A PERSPECTIVE ON DIVIDENDS

Investing in companies that pay dividends has been among the most popular equity investing strategies for generations. But do dividends really matter? From a pure financial perspective, they shouldn't. When a company has positive after-tax earnings, there is a decision to be made by the board of directors: what do we do with these earnings? The choices are many including:

- Reinvest earnings into growth projects in an attempt to maintain a growth profile
- Pay down debt to improve balance sheet flexibility
- Buy back shares to reduce the number of shares outstanding resulting in Earnings Per Share (EPS) accretion
- Pay dividends

The first three are much more tax efficient and should be considered more effective. These should, over time, increase the marginal value of each share. Investors are not taxed on value increase until shares are sold, allowing investors to defer taxation on their investment. At current tax rates, tax deferral is very attractive. When a company chooses to pay dividends out of after-tax earnings, the earnings that are paid out are taxed again at the individual investor level. One could argue that companies that pay dividends should be avoided. So why do 66% of large companies within our universe for this study pay dividends?

Many investors view companies that pay dividends as stable and mature. They are safer companies that can meet both growth and income objectives of investors. Mathematically, dividends shorten the duration of equity investments and therefore should exhibit less risk than companies that don't pay dividends. In other words, investors in dividend-paying companies are being paid part of the company's earnings in cash on a consistent basis, allowing investors to take chips off of the table over time. Conversely, companies that don't pay dividends are forcing investors to wait for their reward at some future liquidation point. One could argue that companies that pay dividends should be favored.

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In an attempt to codify the importance of dividends, we conducted a thorough study of companies that pay dividends and those that don't. Additionally, we explored the different types of dividend-paying companies and analyzed the long term absolute and risk-adjusted returns of these groups. Our conclusion is that regardless of financial theory, dividends do in fact matter.

UNIVERSE

The analysis that we performed was in support of the Principal Street Equity Income Strategy. The Equity Income Strategy is a large cap value strategy managed by Principal Street Partners whose investment process is designed to identify large companies that have the following attributes:

- High quality and liquid balance sheets
- Durable cash flows supported by attractive relative cash flow margins
- Heritage of paying consistent and growing dividends at responsible payout ratios
- Attractive relative valuation

The portfolio is equally weighted across each GICS sector excluding real estate. Each sector has four equally weighted positions. Real estate is excluded because REIT dividend policy is essentially dictated by the structure and the distributions do not receive dividend tax treatment.

The universe used in our analysis of the importance of dividends is similar to the universe used in the Equity Income investment process. The universe is as follows:

- No real estate investment trusts (REITs), master limited partnerships (MLPs), business development companies (BDCs) or closed end funds
- No ADR's
- Domestic companies trading on major US exchanges
- The largest 1,000 companies by market cap at the end of the prior calendar year for each year from 1988 to the present
- Companies that were trading at the beginning and end the given calendar year
- Companies that paid a quarterly dividend (no annual or semi-annual dividend payers)
- Data source is FactSet

To learn more about the Principal Street Equity Income Strategy, please visit www.principalstreet.com.

DIVIDEND PAYERS VS. NON-PAYERS

Our first step into codifying the importance of dividends was to look at the risk and return profiles of companies that pay dividends versus companies that don't. Dividend payers are companies that

