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Finding fortitude in dividend investing

Careful selection of dividend-paying equities may require active management.

SUMMARY

- Dividend investing has historically offered compelling long-term opportunities for total return and income.
- Higher-quality dividend-paying stocks may be able to help dampen portfolio losses.
- History has shown that the second-highest quintile dividend payers have outperformed.

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As we enter 2016, the continued low interest-rate environment makes it difficult for investors to find sources of income without reaching for yield. Recent bouts of volatility in the equity and fixed-income markets have investors worried about future growth. These challenges have resulted in disappointment for many investors searching for total return opportunities.

Despite these challenges, we think dividend-paying stocks continue to be an attractive source of current income, especially when compared to some fixed-income assets that are yielding relatively little in today's low-yield environment. Through careful selection of dividend-paying equities, investors may be able to realize attractive total return through a combination of capital appreciation and dividend income.

However, the highest dividend payers aren't always the best from an investment perspective. By examining the subsections of dividend payers included in the S&P 500 Index, we have found higher-quality, long-term performers aren't necessarily the highest-yielding names. As they seek out strength and durability of dividends, investors may want to consider active management for opportunistic equity exposure, particularly as volatility increases. Active management may help seek out these shareholder-friendly, high-quality businesses that may sustain and grow their dividends.

In this Insight, we explain why we believe dividends offer a compelling long-term investment opportunity. We illustrate why dividends are a major component of total return, and we will offer a case for a timely, disciplined approach to dividend investing. We begin with a look at why dividend-yielding opportunities are important in today's markets.

Dividend income: A major component of total return

From a demographics perspective, dividends offer an alternative source of income that may be appealing to baby boomers. In our view, investors may need to maintain a larger portion of their portfolios in equities as they retire in order to ensure they do not outlive their assets.

Interestingly, dividends have historically represented a major component of equity market returns over the long term, as highlighted in Exhibit A. Over the past 85 years, dividends account for 46.5% of the total return of the S&P 500 Index.

The impact dividends have on return is even more evident when comparing equities to other asset classes. Exhibit B

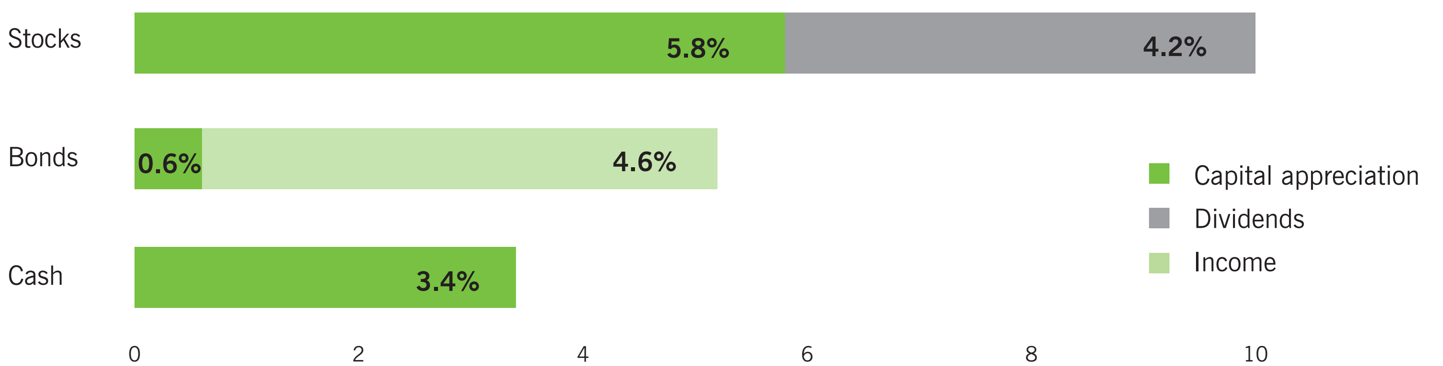
Exhibit A **Dividends have been a major contributor to total return.**

Decade	Total return (%)	Dividends % of total return	Average payout ratio (%)
1930s	14.4	N/A	90.1
1940s	134.1	74.5	59.4
1950s	437.7	41.2	54.6
1960s	107.9	50.2	56.0
1970s	76.4	77.4	45.5
1980s	370.5	38.6	48.6
1990s	411.3	23.2	47.6
2000s	-7.7	N/A	35.3
2010s	104.3	20.1	32.5
Average	**182.2**	**46.5**	**52.2**

Source: Strategas as of 12/31/2015. S&P 500 Index is an unmanaged index of large-cap stocks commonly used as a measure of U.S. stock market performance. Data provided are for informational use only. Past performance is no guarantee of future results. It is not possible to invest directly in an index. Dividends' percentage of total return is represented by "N/A" in cases of either a negative total return or a negative input to total return.

