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Equity Income Investing: Beyond Dividend Yield

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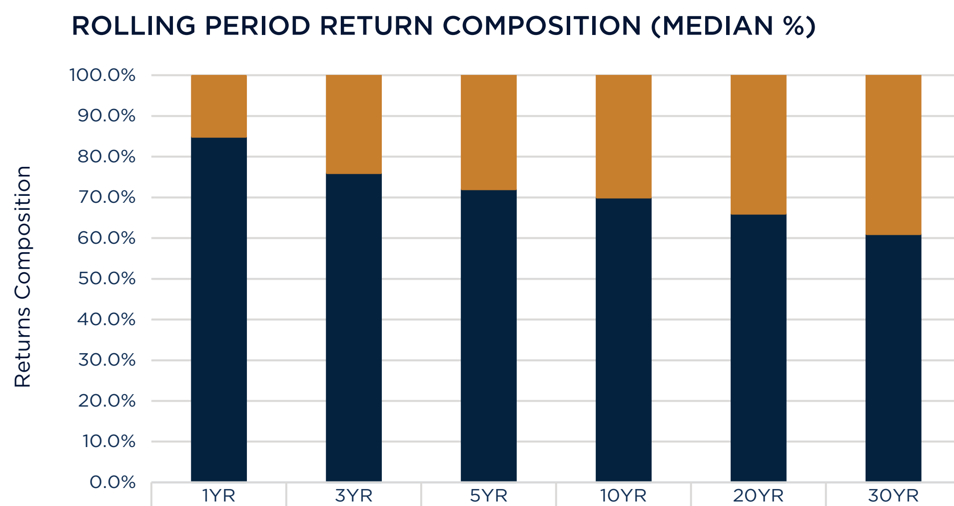
Introduction

In a world of low interest rates, equity income investing provides a means by which investors can generate real income growth in portfolios to meet current and future income needs. In addition to providing for investors' portfolio income needs, certain equity income strategies have demonstrated an ability to generate superior returns compared to other large cap equity strategies, while others have hidden risks that result from focusing on yield over total return. The purpose of this paper is to examine some of the shortfalls to equity income strategies that focus on dividend yield alone, and present what we believe to be a better approach to equity income investing focused on a broader consideration of capital return to shareholders.

The Importance of Dividends to Long-Term Shareholder Returns

Historically, dividends have been a meaningful component of equity total returns. While the proportional impact to total returns from dividends varies meaningfully in the short-term, over the long-term the significant benefit from the compounding effect of dividends' stable and consistent return stream is undeniable. This is illustrated in Figure 1 which shows the median rolling one-year contribution from dividends of 15% versus the median rolling thirty-year contribution of nearly 40%.

Figure 1: Rolling Period Return Compostition (Median %)

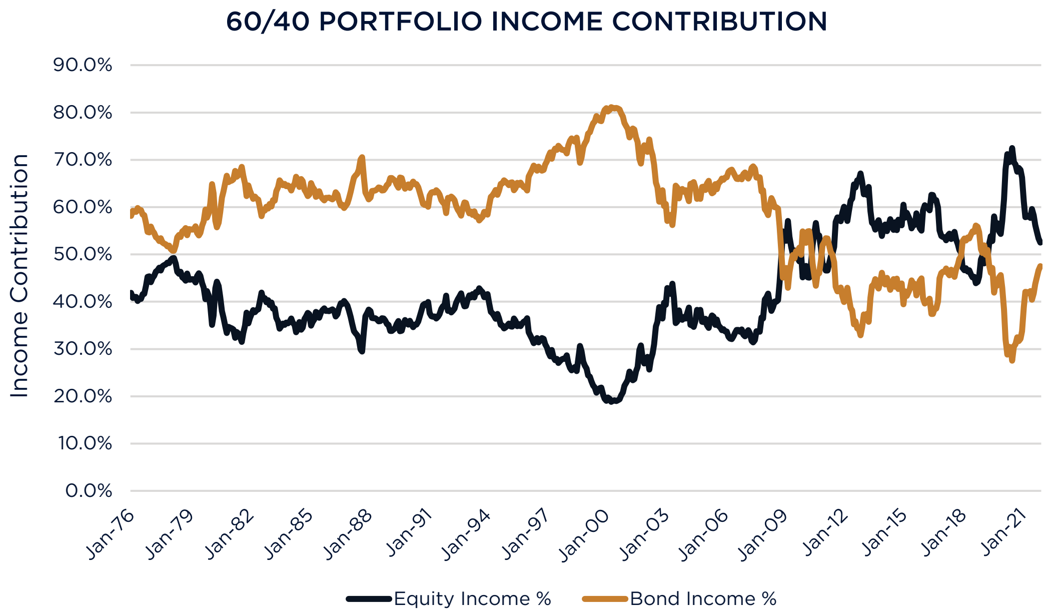


	1YR	3YR	5YR	10YR	20YR	30YR
Dividends	15.0%	24.0%	28.0%	30.0%	34.0%	39.0%
Capital Appreciation	85.0%	76.0%	72.0%	70.0%	66.0%	61.0%

Source: http://www.econ.yale.edu/~shiller/data.htm, Johnson Asset Management
Note: January 1956-December 2021 using median of rolling periods

In the more recent era, characterized by historically low bond yields, dividend income from equities has grown in importance. Over the last twenty years, dividends have grown to account for greater than 50% of the total income generated by a 60/40 balanced portfolio. In fact, dividends have accounted for greater than 50% share of total portfolio income for most of the last decade as illustrated in Figure 2.

