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THE CHALLENGE OF DIVIDEND STOCK INVESTING

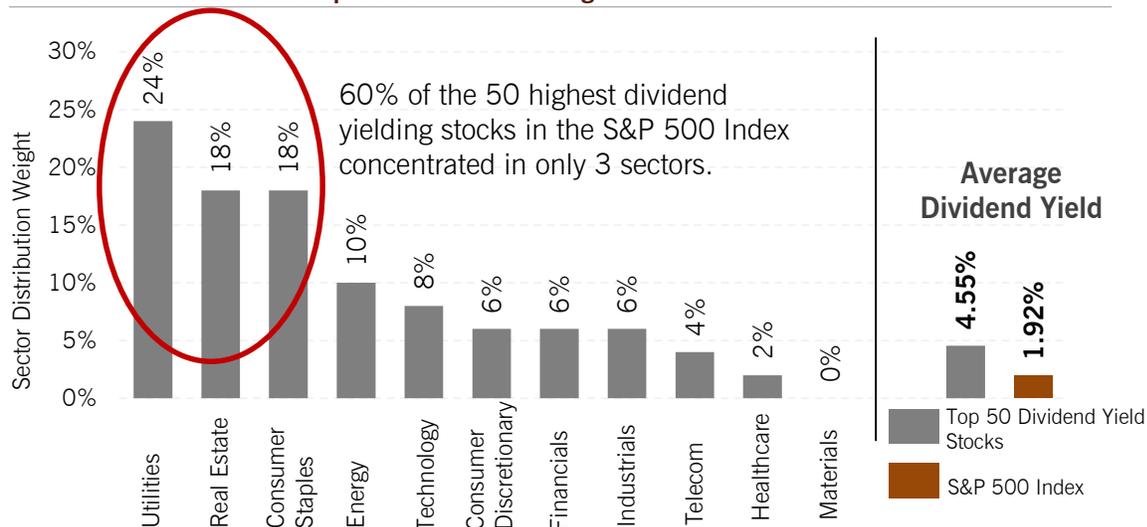
The Lure of High Dividend Yielding Stocks

Strategies that focus on stock dividend yields have long been popular with investors. High dividend pay outs provide tangible recurring compensation for the investment risk taken and this sense of security is bolstered by the traditional fundamental viewpoint that only stable, mature, and profitable companies pay dividends – and the higher the dividend, the better. Basing an investment viewpoint solely on high dividends and ignoring other factors, however, can have drawbacks. When chasing a higher dividend, an investor can unintentionally end up with significant over, and under-weights in different sectors. The typical high dividend yielding stock usually coincides with more “defensive” sectors, such as utilities, real estate, and consumer staples. These sectors are viewed as more defensive in nature because they historically have lower correlation with economic activity than other sectors. This could mean missing out on rallies when less defensive sectors are outperforming, and potentially worse, having more risk than expected when defensive sectors underperform.

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For example, of the 11 GICS (Global Industry Classification Standard) sectors, the sector distribution of the top 50 dividend yielding stocks from the S&P 500 Index would have large exposure to Utilities, Real Estate, and Consumer Staples (combined 60%) with little to no exposure to Materials, Healthcare, and Telecom (combined 6%).

Sector Distribution of the Top 50 Dividend Yielding Stocks in the S&P 500 Index



Chasing high dividends could lead to a less diversified portfolio with unintended sector bets.

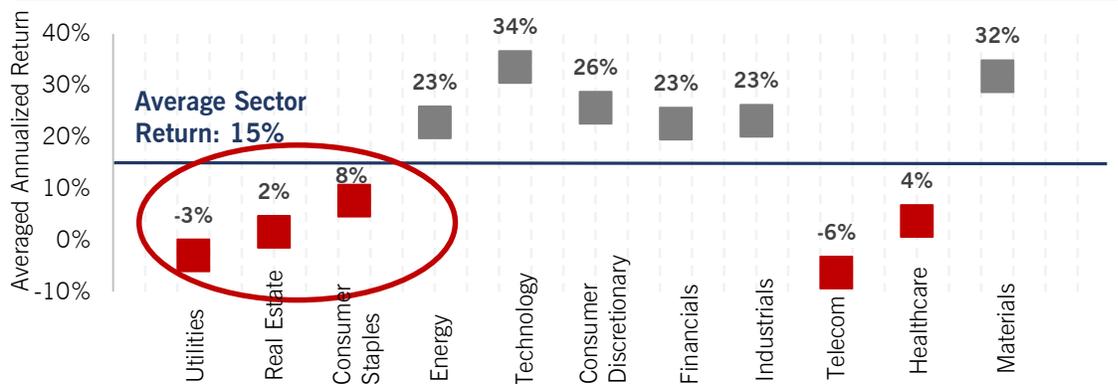
Source: Bloomberg. Date as of 5/31/18. Stocks selected by choosing the top 50 stocks in the S&P 500 Index, organized by highest dividend yield as of 5/31/18 with data supplied by Bloomberg. For illustration purposes only.

The Challenge of Rising Interest Rates For High Yielding Sectors

While the highest dividend yielding companies are often concentrated in defensive sectors with stable revenue and cash flows, the relative attractiveness of that yield can be diminished in a rising interest rate environment.

Exacerbating the downside pressure that can occur in these high dividend yielding stocks in rising rate environments is that these market environments often coincide with stronger economic environments which also have corresponded with higher investor risk appetites, and lower investor appetite for defensiveness.

