Blue Current

Keeping the RUST Out Through Dividend Growth

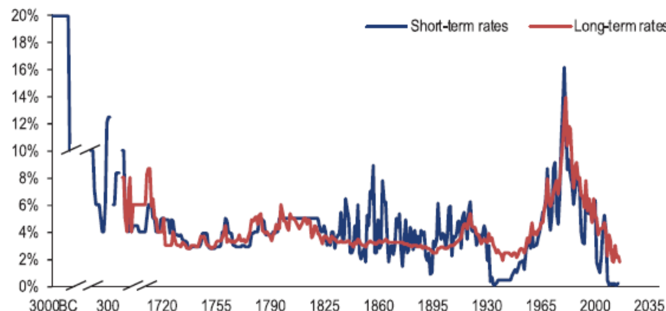
BLUE CURRENT GLOBAL DIVIDEND | JULY 2016

Safe Investments Don't Pay Like They Used To

In the current environment, investors need to make every penny work for them. Not only are traditional income streams providing very little return, in many instances investors are willing to pay to lend to companies and governments. Sales of safes in Japan have risen dramatically as people hoard cash. German citizens are overpaying their taxes in anticipation of refunds that won't be subject to negative rates. More broadly investors are finding that traditional income streams are insufficient for keeping up with continuing obligations and rising costs. The 10-Year US Treasury portfolio required to produce $250,000 of annual income is now $16 million – more than three times as much as the $5 million portfolio required 15 years ago.

10-Year Treasury Yield (since 1790)

Lowest Interest Rates in 5,000 Years



Source: BofA Merrill Lynch

Bond prices continue to achieve all-time highs and now yield their lowest level in 5,000 years (see chart above). The world has a problem with economic growth – not enough of it – and central banks continue to tinker with unprecedented easy money policies that have provided less-than-desirable growth. The S&P 500 is on track to experience five consecutive quarters of declining earnings, a trend not seen since the financial crisis. The lack of economic growth is also creating political volatility, including unprecedented political events like Brexit and the continued polarization within the US political parties. Against this backdrop, US equities are now at all-time highs but for most investors it does not feel good. The popular question these days is "What do you buy when you don't feel like buying anything?"

Unfortunately, the reality of today is the exact opposite of the situation in the early 1980's when interest rates were high and equity valuations were low. This combination left plenty of room for stocks and bonds to advance. Financial repression has created an environment where both yield and growth are now scarce. But even in today's world with low to negative interest rates, slow growth, and higher valuations, sustainable dividend-paying stocks might be less risky than you think – and more fruitful to overcome the headwinds of spending needs and inflation over the next decade.

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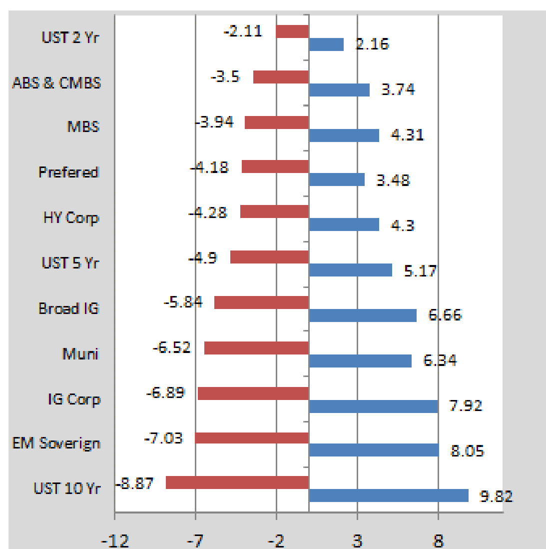
Why Dividend Stocks Matter

