Dividend Funds Come in Different Flavors, but Share the Same Keys to Success

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Contents

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Executive Summary

It isn't hard to understand the appeal of dividend strategies. Couple historically low interest rates with increasing numbers of income-seeking retirees, and it's no surprise that funds with dividend strategies have grown in popularity during the past decade. Dividend payments can offer further benefits such as constraining managers from investing in subpar projects, signaling strong profitability, and potentially improving investor behavior (by reducing the need to sell at inopportune times). We took a closer look at the dividend landscape and found that:

- Dividend strategies have attracted an estimated $86 billion in inflows from January 2006 through January 2016, while passive strategies' share of this pie has grown to 18% from less than 2%.

- Even superficially similar dividend strategies can behave differently from their category peers and each other, reflecting a trade-off between dividend yield and growth. Therefore, it is prudent to consider where each dividend strategy lands on the dividend income/growth spectrum as part of the fund selection process.

- A more nuanced approach to assessing dividend strategies is needed. In this paper, we used a composite scoring system to classify dividend strategies based on their positions on the dividend income/growth spectrum. While that analysis didn't reveal huge differences in risk/return between dividend strategies, it did yield insights into the factors that can give rise to short-term performance divergences.

- Very few dividend funds beat their respective market-cap-weighted dividend benchmarks. This suggests that dividend investors are not immune to the challenges of active management. It is difficult to select managers who can overcome their fees and improve performance through fundamental analysis.

- Winning managers tended to have low fees and strong performance during market downturns, underscoring the importance of risk management. Avoid managers who sacrifice sound business fundamentals for yield, invest in firms with unusually high payout ratios, make concentrated bets, or pay up for firms with weak profitability on the promise of growth.

Introduction

Low interest rates have created a challenging environment for investors hoping to live off their investment income. Many investors have turned to equity dividend strategies to compensate for the low yields bonds offer. But investors need to know far more than an equity dividend fund's yield when considering whether to add such a fund to their portfolio.

Not all dividend strategies are alike. Broadly speaking, these funds tend to fall along a spectrum, with those that emphasize high current dividend income on one end and those that prioritize dividend growth at the other. There is generally a trade-off between income and potential dividend growth. Income-oriented strategies tend to favor stocks with high dividend yields. But the companies offering these yields tend to have low growth potential, and some may not be able to sustain their dividend payments. In contrast, dividend growth strategies accept a lower current yield in exchange for stronger dividend growth potential and safer payouts. A third group of funds falls between these two, attempting to balance the competing needs of income and growth.

This paper aims to tease out the differences between these groups and help dividend investors more prudently choose in order to reach their goals. In the first section, we offer an overview of the dividend strategy landscape; in the second section, we analyze the characteristics and fundamental risks of the three types of dividend strategies mentioned above; we conclude by highlighting some of the more promising strategies of each type and reviewing factors that we believe are worth considering when selecting a dividend-oriented fund.

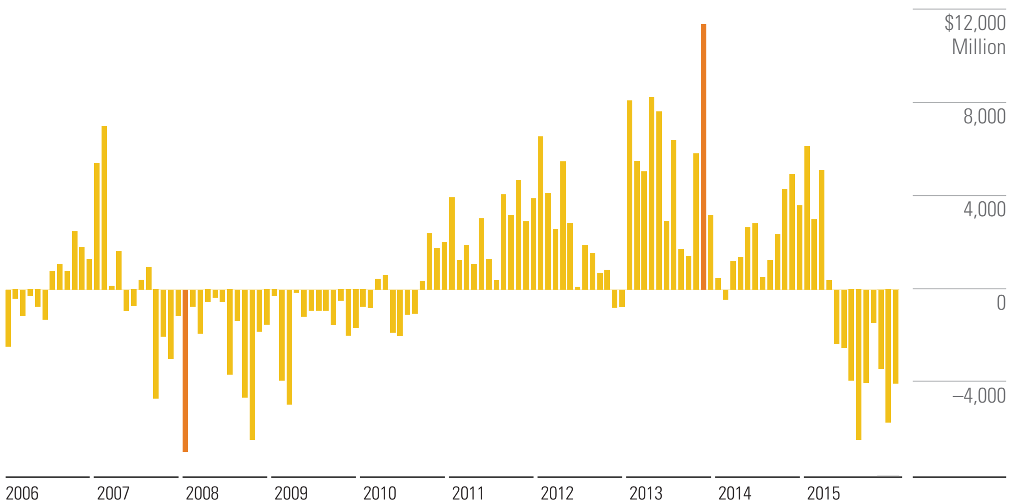
Asset Flows

At the end of January 2016, there were 469 U.S.-listed dividend strategies across the open-end, closed-end, and exchange-traded fund universes, investing in both domestic and international stocks. Nearly one third of these funds (148) have been launched since the beginning of 2013. Collectively, dividend strategies had $745 billion in assets at the end of January 2016. To put this in perspective, that's 8.6% of all equity fund assets in the United States.[1]

While much of that growth came from asset appreciation, these funds experienced an estimated $86 billion in asset inflows from January 2006 through January 2016. Many investors turned to dividend strategies to make up for lost income after the Federal Reserve slashed short-term interest rates close to zero in December 2008. But flows tended to chase performance. Investors put new money to work in the period leading up to the 2007-09 bear market, took money out from late 2007 through August 2010, and came back during the next few years. However, investors turned skittish in mid-2015 as equity markets began to correct, pulling $33.8 billion from these funds between May 2015 and January 2016. The chart below shows the timing of these asset flows.