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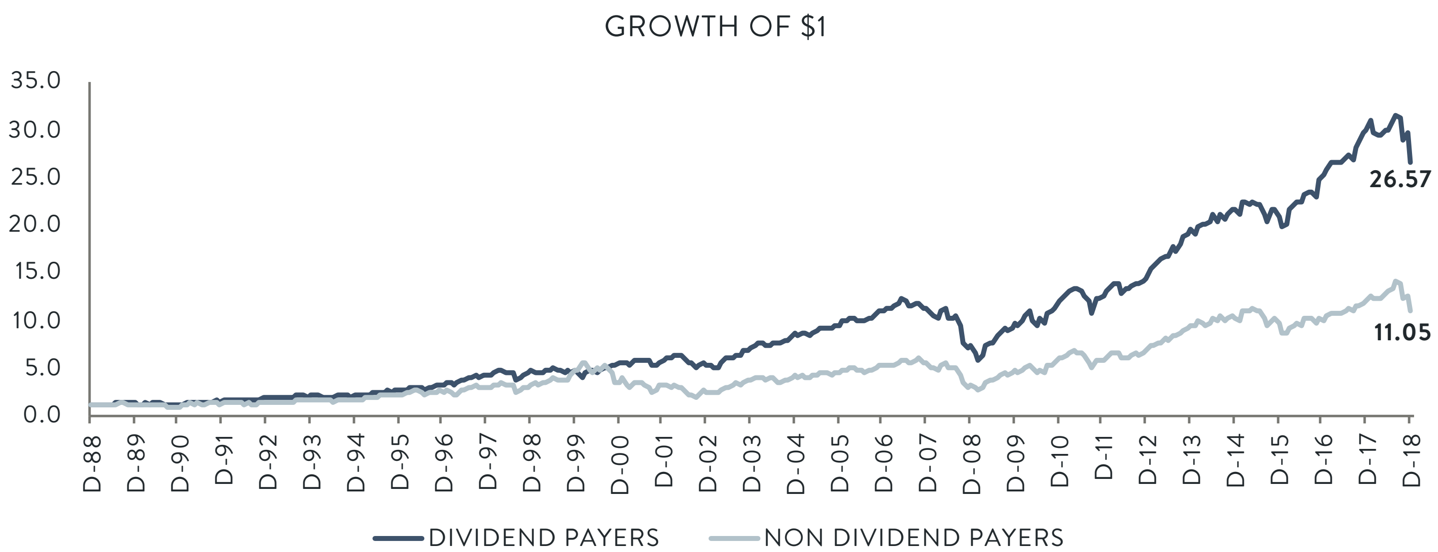
were paying quarterly dividends at the beginning and the end of each calendar year within our universe. Non-Payers are companies that were not paying a quarterly dividend at the beginning, nor the end of each calendar year. The total return of each company was measured monthly and averaged within each of the two categories.



Source: FactSet. Charts are for illustrative purposes only.

The results are telling. From 1989 through 2018, Dividend Payers generated an average return of 11.6% versus 8.3% for Non-Payers. Over the same period, the Russell 1000 generated a 10.1% average annual return. As can be seen in the chart above, $1 invested in Dividend Payers would have grown to $26.57 while Non-Payers would have only grown to $11.05. The risk side of the equation is equally as impressive. Dividend Payers generated these returns with standard deviation of 14.7% versus 22.6% for Non-Payers. Said another way, Dividend Payers provided 2.4 times the return of Non-Payers with 35% less volatility. The maximum drawdown for Dividend Payers in our analysis was -52.5% versus -64.6% for Non-Payers, thus adding credence to the theory that dividends can add a "margin of safety" in stock market downturns.

Dividend Payers do not always outperform Non-Payers on a calendar year basis. Since 1989, Dividend Payers have outperformed 53% of the time. Moreover, Dividend Payers outperformed the majority of years that the broad market (Russell 1000) was in negative territory; outperforming Non-Payers by an average of 15% over those years.

