Harnessing the Power of Dividends

(Includes a Review of the Smart Ten and High 20 Dividend Strategy Trusts)

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Dividends themselves represent a portion of a given company's profits, or reserves, that are paid out to shareholders in the form of a dividend distribution. Distributions generally can take the form of a cash payment or a shares distribution. These distributions can occur on regular schedule of frequency (*ex. monthly, quarterly, semi-annually or annually*) or on an irregular basis. At SmartTrust®, we tend to attach a degree of financial health to those companies that make dividend distributions on a regular basis and that have a history of growing their dividend distribution amount. In a similar fashion, we also view favorably those companies that have positive free cash flow on their balance sheet because the excess cash can be used to maintain current dividend distributions and perhaps support future dividend increases.

Dividends have long been a critical part of the total return investment equation for investors in common stocks. Put very simply, there are two ways that an investor can make money when investing in a common stock: 1) when the market price of the stock appreciates from the price at which the investor purchased the stock or 2) when dividends from the common stocks are paid out to shareholders. The combination of (1) and (2) equates to the total return of a stock over a defined period of time. Whether or not these dividends are reinvested back into the stock will also have an influence on the total return calculation. In this regard, according to Guinness Atkinson Management, dividends have accounted for over half of the total return of stocks represented in the S&P 500 index (S&P 500) for individual decades, on average, since 1940, not including the decades of the 2000s due to its negative overall total return.

S&P 500 Returns for Individual Decades Since 1940

Decade	Total Return	Price Appreciation	Dividends	Dividends as a % of Total Return
1940s	143.1%	34.8%	108.3%	75.7%
1950s	467.4%	256.7%	210.7%	45.1%
1960s	109.5%	53.7%	55.8%	51.0%
1970s	76.9%	17.2%	59.7%	77.6%
1980s	389.2%	227.4%	161.8%	41.6%

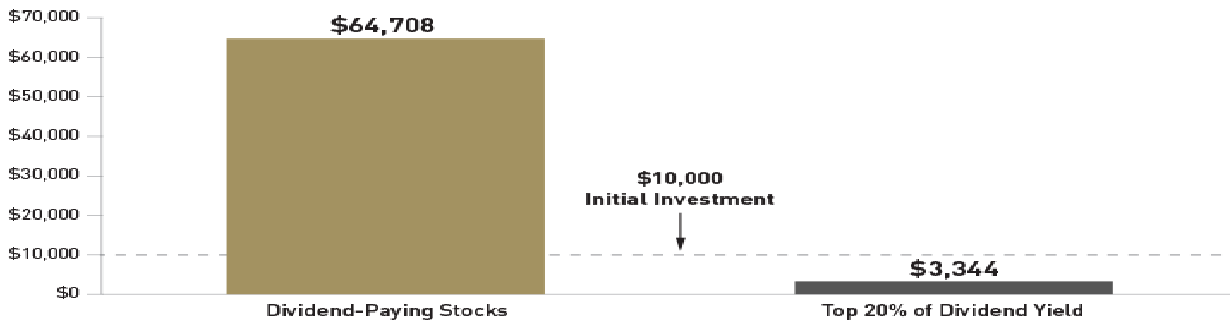
1990s	432.2%	315.7%	107.5%	25.4%
2000s	-9.0%	-24.1%	15.0%	Not Meaningful
Average	*228.6%*	*125.9%*	*102.7%*	*52.7%*

Source: *Bloomberg, Guinness Atkinson Asset Management, 12/31/40 – 12/31/11, "Why Dividends Matter." Past performance is not indicative of future results. Data provided for informational purposes only. Returns do not reflect, nor should they be compared to, actual UIT returns.*

There is also more recent evidence that dividend paying stocks, as measured by the S&P 500 index, tend to outperform non-dividend paying stocks on an annualized total return basis with less risk, as measured by annualized standard deviation, according to a study conducted by Lord Abbett.

Source: *Lord Abbett. The chart is based upon an equal-weighted geometric average of the historical total return and standard deviation of dividend-paying and non-dividend paying stocks in the S&P 500® index for the period 12/31/1989–06/30/2016. The dividend policy for each stock in the S&P 500 Index is determined monthly, based on dividends paid over the trailing 12 months. Components are reconstituted and rebalanced monthly. The periods shown do not represent the full history of the S&P 500 Index. Past performance is no guarantee of future results. Dividends are not guaranteed and may be increased, decreased, or suspended altogether at the discretion of the issuing company.*

Interestingly, according to this same Lord Abbett study, the stocks with the highest yields are not necessarily the best performers.