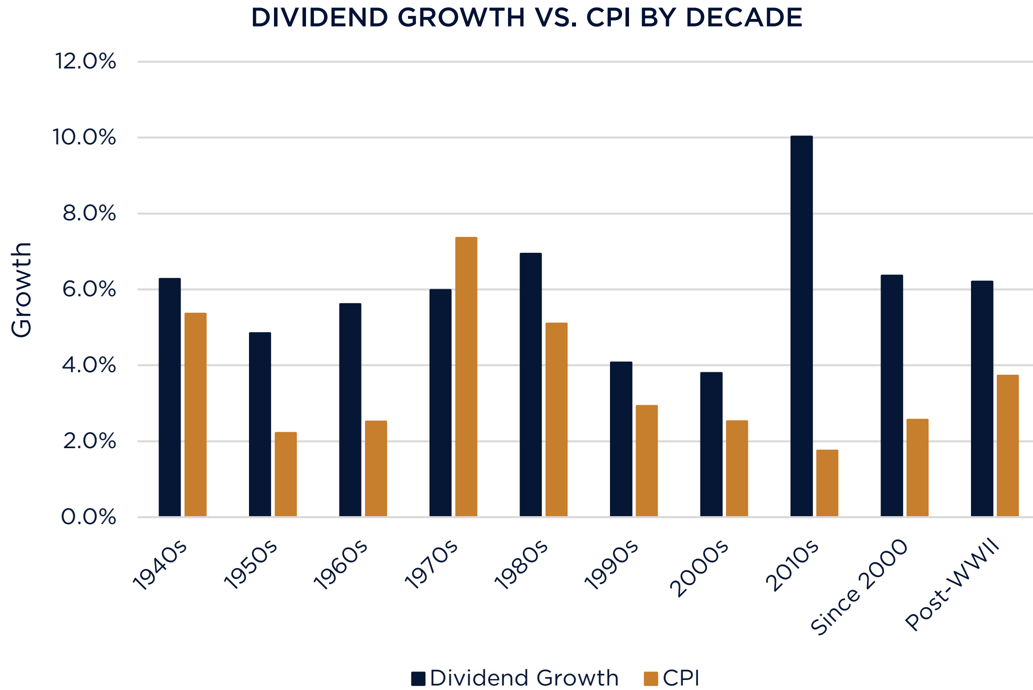
Figure 2: 60/40 Portfolio - Income Contribuiton



Source: Bloomberg, http://www.econ.yale.edu/~shiller/data.htm, Johnson Asset Management
Note: S&P 500 Composite dividend yield and Bloomberg U.S. Aggregate Yield-to-Worst used for period January 1976-December 2021

Along with the increasing portfolio income contribution, equity dividends have helped enhance the real income stream generated by a balanced 60/40 portfolio. Dividend growth has outpaced CPI inflation in the post-WWII period, and in every decade except the 1970s (Figure 3). Companies that grow their dividends provide an effective inflation hedge to portfolio income streams, an attribute that bond income does not provide.

Figure 3: Dividend Growth vs. CPI By Decade



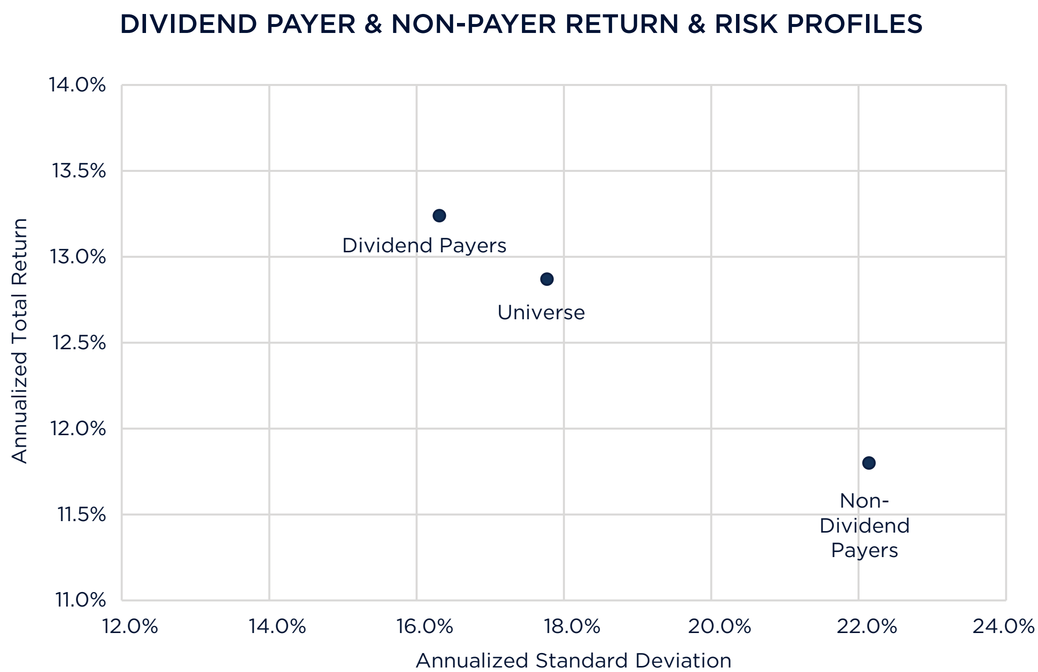
Source: http://www.econ.yale.edu/~shiller/data.htm , Johnson Asset Management
Note: S&P 500 Composite dividend growth; Consumer Price Index

A Signal of Quality

A healthy and growing dividend is a sign of a stable business with a strong balance sheet and a consistent ability to grow earnings. Investors often view a dividend as a sign of management's confidence in future growth of the business and its commitment to shareholders. Unlike other accounting-based measures of profitability, dividends are difficult to manipulate. A dividend policy focused on the sustainability and regular growth of a dividend is often rewarded by the market through higher valuations. This can have the effect of disincentivizing management teams from speculative investments that may endanger free cash flow and erode shareholder value. A prudent dividend policy can result in a company being less susceptible to the negative effects of a recessionary shock. Please see our whitepaper, "Quality: The Key to an All-Weather Equity Income Approach" where we go more in-depth on how we define quality.