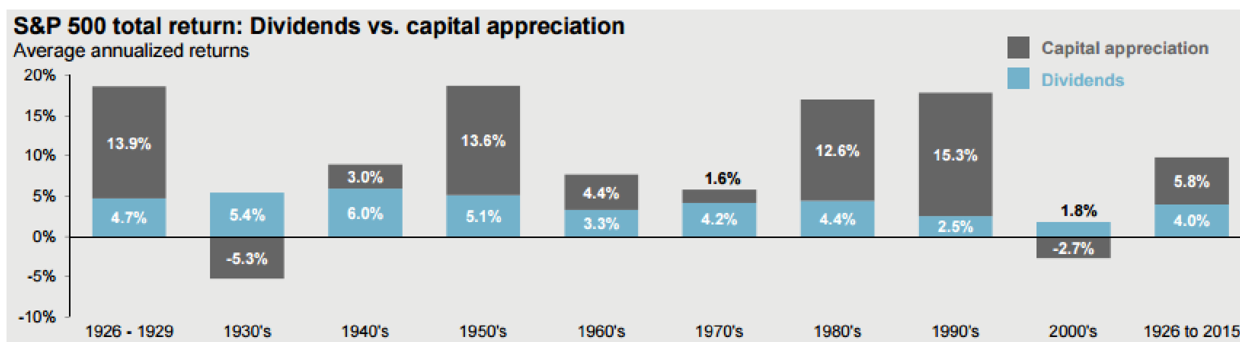
Incredibly, the 10-Year Treasury has returned 8% year-to-date through June, which is impressive until investors realize the 30-Year Treasury is up nearly 17% over the same period. These returns are hard to imagine considering that both maturities were yielding just 1.8% and 2.6%, respectively, earlier in the year. Testifying to the power of duration (defined as the impact to bond prices from interest rate changes), the 10-Year and 30-Year Treasuries can still experience outsized returns should rates decline by another 1%. This would result in additional 10% and 25% returns, respectively.

Price Impact of a 1% Change in Rates



Over the long term, however, investors should recognize that US interest rates have limited “room” between where they currently are and zero. The 10-year buy-and-hold strategy in investment grade bonds looks riskier now than in the past: now there is a real chance that you can lose principal or the purchasing power of money over time. While yields can continue to head lower, bond math suggests that a 1% rise in rates can lead to a 9% decline in the price of a 10-Year Treasury and a 19% fall in the 30-Year Treasury. Even if interest rates stay flat for the next 10 years, investments in the 10-Year Treasury will compound at a 1.5% annualized return – before taxes and inflation!

How do investors offset the pressures above? We believe growing cash flow in the form of a rising dividend should be an important component to overcome the headwinds of spending needs and inflation. Fixed income is just that – a fixed stream of cash flow that inflation and spending will slowly erode over time. On the other hand, rising cash flow provided by quality, dividend equities is one of the few investments that enable consumers to preserve their purchasing power. In addition, over time dividends have represented a significant component of the equity markets’ total return. Depending on the decade, dividends have represented more than 70% of investors’ return and over a very long period (from 1900 to 2015) Cambridge highlights that dividends are responsible for nearly 40% of equity returns. We believe investors can capture the best of both worlds – rising income and capital appreciation.



Source: JP Morgan

Looking ahead, the path of interest rates, inflation, and global growth are varied. A probable scenario is that investors continue to muddle through low rates, moderate inflation, and slow growth. In this environment where global equities are yielding 3.0% with dividends that can grow at a similar rate as earnings, we argue growing cash flow strategies will be a relative winner, producing more attractive returns than 10-Year Treasuries yielding 1.5%.

The continuation of the current scenario prompts a closer examination of equity valuations and why equities continue to benefit when broad growth is flat to negative. From a valuation perspective, US stocks are fairly valued relative to their 20-year history, especially considering interest rates were a lot higher on average during this time frame. Yet if bond yields stay lower for longer, valuations could go even higher. The risk premium is the return investors demand to hold stocks over relatively safe government bonds. As interest rates decline, the value of future cash flows increase. With the 10-Year Treasury note near a record low, risk premiums are rising and increasing the attractiveness of equities. This phenomenon has created a popular investor acronym: T.I.N.A (**T**here **I**s **N**o Other **A**lternative). As a result, dividend equities have benefitted from T.I.N.A, especially for those seeking cash flow that can support purchasing power.