1 This calculation includes open-end mutual funds, ETFs, and CEFs.

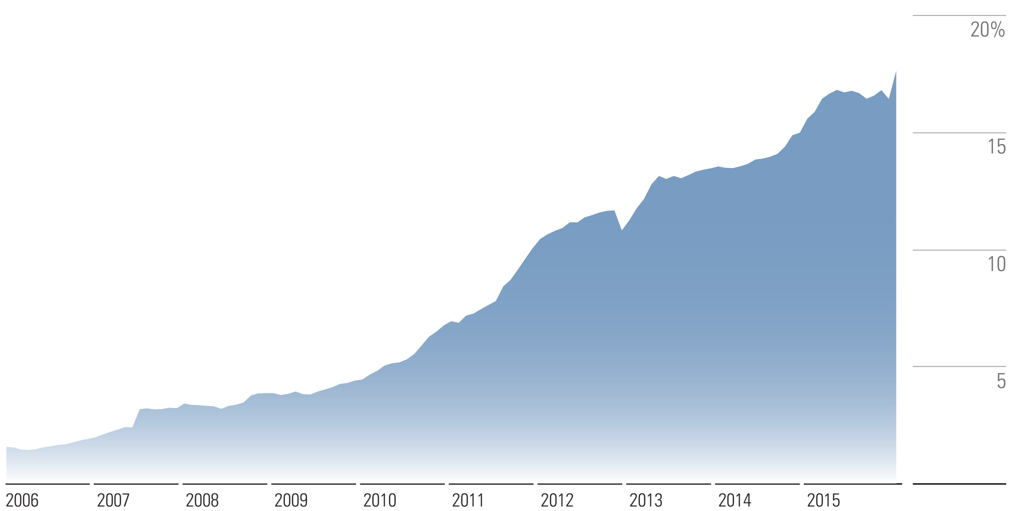
Exhibit 1 Dividend Fund Asset Flows



Source: Morningstar, Inc. Data as of 1/31/16.

Consistent with the broader market, there has been a shift to passive dividend strategies from active. From the end of January 2006 to January 2016, passive funds' market share grew to 18% of equity-dividend fund assets from less than 2%, as the chart below illustrates. The increasing popularity of index strategies is also reflected in recent fund launches. Of the 148 strategies that launched between January 2013 and January 2016, 67 are passive. These funds generally employ simple backward-looking screens for high dividend yields or dividend growth, though some also screen for dividend safety. But passive dividend funds' market share is still smaller than the passive share for the broader U.S.-listed equity fund universe (37%).

Exhibit 2 Passive Share % of Dividend Strategies



Source: Morningstar, Inc. Data as of 1/31/16.

Category Distribution

Most dividend strategies lean toward value. Of the 246 large-cap U.S. dividend strategies, 160 fall in the large-value Morningstar Category. This is not too surprising; stocks with high dividend yields are often mature businesses that aren't expected to grow as quickly and thus trade at lower valuation multiples. But, as this paper will show, this is not universally the case given the proliferation of dividend growth strategies.

U.S.-equity-focused dividend strategies invest primarily in large-cap stocks. This is because, outside of REITs and MLPs, mature, large-cap companies tend to be the biggest dividend payers. The table below shows the distribution of dividend strategies across several broad category groups. We excluded funds that focus exclusively on real estate investment trusts, business development companies, and master limited partnerships, as these do not target traditional dividend-paying stocks.

Exhibit 3 Category Distribution of Dividend Strategies

Plan Name	Number of Funds	Assets ($ Billion)
Diversified EM	19	5.63
Foreign Large	46	27.68
Foreign Small/Mid	5	3.76
US Large	**236**	**536.52**
US Large Value	155	334.9
US Large Blend	69	190.09
US Large Growth	12	11.53
US Mid	25	18.8
US Small	14	4.12
World Stock	70	104.24
Sector	18	5.64
Europe	14	17.01
Pacific Asia	9	7.48
Single Country/Other Region	13	13.83
Total	**469**	**744.71**

Source: Morningstar, Inc. Data as of 1/31/16.

At the end of January 2016, $536.5 billion was invested in U.S. large-cap dividend funds with most of the remaining $208.5 billion in world and foreign-equity funds. The gap between these two groups suggests a degree of home-country bias among U.S. investors. This dynamic is not specific to dividend strategies, but it's somewhat surprising in this case given that foreign stocks generally offer higher yields. U.S. firms tend to follow more-conservative dividend payout policies and are less likely to cut their dividends than their foreign counterparts. That's because many foreign firms directly link their dividend payments to earnings, resulting in more-volatile distributions. Foreign firms also tend to make less frequent dividend payments (distributing cash once or twice a year), which could be unappealing for investors looking for regular income. In some cases, tax treatment of foreign dividends can also be less favorable. If a firm is based in a country that does not have a tax treaty with the U.S., its dividend payments are unqualified and taxed at a higher rate.

Dividend Growth vs. Dividend Income

Apart from geography, the most important distinction among dividend strategies is whether they emphasize dividend income or dividend growth. Income-oriented strategies tend to target stocks with high dividend yields that are the result of generous payout policies, low valuations, or both. Firms that pay out a larger share of their earnings generally have less cash to reinvest in their businesses. That may be a good way to prevent managers from investing in low-return projects and acquisitions, but it also tends to lead to lower earnings and dividend growth rates.

Firms with high dividend payouts are more likely to cut their dividends than those with lower payout ratios because they have a smaller buffer should earnings fall. For example, at the end of 2015, ConocoPhillips offered a 6.4% dividend yield, but after losing money in 2015 because of low oil prices, the firm cut its quarterly dividend to 25 cents per share from 74 cents in February 2016 to conserve capital. Dividend income strategies can--and often do--take steps to limit this risk by applying fundamental analysis or quantitative screens to filter out high-risk names.

Simply buying the highest-yielding stocks, however, still courts considerable risk. These companies tend to pay out a dangerously high share of their earnings and may face financial distress. A survey of the constituents of the Russell 1000 Index between 2006 and 2015 revealed that dividend cuts were more common among higher-yielding stocks. Of the current members of the Russell 1000 Index that cut their dividends between 2006 and 2015, 64% had dividend yields that were greater than the index's in the year before making the cut. Stock prices typically decline ahead of (and with) these dividend cuts.

Dividend growth managers have less exposure to this type of risk. They are willing to accept lower current yields in exchange for potentially higher payouts in the future and generally favor firms with durable competitive advantages, long dividend growth histories, and strong profitability. Such quality companies tend to trade at higher price multiples than companies with higher dividend yields, potentially leading to lower future returns. While these firms pay out a smaller share of their earnings, they are also less likely to cut their dividends. But that doesn't necessarily mean that dividend growers are less risky investments overall than higher-yielding stocks. They generally face more-demanding expectations and may have a tougher time meeting them.

Dividend Strategy Classification

In order to determine where funds fall on the dividend income/growth spectrum, we created a composite style score based on the following portfolio-level metrics at the end of 2015:

- Payout ratio (forward dividend yield/earnings yield).
- Dividend yield (based on expected payments over the next year).
- Return on invested capital.
- Dividend growth of each fund during the past five years.
- Fund name: whether it contains phrases such as "dividend growth," "dividend appreciation," "rising dividend," or abbreviations for those terms.