The operational quality signaled by a dividend is evident in historical returns. Analyzing the dividend factor at the individual stock level shows that dividend-paying stocks have outperformed non-payers with less risk over time (Figure 4).

Figure 4: Dividend Payer & Non-Payer Return & Risk Profiles

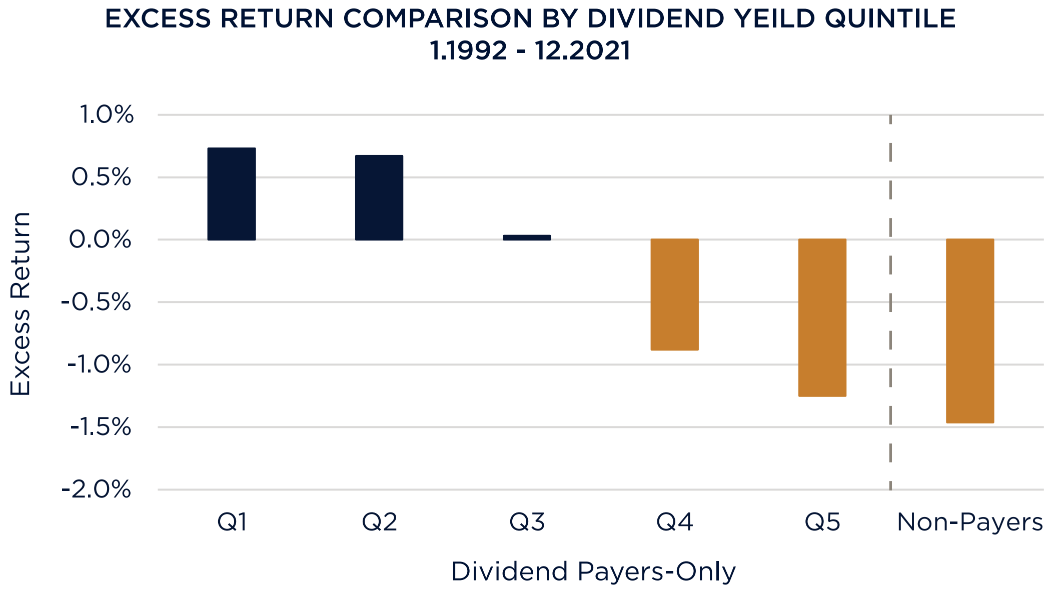


Source: FactSet Alpha Test

Note: Universe is Russell 1000 Equal-Weighted, 12/31/1984 To 12/31/2021. Please see disclosures at the end of the paper.

Given that dividends are a component of total return and dividend-paying stocks in aggregate have attractive risk adjusted returns, it would seem to be a logical conclusion that selecting stocks based on their absolute yield would be a winning strategy. Over the last 30 years, this was a valid approach as illustrated in Figure 5, which shows the dividend-paying universe broken out by quintile with all stocks that did not pay dividends broken out separately in the far-right bar. The data shows that the stocks with the highest dividend yields did indeed generate the highest positive excess returns while the lowest dividend-yielding stocks and the stocks that did not pay dividends exhibited meaningfully negative excess returns.