DIVIDEND INITIATORS

Regardless of financial theory and tax efficiency, we hypothesized that if dividends really matter to investors, then companies that initiate a dividend during the calendar year would attract a new group of investors and due to increased demand, outperform Dividend Payers. To perform this

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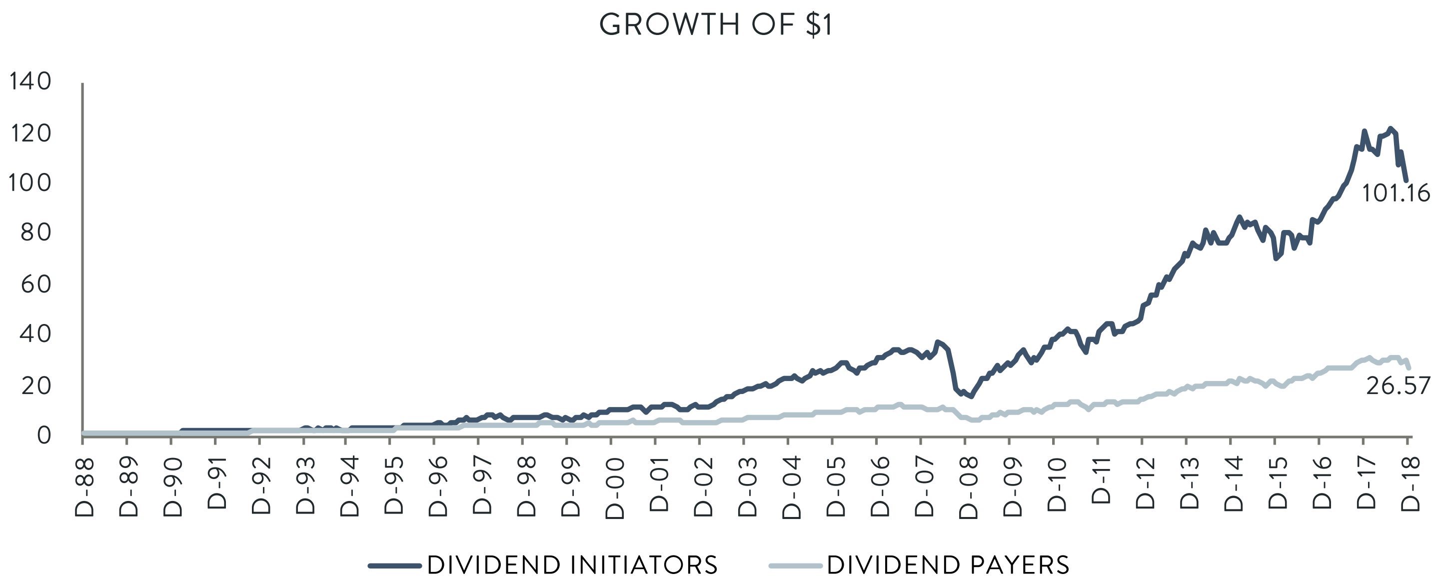
analysis, we selected companies that paid no dividend at the beginning of each calendar year and paid some dividend at the end of the calendar year.



Source: FactSet. Charts are for illustrative purposes only.

Our hypothesis was correct. If an investor were lucky (or skilled) enough to have only selected the average of 30 companies each year that initiated a dividend, that investor would have enjoyed an average return of a staggering 16.6% per year versus 11.6% for Dividend Payers. One dollar invested would have grown to $101.16 for Dividend Initiators versus $26.57 for Dividend Payers. Volatility was higher for Dividend Initiators (19.4% versus 14.7% for Dividend Payers); however, a Sortino Ratio of 1.15 and Alpha of 6.1 to the Russell 1000 suggests that there is substantial upside volatility within the Initiators.

1989 - 2018	RETURN	STD DEV	SHARPE RATIO	SORTINO RATIO	ALPHA
DIVIDEND INITIATORS	16.6%	19.4%	0.74	1.15	6.2
DIVIDEND PAYERS	11.6%	14.7%	0.62	0.92	1.7
RUSSELL 1000 TR	10.1%	14.3%	0.53	0.78	0.0

Source: FactSet. Charts are for illustrative purposes only.

