm in April of 2006 and is head of the Equity Income Strategy. In addition, Mr. Daniels is also an Equity Analyst covering the Information Technology sector. Since joining Regions Investment Management he has been responsible for analyzing the Information Technology sectors for the Equity Team. As a member of the Equity Analyst Team, Mr. Daniels participates in the management of the Total Return Opportunity Portfolio and the Equity Income Portfolio, as well as various institutional strategies. Mr. Daniels is currently a member of the RIM Investment Strategy Group. His industry experience began in 2003. Prior to joining the firm Mr. Daniels worked as a financial advisor on the retail side of the investment management business. Mr. Daniels graduated from the University of Alabama with a B.S. in Marketing. Mr. Daniels is a CFA® charterholder and a member of the CFA Society of Alabama.

Disclosures:

The Equity Income Opportunity Portfolio referred to in this report is one of the investment strategies offered by Regions Investment Management, Inc. It is comprised of domestic large cap stocks. Prior to September 1, 2012, the Equity Income Opportunity Portfolio strategy centered on selecting 50 equities, and giving each an equal 2 percent weight in the portfolio. The strategy has since been revised to permit weights varying between 1 percent and 3 percent, and permits a variable number of securities to be held in the portfolio. On April 11, 2016, the strategy was revised to permit each stock between a one and four percent weighting. Weightings may be adjusted particularly when the weighting of the stock in the index is over 3 percent. Not all investments are prudent for all clients; consult with your Investment Professional to determine whether or not the investment documented in this report may fit your investment needs, goals, risk tolerances and investment time horizon. Some investments may require a minimum investment amount and/or additional qualifying requirements in order to invest. Consult with your Investment Professional to determine whether or not you meet these requirements, if any. Investors should consider this report as only a single factor in making their investment decision. This report is not to be relied upon in substitution for the exercise of independent judgment

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We look forward to serving you. Form more information, please see RIM's current Form ADV Part 2A, a copy of which is available upon request at 205-264-6735.

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