Appendix 6 describes the methodology behind the composite score. We used this score to divide the large-cap universe into three equal-sized groups: dividend income, income and growth, and dividend growth. We repeated this process for foreign large-cap and world-stock dividend strategies.
Not surprisingly, fees are one of the best predictors of performance in all three groups. Very few funds in each group have been able to beat the corresponding market-cap-weighted dividend benchmark. Therefore, it is more important to focus on fees than dividend yields or growth rates to select winning funds.

It is still useful to organize dividend funds by their growth and income focus because funds at different ends of this spectrum tend to look and behave differently from each other, particularly over short horizons. Funds with a dividend income focus primarily fall in the large-value category, while most dividend growth funds land in large-blend. But these funds tend to behave differently from their broader categories, generally exhibiting lower sensitivity to market fluctuations. It is prudent to evaluate them separately.

The tables below summarize the portfolio characteristics of each dividend strategy group at the end of 2015. Appendixes 1 and 2 provide this information for the international and world dividend strategies.

Exhibit 4 U.S. Dividend Funds: Portfolio Snapshot

							Moat				**Beta**
Name	Dividend Yield	P/B	Forward P/E	Dividend Payout	ROIC (TTM) (Long)	Historical Dividend Growth	Wide	Narrow	None	Std Dev 5-Year	01/01/2011 to 12/312015
Dividend Growth	2.53	2.50	16.76	0.42	13.3	15.87	45.68	35.05	7.96	12.97	0.96
Dividend Growth and Income	3.17	2.17	15.86	0.50	12.44	5.66	43.96	35.32	10.28	12.58	0.93
Dividend Income	3.98	1.99	16.03	0.64	10.37	–1.96	36.06	38.86	11.60	12.01	0.85
Vanguard Large-Cap ETF	2.22	2.35	17.38	0.39	12.48	12.18	48.49	36.69	9.15	13.20	1.00

Name	Basic Materials	Communication Services	Consumer Cyclical	Consumer Defensive	Energy	Financial Services	Healthcare	Industrials	Real Estate	Technology	Utilities
Dividend Growth	3.22	3.07	11.54	10.86	6.11	15.22	15.24	12.91	1.46	14.97	2.45
Dividend Growth and Income	3.11	4.39	9.50	11.43	8.23	17.00	13.27	12.07	2.29	12.90	3.84
Dividend Income	3.45	5.99	8.68	12.48	9.67	11.81	9.60	10.33	4.65	10.09	9.99
Vanguard Large-Cap ETF	2.77	4.23	11.58	9.55	6.42	15.10	15.52	10.79	2.57	18.28	2.91

Source: Morningstar, Inc. Data as of 12/31/15.

Dividend Income

As expected, dividend income funds had a much higher average (pre-expense) dividend yield and payout ratio than the broad large-cap market and other two dividend groups. But their average dividend distributions slightly shrank during the trailing five years through December 2015, while distributions from the broad, market-cap-weighted Vanguard Large-Cap ETF VV grew at a healthy clip. A few other characteristics stand out.

Income funds tended to exhibit a more pronounced value tilt than the other two groups. More than 90% of the funds in this group fell in the large-value category. Their holdings traded at a lower average multiple of book value than the other cohorts, and they were less profitable. Consistent with these characteristics, dividend income funds had less exposure to stocks with wide Morningstar Economic Moat Ratings, signifying a durable competitive advantage, than the dividend growth group. The confluence of high payout ratios and below-average growth and profitability in most high-yielding companies not only reduces dividend growth potential, but may also increase the risk of a dividend cut.

While stretching for yield can be risky, the dividend income group exhibited lower return volatility than the dividend growth group during the trailing five years through December 2015. These funds also tended to be less sensitive to market fluctuations over that horizon, as measured by market beta relative to the CRSP U.S. Large Cap Index. This may not always be the case. For example, international and world dividend income strategies exhibited greater volatility and market sensitivity than their growth-leaning counterparts during the trailing five years through December 2015.

Differences in sector weightings among the three groups could also contribute to performance differences. At the end of 2015, income-oriented funds had greater exposure to the utilities, real estate, and energy sectors than growth-oriented strategies, and less exposure to financials, technology, and healthcare stocks. These sector tilts aren't static, as tables in appendixes 3, 4, and 5 illustrate. For instance, in December 2007, U.S. dividend income funds had greater exposure to financial services stocks than dividend growth funds, but this tilt reversed after the financial crisis when many stocks in this sector cut their dividends.

Dividend Growth and Income

The growth and income group represents a middle ground on the dividend income/growth spectrum. Not surprisingly, the group's average yield, earnings payout ratio, ROIC, and historical dividend growth rates fall in between the corresponding figures for the dividend growth and dividend income groups. These funds tend not to go to extremes in their search for either growth or income. They still offered a higher dividend yield and payout ratio than VV but clocked in with a lower dividend growth rate.

Like their income-oriented counterparts, growth and income funds tended to have a value tilt, though it was less pronounced based on price/book. About three fourths of the funds in this group landed in the large-value category at the end of 2015, with the rest falling in large-blend.

It is noteworthy that these funds' average sector weightings each fell in between the other two dividend cohorts' at the end of 2015, with the exception of financial services, where they had greater exposure than the other two groups.

Dividend Growth

While dividend growth funds aren't the highest yielding, they tended to invest in companies with stronger fundamentals than the other two groups. The group's average dividend payout ratio at the end of 2015 was close to VV's, and its dividend yield was only slightly higher. Not surprisingly, these funds stand out on dividend growth. In fact, this was the only group to boast a higher dividend growth rate than VV between 2010 and 2015. Of the three groups, dividend growth funds also boasted the highest ROIC, which can fuel future dividend growth. And they had greater exposure to wide-moat stocks. Durable competitive advantages make it easier for firms to grow their dividends. Dividend growth funds generally had less exposure to value stocks than their income-oriented counterparts. In fact, more than 70% of these funds landed in the large-blend or large-growth categories. They carried trading at comparable average multiples of book value and forward earnings to VV at the end of 2015.

Most of the group's sector weightings were also similar to those of the index fund, though it had a bit less exposure to technology stocks. The differences between this group and the dividend income cohort are more stark. Unlike the income group, dividend growth funds do not have overweightings to higher-yielding sectors like telecom, utilities, real estate, and energy.

The U.S. dividend strategy groups each include 73-74 funds. The Morningstar Medalists in each group are highlighted in exhibits 8 through 10.

Historical Trends

In order to assess how the characteristics of each U.S. dividend strategy group have changed over time, we extended our analysis back to the end of 2005. We repeated the growth-income composite scoring and ranking process described above, using data at the end of December each year from 2005 through 2014 and all U.S. large-cap dividend strategies that were available as of each date.[2] This ensures that there is no survivorship bias.