In a rosier scenario with stronger economic growth, we would expect inflation fears to surface, ultimately leading to higher interest rates and additional pressure on fixed income prices. With interest rates at current levels, we believe inflation is one of the more under-priced risks in the market. Even a small inflation surprise may lead to a sharper than expected decline in fixed income prices. Stronger economic growth is a tailwind for cash flow and earnings and ultimately should lead to stock price appreciation over the long term. Under this scenario, we would expect some pressure on the multiples of yield-heavy sectors (such as utilities), so we encourage active (not passive) management to avoid specific areas of the market that are extended and owned by “fast money.” Under this scenario, we believe dividend growth investing will outperform dividend yield investing. More on this to follow….

Lastly, the ugly scenario is a deflationary environment coupled with a US recession. This outcome could lead to a global recession where central banks are "out of bullets," bond yields head lower, and equity earnings decline. This scenario would be bullish for bonds and bearish for stocks. Historically speaking, however, dividend stocks have provided a greater margin of safety in market drawdowns as compared with broad equity indices.

Successful investing starts with adherence to and execution of a long-term plan and time horizon, and not falling victim to short-term distractions. Dividends matter in the short run and the long run. Robert J. Shiller, in his book *Irrational Exuberance*, calculated that the dividend-per-share peak-to-trough decline averaged -8% during the past five US recessionary periods, while the earning-per-share peak-to-trough decline averaged -42%. Importantly, having a sustainable and growing income stream can help investors weather difficult environments and provide cash flow through the ups and downs of the investment cycle.

Recommend Dividend Growth Above Dividend Yield

As history has repeatedly illustrated, chasing high dividend yields does not necessarily produce better results. Nearly every bank cut or reduced its dividend from 2007 through 2009. Equity investors in General Motors – a long-time dividend payer – were wiped out. Most recently, ConocoPhillips, a dividend grower since 1987, cut its dividend earlier this year by 66%. More often than not, high yields indicate high stress. More important to long-term returns is dividend growth, not dividend yield. Critical to the success of the strategy is finding those companies that are committed to the dividend and have a balance sheet and business model to produce a sustainable and growing dividend during both good times and bad.

Dividend equity is by no means a shocking discovery; the praise has become so widespread that today's stock market leadership continues to be driven by higher yielding equities – a development caused by record low bond yields, with nearly 30% of the global bond index having a negative yield. Low bond yields make dividend income all the more appealing, but they also have produced rich valuations in certain sectors that have become bond substitutes.

Starting with valuation, two popular yield sectors, utilities and consumer staples, are more expensive than the market, which is not abnormal, but the extent to which valuations are stretched is. For example, utilities are currently valued at a 5 point premium to its own historical 25-year average P/E. Less extended, staples are valued at a 3 point premium to historical averages. It is not uncommon today for large cap utilities and staples to trade above 23x earnings.