<u>Source</u>: Lord Abbett. The chart is based upon an equal-weighted geometric average of the historical total return of dividend-paying and a subset of the top 20% of stocks ranked by dividend yield in the S&P 500® Index for the period 12/31/1989–06/30/2016. The dividend policy for each stock in the S&P 500 Index is determined monthly, based on dividends paid over the trailing 12 months. Components are reconstituted and rebalanced monthly. Dividend-paying stocks are ranked by dividend yield each month to form the top 20% grouping. The periods shown do not represent the full history of the S&P 500 Index. Past performance is no guarantee of future results. Dividends are not guaranteed and may be increased, decreased, or suspended altogether at the discretion of the issuing company.

Hence, it is fair to conclude that dividends are worthy of consideration for both income and growth investors. The question then becomes how best to identify those stocks that can provide for current income with a potential for capital appreciation incorporating an emphasis on dividends. One such widely recognized strategy for these purposes is known affectionately as the "Dogs of the Dow." This strategy identifies the top ten highest yielding stocks, as of a point in time, within the Dow Jones Industrial Average (DJIA). The DJIA is a price-weighted average of 30 actively traded large cap stocks, that trade on the New York Stock Exchange. It is often used as a barometer of U.S. stock market performance. This strategy is available through several different packaged product types (*Exs. Mutual Funds, Exchange-traded Funds, Unit Investment Trusts, etc…*). In fact, SmartTrust® even has its own version of this strategy in a unit investment trust (UIT) called the **Smart Ten Trust**. The current series of the Smart Ten Trust (i.e. Series 5), has the following stocks in its portfolio composition based on the ten stocks within the Dow Jones Industrial Average that had the highest dividend yields as of July 18, 2016, approximately equally weighted:

1. The Proctor & Gamble Company (<u>Ticker</u>: *PG*)
2. Chevron Corporation (<u>Ticker</u>: *CVX*)
3. Exxon Mobil Corporation (<u>Ticker</u>: *XOM*)
4. Merck & Co., Inc. (<u>Ticker</u>: *MRK*)
5. Pfizer Inc. (<u>Ticker</u>: *PFE*)
6. The Boeing Company (<u>Ticker</u>: *BA*)
7. Caterpillar Inc. (<u>Ticker</u>: *CAT*)
8. Cisco Systems, Inc. (<u>Ticker</u>: *CSCO*)
9. International Business Machines Corporation (<u>Ticker</u>: *IBM*)

10. Verizon Communications Inc. (Ticker: *VZ*)

In terms of performance, the portfolio of "Dogs" has performed well during certain market cycles, but not as well during other market cycles, despite arguably still helping to meet investors' current income objectives during all market cycles. For those looking to dig further into this particular dividend based strategy, one helpful online resource can be found at http://www.dogsofthedow.com.

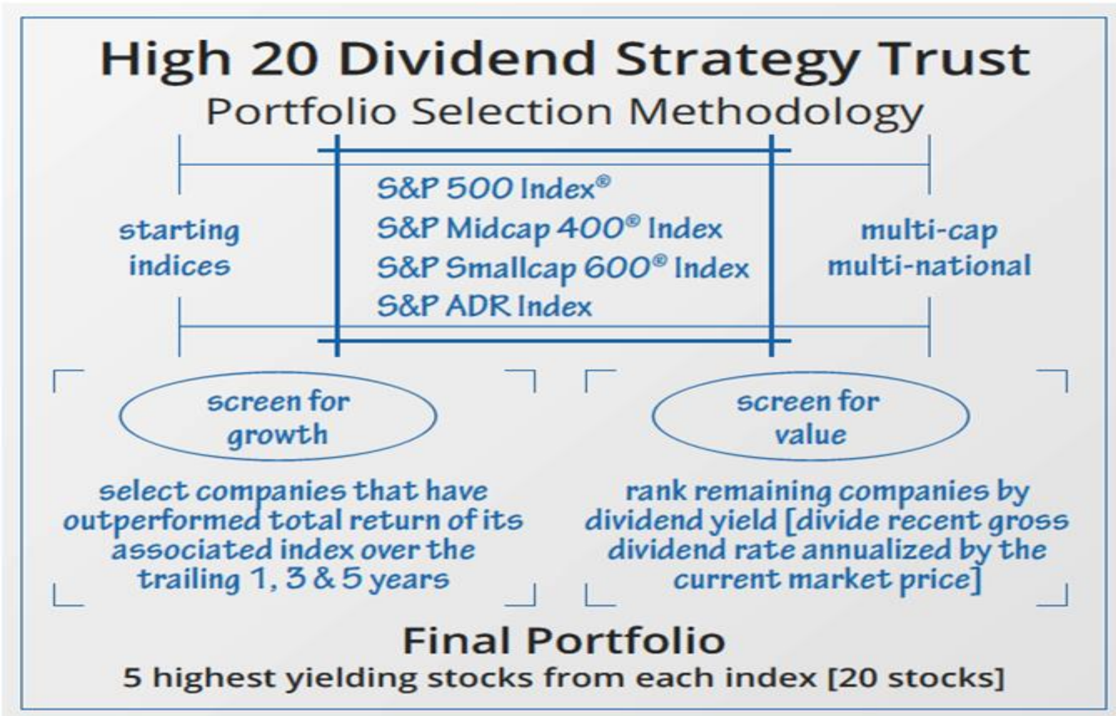
Some of the potential reasons for underperformance in different market conditions that I see is that the selection criteria;

