Dividends Matter

Five Reasons Investors Should Seek Dividends

SmartETFs

Will Rogers famously quipped that the way to make money in the stock market was to, "...buy some good stock, and hold it until it goes up, then sell it. If it don't go up, don't buy it." This is indeed, great - if difficult to follow - advice. But there is another, simpler way: **Investing in quality stocks that pay regular, and, ideally growing dividends.** There are five good reasons to invest in quality dividend stocks.

1. Dividend stocks have historically outperformed in the long run.

2. Dividend stocks are generally less volatile.

3. Dividends can increase over time.

4. Historically, dividend growth has exceeded the rate of inflation.

5. Historically, companies that pay higher dividends experience higher earnings growth.

"The little pig with the portfolio of straw and the little pig with the portfolio of sticks were swallowed up, but the little pig with the portfolio of bricks withstood the dip in the market."

1 Dividend Stocks Have Historically Outperformed

Despite the excitement of high flying, high returning growth stocks, in the long run, as a group, stocks that pay dividends outperform stocks that do not pay dividends. A number of research studies have found that dividend stocks outperform non-dividend payers.

A study by Chicago-based Greenrock Re-

search found that,

> "Since 1958 a hypothetical dividend- oriented portfolio consisting of the top 20% of the S&P 500 index companies ranked by dividend yield and weighted by market capitalization outperformed the overall benchmark S&P 500 by 218 basis points[1] or 2.2% per year."[2]

While dividend payers outperformed overall, they do not necessarily outperform each and every year. In their study, Greenrock examined the 60 distinct years from 1958 through 2017.[3] The dividend payers outperformed in 53% of these years. Over the long run, however, the dividend payers provided a substantial return premium. How substantial? The 218 basis points of incremental return is extremely significant: over the course of the 60 years (1958 through 2017) a $10,000 investment in the S&P 500 grew to $4.19 million. A similar investment in the dividend payers returning 218 additional basis points would have resulted in an ending value of $13.5 million.

In another study, *What Difference Do Dividends Make?*, published in the Financial Analysts Journal, the authors find that, "high dividend payers have the least risk yet return over 1.5% more per year than do non- dividend payers."[4]

2 Dividend Stocks Are Generally Less Volatile

That dividend paying stocks are less volatile is a generally held view by investors and that view is supported by the data. From *What Difference Do Dividends Make*, the authors write,

> "...the evidence...confirms the long- held favorable view of many investors regarding dividend-paying stocks. First dividend-paying stocks can reduce portfolio risk significantly. Second, the reduction in risk is achieved without a corresponding reduction in return."[5]

But note that we have said that dividend stocks are *generally* less volatile than non-dividend paying stocks. The results from Greenrock Research focus on the top dividend paying 100 from the S&P 500—the top quintile of dividend payers in the index. We've seen that focusing on the top quintile produces a significant performance premium versus the S&P 500 as a whole. But, it does so with slightly higher levels of volatility. This increase in volatility may well be a worthwhile tradeoff to achieve the greater return. Further,

1. A basis point is 1% of 1%; 100 basis points is one percent.
2. *The Case For...High and Growing Dividends,* Greenrock Research, May 2018. www.greenrockresearch.com.
3. The S&P 500 index began in its present form in March of 1957. The first full calendar year results begin in 1958.
4. *What Difference Do Dividends Make?* by C. Mitchell, CFA, CIPM, Gerald R. Jensen, CFA, and Marc W. Simpson, CFA. Financial Analysts Journal, Volume 72, Number 6. Published by the CFA Institute. 2016
5. *Ibid*

Greenrock believes the higher dividend payments offer a significant advantage in the long stretches of relatively flat performance.

In *What Difference do Dividends Make?*, the authors studied all dividend stocks (as opposed to the highest quintile dividend yield) and compared them to all non-dividend

stocks. As mentioned, they found both a higher level of return *and* lower levels of volatility.

Based on this data, dividend investors have a choice between higher yielding and historically better performing and more volatile dividend stocks or, lower yielding dividend stocks that historically outperform non-dividend payers and offer lower levels of volatility.

3 Dividends Can Grow

Investors seeking income often invest in bonds, which are generally referred to as fixed income investments. The benefit of bonds is that the bond issuer is *obligated* to pay the interest on the bonds. But this obligation only applies to the agreed upon rate of interest.[6] The flip side of this is that the issuer will never pay anything more than the agreed interest rate. Dividends, on the other hand, while they are paid at the discretion of the board of directors, can, and ideally do, grow over time.