Average Return During Risking Rate Environments¹



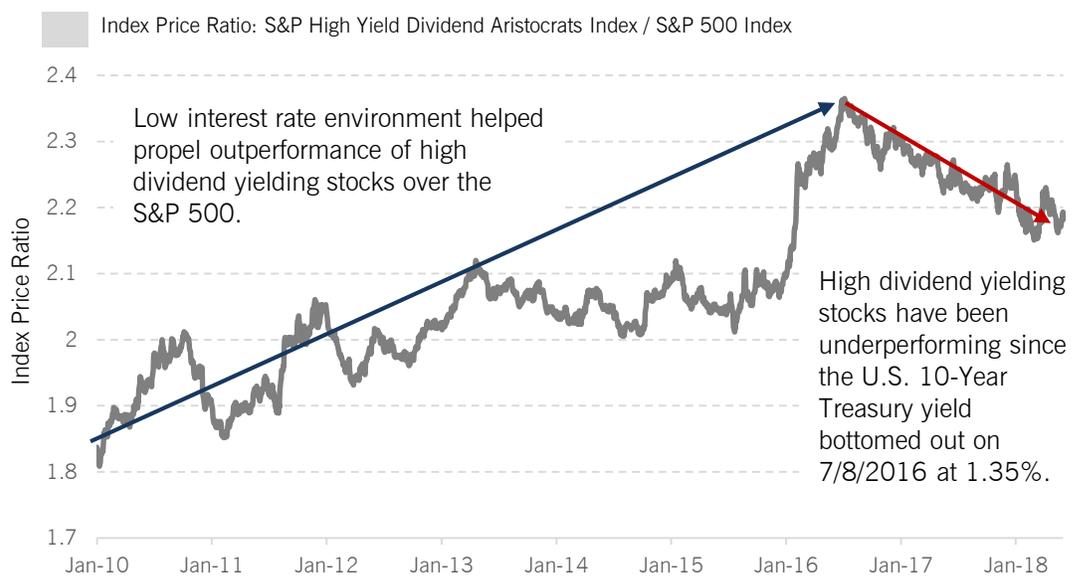
When chasing higher yields, an investor may typically be overweight more interest rate sensitive sectors.

Source: Bloomberg. Data is as of 5/31/18. ¹ Rising rate environment was selected for periods when the U.S. 10-Year Yield Treasury increased at least 100 basis points since year 2000. The selected periods are listed here: 1/31/01 - 3/21/02, 6/11/03 - 10/15/03, 3/8/04 - 6/14/04, 9/1/05 - 6/22/06, 12/31/08 - 6/3/09, 10/7/10 - 2/8/11, 5/8/13 - 3/30/14, 7/7/16 - 3/20/17, 9/7/17 - 5/17/18. For illustration purposes only.

Changing Trends

Understandably, demand for high dividend yielding stocks increased following the financial crisis when the Federal Reserve pushed interest rates to historic lows. This drove yield starved investors to buy more dividend focused strategies. While this may have worked well for almost seven years, high dividend stocks, tracked by the S&P High Yield Dividend Aristocrats Index, have been underperforming relative to the S&P 500 Index in the last two years. The current rising rate environment has been putting pressure on high dividend stock strategies in two ways: (1) as shown above, strategies that focus only on higher dividends tend to be overweight in interest rate sensitive sectors, and (2) higher yields in bonds means stock dividends are relatively less attractive.

Relative Performance of S&P High Yield Dividend Aristocrats Index vs. S&P 500 Index



High dividend yielding stock strategies may be less attractive in today's rising rate environment.

Source: Bloomberg. Data as of 5/31/18. For illustration purposes only.

Conclusion

An investment approach that focuses on a singular methodology without consideration for other factors could have unintended consequences. In the case of seeking to invest in high dividend yielding stocks, focusing solely on the highest dividend number may introduce unwanted sector bias and interest rate sensitivity in a portfolio. Especially in today's investment environment where the risk of continued rising rates is high, it may be time to consider a more diversified, differentiated approach going forward.

Definitions & Indices: **High Dividend Yielding** is defined by Redwood as stocks that have a dividend yield relatively higher than the average dividend yield of the general stock market. **Dividend yield** is a dividend expressed as a percentage of current share price. **Defensive sector** is synonymous to a sector with non-cyclical stocks, or companies whose business performance and sales are not highly correlated with the larger economic cycle. **Interest rate** is in reference to the U.S. 10-Year U.S. Treasury note yield. The interest rate risk is the risk that an investment's value will change due to a change in the absolute level of interest rates, in the spread between two rates, in the shape of the yield curve, or in any other interest rate relationship. Furthermore, Interest rate sensitivity is a measure of how much the price of an investment will fluctuate as a result of changes in the interest rate environment. Securities that are more sensitive have greater price fluctuations than those with less sensitivity. **Annualized return** is the geometric average of returns over one year. The **U.S. 10-Year Treasury yield** is the yield of U.S. Treasury bills that have a maturity of 10 years. The **S&P High Yield Dividend Aristocrats Index** is designed to measure the performance of companies that have followed a managed-dividends policy of consistently increasing dividends every year for at least 20 years. The **S&P 500 Index** is a stock market index based on the market capitalizations of 500 leading companies publicly traded in the U.S. stock market, as determined by Standard & Poor's. **S&P 500 Sector Returns:** returns within the S&P 500 Index broken down by GICS (Global Industry Classification Standards). Indices used to show performance are the S&P 500 Utilities Sector Index (Utilities), S&P 500 Telecommunications Sector Index (Telecom), S&P Consumer Staples Sector Index (Consumer Staples), S&P 500 Health Care Sector Index (Health Care), S&P 500 Industrial Sector Index (Industrials), S&P 500 Technology Sector Index (Technology), S&P 500 Consumer Discretionary Sector Index (Consumer Disc.), S&P 500 Materials Sector Index (Materials), S&P 500 Energy Sector Index (Energy), S&P 500 Financials Sector Index (Financials). Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Investors may not make direct investments in an index.

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