The same general pattern that the three U.S. dividend equity strategy buckets displayed at the end of 2015 held throughout the historical period. The dividend growth oriented funds had lower average dividend yields, lower payout rates, and higher ROICs than those in the income-leaning group. They also had higher dividend growth rates in every year except 2014. That exception is because of an outlier in the dividend income group, JNL/S&P Dividend Income & Growth, with an extremely high growth rate, owing to a very small dividend distribution in 2009. Excluding that fund, the dividend growth group had a higher dividend growth rate than the income group in 2014.

Earnings payout rates have gradually increased from their levels at the end of 2005 in all three dividend strategy groups. As a result, dividend yields have slightly increased, though expanding

2 We choose to not to conduct this historical analysis for international and world dividend strategies for the sake of brevity and because these groups contained a much smaller number of funds than the U.S. cohort.

price/earnings multiples partially offset the effect of this change on yields in the dividend income group. The average trailing five-year dividend growth rate for income-leaning funds was negative in eight of the past 11 years, suggesting that the negative growth rate through 2015 was not unusual. Funds in each of the three groups increased their exposure to wide-moat stocks between the end of 2008 and 2009 and have maintained elevated exposure since.

Their sector allocations have also shifted over time. Between 2005 and 2015, all three dividend strategy groups trimmed their exposure to financial services stocks, many of which cut their dividend payments during the 2008 financial crises. During that time, they increased exposure to the healthcare and consumer defensive sectors. In addition, the income and growth-income cohorts shifted toward technology stocks. Appendixes 3, 4, and 5 illustrate how the portfolio characteristics of each dividend strategy group have changed over time.[3]

Performance

After forming the dividend strategy groups at the end of each year, we tracked the average monthly returns of funds in each group over the subsequent year and repeated the exercise with the new list of funds for the following year. From the end of December 2005 through December 2015, the dividend income strategy group outpaced the dividend growth group by a small margin (49 basis points annualized), with comparable volatility. And while high-yielding stocks may be more likely to cut their dividends than their more growth-oriented counterparts, the dividend income group exhibited slightly lower volatility than the dividend growth group. The growth and income group fell in between from both a risk and return perspective.

However, these long-term averages mask short-term variability in relative performance. The return gap between the income and dividend growth funds was larger over shorter horizons. For example, the dividend income group outpaced the dividend growth group by 1.9 percentage points from January 2006 through December 2011. But dividend growth funds outperformed income funds by 1.8 percentage points from that point through December 2015. This suggests that one approach isn't uniformly better than the other and that their performance may diverge, particularly over short horizons.

Exhibit 5 Annualized Performance (January 2006-December 2015)

Plan Name	Dividend Growth	Growth & Income	Dividend Income	Vanguard Large-Cap ETF
Return	5.42	5.6	5.91	7.48
Std Dev	15.27	15.17	14.60	15.14
Sharpe	0.28	0.30	0.33	0.42
Beta	0.94	0.93	0.88	1.00
***Risk-Free Return**	**1.12**			

Source: Morningstar, Inc. Data as of 12/31/15.

3 2008 is the first year in which fund moat data was available.

All three groups underperformed VV, partially because of higher fees and lower market betas, meaning that they were less sensitive to market fluctuations. This contributed to their underperformance because the market trended up during the sample period. Intuitively, it seems as though funds in the dividend growth group should be more defensive than the dividend income group because they tend to invest in more-profitable names with stronger outlooks. And there were some growth strategies, like Vanguard Dividend Growth, that were more defensive than most of their income-oriented counterparts. But on average, the income group actually had a slightly lower beta. While funds in the U.S. dividend income group had a lower average market beta than those in the dividend growth group between 2006 and 2015, this may not always be the case. Strategies that emphasize firms with stable earnings and durable competitive advantages should hold up better during bad times than those that focus narrowly on dividend yield.

Vanguard Dividend Appreciation ETF VIG and Vanguard High Dividend Yield ETF VYM illustrate this point. VIG targets stocks that have raised their dividends in 10 consecutive years, which favors highly profitable stocks with strong competitive advantages. In contrast, VYM targets stocks representing the highest-yielding half of all U.S. dividend payers by market capitalization. Both funds weight their holdings by market capitalization. As a result of its stronger quality bias, VIG had a lower downside capture ratio and market beta and has been less volatile than VYM from the latter's inception in November 2006 through March 2016.

Performance Benchmarking

Often, dividend fund managers benchmark themselves against broad indexes like the Russell 1000 Value or Russell 1000 indexes. But because dividend stocks tend to have different performance characteristics from the rest of the market, it is also useful to benchmark these strategies against indexes that target dividend-paying stocks. And it makes sense to account for the differences between dividend growth and income strategies when selecting performance benchmarks. The FTSE High Dividend Yield Index, for example, is a good benchmark for U.S. dividend income strategies. This market-cap-weighted index tracks the performance of stocks representing the higher-yielding half of all U.S. dividend payers by market capitalization, and it is investable. VYM tracks this benchmark.

On the other end of the spectrum, the Nasdaq U.S. Dividend Achievers Select Index, which VIG tracks, is a good U.S. dividend growth strategy benchmark. It targets stocks that have raised their dividends in each of the past 10 years, adds some proprietary payout sustainability screens, and weights those that pass by market capitalization. These benchmarks are investable, cleanly represent their respective investment styles, and have at least a decade of historical performance data—back to November 2006 for the FTSE index and April 2006 for the Nasdaq index.
The following checklist can help investors determine whether a fund has a stronger dividend growth or income orientation, which should then point to the appropriate benchmark:

Exhibit 6 Checklist for Determining Income or Growth Orientation

1. Does the fund have an explicit dividend growth or income mandate?
2. Are the fund's following characteristics more similar to FTSE High Dividend Yield or Nasdaq US Dividend Achievers Select?
   a. Dividend yield
   b. Dividend payout ratio (dividend yield/earnings yield)[4]
   c. ROIC
   d. Past dividend growth

Source: Morningstar, Inc.

It is tougher to benchmark dividend funds that pursue a more balanced growth and income strategy. As a solution, investors could use the composite performance of the FTSE High Dividend Yield and Nasdaq U.S. Dividend Achievers Select indexes to benchmark these funds.