How much do dividends grow over time? Well, that varies and is company specific. But, in the aggregate, investors might hope for a dividend growth rate of approximately 5%.[7] The historical growth rate for the S&P dividend since 1958 has been 5.85%.[8] But, investors focusing on dividend growers may be able to obtain dividend growth rates in excess of this amount. One of the reasons we focus on quality companies is our belief that quality companies are more likely to increase their dividends at a rate faster than average.

Note that these are average growth rates and that there are years where the dividends are reduced or, at the individual stock level, eliminated. In the 63 calendar years from 1958 to

6. There are some bonds that might carry an interest rate that can vary, most notably US Treasury Inflation Protected Securities or TIPS. The interest payment on TIPS is linked to the rate of inflation. Note that the yield on TIPS is at present, and generally, quite low.
7. Since the inception of the S&P 500 in 1958, the dividends paid by the S&P 500 have grown at an annualized rate of 5.81%. Source: Shiller Data (http://www.econ.yale.edu/~shiller/data.htm); calculations by Guinness Atkinson.
8. Source: Shiller Data; calculation by Guinness Atkinson

the end of 2020 the total dividends paid by the S&P 500 increased 57 times but was reduced six times. Most of these dividend declines were minor, but one, in 2009 the dividend cut was substantial; the decline in the dividend represented a reduction of 21.1%. As painful as that was, the next four years saw dividend increases and at the end of the four years the dividend payment was greater than it had ever been and by 2021 the dividend payment has increased 105%[9] over what it had been prior to the reduction.

4 Historically, Dividend Growth has Exceeded the Rate of Inflation

Dividends don't just have a history of growing over time, they have a history of growing at a rate faster than inflation. The real rate[10] of growth for dividends since the end of 1958 is 2.10%.[11] As with the nominal growth rate, there are years when the rate of inflation outpaces the dividend increase; and of course there are years when the dividends are reduced. Over the 63 year period ending December 2020, the S&P 500 dividend increased at a rate greater than inflation 40 times (63%) and increased at a rate less than the rate of inflation 23 times (37%).[12] In the long run it is the overall rate that is of most interest and here the dividend growth rate has historically kept well ahead of the rate of inflation.

"Instead of worrying so much about your money working harder, why don't you work harder?

5 Companies that Pay Higher Dividends have Experienced Higher Earnings Growth in the Past

We've seen that dividend paying stocks have outperformed non-dividend payers and we've seen that they have done so with a lower level of volatility. The knock against dividend paying companies is that the payment of the dividend is proof that the companies cannot deploy their capital effectively to generate a high growth rate. In effect, the payment of the dividend is evidence of management failure; a confession of sorts that management has nothing better to do with the capital. If this supposition is true then one might wonder how is it that some dividend payers are able

9. Source for all of the calculations in this paragraph: Shiller Data; calculations by Guinness Atkinson.
10. The "real" rate is the rate adjusted for inflation.
11. Source: Shiller data: calculation by Guinness Atkinson.
12. Source: Shiller data: calculation by Guinness Atkinson.

to outperform. As it turns out, this supposition has proven to be false: dividend payers have often enjoyed greater rates of earnings growth than non-dividend payers. In *Surprise! Higher Dividends = Higher Earnings Growth*, Robert D. Arnott and Clifford S. Asness find that,

> "The historical evidence strongly suggests that expected future earnings growth [was faster] when current payout ratios [were] high and slowest when payout ratios [were] low."[13]

We recognize that there is more potential excitement in seeking capital gains, particularly with growth stocks. But Arnot and Asness found that earnings growth was positively correlated with higher dividend payments.

Dividend Growers vs. High Yield

Our preference is for higher quality stocks and that generally means a focus on companies more likely to grow their dividend vs. dividend paying companies that pay a high yield but may be less likely to increase their dividend. This preference is admitedly subjective and some investors will rationally prefer higher yielding dividend stocks. It is our focus on quality stocks that leads us to prefer moderate and growing dividends.

What is Quality and Why does it Matter

We've referred to quality a number of times in this report, but what do we mean by quality? Our definition of quality has a specific definition and is key to understanding our approach to dividend investing. This is important because companies are not obligated to pay dividends; they can be discontinued and are not guaranteed.