Exhibit B **Dividend return has exceeded cash returns over the past 89 years.**

S&P 500 vs. U.S. government bonds and cash – historical returns 1926 - 2015



Source: Ibbotson Associates as of 12/31/2015. Bonds as measured by the Ibbotson U.S. Intermediate-Term Government Bond Index. Past performance is no guarantee of future results. It is not possible to invest directly in an index. Index returns do not reflect the effect of any applicable sales charges, commissions, expenses, taxes or leverage, as applicable.

summarizes 89 years of history, showing that the return from dividends alone has exceeded cash returns and has nearly matched bond income.

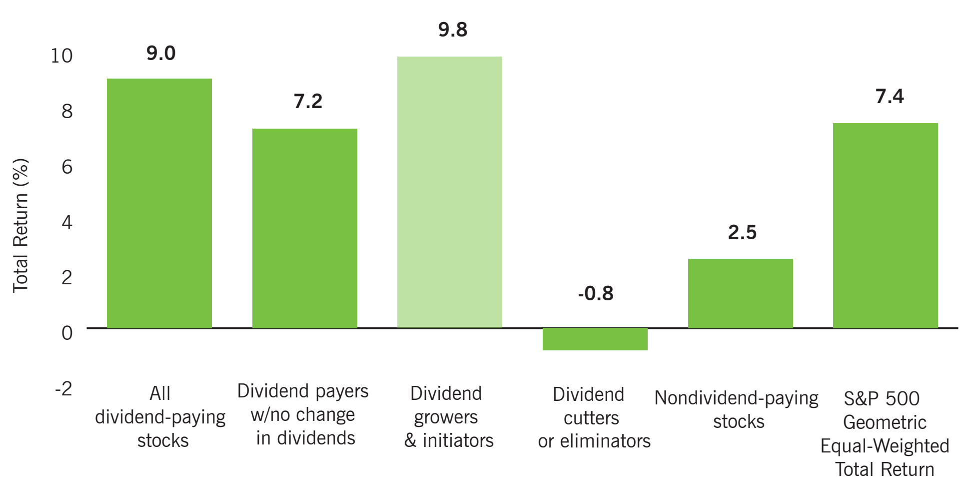
The long-term performance of dividend-paying stocks has been compelling. And the wisdom of dividend investing is certainly not new. However, dividend investing tends to be a foreign concept to many investors raised during the high-growth periods of the 1980s and 1990s, when companies mainly used cash for buying back stock or mergers and acquisitions. For example, when investors think of dividend stocks, so-called "blue chip" stocks generally come to mind. There is still a common belief that companies only pay a dividend if there are no other growth opportunities.

Ironically, dividend-paying and growing companies as a group have historically been the healthiest, outperforming nondividend paying issues and providing a competitive return. And there is a significant pool of companies that either raise or initiate dividends each year. This simple

Exhibit C **Total return of dividend growers and initiators outpaces all dividend-paying stocks.**

Historical total return of stocks within the S&P 500

01/31/1972 to 12/31/2015



Source: Ned Davis Research as of 12/31/2015. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

metric has had the most meaningful impact on total return over time. Dividend growth has been an especially critical component of long-term total return.

As demonstrated in Exhibit C, companies that grow or initiate dividends had better returns than all dividend-paying stocks, and dramatically outperformed non-dividend paying stocks. This reality is in stark contrast to the common belief that only slow- or no-growth companies pay dividends. In the case of companies that grow their dividends over time, dividend income may provide a hedge against inflation, unlike fixed interest from U.S. Treasurys and other bonds.

Why dividend investing now

Beyond their contribution to total return, dividends can potentially offer investors:

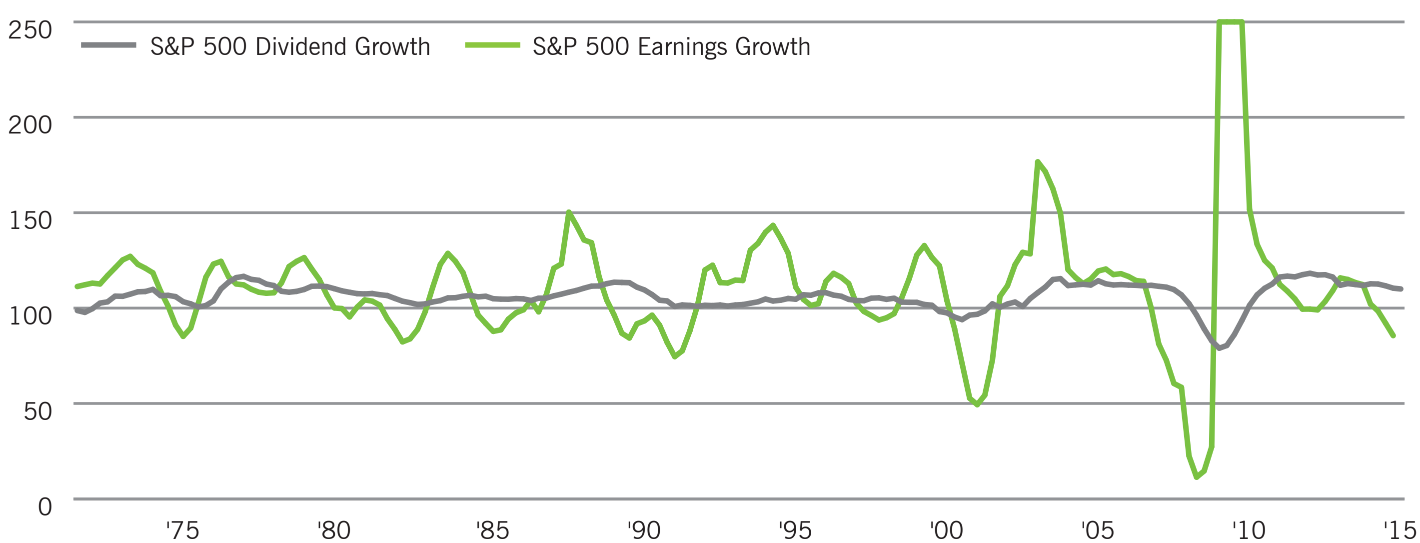
- A sign of sound corporate governance.
- Historically lower volatility.
- A hedge against inflation.
- Tax efficiency.

Indeed, dividends can also signal the success of a company's business strategy as well as highlight its financial strength. Paying and consistently raising dividends has historically been a sign of sound corporate governance and management's confidence in a company's business prospects. In our view, launching or increasing dividend payouts is often a better use of a company's capital than, say, buying back stock from shareholders or engaging in acquisitions.

As dividends are paid from real earnings, there is no opportunity for creative accounting or questionable financial reporting practices. Companies that pay dividends must have the cash (and fortitude) to do so, putting actual earnings in the pockets of investors.

Another significant advantage of dividends is that, historically, dividends-per-share growth has exhibited lower volatility than earnings per share growth. As shown in Exhibit D, dividends per share have been much less volatile than earnings per share. Dividend income is also an additional source of return in flat markets, and can help to dampen total return volatility.

Exhibit D **Volatility of dividends has been historically lower than earnings.**



Source: Ned Davis Research as of 12/31/2015. All values above 250 are limited to 250 on the chart. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

Thinking more broadly about volatility, as the Federal Reserve adjusts monetary policy and liquidity begins to recede from the system, we think it is likely that markets will see an increase in volatility. We believe this volatility will present active managers with opportunities to seek out higher-quality dividend payers with solid balance sheets and cash flow characteristics.

Dividends have also historically been an inflation hedge. Even without following the strategy of focusing on high-dividend growers and initiators, investors outperformed inflation – simply by receiving the dividends in the S&P 500 Index.

Lastly, dividend-paying stocks can play a significant role in many investors' portfolios thanks to the favorable tax treatment of dividends. Under the American Tax Relief Act of 2012, qualified dividend income (QDI) is taxed at the lower long-term capital gains rates.