These benchmarks have been tough to beat net of fees. Of the 59 funds in the U.S. dividend income group at the end of 2006, 43 survived until the end of 2015, but only six outpaced the FTSE High Dividend Yield Index net of fees between January 2007 and December 2015. The story is similar for the other groups, as the table below illustrates. Fees largely explain the low success rates among the surviving funds. Gross of fees, these success rates were considerably higher.

Exhibit 7 Success vs. Dividend Benchmarks

	Number of Funds in Each Group (12/2006)	Survivorship Count	Number of Funds That Beat Index		Benchmark
			Net of Fees	Gross of Fees	
Dividend Growth	59	29	5	18	Nasdaq US Dividend Achievers Select
Growth and Income	58	40	2	16	50% Nasdaq US Div Achievers Select, 50% FTSE High Div Yield
Dividend Income	59	43	6	23	FTSE High Dividend Yield

Source: Morningstar, Inc. Data as of 12/31/15.

The income funds that did outperform all generally held up better than the benchmark during market downturns. And with the exception of Northern Income Equity NOIEX, their yields weren't among the highest in the cohort, a reminder that high yields don't necessarily translate into high total returns. All six outperformers fell in the cheaper half of the income cohort at the end of 2006. The same was true of the fees the benchmark-beating funds in the other two groups charged. The winners in the income and growth and income cohorts all held up better than the average fund in their respective groups during market downturns, though not all held up better than their respective benchmarks. This suggests that strong risk management and reasonable fees are critical for success.

4 With Morningstar data, this is based on the Equity Style Factor Dividend Yield and P/E, which look forward over the next year. Because dividend yield is presented in percent, it is necessary to multiply the earnings yield by 100: dividend payout ratio = (dividend yield)/(100/(P/E)).

International and Global Benchmarks

The FTSE All-World ex-U.S. High Dividend Yield Index is a good benchmark for income-oriented strategies that invest primarily outside the U.S. It follows the same construction process as its U.S. counterpart and includes stocks listed in both developed and emerging markets. The recently launched Vanguard International High Dividend Yield ETF VYMI tracks this index. Performance data goes back to the end of 2008.

Performance data for the Nasdaq International Dividend Achievers Select Index--which applies the same approach as the U.S. version--only goes back to September 2015. In its place, investors could use the MSCI EAFE Dividend Masters Index, which has performance data going back to November 2002. This index targets stocks listed in developed markets that have raised their dividends in at least 10 consecutive years and equally weights them. Vanguard International Dividend Appreciation ETF VIGI tracks this index.

For global dividend strategies, the FTSE All World High Dividend Yield Index is a good benchmark for global dividend income strategies with data going back to March 2008. There isn't a great global dividend growth index as of this writing, but investors could use a blended average of the U.S. and international dividend growth indexes (based on each fund's regional allocations) to benchmark the performance of global dividend growth strategies.

Fund Selection

Investors need to look beyond dividend yield and past performance to select appropriate dividend strategies. Keeping costs low is one of the simplest and most effective ways to improve the probability of success. To illustrate, we ranked the funds in each of the three U.S. dividend strategy groups by their annual report expense ratios at the end of each year from 2005 through 2014 and used this data set to subdivide each group into three cohorts. For example, funds representing the most expensive third of the dividend growth group formed one cohort, the next expensive went into another cohort, and so on. We then calculated the average monthly returns of the funds in each fee cohort over the next year, reconstituted the cohorts at the end of the year, and strung the returns together.

Among dividend growth funds, the cheapest cohort outpaced the most expensive by 2.1 percentage points per year (this result was statistically significant). Cheaper dividend income and growth-income groups also prevailed over their more-expensive counterparts. Here, the corresponding return spreads between the cheapest and most expensive cohorts were 114 and 60 basis points, respectively. These spreads weren't statistically significant (meaning that there is a greater than 5% probability that this outperformance was caused by chance). But they are economically meaningful and they corroborate extensive research that has shown that lower-cost funds tend to do better. It's even better when a low-cost fund is run by a well-equipped portfolio management team with a record of success and large investments in the strategy.

Investors may also improve their odds of success by sticking to strategies with a rigorous investment process, including disciplined risk management. In the dividend income segment that often means avoiding managers who sacrifice sound business fundamentals for yield and those with large industry bets. Dividend growth managers can get ahead of themselves too if they pay too much attention to growth expectations and not enough to valuations. Investors can gauge risk by comparing a fund's performance against an appropriate benchmark during market downturns and by monitoring the valuations, profitability, and dividend payout ratios of its holdings.

For those who don't wish to select and monitor active managers, VIG and VYM are good baseline U.S. dividend growth and income strategies, respectively. These index funds both charge a low 0.10% expense ratio, consistently reflect their respective styles, and have been difficult to beat. The mutual fund share classes of Vanguard Dividend Appreciation and Vanguard High Dividend Yield carry Morningstar Analyst Ratings of Gold and Silver, respectively.

Investors could substitute the low-cost, actively managed Gold-rated Vanguard Dividend Growth VDIGX for Vanguard Dividend Appreciation. It charges a low 0.32% net prospectus expense; in exchange for the extra fee, investors get a manager (Donald Kilbride) who is explicitly paid to beat the index that Vanguard Dividend Appreciation tracks (and who has done so) and can take qualitative and forward-looking considerations into account.

VIGI (0.25% expense ratio) and VYMI (0.30% expense ratio) are good baseline index strategies for exposure to foreign-listed dividend growth and income stocks, respectively. As they were launched in February 2016, they have not yet established a meaningful record. But they apply the same approach as their U.S. counterparts.

The tables below list all of the Medalists in each U.S. dividend strategy group.

Exhibit 8 Dividend Growth Medalists

Name	Ticker	Morningstar Analyst Rating
Vanguard Dividend Growth	VDIGX	Gold
Vanguard Dividend Appreciation	VDAIX	Gold
T. Rowe Price Dividend Growth	PRDGX	Silver
Parnassus Core Equity	PRBLX	Silver
Amana Income	AMANX	Silver
Columbia Dividend Income	GSFTX	Silver
TIAA-CREF Growth & Income	TIGRX	Bronze
Fidelity® Growth & Income	FGRIX	Bronze

Source: Morningstar, Inc. Data as of 12/31/15.