Our view on quality is objective: it is based on a company's financial results. While we look at a large number of financial metrics, we put a large importance on two specific figures. First, we focus on the Cash Flow Return on Investment (CFROI). This cash flow metric seeks to calculate cash flow return on investment adjusted for inflation and on a standardized global/industry basis. We seek to invest in companies that consistently achieve a top quartile ranking in CFROI for the last 10 consecutive years. This is an extremely difficult benchmark for companies to clear and only three percent of companies globally are able to achieve this. Second, we seek companies that have low levels of debt, typically investing only in companies that have a debt to equity ratio of less than one.

We are cognizant that other dividend investors and investment styles are less concerned about debt and CFROI, instead focusing more

13. Surprise! Higher Dividends = Higher Earnings Growth, Robert D. Arnott and Clifford Asness, Financial Analysts Journal January/ February 2003.

on dividend history or the amount of the dividend. Our view is that the dividend is a function of the earnings and free cash flow and the ability to maintain and grow the dividend is directly related to the companies earnings ability. We focus on the debt to equity ratio because we know that when times get tough companies that have little debt are better able

Conclusion

On one level it is obvious that dividends are a good thing. Who doesn't like regular cash flow? Certainly investors in retirement would appreciate the potential for regular and growing stream of dividend income. Investors accumulating assets should also appreciate a sound dividend strategy given the evidence that dividend investing may offer greater returns and, depending on how the dividend strategy is implemented, also reduce volatility. And, we've seen that historically a portfolio of growing dividend companies can help investors keep ahead of inflation.

For more information on the SmartETFs Dividend Builder ETF visit www.SmartETFs.com.

To view the ETF holdings, visit www.SmartETFs.com/DIVS

Still Ahead

There are four additional sections for interested readers on the following pages:

- About the SmartETFs Dividend Builder ETF (Symbol: DIVS)
- Compounding: Time is on your Side
- The Language of Dividends
- Important Information.

About the SmartETFs Dividend Builder ETF (Symbol: DIVS)

The SmartETFs Dividend Builder ETF (symbol: DIVS) invests in high quality dividend paying companies from around the world. The ETF seeks to invest in companies that are likely to increase their dividend payments over time and does not generally seek to maximize the current yield.

Our Dividend Builder ETF uses an innovative 10 over 10 strategy in an effort to invest in objectively quality companies:

First we look for companies that have generated an inflation adjusted cash flow return on investment of at least 10% in each of the last 10 years. We also only look at companies with a market capitalization of over $1 billion and a debt to equity ratio of less than 1. (This process reduces the potential field from 15,000 companies to about 500).

Next we look for companies that have a history of paying growing dividends and are attractively valued.

Each of the remaining candidates is thoroughly scrutinized using our fundamental individual security analysis, taking into account both macro and company business metrics.

The ETF typically invests in 35 different dividend-paying companies from around the world and weights these holdings equally.

The expense ratio for the ETF has been capped at (see page 10).

More information is available at www.SmartETFs.com/DIVS.

Compounding: Time is on your side

Albert Einstein is credited with the saying. "Compound interest is the eighth wonder of the world." For investors this insight may be more important than E=mc2.

For long term investors that do not need current income, dividends paid by corporations and mutual funds can be reinvested. These reinvested dividends purchase more shares and these shares also pay dividends. This incremental gain may seem trivial at the start but over time the effect can be magnificent. Time is a key element to compounding: the sooner one starts, the more time for the benefits of compounding.

We are mindful that many of the readers of this report will be young and view retirement as an extremely distant and remote event. The more distant and remote the better! Our friendly and unsolicited advice to those early in their lives/careers: start saving now even if it is a small amount each month.

Not surprisingly we recommend a plan of investing in dividend paying stocks, especially those that have the ability to grow their dividends. If you are nearer to retirement and are behind in your savings goals, fear not; you're not alone as a majority of Americans are underfunded for retirement. Even Einstein cannot reverse time but our advice is to start as soon as you can.

The Language of Dividends:
A glossary of dividend terms

Dividend Aristocrats: Companies that have increased their dividend for 25 consecutive years. Many believe that these companies are likely to continue to increase their dividends. There is some truth to this view as companies that have achieved aristocratic status are reluctant to lose it. However, we find that a more reliable way to ensure dividend growth is to focus on company fundamentals and quality.

