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THOUGHT LEADERSHIP: EQUITY STRATEGIES - THE SUPPLY AND DEMAND DYNAMIC OF HIGH DIVIDEND STOCKS

An Investor Search For Yield

Traditional fixed-income instruments have historically played an important role for investors seeking to achieve targeted income expectations. However, since the 2008 financial crisis, the achievement of such income targets has been a challenge in a generational low interest rate environment driven by unprecedented monetary stimulus. These tempered, forward-looking, expectations from fixed-income yields drove investors to seek alternatives to achieve their income targets. One potential alternative that investors appeared to focus on was high dividend paying stocks.

The dynamic of investor demand for higher yields found in equities can be one explanation for the price trends of high dividend stocks in 2016, as fixed-income yields were persistently lower than equity yields. From the end of 2015 through mid-July of 2016, the S&P High Yield Dividend Aristocrats (High Dividend) Index outperformed the broad market (S&P 500 Index) approximately by a staggering 12%. During the same period, the U.S. 10-Year Treasury Yield (10-Year) fell to historic lows. However, since that point, as the 10-Year yield began trending higher (as of 12/31/16), the High Dividend Index under-performed the S&P 500 by approximately -3%.

A historically low-rate environment may have driven strong returns of high dividend stocks in recent years. With the intermediate-term trend reversing, will high dividend strategies lag?

U.S. 10-YEAR TREASURY YIELD VS. S&P 500 INDEX YIELD

Source: Bloomberg. Data as of 12/31/16. For illustration purposes only. Past performance is not a guarantee of future results. Please see disclosures at the end for additional information.

Searching for Demand-Driven Alpha

In recent months, investors have made impactful recalibrations of expectations on both fiscal and monetary fronts. The speculation regarding pro-growth policies of the new administration have helped drive equity markets to all-time highs. At the same time, the Federal Reserve raised rates and indicated future hikes as economic data has trended positively.

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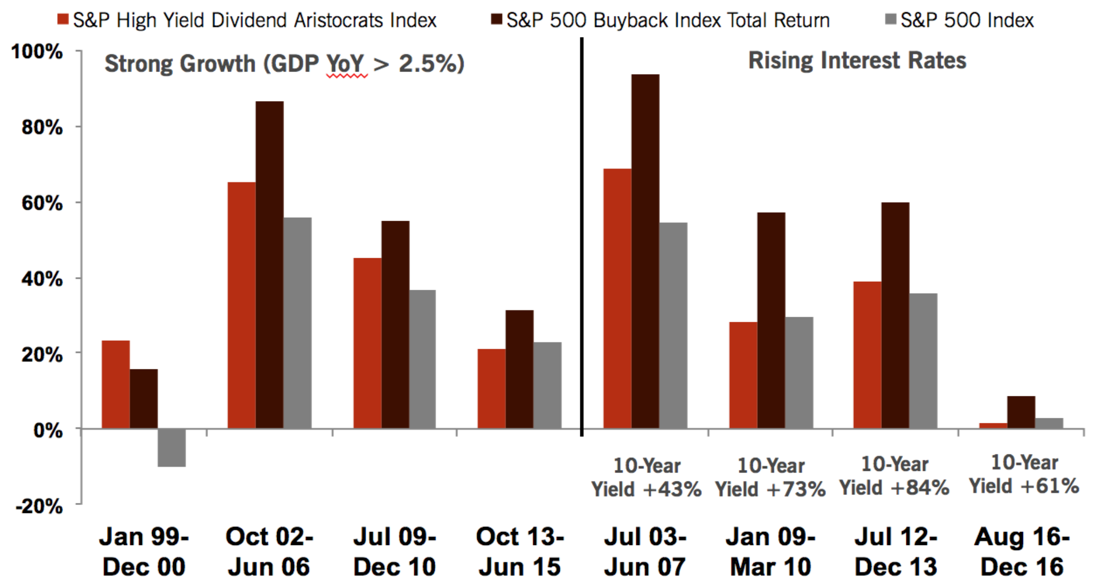
Historically, buy backs have on average outperformed high-dividends in periods of growth and rising rates.

A potentially stronger growth and rising rate environment may continue to reduce the relative attractiveness of high dividend stocks to investors. This, in turn, may spur the search for new demand-driven outperformance. As stock dividends become relatively less attractive to investors versus bonds, a source of direct demand may be coming from corporations themselves, such as through stock buybacks. A look back at other historical periods of rising interest rates and/or higher GDP growth supports this thesis.

The following table shows returns in different periods since 1999 identified as "Strong Growth", defined as periods where GDP growth year-over-year (YoY) was greater than 2.5%, and "Rising Interest Rates", where a 10-Year yield rising trend persisted. In these periods, the S&P 500 Buy Back Index outperformed High Dividend Index six out of seven times, and outperformed the S&P 500 Index seven out of seven times.

DIVIDENDS AND BUYBACK STRATEGIES PERFORMANCE AT DIFFERENT MACRO ENVIRONMENTS



Source: Bloomberg. Data as of 12/31/16. For illustration purposes only. Past performance is not a guarantee of future results. Dates are from the first day of the beginning month to the last day of the ending month. Please see disclosures at the end for additional information.

Conclusion

Historical performance has obvious limitations, and we can never know exactly what the future holds. However, markets are not static, and analyzing periods in different environments can help paint a picture of what fundamental and technical trends may persist. A poignant quote attributed to Mark Twain makes the point well, "History doesn't repeat itself, but it often rhymes." Ultimately, what has worked for the past several years may not necessarily work in the years ahead; but this is why markets move and opportunities exist.

Definitions and Disclosure:

The Federal Reserve is the central bank of the U.S. **A stock buyback** occurs when a company buys its own shares from the market place. **YoY** represents "year-over-year". **GDP** is the gross domestic product, which is the total value of a nation's output produced within the country's physical borders and is often used as a gauge of economic growth. The **S&P 500 Index** is a stock market index based on the market capitalization of 500 leading companies publicly traded in the U.S. stock market, as determined by Standard & Poor's. The **S&P High Yield Dividend Aristocrats Index** is designed to measure the performance of the S&P 500 Index constituents that have followed a policy of consistently increasing dividends every year for at least 25 years. **S&P 500 Buy Backs** refers to the **S&P 500 Buyback Index,** which is designed to measure the performance of the top 100 stocks with the highest buyback ratios in the S&P 500. The **U.S. 10-Year Treasury Yield** refers to the yield of U.S. treasuries, which are debt obligations by the United States government with a maturity of 10-years. Reference to "strategies" use index data for illustration purposes. Actual strategy performance may differ from that of the index in both mandate, objective and performance. This piece is for informational purposes only and contains opinions of Redwood that should not be construed as facts. All rights reserved. Third-party information in this piece was obtained from sources that Redwood considers to be reliable; however, no representation is made as to, and no responsibility, warranty or liability is accepted for, the accuracy or completeness of such information. The information and opinions expressed in this report are for informational purposes only. The information contained herein does not constitute and should not be construed as investment advice, an offering of investment advisory services or an offer to sell or a solicitation to buy any securities. This material may not be published, broadcast, rewritten or redistributed in whole or part without the express written permission. Past performance is not indicative of future results. The price of any investment may rise or fall due to changes in the broad markets or changes in a company's financial condition and may do so unpredictably. Redwood Investment Management, LLC ("Redwood") is an SEC registered investment adviser. Such registration does not imply a certain level of skill or training and no inference to the contrary should be made. Redwood and further disclosures are described in more detail in Part 2 of Redwood's current Form ADV, and available upon request.

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