Exhibit 9 Dividend Growth & Income Medalists

Name	Ticker	Morningstar Analyst Rating
American Funds Washington Mutual	AWSHX	Gold
JPMorgan Equity Income	HLIEX	Silver
American Funds Invmt Co of Amer	AIVSX	Silver
Vanguard Equity-Income	VEIPX	Silver
AllianzGI NFJ Dividend Value	NFJEX	Silver
Invesco Growth and Income	ACGIX	Bronze
Hartford Dividend and Growth	IHGIX	Bronze
BlackRock Equity Dividend Inv	MBDVX	Bronze
BlackRock Enhanced Equity Div	BDJ	Bronze
Oppenheimer Equity Income	OAEIX	Bronze
ClearBridge Dividend Strategy	SOPTX	Bronze

Source: Morningstar, Inc. Data as of 12/31/15.

Exhibit 10 Dividend Income Medalists

Name	Ticker	Morningstar Analyst Rating
T. Rowe Price Equity Income	PRFDX	Bronze
SunAmerica Focused Dividend Strategy	FDSAX	Bronze
ASTON/River Road Dividend All Cap Val	ARDEX	Bronze
Invesco Diversified Dividend	LCEAX	Silver
American Century Equity Income	TWEIX	Silver
Neuberger Berman Equity Income	NBHIX	Silver
Vanguard High Dividend Yield	VHDYX	Silver

Source: Morningstar, Inc. Data as of 12/31/15.

Conclusion

Dividend funds have grown in popularity, but they are not all alike. Beyond geographic and market-cap differences, the most important distinction among these funds is whether they emphasize current income or future dividend growth. Investors should take this focus into account in their fund selection process. Income-leaning funds tend to invest in firms with weaker business fundamentals than dividend growth funds, and they are more likely to cut their dividends. Because these risks tend to be more elevated among the highest-yielding stocks, it is not prudent to select funds on yield alone. Investors who do so may lose out on dividend growth and potentially higher total returns.

At the other end of the spectrum, dividend growth funds' holdings tend to have higher expectations to meet and may have a greater chance of falling short. And even if these firms hit their growth targets, their management teams may choose to retain the cash and invest in low-return projects rather than increasing dividends.

Despite differences in the risks they face, dividend income and growth funds have exhibited similar returns from 2006 through 2015, but bigger differences emerged over shorter windows. Income-oriented funds should have an edge over dividend growth funds when value stocks are in favor because they tend to have more pronounced value tilts. During the sample period, value stocks underperformed growth stocks, and yet income funds generated slightly higher returns than dividend growth funds. This performance gap may widen if value stocks fare better in the future.

Very few funds in all three groups have been able to beat market-cap-weighted benchmarks that correspond to their respective styles, which are available in low-cost index funds. This highlights the importance of low fees and the difficulty of improving returns through fundamental analysis. While it is tough to beat low-cost index funds like Vanguard Dividend Appreciation and Vanguard High Dividend Yield, investors looking to do so should stick with managers that have low fees and strong risk management.

Appendix

Appendix 1 International Dividend Funds: Portfolio Snapshot

Name	Dividend Yield	P/B	Forward P/E	Dividend Payout	ROIC (TTM) (Long)	Historical Dividend Growth	Moat: Wide	Moat: Narrow	Moat: None	Std Dev 5-Year	Beta 01/01/ 2011 to 12/31/2015
Dividend Growth	3.42	2.25	15.42	0.52	36.65	–2.47	16.55	26.28	13.24	15.13	0.88
Dividend Growth and Income	5.01	1.61	14.42	0.72	12.42	0.06	17.26	29.39	20.36	15.99	0.94
Dividend Income	6.44	1.43	13.51	0.87	10.05	–3.55	15.09	28.35	24.91	17.56	1.00
Vanguard FTSE Developed Markets ETF	3.29	1.52	15.13	0.50	13.65	3.52	16.29	24.64	21.59	16.56	1.00

Name	Basic Materials	Communication Services	Consumer Cyclical	Consumer Defensive	Energy	Financial Services	Healthcare	Industrials	Real Estate	Technology	Utilities
Dividend Growth	5.08	6.20	13.56	12.53	4.18	14.94	11.43	11.20	3.00	6.25	3.12
Dividend Growth and Income	5.24	11.54	9.73	10.96	7.46	19.53	9.17	9.23	2.33	4.68	7.45
Dividend Income	7.37	12.51	7.09	8.59	12.01	17.93	5.64	8.64	4.67	4.21	8.86
Vanguard FTSE Developed Markets ETF	7.09	4.61	12.46	11.45	4.54	20.25	11.08	11.75	3.33	6.92	3.21

Source: Morningstar, Inc. Data as of 12/31/15.
Note: The ROIC for the dividend growth group drops to 15.76 after excluding an outlier, Copeland International Risk Managed Dividend Growth.

Similar to U.S. dividend strategies, international large-cap dividend income funds had a higher dividend yield and more pronounced value tilt than their dividend growth counterparts at the end of 2015. Outliers did not drive the average yield: They were high across the income-oriented board, ranging from 4.3% to 8.3%. They also had greater exposure to no-moat stocks than growth-oriented funds and tended to invest in less-profitable stocks.

While all three international dividend strategy groups offered higher dividend yields than their U.S. counterparts, these yields came at the expense of slower dividend growth. Dividend income funds' distributions shrank between 2015 and 2010. International dividend growth funds also experienced a negative dividend growth rate. This was partially because of a small sample size (only six of the 14 funds in this group had sufficient dividend data for the calculation) and closed-end fund BlackRock International Growth & Income's large decline in distributions.

Consistent with U.S. dividend strategies, foreign large-cap dividend income strategies had greater exposure to the utilities and energy sectors than dividend growth strategies, and less exposure to healthcare and consumer cyclical stocks. But they also had greater exposure to financial services stocks and less exposure to consumer defensive stocks. And unlike the experience in the U.S., foreign large-cap dividend income funds tended to exhibit greater volatility and market sensitivity than their dividend growth counterparts during the past five years.