Payout Ratio: The percentage of a company's earnings paid out as dividends. Ideally the payout ratio isn't too high as a high payout ratio suggests there is less room for a dividend increase. But what's too high? The answer is subjective and varies considerably by industry and over time. Utility stocks typically have higher payout ratios and tech companies typically have lower payout ratios.

Dividend Yield: The annual dividend divided by the current stock price. But, what is the annual dividend? For many the answer is to just multiply the most recent quarterly dividend by four. This generally works well for US stocks which tend to have more stable dividends. In other parts of the world the dividend is more a function of a stable payout ratio. This means the dividends may fluctuate more both within a year and year over year. In these instances the dividend yield might best be calculated using the dividends paid over the last 12 months divided by the stock price.

Ex-Dividend Date: The first day of trading where a purchaser of a stock will not receive the next dividend. Typically a stock will be considered unchanged if on the ex-dividend date the stock closes down by the amount of the declared dividend.

Record Date: This is the date by which a shareholder needs to be a shareholder of record in order to receive the next dividend. An investor would need to have his trade settled by the record date in order to receive the next dividend. Assuming trade date plus one, an investor would need to purchase a day before the record date in order to receive the next dividend.

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Important Information

Performance as of 06/30/2022	YTD	1 Year	3 Years	5 Years	10 Years	Since Inception*
DIVS at NAV	-13.14%	-4.93%	9.92%	9.60%	10.33%	9.83%
DIVS at Market Price	-12.71%	-4.63%	10.06%	9.68%	10.38%	9.87%
MSCI World NR	-20.51%	-14.34%	6.99%	7.66%	9.51%	8.71%

All returns over 1 year annualized.

* Fund Inception Date: March 30, 2012

Source: Bloomberg, SmartETFs, Guinness Atkinson Asset Management

Expense Ratio: 0.65% (net); 1.08% (gross)

Performance data quoted represents past performance and is no guarantee of future results. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than quoted. Performance data for the most recent month-end is available above.

The fund Benchmark Index is the MSCI World Index.

The MSCI World Index is a broad global equity index that represents large and mid-cap equity performance across 23 developed markets countries. It covers approximately 85% of the free float-adjusted market capitalization in each country and MSCI world index does not offer exposure to emerging markets.

An investor cannot invest directly in an index.

Effective as of the close of business on March 26, 2021, the fund acquired the assets and assumed the performance, financial and other historical information of the Guinness Atkinson Dividend Builder Fund, an open-end mutual fund (incepted March 30, 2012). The fund's investment objectives, strategies and policies are substantially similar to those of the predecessor mutual fund and it was managed by the same portfolio managers. Performance information for periods prior to March 26, 2021 is the historical performance of the predecessor mutual fund and reflects the higher operating expenses of the predecessor mutual fund. The fund has lower expenses than the predecessor mutual fund. For periods prior to March 29, 2021, the fund's performance would have been higher than

shown had it operated with the fund's current expense levels.

*The Adviser has contractually agreed to reduce its fees and/or pay ETF expenses (excluding acquired fund fees and expenses, interest, taxes, dividends on short positions and extraordinary expenses) in order to limit the Fund's total annual operating expenses to 0.65% through June 30, 2025. This contractual arrangement may be terminated by the Board of the Fund at any time without penalty upon 60 days' notice.

Investments involve risk. Principal loss is possible.

The Fund invests in securities that pay dividends, and there is no guarantee that the securities held by the Fund will declare or pay dividends in the future, or that dividends will remain at current levels or increase. Investments in foreign securities involve greater volatility, political, economic and currency risks and differences in accounting methods. These risks are greater for emerging markets countries. For more information on the risks of investing in this Fund, please see the prospectus.

The S&P 500 Index, or the Standard & Poor's 500 Index, is a market-capitalization-weighted index of the 500 largest publicly-traded companies in the United States.

Cash Flow is the net amount of cash and cash equivalents being transferred into and out of a business.

Cash Flow Return on Investment (CFROI®) is a valuation model that assumes the stock market sets prices on cash flow, not on corporate earnings. It is determined by dividing a company's gross cash flow by its gross investment.

CFROI® is a proprietary metric prepared by HOLT, a division of Credit Suisse. CFROI is a registered trademark of Credit Suisse AG or its affiliates in the United States and other countries. For more information on HOLT, a corporate performance and valuation advisory service of Credit Suisse, please visit their website at https://www.credit-suisse. com/investment_banking/holt/en/index.jsp

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