

Dividend-Focused ETFs Are Taking Off

By Rob Wherry
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THE ISHARES Dow Jones Select Dividend Index fund (D^{VY}¹) invests in some of the country's best-known companies, such as **AT&T** (T²), **Bank of America** (BAC³) and **Altria** (MO⁴). Those firms have helped this exchange-traded fund chalk up an average annual gain of 15.9% over the last three years, about 2.6 percentage points better than the S&P 500. But the ETF had a little help along the way from something investors often overlook: dividends. It specializes in stocks that pay this extra income to shareholders. Studies have shown that dividend-paying stocks consistently outperform those that don't over the long haul.

It's no coincidence the ETF can trace its roots back to the summer of 2003. It was four years ago this month that President Bush, standing behind a podium in the East Room of the White House, touted a new piece of legislation called the Jobs and Growth Tax Relief Reconciliation Act that, among other things, slashed the tax rate on qualified dividends to 15% from as much as 38.6%. While Bush spoke highly of its positive impact on baby boomers' wallets, he also surmised it would bring to a close the memories of the tech bust. "The days when people could say, 'Invest with me because the sky's the limit,' will be changed by dividend policy," he said. "It's hard to...pay dividends unless you are actually profitable."

He's right, of course, because you can't fudge a dividend payment. But Bush might have been too optimistic about putting an end to pie-in-the-sky corporate shenanigans. However, the legislation has been a boon to dividend-focused products. While mutual-fund firms have embraced this trend — according to Lipper, equity income funds, which typically buy dividend-paying stocks, have doubled in number to 267 since 2002 — so has the exchange-traded-fund world. WisdomTree, PowerShares, State Street and Vanguard each have dividend-focused products.

Further spurring this trend is the change of heart about dividends not only from individual investors but inside many boardrooms, too. Baby boomers, especially those burned during the late 1990s downturn, have flocked toward dividend-focused ETFs. Wisdom Tree has amassed almost \$4 billion in assets after just a year on the market. The iShares ETF has a whopping \$8.7 billion sitting in its coffers. These inflows mirror similar flows into equity-income mutual funds, which have seen their assets balloon 150% to \$166 billion since 2002.

In addition, according to Standard & Poor's, 383 companies in the S&P 500 index now pay dividends, up from 351 in 2001. Most of those are financial firms, like banks, but tech companies such as **Microsoft** (MSFT⁵) are some of the newer names that have paid out cash to shareholders. The payout ratio — the percentage of earnings paid to stockholders in dividends — is currently 32%, well below the historical average around 50%. But our experts think that mark will increase, especially if the legislation is renewed some time after 2010. "Share buybacks don't indicate how a board of directors feels about the future of a company," says Judy Saryan, an Eaton Vance vice president and portfolio manager. "Investors have become more conservative. They want a strategy with lower risk."

While there is some debate about growth stocks — the shares of companies whose earnings are growing at a pace that exceeds the broader market — finally performing better than other categories like dividend payers, many advisors feel comfortable using dividend-focused ETFs as a core holding. Indeed, there is a strong historical argument at play here. According to Morgan Stanley, 40% of the S&P 500's returns between 1926 and 2004 can be chalked up to dividends. That said, if you are investing in these ETFs outside a tax-advantaged account you do need to be aware of capital gains, even with the lower rate. "If you have gains it's not a bad thing," says Anton Bayer, a senior vice president with CBIZ Wealth Management. "But [investors] have to remember: It's what you keep, not what you make that is important."

If you are sold on the concept, there are plenty of ETFs to consider. You could start with one of the broadest portfolios out there, the **WisdomTree Total Dividend ETF** (DTD⁶). This fund tracks an index that weights companies based on their dividend yield. Currently, the 770-stock portfolio is 78% invested in large-capitalization stocks like **General Electric** (GE⁷), **Citigroup** (C⁸) and **Exxon Mobil** (XOM⁹). It is slightly ahead of the S&P 500 since being launched last June. The iShares Dow Jones Select Dividend Index fund limits its portfolio to about 100 or so stocks in the Dow Jones Total Market Index that have increased and never cut their dividends over the last five years. (Real estate investment trusts aren't included.) It has 63% of its assets in financial stocks and utilities, two traditional sectors that pay hefty dividends. It charges a cheap 0.40% annual expense ratio and yields 3%, almost three-quarters more than the S&P 500.

One of the more concentrated dividend portfolios is the **PowerShares High Yield Dividend Achievers fund** (PEY¹⁰). It invests in just 50 stocks that have increased their payouts every year for the past 10 years. "Baby boomers are saying they need income and they need it to grow over time," says Bruce Bond, the founder of PowerShares.

If you are uncomfortable investing in ETFs or do most of your retirement saving in a 401(k) plan, you can add some dividend flair to your portfolio with an equity-income fund. Some mutual funds implement a strategy called "dividend capture," which involves

buying a stock when it declares a special or regular dividend and then holding it for 61 days to qualify for the attractive tax rates. That might be a bit much for the conservative investors out there. If so, stick to a fund like **American Century Equity Income** (TWEAX¹¹), a multicap offering that seeks stocks trading in the cheapest half of the Russell 3000 based on debt-adjusted cash-flow valuations. Or manager Joe Suty's **Principal Equity Income Fund** (PQIAX¹²), which invests in large-cap stocks that trade at a discount to their peers based on financial ratios such as share price to book value, cash flow or earnings per share. Top holdings include General Electric, AT&T and Bank of America. The dividend trend, says Suty, is "just a reversion to the mean. Those who invested just for capital gains have gone the other way."

There are also dividend-growth funds to consider, a category that not only favors dividend stocks but also those that increase their payments every year. The four managers of the \$1.9 billion **RiverSource Dividend Opportunity fund** (INUTX¹³) try to build a portfolio that will yield 50% more than the S&P 500. By favoring dividend growth, estimated by Bank of America analyst Thomas McManus at 10% this year for the broad market, co-manager Laton Spahr and his colleagues think they have a good hedge against inflation, too. Dividend Opportunity owns traditional dividend stocks like Citigroup and Bank of America, but it also owns telecom companies like **Embarq** (EQ¹⁴). The fund is in the top 4% of its Morningstar category over the past three years.