Figure 5: Excess Return Comparison by Dividend Yield Quintile

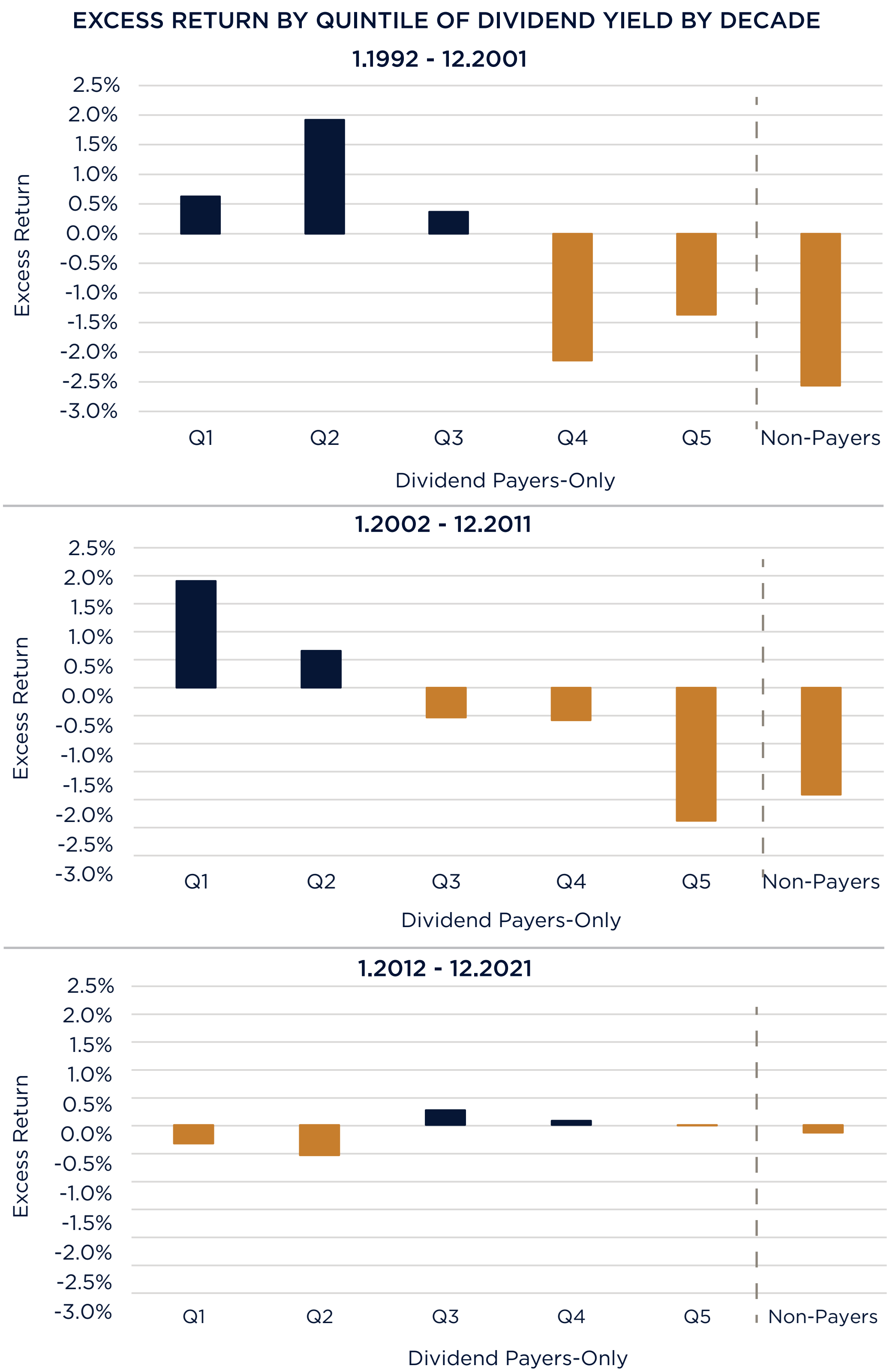


Source: FactSet Alpha Test

Note: Q1 is highest quintile by yield; Average monthly annualized excess returns by quintile of dividend yield and for non-dividend-paying stocks versus the Russell 1000 equal-weighted universe from 12/31/1991 to 12/31/2021.

Despite this long-term benefit, the efficacy of selecting stocks with the highest absolute dividend yield varies meaningfully depending on the period measured. An illustration of this is shown below in the charts in Figure 6. There are three charts displaying the last three ten-year periods. The highest dividend-yielding quintile of stocks generated the highest positive excess returns in only one of the periods, the 2002-2011 period. Over the last decade, the highest dividend-yielding stocks generated negative excess returns. The inconsistency of excess returns across time periods and lack of ordinality by quintiles illustrates that the dividend yield factor has not been a strong alpha generator by itself.

Figure 6: Excess Return by Quintile of Dividend Yield by Decade

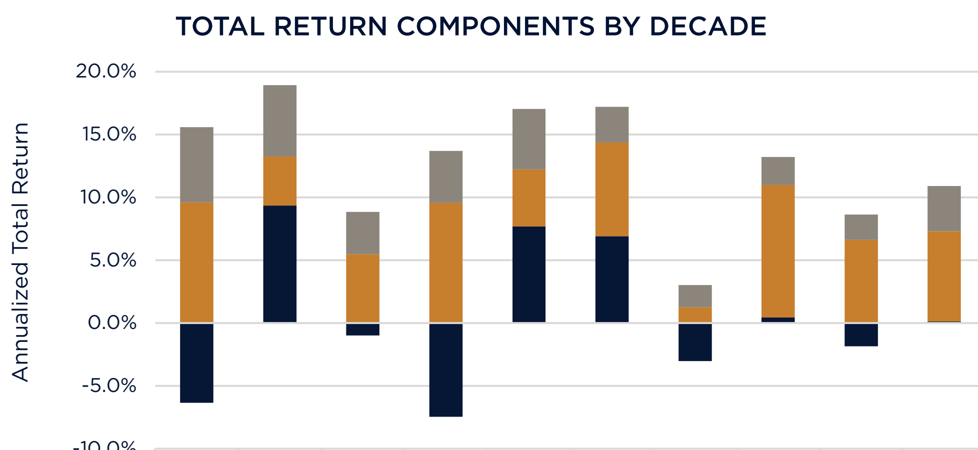


Source: FactSet Alpha Test

Note: Q1 is highest quintile by yield; Average monthly annualized excess returns by quintile of dividend yield and for non-dividend-paying stocks versus the Russell 1000 equal-weighted universe from 12/31/1991 to 12/31/2021.

Broadening the historical return perspective beyond the last three decades, we conducted a deeper dive analysis into the post-WWII total returns from equities. Our research found that it is the fundamental cash flow growth of a business, realized in earnings and dividend growth, that drives capital appreciation in stock prices. Equity total returns can be deconstructed into three components: 1) changes in valuation 2) changes in fundamentals and 3) income. This deconstruction of total returns can be done across several fundamental variables including earnings, cash flows, and dividends. Using dividends as the fundamental component in our analysis (Figure 7), dividend yield plus dividend growth has accounted for nearly the entirety of long-term equity returns. Changes in valuation have made meaningful contributions to total returns over shorter periods and in certain decades, but the long-term contribution from changes in valuation have been a relatively minor 0.40% annualized in the post-war period (Figure 7).