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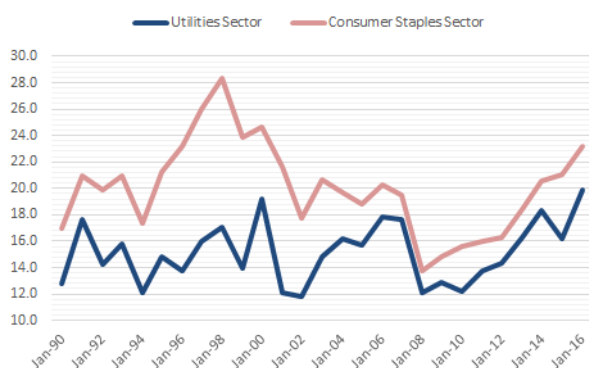
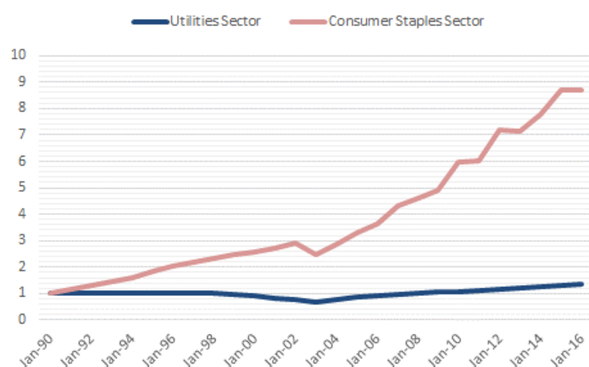
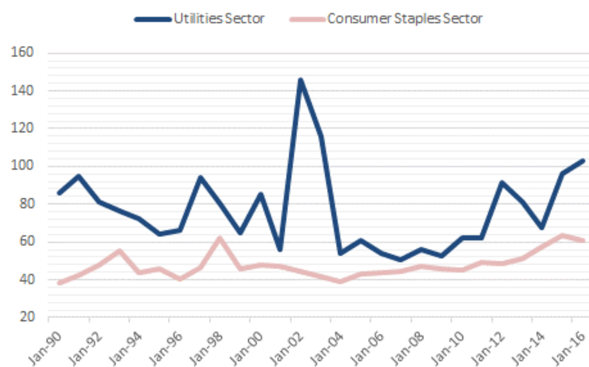
Price to Earnings Ratio



Dividend Growth Rate (%)



Dividend Payout Ratio (%)



Source: Bloomberg

Both sectors have been outstanding performers this year – up 23% and 10%, respectively, through June 30. Utilities and consumer staples have historically offered attractive dividends and stable businesses during good times and bad.

Meanwhile, utilities have historically been low dividend growers. As regulated businesses, they have limitations on price increases and project growth. As seen in the middle chart, utilities have increased their dividend by less than inflation since 1990. On the other hand, consumer staples have been significant dividend growers, compounding dividend increases by double-digit percentages.

Importantly, the utility sector is now more dependent than ever on earnings for dividend growth. As seen on the bottom chart, the dividend payout ratio for utilities is nearly 100% of earnings. Since 1990, the average payout ratio has been 78%. Meanwhile, the consumer staples sector has a 60% payout ratio – its highest payout since 1998, but certainly a greater margin of safety for future dividend growth during good times and bad.

So why are investors paying so much for a historically slow dividend grower that is not well covered for future dividend increases? It demonstrates the market's preoccupation with dividend yield as utilities have become bond substitutes.

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As the information suggests, investor preference for equity yield as a substitute for fixed income has elevated valuations in select sectors to cautious levels. The investing media has assigned the acronym R.U.S.T. (**R**EITs, **U**tilities, **S**taples, **T**elecom) to sectors that are perceived as bond proxies. Unfortunately for investors, many popular dividend ETFs are heavily exposed to R.U.S.T. sectors. For example, the Dow Jones US Select Dividend ETF (DVY) has $16 billion in assets and utilities account for approximately 33% of the index. In addition to exposure to what we believe are inflated sectors of the market, an index cannot anticipate dividend cuts or reward companies in anticipation of dividend growth.

Look Outside The US For Higher Yields

While we selectively like US dividend growers, the opportunity is not just a local one as fixed income yields outside of the US offer even less value than Treasuries. From a valuation perspective, global stocks excluding US stocks trade at 14.6x 2016 earnings and yield 3.3%. US stocks trade at 17.6x 2016 earnings and yield 2.2%. That is 3 multiple points lower and a pickup in yield of over 1%. European dividend payers, in particular, are also trading at a discount to their US peer group and have an equally impressive history of growing dividend payments.