The following list highlights some of the 14-15 funds in each bucket:

Dividend Growth

- Nuveen Santa Barbara International Dividend Growth
- Forward International Dividend Advisor
- Goldman Sachs Enhanced Dividend Global Equity

Growth and Income

- WisdomTree International Large Cap Dividend ETF
- Henderson Global Equity Income
- PIMCO International Dividend

Dividend Income

- iShares International Select Dividend
- Voya International High Dividend Equity Income
- BNY Mellon International Equity Income

Appendix 2 World Dividend Funds: Portfolio Snapshot

Name	Dividend Yield	P/B	Forward P/E	Dividend Payout	ROIC (TTM) (Long)	Historical Dividend Growth	Moat: Wide	Moat: Narrow	Moat: None	Std Dev 5-Year	Beta: 01/01/ 2011 to 12/31/2015
Dividend Growth	2.85	2.28	16.08	0.45	13.38	–0.55	32.39	30.59	11.37	13.35	0.87
Dividend Growth and Income	3.83	1.86	15.20	0.58	11.11	–6.02	27.08	35.23	15.43	13.80	0.90
Dividend Income	6.54	1.51	15.27	1.05	7.99	–6.70	16.94	28.19	15.31	14.90	0.96
Vanguard Total World Stock ETF	2.69	1.88	16.03	0.43	12.52	8.91	29.05	28.31	13.23	14.59	1.00

Name	Basic Materials	Communication Services	Consumer Cyclical	Consumer Defensive	Energy	Financial Services	Healthcare	Industrials	Real Estate	Technology	Utilities
Dividend Growth	2.55	5.12	11.08	12.17	4.25	17.43	12.87	10.68	1.93	11.73	2.38
Dividend Growth and Income	3.16	6.86	8.15	11.92	6.45	15.61	12.26	9.11	3.28	9.20	7.48
Dividend Income	3.42	8.15	6.71	7.85	9.55	12.29	6.38	10.37	10.46	5.36	15.23
Vanguard Total World Stock ETF	5.01	4.30	11.85	9.48	5.67	17.46	12.32	11.12	3.86	13.66	3.12

Source: Morningstar, Inc. Data as of 12/31/15.

Dividend strategies in the world-stock category exhibited a similar pattern to their U.S. and foreign large-cap counterparts. Dividend income strategies had a higher average dividend yield than more growth-leaning funds at the end of December 2015. But there were a few outliers: For example, Global X YieldCo ETF YLCO had a dividend yield of 18.46%. Excluding this fund from the calculation, the average dividend yield for the dividend income group falls to 5.97%.

Consistent with the experience among international large-cap dividend strategies, dividend growth rates among both world dividend income and dividend growth strategies fell well short of the corresponding figure for the broad market. And like their international counterparts, world-stock dividend income funds exhibited slightly greater volatility and market sensitivity than their dividend growth counterparts.

Here again, dividend income strategies had greater exposure to the utilities and energy sectors than their growth counterparts, and less exposure to the healthcare and consumer cyclical sectors. They also had less exposure to financial services, technology, and consumer defensive stocks and greater exposure to real estate.

The three world-stock dividend strategy groups each included 22 funds. The following list highlights some of the funds in each group.

Dividend Growth

- Sit Global Dividend Growth
- Fidelity Global Equity Income
- Eaton Vance Global Income Builder

Growth and Income

- Dreyfus Global Equity Income
- Lazard Global Total Return & Income
- John Hancock Global Shareholder Yield

Dividend Income

- WisdomTree Global High Dividend ETF
- Columbia Global Dividend Opportunity
- SPDR S&P Global Dividend ETF

Appendix 3 Historical Trends: Dividend Growth

	Equity Style Factor					Moat		
Name	P/E	Dividend Yield	ROIC (TTM)	Dividend Payout	Historical Dividend Growth	Wide	Narrow	None
12/2005	16.49	1.61	—	0.26	12.39	—	—	—
12/2006	16.30	1.60	—	0.26	14.14	—	—	—
12/2007	14.82	1.74	—	0.25	18.65	—	—	—
12/2008	10.54	3.03	—	0.32	34.25	23.19	21.69	6.52
12/2009	14.12	2.49	14.14	0.35	11.68	37.27	42.73	10.92
12/2010	13.40	2.15	15.12	0.29	11.56	33.00	43.89	12.84
12/2011	11.75	2.32	16.00	0.27	2.70	37.53	43.30	10.42
12/2012	12.98	2.43	14.60	0.31	8.52	37.32	45.34	9.68
12/2013	16.00	2.36	12.93	0.37	4.64	40.49	38.98	8.66
12/2014	16.96	2.24	14.91	0.38	9.95	43.06	37.46	7.07
12/2015	16.76	2.53	13.30	0.42	15.87	45.68	35.05	7.96

Name	Basic Materials	Communication Services	Consumer Cyclical	Consumer Defensive	Energy	Financial Services	Healthcare	Industrials	Real Estate	Technology	Utilities
12/2005	3.32	3.32	9.75	7.63	7.84	18.92	12.28	12.83	0.45	13.32	2.34
12/2006	2.64	4.27	10.13	8.60	8.31	18.08	12.30	12.87	0.67	14.86	1.67
12/2007	3.73	4.20	8.62	9.31	11.17	14.49	11.56	11.92	0.70	15.32	2.53
12/2008	3.77	4.11	7.83	11.65	11.46	13.06	14.06	12.43	0.52	12.61	3.00
12/2009	3.62	3.85	7.84	11.37	11.03	12.91	13.32	11.83	0.46	15.2	2.53
12/2010	4.69	4.05	9.22	10.35	12.37	13.81	10.95	12.70	0.67	14.18	1.89
12/2011	4.67	3.91	10.34	11.02	12.60	12.49	12.04	12.58	0.50	14.42	2.18
12/2012	4.11	3.70	10.75	11.20	11.55	14.74	12.07	13.45	0.96	13.99	2.29
12/2013	4.14	2.91	10.61	11.92	10.47	14.97	12.42	13.18	1.19	12.84	2.03
12/2014	3.40	2.75	11.50	10.72	8.81	14.50	13.94	12.72	1.03	15.02	2.07
12/2015	3.22	3.07	11.54	10.86	6.11	15.22	15.24	12.91	1.46	14.97	2.45

Source: Morningstar, Inc. Data as of 12/31/15.