Figure 7: Total Return Components by Decade



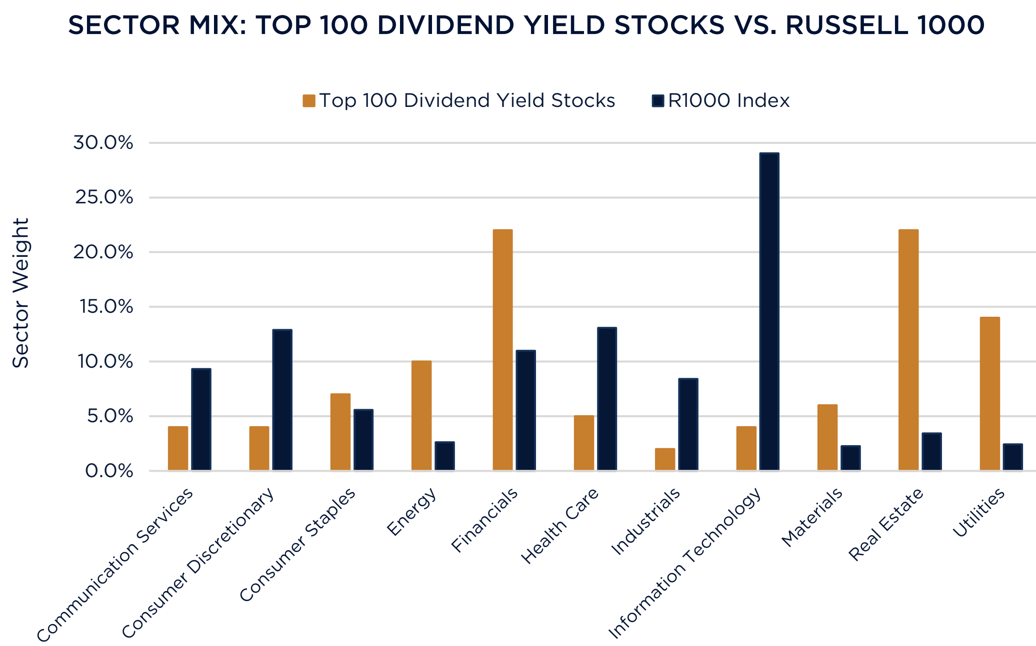
	1940s	1950s	1960s	1970s	1980s	1990s	2000s	2010s	Since 2000	Post-WWII
Dividend Income	6.0%	5.7%	3.3%	4.1%	4.8%	2.8%	1.8%	2.2%	2.0%	3.6%
Dividend Growth	9.6%	3.9%	5.5%	9.5%	4.5%	7.5%	1.3%	10.5%	6.6%	7.2%
Valuation	-6.4%	9.3%	-1.0%	-7.5%	7.7%	6.9%	-3.0%	0.4%	-1.8%	0.1%
Total Return	9.2%	18.9%	7.8%	6.2%	17.0%	17.2%	0.0%	13.2%	6.8%	10.9%

Source: http://www.econ.yale.edu/~shiller/data.htm , Johnson Asset Management

Note: January 1940-December 2021; Post-WWII period January 1946-December 2021.

This analysis supports the intuitive conclusion that investors should care about more than just absolute dividend yield in their investment approach, but also consider cash flow growth in the form of dividend growth. A strategy of investing in the highest dividend-yielding stocks can potentially exclude companies exhibiting stronger business fundamentals from portfolios. It also exposes investors to certain undesirable systematic risks. Our analysis found that the highest dividend-yielding stocks tend to be concentrated in certain sectors. A comparison of relative sector weights between the top 100 stocks by dividend yield in the Russell 1000 versus the overall Russell 1000, illustrates the sector concentration risk and lack of diversification (Figure 8). Approximately 70% of an equal-weighted portfolio of the top 100 dividend-yielding stocks is allocated to four sectors: Financials, Real Estate Investment Trusts, Energy, and Utilities. These sectors are largely characterized by lower earnings growth, higher leverage, and lower profitability. Additionally, some of these sectors (i.e., Utilities and REITs) are regularly among the highest issuers of new equity. Dividend sustainability can be a concern for stocks with the highest payout ratios and that are reliant on equity issuance for funding, particularly in periods of economic and market stress.

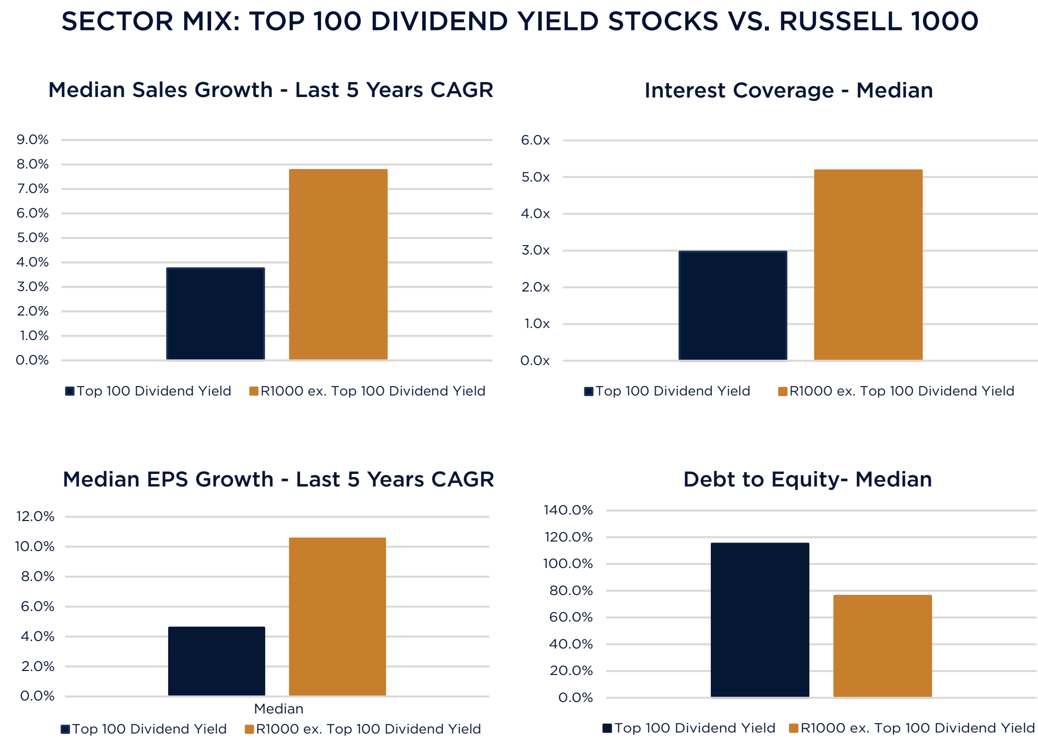
Figure 8: Sector Mix: Top 100 Dividend Yield Stocks vs. Russell 1000



Source: FactSet as of 12/31/2021; Comparison shows portfolio of Top 100 Dividend Yield Stocks equal-weighted versus Russell 1000 Index market cap-weighted

As a result, the highest dividend-yielding stocks tend to have sub-par long term growth prospects or too much leverage. Also, high-yielding stocks in certain sectors such as Financials and Energy tend to display greater cyclicality to business fundamentals. Figure 9 compares sales and EPS growth, interest coverage, and the debt-to-equity ratio of the top 100 dividend-yielding stocks in the Russell 1000 Index versus the rest of the Russell 1000 universe. The top 100 dividend-yielding stocks have exhibited lower sales and EPS growth and have higher leverage metrics.