Company	Credit Rating	5-Year Bond Yield	Div Yield	Yield Pickup	5 Yr Div Growth	Currency
Diageo	A-	-0.15%	3.4%	3.6%	6.5%	Euro
Sanofi	AA	-0.05%	4.0%	4.1%	3.2%	Euro
Nestle	AA+	-0.10%	3.0%	3.1%	4.0%	Euro
Siemens	A+	-0.15%	4.0%	4.2%	5.3%	Euro
Unilever	A+	-0.05%	2.8%	2.9%	4.7%	Euro
LVMH Moet Hennessey	A+	0.00%	2.7%	2.7%	11.1%	Euro

Source: Bloomberg

As seen above, we compare a select group of European dividend payers that currently have negative bond yields to their respective dividend yields. The negative fixed income yields suggest that investors will not be made whole upon maturity – a very poor outcome especially for those that have the opportunity to increase their cash flow by owning the high quality, equity equivalent. Aside from the potential rotation into stocks for enhanced cash, the overall level of dividend yields in Europe are higher than the comparable US business. This serves as another demonstration of the attractiveness of sustainable dividend stocks relative to corporate bonds that have *fixed* income streams and prices so high that investors are willing to pay to lend them money.

In summary, investor pursuit of yield has pushed bond prices to the point that investors are willing to receive less than they gave, while yield-starved equity investors have pushed valuations beyond what

history and fundamentals would suggest is appropriate. Where do investors turn for cash flow? We remind them of the following:

- Invest for dividend growth over dividend yield
- Valuations matter more than ever
- Active over passive
- Think global, especially where valuations are lower and yields higher

Blue Current Global Dividend Strategy

The Blue Current Global Dividend strategy invests in a niche universe of high quality, dividend-paying companies that are committed to increasing the dividend each year. Although the dividend growth rate can vary depending on industry and corporate fundamentals, since the strategy launched in 2009 we have been able to deliver a 10% annualized increase in distributable cash flow to investors. Our belief is if we are successful in identifying companies that are capable and committed to increasing the dividend, and we pay a reasonable multiple for a company's future earnings and cash flow, we should deliver an attractive total return to our investors over time.

Our portfolio is concentrated in the top 25 to 50 companies that we believe will increase the dividend and deliver an attractive total return through the ups and downs of the business cycle. More importantly, our discipline to value has resulted in a portfolio that is significantly underexposed to the R.U.S.T. sectors, especially relative to popular dividend ETFs and other active strategies that rely heavily on these sectors to generate yield. As of the second quarter, the Blue Current Global Dividend strategy's price to earnings ratio is approximately 16.4x 2016 earnings, representing a significant discount to the utility and staples sectors. We are selective in the securities and do not feel compelled to own all sectors all of the time.

As indicated below, our exposure to the R.U.S.T. sectors is approximately 20%, which compares to a 40% weighting in the popular yield ETF: DVY (Dow Jones Select Dividend ETF). We remain overweight sectors that offer compelling value and attractive dividend growth prospects, while we have 0% exposure to utilities and companies that we do not believe offer value in today's environment.

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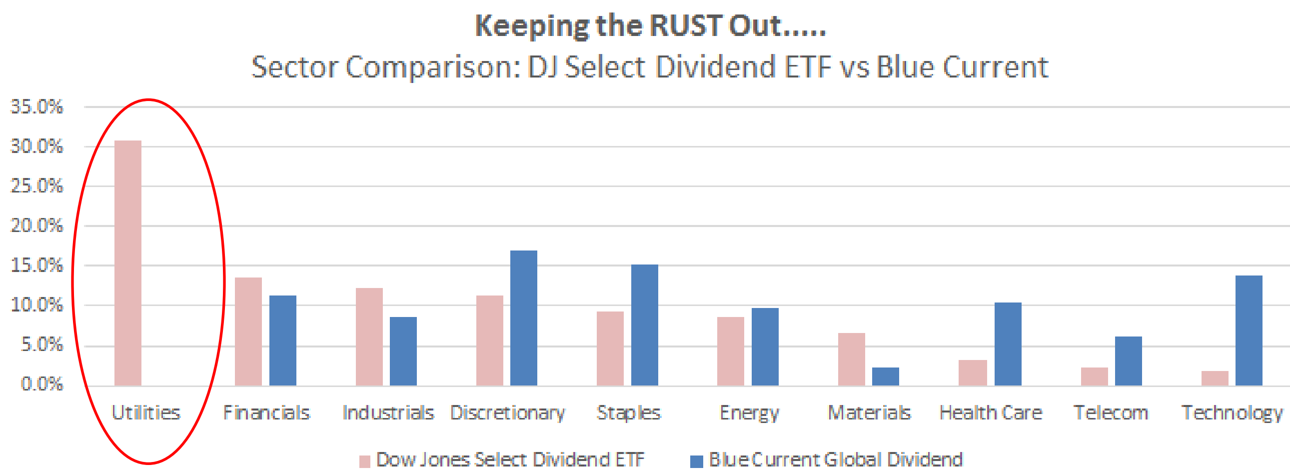