a) has limited diversification as it only looks at an initial population of thirty U.S. large-cap stocks,
b) only looks at current dividend yields without factoring in trailing price performance of each stock, and
c) does not necessarily consider companies that have been increasing their distributions (i.e. dividend growers) or have positive free cash flow on their balance sheets.

To help address some of these potential strategy limitations, SmartTrust® introduced the **High 20 Dividend Strategy Trust** as another alternative for dividend-focused investors to consider. The High 20 Dividend Strategy applies both growth and value screens using four different S&P indices, as opposed to just the DJIA, to help identify stocks with a combination of attractive dividend yield and positive performance characteristics. The four S&P indices are as follows:

- **The S&P 500® index** includes 500 companies in leading industries of the U.S. economy, capturing approximately 75% coverage of U.S. equities.
- **The S&P MidCap 400® index** covers over 7% of the U.S. equity market and seeks to measure the risk and return characteristics of mid-sized companies.
- **The S&P SmallCap 600® index** covers approximately 3% of the domestic equities market measuring the small cap segment of the market. The index is designed to be an efficient portfolio of companies that meet specific inclusion criteria to ensure that they are investable and financially viable.
- **The S&P American Depositary Receipts ("ADR") index** is based on the non-U.S. stocks of the S&P Global 1200 traded in the U.S. exchanges. The index draws constituents from these six indices: S&P Europe 350, S&P/TOPIX 150 (Japan), S&P/TSX 60 (Canada), S&P/ASX All Australian 50, S&P Asia 50, and S&P Latin America 40.

More specifically, the High 20 Dividend Strategy selects from these four diverse indices which include large, mid and small capitalization companies of 1,500 U.S. equities and the ADR's of over 150 international companies. Additionally, before ranking the companies by dividend yield, the indices are also screened so that only companies that have outperformed their respective index for the past 1, 3 and 5 year periods are considered. Hence, potential concerns regarding a lack of diversification or disregard for historical price performance have been addressed to a degree with the screens implemented as part of the High 20 Dividend Strategy selection process.



In terms of the key differences between the two approaches, please see the table below.

	Smart Ten Trust	High 20 Dividend Strategy Trust
Approx. #of Overall Stocks Considered	30	1,650
# of Indices Considered	1	4
Incorporates High Current Dividend Yield Screens	Y	Y
Incorporates Price Performance Screens	N	Y
# of Stocks in Resulting Portfolio	10	20
# of Asset Classes in Resulting Portfolio	1	4
Resulting Portfolio has International Diversification?	N	Y
Resulting Portfolio has Market Cap Diversification?	N	Y

It should be noted that neither the Smart Ten Trust nor the High 20 Dividend Strategy Trust necessarily look for companies that have been increasing their dividend distribution rates or those companies that have free cash flow on their balance sheets - both of which I believe to be important factors for the potential sustainability of dividend income over time. SmartTrust®, however, does have other equity income-oriented UIT strategies that do include screens for dividend growth and free cash flow. If you are interested in learning more about these other strategies as well, please visit www.smarttrustuit.com or call 888-505-2872.

I offer the two specific UIT strategies discussed in this whitepaper as examples of how investors could potentially harness the power of dividends. In so doing, I am not necessarily suggesting that one strategy is better than the other from a growth or income standpoint as there are a variety of factors that could cause one strategy to perform better than another during different market cycles. Looking at our most recent bull market cycle that began in March of 2009 would find that more U.S. large cap focused strategies, such as the Dogs of the Dow, would have performed better than strategies that incorporate international stocks or, to a lesser extent, U.S. mid-cap or U.S. small cap stocks. Moving forward, should international start to outperform domestic (*as many are currently forecasting*), strategies that incorporate international stocks may perform better than those that focus purely on domestic (*i.e. U.S.*) stocks.