Figure 9: Fundamentals: Top 100 Dividend Yield Stocks vs. Russell 1000



Source: FactSet as of 12/31/2021

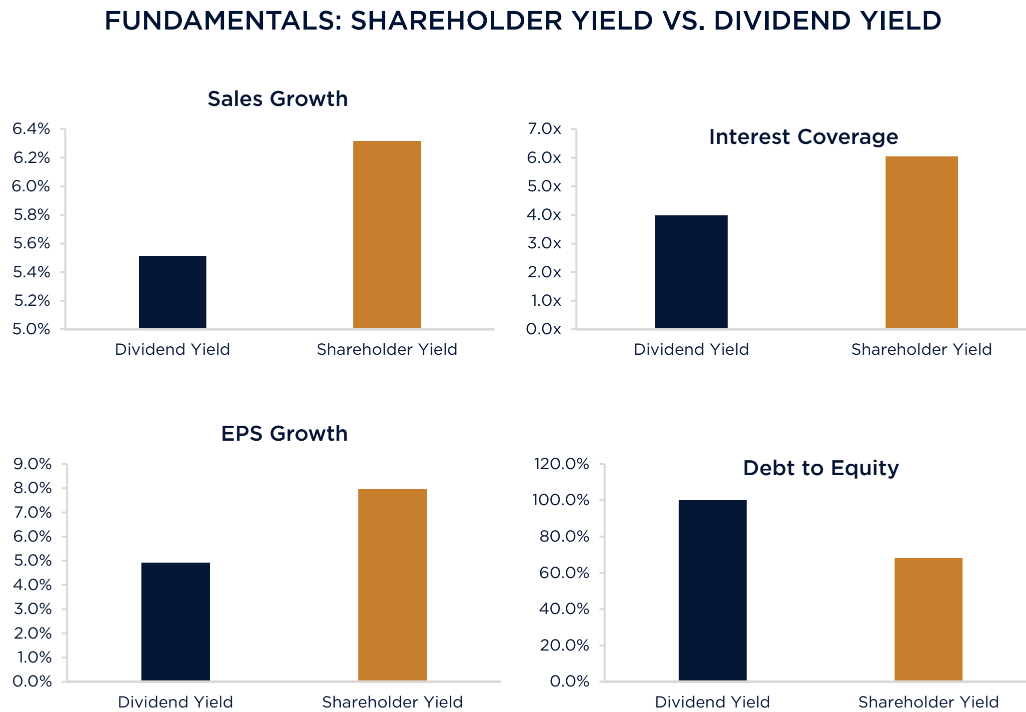
Shareholder Yield: A More Nuanced Approach

Our research indicates that broadening the view on shareholder capital return to account for all capital allocation priorities of a company further enhances excess returns. Prior to the mid-1980s, share repurchases were a relatively insignificant component of corporate shareholder return policies. Since then, corporate policies have shifted meaningfully, increasing the emphasis on share repurchases and lowering dividend payout ratios. This has resulted in greater tax efficiencies and higher earnings per share growth by companies reinvesting in their businesses by reducing share count.

Despite relatively less emphasis on dividend payouts in corporate capital allocation policies in recent years, dividends and dividend growth are still foundational to these policies and tangible signals of a company's quality. While the Johnson Equity Income approach strives to maintain a portfolio dividend yield above the overall market, we take a more integrated view of a company's capital return to shareholders considering both dividend yield and dividend growth, as well as net share repurchases and net debt issuance. Our process places greater importance on a company's shareholder yield than its absolute dividend yield.

Comparing stocks with positive shareholder yields versus stocks with the highest dividend yields, the former tend to have more attractive fundamental growth characteristics and stronger, more resilient balance sheets than the latter. Figure 10 illustrates this, comparing sales and EPS growth, interest coverage, and leverage metrics.

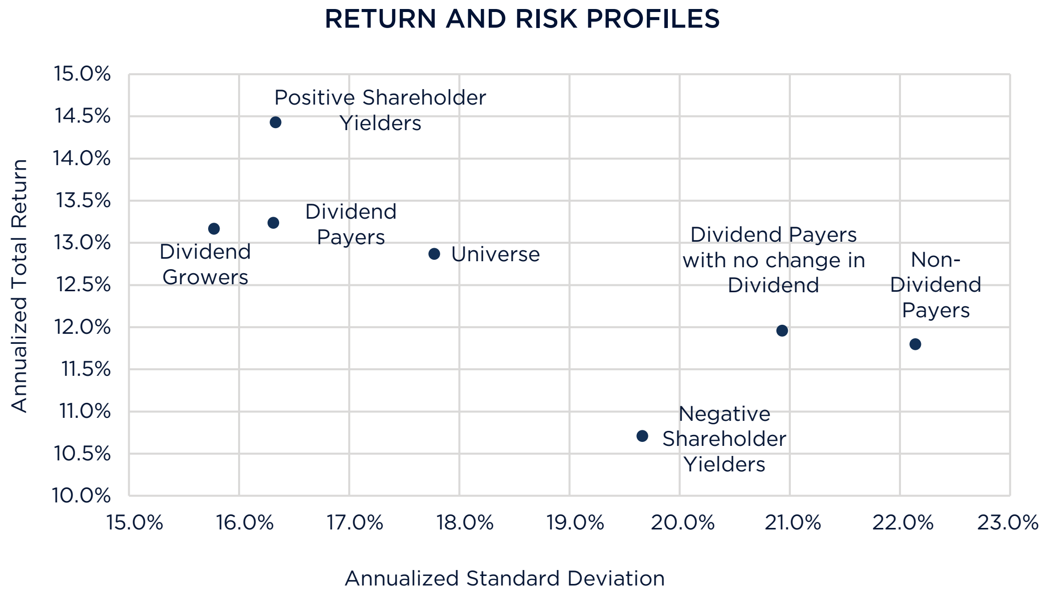
Figure 10: Fundamentals: Shareholder Yield vs. Divided Yield