Source: Dow Jones

Blue Current Global Dividend Strategy Historical Performance

	MORNINGSTAR PEER GROUP ANALYSIS								
	YTD through 7/31/2016	1 year	Peer Group Quartile	3 years	Peer Group Quartile	5 years	Peer Group Quartile	7 years	Peer Group Quartile
Blue Current Global Dividend Strategy (net)	**8.83%**	**3.77%**	**1**	**6.12%**	**2**	**10.34%**	**1**	**11.87%**	**1**
MSCI World High Dividend Yield Index	9.46%	4.87%	1	5.69%	2	7.60%	2	9.47%	2
MSCI World Index	4.91%	-0.46%	2	6.59%	2	7.91%	2	9.64%	2
Funds in category		1,136		944		734		633	

Blue Current performance is net of a 1% management fee

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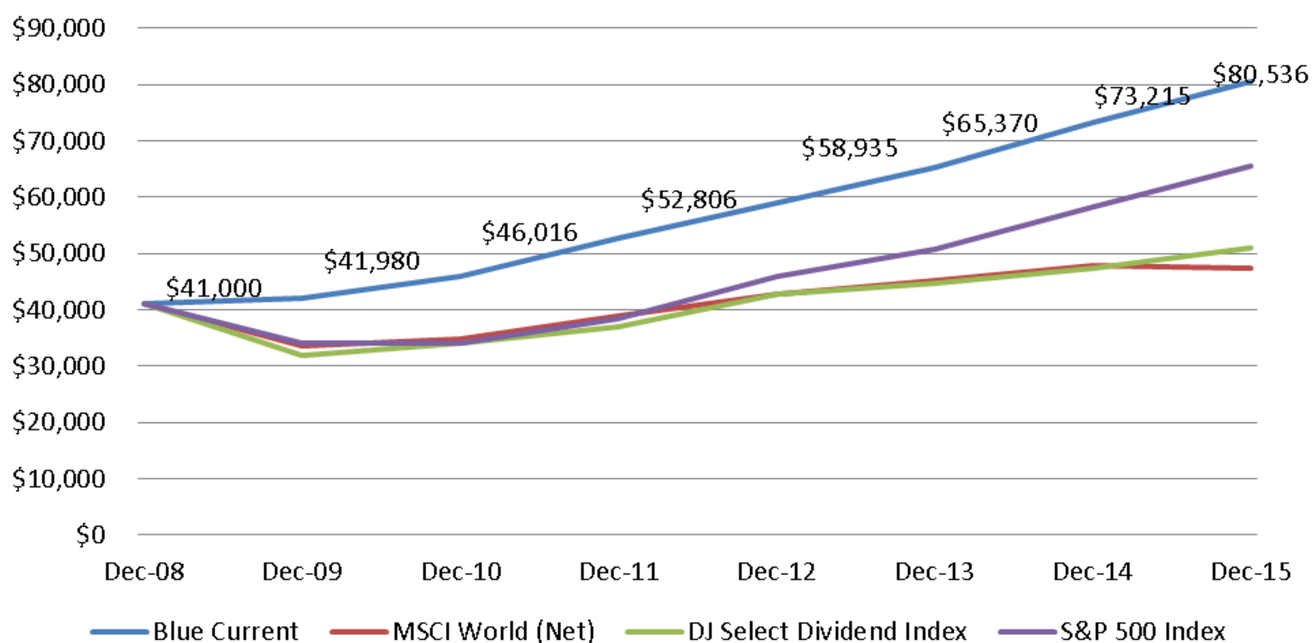