Appendix 4 Historical Trends: Dividend Growth & Income

	Equity Style Factor					Moat		
Name	P/E	Dividend Yield	ROIC (TTM)	Dividend Payout	Historical Dividend Growth	Wide	Narrow	None
12/2005	15.18	2.31	—	0.35	3.25	—	—	—
12/2006	15.27	2.24	—	0.34	11.51	—	—	—
12/2007	13.60	2.45	—	0.33	14.49	—	—	—
12/2008	10.22	3.95	—	0.40	14.97	21.19	21.98	5.67
12/2009	13.69	3.41	12.36	0.47	4.97	34.93	44.31	12.02
12/2010	12.69	2.58	14.02	0.33	8.64	33.47	42.98	14.21
12/2011	11.51	2.92	14.45	0.34	1.95	35.60	41.54	11.42
12/2012	12.50	3.09	12.26	0.38	2.20	34.33	43.68	9.91
12/2013	15.12	2.81	11.64	0.43	–10.90	37.04	42.42	9.27
12/2014	16.17	2.80	13.68	0.45	4.59	38.81	41.17	7.96
12/2015	15.86	3.17	12.44	0.50	5.66	43.96	35.32	10.28

Name	Basic Materials	Communication Services	Consumer Cyclical	Consumer Defensive	Energy	Financial Services	Healthcare	Industrials	Real Estate	Technology	Utilities
12/2005	3.75	5.15	7.84	8.53	10.19	20.84	10.64	11.09	1.31	8.04	5.80
12/2006	3.62	6.15	7.73	8.39	9.27	22.09	9.19	10.66	1.18	7.62	7.14
12/2007	3.14	5.78	7.26	9.75	12.47	17.85	10.09	10.79	0.50	9.90	5.45
12/2008	3.16	5.34	7.00	11.37	11.59	14.27	11.60	11.98	1.25	9.33	6.29
12/2009	4.38	5.47	7.62	11.73	11.66	13.98	11.40	11.92	1.24	11.70	4.57
12/2010	4.32	4.77	8.32	11.72	11.34	15.41	10.63	12.96	1.74	11.36	3.31
12/2011	4.43	4.84	7.58	12.68	11.56	13.14	11.45	12.08	2.00	10.35	4.33
12/2012	3.93	5.20	8.00	11.88	11.49	15.13	11.70	11.77	2.03	9.17	4.72
12/2013	3.47	4.27	8.83	11.21	11.29	16.6	12.16	12.16	1.56	11.11	3.78
12/2014	3.30	4.08	9.15	10.30	9.02	16.88	13.04	12.20	2.62	12.60	4.27
12/2015	3.11	4.39	9.50	11.43	8.23	17.00	13.27	12.07	2.29	12.90	3.84

Source: Morningstar, Inc. Data as of 12/31/15.

Appendix 5 Historical Trends: Dividend Income

	Equity Style Factor					Moat		
Name	P/E	Dividend Yield	ROIC (TTM)	Dividend Payout	Historical Dividend Growth	Wide	Narrow	None
5/Dec	14.65	3.51	—	0.51	–7.65	—	—	—
6/Dec	15.11	3.17	—	0.48	–2.77	—	—	—
7/Dec	13.80	3.68	—	0.51	–2.87	—	—	—
8/Dec	10.15	5.66	—	0.57	8.35	20.99	23.49	5.25
9/Dec	13.42	4.54	10.55	0.61	1.83	26.33	49.28	13.98
10/Dec	13.19	3.59	12.38	0.48	–2.48	28.28	47.38	10.50
11/Dec	12.66	3.70	12.78	0.47	–5.88	32.21	44.5	8.52
12/Dec	12.95	3.88	10.89	0.50	–2.65	29.81	45.45	9.40
13/Dec	15.47	3.67	9.95	0.57	–6.15	30.62	43.15	9.28
14/Dec	16.43	3.64	12.36	0.60	10.69	31.77	44.35	7.57
15/Dec	16.03	3.98	10.37	0.64	–1.96	36.06	38.86	11.6

Name	Basic Materials	Communication Services	Consumer Cyclical	Consumer Defensive	Energy	Financial Services	Healthcare	Industrials	Real Estate	Technology	Utilities
5/Dec	5.83	5.40	6.08	7.87	9.51	20.03	7.01	9.66	5.36	4.37	10.28
6/Dec	4.45	6.45	5.85	9.04	8.44	22.29	7.08	8.96	4.67	3.14	11.87
7/Dec	4.42	6.61	6.10	9.53	10.06	18.93	7.31	9.81	4.34	4.97	11.12
8/Dec	4.21	7.05	6.48	10.9	11.80	14.26	9.61	10.53	4.00	4.81	9.33
9/Dec	4.12	7.47	7.41	10.92	12.39	12.52	8.89	10.55	3.45	5.66	11.02
10/Dec	4.06	7.86	6.25	11.46	12.96	10.92	9.22	11.06	3.00	6.55	9.90
11/Dec	3.66	7.80	5.51	12.60	11.83	9.41	11.30	9.96	3.22	6.71	11.03
12/Dec	3.98	6.57	6.52	12.15	12.17	9.91	10.18	10.30	3.32	7.59	10.36
13/Dec	4.55	6.30	7.11	11.55	12.44	10.58	9.58	9.80	3.91	9.91	8.70
14/Dec	3.88	6.16	7.99	12.26	11.81	11.58	9.51	9.41	4.53	9.63	9.40
15/Dec	3.45	5.99	8.68	12.48	9.67	11.81	9.60	10.33	4.65	10.09	9.99

Source: Morningstar, Inc. Data as of 12/31/15.

Appendix 6—Composite Score Methodology

To assign our composite score, we ranked all U.S. large-cap dividend strategies on yield, payout ratio, ROIC, past dividend growth, and name. The dividend payout ratio is one of the best indicators of future dividend growth potential. It is the portion of forward earnings a firm is expected to distribute as dividends during the next year. Firms that pay out a larger share of their earnings in dividends have less cash to reinvest in the business to drive dividend growth. Funds that invest in such businesses tend to be more income-oriented. It is also useful to consider dividend yields as a stand-alone metric, as high yields are naturally associated with income-oriented strategies.

ROIC is a measure of profitability that should be positively related to dividend growth potential. Highly profitable firms tend to have strong business fundamentals and are more likely to enjoy durable competitive advantages, which can fuel dividend growth, than their less-profitable counterparts.

The past growth of a fund's distributions is related to the dividend growth of its holdings, but it isn't a perfect metric. For example, even if all of a fund's holdings increased their dividends, the fund's dividend distributions could decline if a manager moves from high-yielding stocks into lower-yielding ones. Fund name isn't a perfect metric either, but funds that market themselves as dividend growth oriented are more likely to emphasize dividend growth than those that do not. Indeed, SEC rule 35d-1 requires that funds invest at least 80% of their assets in the manner suggested by their name.

We took each fund's percentile rank on each metric--with the exception of name, which is binary. For this metric, we assigned a score of 100 to funds that contained one of the target words, and 0 to all other funds. In order to keep the ranking interpretation consistent across all five metrics, we used the inverse of dividend yield and payout ratio, so that larger rankings are indicative of more growth-oriented strategies. The composite score is simply the average of the five numbers. When data is missing for one or more metrics, the composite score is calculated as the average of the other metrics. Funds needed to have data for at least two metrics to qualify for inclusion.