Source: FactSet Alpha Test, Measurement period is December 1984 – December 2021

Historical return research validates taking this more integrated approach as the companies that grew dividends and had positive shareholder yields achieved stronger absolute and risk-adjusted returns (Figure 11).

Figure 11 – Return and Risk Profiles

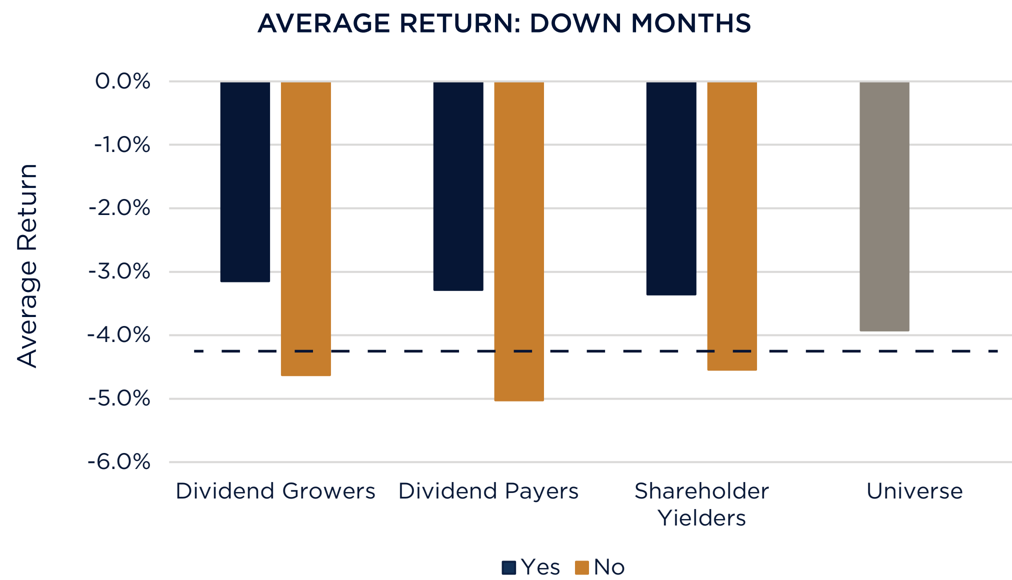


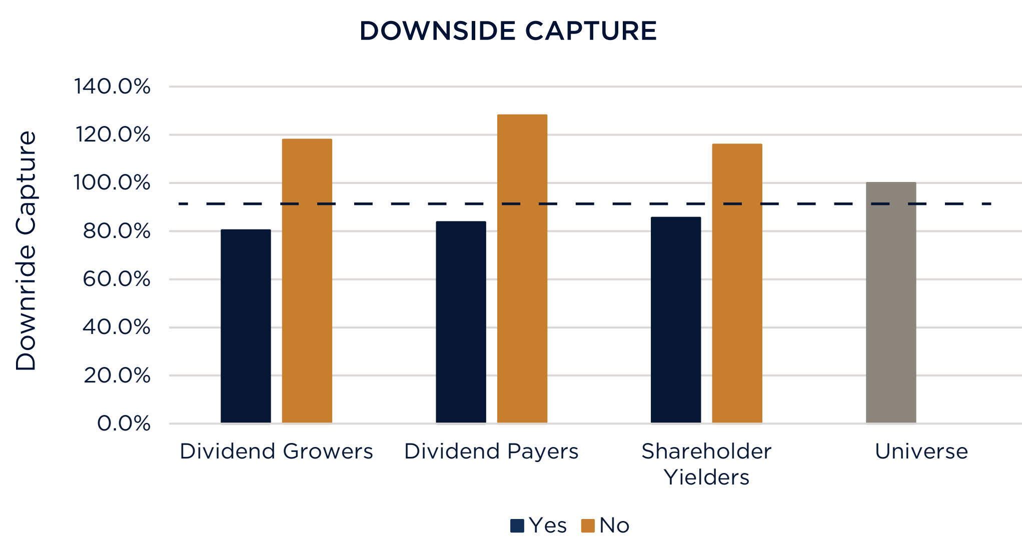
Source: FactSet Alpha Test

Notes: 12/31/1984 To 12/31/2021, Universe= Russell 1000 Equal-Weighted

Avoiding low quality stocks by focusing on owning companies that pay a dividend, that can consistently grow that dividend, and that are able to return capital to shareholders by other means is a cornerstone of our equity income approach. Stocks with these characteristics have exhibited superior downside protection compared to stocks that do not pay dividends, do not grow their dividends, or have negative shareholder yields. Figure 12 illustrates this by comparing average returns (top) and downside capture (bottom) in down months. Stocks that meet our shareholder capital return criteria have not only exhibited superior downside protection characteristics compared to stocks that do not meet our criteria, but also compared to the broader universe of stocks.