We do not believe that a Dividend Initiator strategy is a reasonable investment strategy as so few

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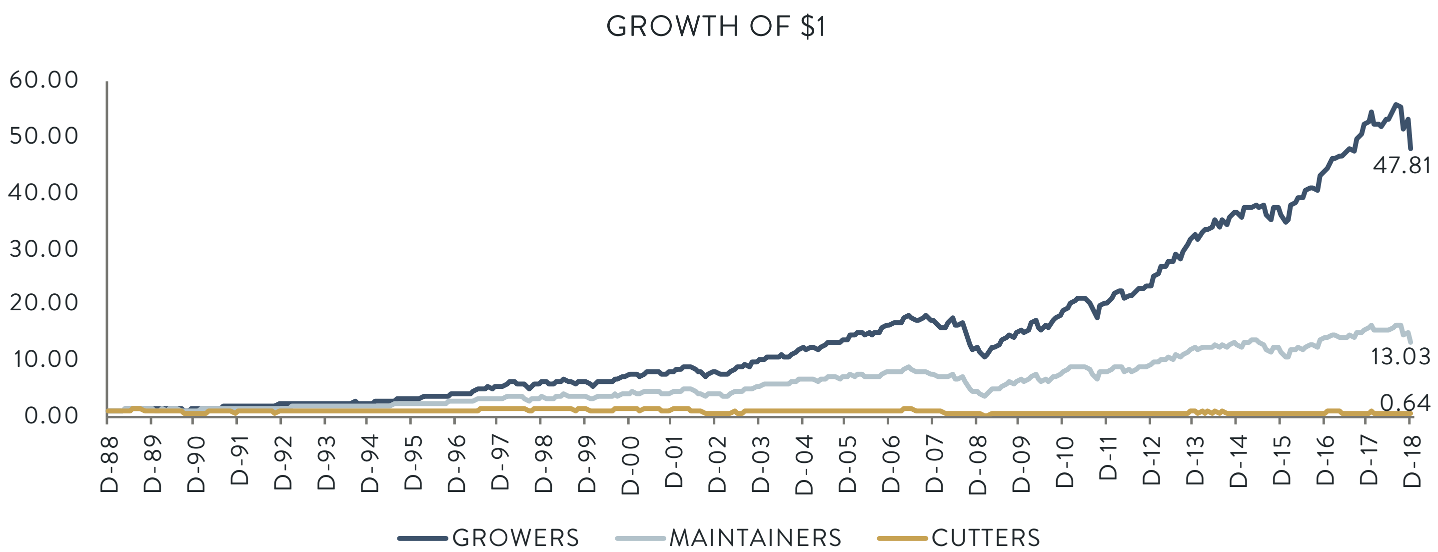
companies initiate each year and the probability of correctly choosing the handful of companies that initiate a dividend on a consistent basis is extremely low. The point of this analysis is to highlight the importance of dividends from the investing community's perspective. The results suggest that when a company transitions from being a Non-Payer to a Dividend Payer, they tap into a wider investor base generating incremental demand.

GROWERS, MAINTAINERS AND CUTTERS

Taking a deeper look at the importance of dividends, we divided the universe of payers into Dividend Growers, Dividend Maintainers and Dividend Cutters. Our theory was that Growers should outperform Maintainers and Maintainers should outperform Cutters. Again, our assumption was correct. Growers, Maintainers and Cutters generated total returns of 13.8%, 8.9% and -1.5%, with volatility of 13%, 16% and 21%, respectively.



Source: FactSet. Charts are for illustrative purposes only.

It is clear from this analysis that Cutters should be avoided at all cost as the alpha of Cutters was a staggering -11.6! Within the Dividend Payer universe, investors should seek out companies that maintain and/or grow their dividends. This task, while difficult, is more realistic than attempting to identify Dividend Initiators as discussed in the prior section. Companies with stable and growing dividends have common attributes, including higher quality and more liquid balance sheets, durable cash flows and sensible dividend policy.