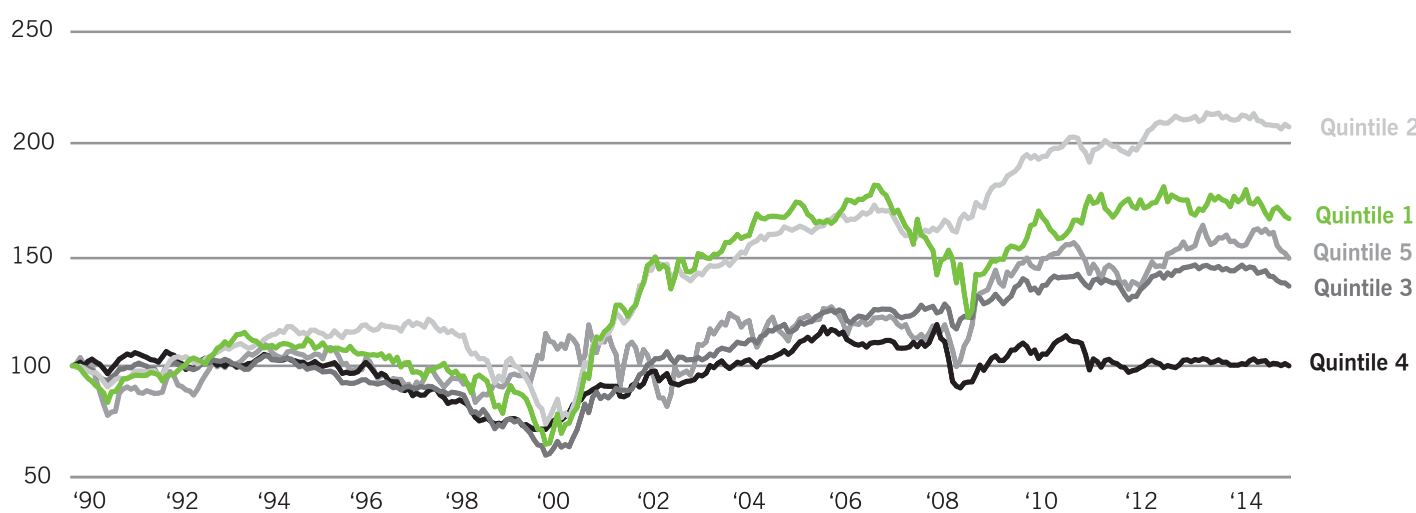
Don't settle for second – embrace it

In a low-yield environment, the temptation may be to reach for the highest-yielding dividend names. Since the 1940s, strategies emphasizing high-dividend-paying stocks have outperformed strategies emphasizing low-paying stocks. However, this outperformance has not come from chasing the highest-yielding stocks.

Over the course of time, we have noted the outperformance of the second-highest quintile dividend payers of the S&P 500 Index. Essentially, we rank dividend-paying members of the S&P 500 Index by dividend yield. The first quintile includes the highest-paying stocks, but we have found that historically these are the weakest companies with an inability to sustain their dividend payments.

We view the second-quintile group as the "sweet spot." This group has outperformed the market by a wide margin, with a cumulative return significantly higher than that of other

Exhibit E **The second quintile of dividend payers in the S&P 500 has outperformed by a wide margin.**
Performance of dividend yield quintiles of S&P 500 (2/1/1990 to 12/31/2015)



Source: Strategas as of 12/31/2015. Data are indexed to 100. Quintile 1 is comprised of the highest dividend-paying stocks, while Quintile 5 is comprised of the lowest dividend-paying stocks. Data provided are for informational use only. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

dividend yield quintiles in the S&P 500 Index over the last 25 years, as Exhibit E illustrates. By targeting this second-quintile group, we tend to find companies that are of high quality with attractive valuations. Additionally, these companies have tended to show the ability to sustain and grow their dividends over time.

Importance of thinking globally

U.S. investors may not realize that many foreign dividend-paying stocks offer attractive investment opportunities. Investing internationally may lower the risk associated with holding an all-U.S. basket of stocks, and may provide support as currencies fluctuate. This diversification may help lower the country-specific risks inherent in a potentially unstable domestic economic recovery; if the dollar weakens against other major currencies, dividends paid in pounds sterling or euros compare favorably to their dollar-denominated peers.

European companies, in particular, have had a strong culture of paying dividends to shareholders. As of December 31, 2015, the dividend yield for the MSCI EAFE Index was 3.2% versus 2.1% for the S&P 500 Index.

Seeking strength and durability

As this Insight has illustrated, dividend income is an important component of total return for equity securities. Beyond this contribution, dividend-paying stocks may provide investors with attractive income relative to other sources of yield, a hedge against inflation and tax efficiency.

With the backdrop of a global market that is economically weak as well as volatility due to liquidity draining from the market, we think there will be a renewed focus on the part of investors for quality and sustainable dividends.

The challenge, however, comes as investors seek out strength and durability of dividends. We think that active management will play an important role in finding high-quality businesses that may sustain and grow their dividends.

The views expressed in this insight are those of the authors and are current only through February 1, 2016. These views are subject to change at any time based upon market or other conditions, and Eaton Vance disclaims any responsibility to update such views. These views may not be relied upon as investment advice and, because investment decisions for Eaton Vance are based on many factors, may not be relied upon as an indication of trading intent on behalf of any Eaton Vance fund. Eaton Vance does not provide legal or tax advice. The discussion herein is general in nature and is provided for informational purposes only. There is no guarantee as to its accuracy or completeness. Individuals should consult their own legal and tax counsel as to matters discussed.

About Risk

The success of any investment program depends on portfolio management's successful application of analytical skills and investment judgment. Active management involves subjective decisions. Fund performance is sensitive to stock market volatility. Changes in the dividend policies of companies could make it difficult to provide a predictable level of income. Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical or other conditions. Dividend capture strategies may result in higher portfolio turnover, increased trading costs and potential for capital loss or gains. When interest rates rise, the value of preferred stocks and other hybrid securities will generally decline. As interest rates rise, the value of certain income investments is likely to decline.

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If you like the views expressed in this Insight, you might be interested in learning more about Eaton Vance's dividend investing strategies.

For more information about these and other income strategies from Eaton Vance, please visit eatonvance.com or call 800-836-2414.

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