Figure 12: Downside Protection



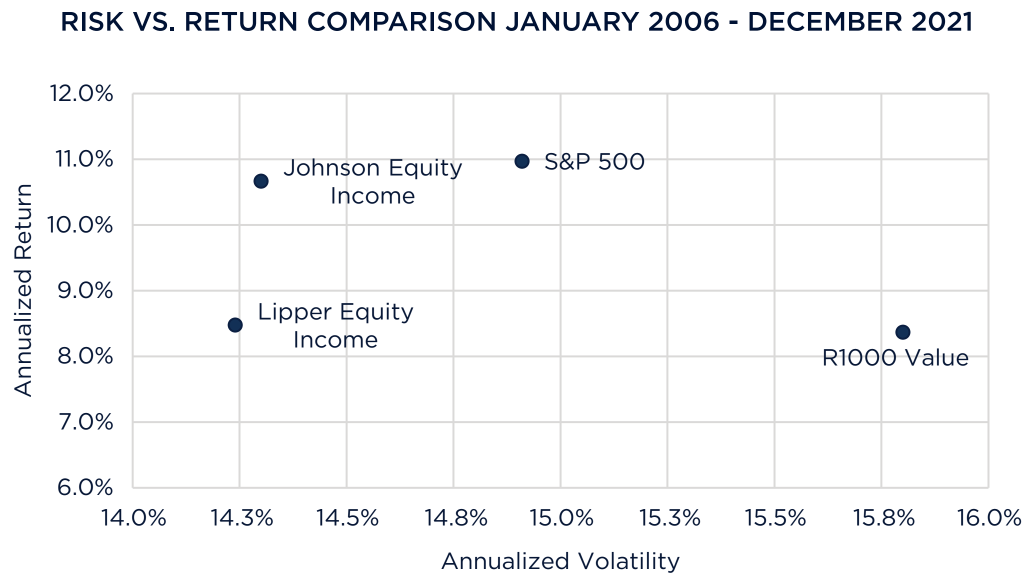


Source: FactSet Alpha Test

Notes: 12/31/1984-12/31/2021; Universe = Russell 1000 equal-weighted

Overall, our approach to equity income investing has enabled us to achieve our portfolio objective of delivering superior risk-adjusted returns to our shareholders (Figure 13). The integration of dividend growth and shareholder yield into our yield evaluation allows us to accomplish this with a core investment style. This contrasts with many other equity income approaches which have heavier value factor exposures, and therefore higher volatility. You can read more about our views on style differences in equity income investing in our **"Balancing Quality with Valuation: Breaking Down Our Equity Income Approach"** whitepaper.

Figure 6: Excess Return by Quintile of Dividend Yield by Decade



Source: FactSet as of 12/31/2021

Putting It All Together: A Better Approach to Equity Income Investing

In summary, dividend income has been a significant contributor to equity investors' total returns and a growing percentage of a balanced portfolio's income. Dividend-paying stocks have outperformed non-dividend-paying stocks meaningfully over time while incurring less risk. Despite this long-term outperformance, a strategy focused on owning the highest dividend-yielding sub-segment of stocks has generated inconsistent relative performance. It has resulted in portfolios with less attractive fundamental characteristics and a lack of diversification by sector and factor exposure. Our research shows that a focus on owning stocks with stronger dividend growth and positive shareholder yields is the most consistent method to achieve superior risk-adjusted long-term capital appreciation. In our view, targeting the highest possible dividend yield level is not a consistent way to successfully pick stocks nor is it the best way to pick an equity income manager. By pairing a quality focus with a more integrated consideration of equity income, including dividend yield, dividend growth, and shareholder yield, we can build a portfolio of companies that provides the best opportunity for superior long-term equity returns. While this integrated approach can result in a portfolio dividend yield that is often below that of other equity income funds, this approach has resulted in superior absolute returns and better downside protection over time.

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Disclosures & Key Terminology

Lipper Equity Income Universe *is composed of funds that, by prospectus language and portfolio practice, seek relatively high current income and growth of income by investing at least 65% of their portfolio in dividend-paying equity securities.*

Russell 1000 Index *includes the top 1,000 companies by market-capitalization in the United States. It is considered a bellwether index for large cap equity investing.*

S&P 500 *is a market-capitalization weighted index that includes the 500 most widely held companies chosen with respect to market size, liquidity, and industry.*

Consumer Price Index *is an index that measures the monthly change in prices paid by U.S. consumers. It is calculated by the Bureau of Labor Statistics (BLS). It is a weighted average of prices for a basket of goods and services representative of aggregate U.S. consumer spending.*

Downside Capture *is a ratio that measures a manager's relative performance in down-markets by comparing the manager's monthly returns with those of a benchmark index. The bottom chart in Figure 12 measures Downside Capture relative to the Russell 1000 equal-weighted universe.*

Raw data used in Figures 1, 2, 3, and 7 comes from data developed by Professor Robert J. Shiller using various public sources. Historical price, dividend, and valuation data used in these figures represents the S&P Composite.

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There is no guarantee that the investment objectives will be achieved. Moreover, past performance is not indicative nor a guarantee of future results.

Before you invest, you may want to review the Fund's Prospectus and Statement of Additional information, which contains more information about the Fund and its risks. You can find the Fund's Prospectus and other information about the fund online at https://www.johnsoninv.com/mutualfunds/documents. You can also get this information at no additional cost by calling (800) 541-0170 or by sending an email request to prospectus@johnsonmutualfunds.com.

Information about indices is provided to allow for certain comparisons of the relevant Johnson Equity Income Fund strategy to that of certain well known and widely-recognized indices. Such information is included to show the general trend in the markets during the periods indicated and is not intended to imply that the holdings of the relevant fund were similar to the indices, either in composition or risk profile. Such indices are not actively managed and therefore do not have transaction costs, management or performance fees or other operational expenses. The investment program of the fund is not restricted to the securities comprising such indices and allows for, among other things, the use of leverage, short selling and the use of derivatives. The funds' portfolios may not be as diversified as such indices and the volatility of indices may be materially different from the volatility of the funds. Definitions for the indexes utilized in this document set out below.