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1989 - 2018	RETURN	STD DEV	SHARPE RATIO	SORTINO RATIO	MAX DRAWDOWN	ALPHA
GROWERS	13.8%	13.4%	0.81	1.26	-42.5%	4.2
MAINTAINERS	8.9%	16.2%	0.43	0.62	-57.5%	-1.1
CUTTERS	-1.5%	20.8%	-0.11	-0.14	-83.5%	-11.6
DIVIDEND PAYERS	11.6%	14.7%	0.62	0.92	-52.5%	1.7
NON-DIVIDEND PAYERS	8.3%	22.6%	0.34	0.49	-64.6%	-1.1
RUSSELL 1000 TR	10.1%	14.3%	-.53	0.78	-51.1%	0.0

Source: FactSet. Charts are for illustrative purposes only.

DOES RELATIVE YIELD MATTER?

Dividend-focused investment strategies typically are focused on dividend yield or dividend growth. Dividend yield strategies typically focus on stocks that have the highest dividend yields regardless of whether that means a lower prospect for future dividend growth. Dividend growth strategies assign the highest value to stocks that have exhibited consistent dividend growth. Current dividend yield is less a primary consideration for dividend growth strategies as many of these strategies have yields either in line or even below that of the broad market. We wanted to understand which is better: dividend yield or dividend growth. Our conclusion is that both are better.

To perform this analysis, we divided Dividend Payers into quintiles based on dividend yield. The average dividend yield of quintile 1, 2, 3, 4 and 5 was 5.5%, 3.1%, 2.1%, 1.4% and 0.6%, respectively, compared to 2.1% for the S&P 500 index over that period. The higher the dividend yield, the lower the average dividend growth rate, ranging from -2.2% for quintile 1 to +37.2% for quintile 5. The best absolute and risk-adjusted return (+12.3%) came from the 2nd quintile.

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1989 - 2018	RETURN	STD DEV	SHARPE RATIO	SORTINO RATIO	MAX DRAWDOWN	AVG. ANN'L DIV. GROWTH RATE
QUINTILE 1	11.6%	13.6%	0.66	1.00	-51.9%	-2.2%
QUINTILE 2	12.3%	14.4%	0.67	1.01	-47.5%	5.1%
QUINTILE 3	11.6%	15.4%	0.59	0.88	-52.3%	8.7%
QUINTILE 4	11.3%	15.8%	0.57	0.85	-55.1%	13.9%
QUINTILE 5	10.5%	17.2%	0.49	0.71	-56.5%	37.2%

Source: FactSet. Charts are for illustrative purposes only.

While high-dividend yields may seem attractive, they should be approached with caution. Extremely high dividend yields are often the result of a company's share price dropping considerably due to some form of financial stress that may result in dividend cuts in the future (as demonstrated by the negative average dividend growth rate for the highest yielding quintile). Please reference the performance of Dividend Cutters discussed previously. The sweet spot for dividend investors appears to be the 2nd quintile due to an attractive average dividend yield of 3.1%, dividend growth of 5.1% and total return of 12.3%. This quintile has the best Sharpe Ratio (0.67) and Sortino Ratio (1.01) of any of the quintiles. Based on the data, taking a "middle of the road" approach that balances dividend yield with dividend growth provided the most optimal risk-adjusted returns over the past 30 years.

CONCLUSION

Theoretically, investors should favor tax efficient uses of corporate earnings, including reinvestment in growth projects, debt reduction or share buybacks. Dividend payments remove cash from the companies and are potentially taxed twice. However, if history is a guide, dividends do matter and, as a result, Dividend Payers have substantially outperformed Non-Payers on both an absolute and risk-adjusted basis. Within the dividend paying universe, investors should at all cost avoid companies that are likely to cut dividends and attempt to identify those companies that will maintain and preferably grow their dividend distributions over time. Finally, investors should approach the highest dividend yielding stocks with caution and focus more on a balance between current dividend yield and dividend growth. In our analysis, the dividend yield based second quintile provides this balance. Based on our analysis, we feel that dividends will continue to be a significant factor to total return in the years to come.

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