The calculation of dividend growth for the GGI composite takes the weighted average position size of each security held throughout each calendar year multiplied by the dividend growth rate of each security for each calendar year. The GGI composite includes securities owned and sold throughout the calendar year. The dividend growth rate excludes special dividends, including cash or distributions of stock. The dividend growth rate for international equities is the gross dividend in local currency. The dividend growth rate for the GGI composite assumes a fully invested portfolio and excludes cash. The dividend growth rate within the current calendar year is estimated based upon an annualized number from Bloomberg estimates or dividends declared. The S&P 500, MSCI All World, and Dow Jones Select Dividend are representative indices to compare historical dividend growth rates. One cannot invest directly in an index. The source of the dividend data for the GGI composite holdings and each benchmark is from Bloomberg as of December 2013. The hypothetical income growth for the GGI composite and indices assumes the estimated annual income as of 12/31/08 for a hypothetical $1,000,000 portfolio and applies the actual dividend growth rate as described above for each calendar year. Backtested investment data (including historical performance) does not represent actual investment and should not be interpreted as an indication of such performance. Actual performance for client accounts may be materially lower. Backtested performance results have certain inherent limitations. Such results do not represent the impact that material economic and market factors might have on an Edge's decision-making process if Edge were actually managing client assets. Backtested performance also differs from actual performance because it is achieved through the retroactive application of the client's current investment objectives and investors should not place undue reliance on pro forma or hypothetical performance. All figures are estimated and unaudited. Past performance is not necessarily indicative of future results.

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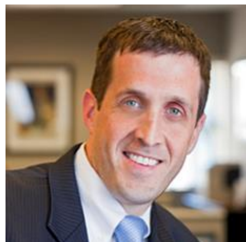
For more research and commentary, visit us online at www.bluecurrentportfolios.com.

ABOUT THE AUTHORS

Harry Jones
Portfolio Manager

Harry Jones is a Co-Portfolio Manager of the Blue Current Global Dividend mutual fund and SMA strategy. Harry's passion for investing began with a college internship on the New York Stock Exchange in 1991. Prior to Blue Current, Harry spent his entire professional career in the investment advisory business at Credit Suisse, Morgan Stanley, and as an analyst for the Excelsior Value & Restructuring Fund. Harry earned a Bachelor of Arts in History and Economics with distinction (Omicron Delta Epsilon) from Hampden-Sydney College and graduated with a Master of Business Administration degree from the University of North Carolina Kenan-Flagler School of Business. Harry is active with his community endeavors, including his time as a youth lacrosse coach and being awarded the 2011 Man of the Year award for Leukemia & Lymphoma Society's Georgia chapter. He is also a member of YPO and the Advisory Council of Woodberry Forest School and Pershing Advisory Solutions.



Dennis Sabo
Portfolio Manager

Dennis Sabo is a Co-Portfolio Manager of the Blue Current Global Dividend mutual fund and SMA strategy. Dennis graduated from the University of Miami with a Bachelor of Science in Electrical Engineering and was a member of the electrical and computer engineering honor society (Eta Kappa Nu). Following college, he worked in the telecommunications industry as an engineer and project manager with Harris Corporation in Florida and later at Cisco (formerly Scientific-Atlanta) in Georgia. In 2002, Dennis transitioned his career to the investments industry and graduated from the University of Georgia with a Master of Business Administration degree. After business school, Dennis spent several years as a sellside equity analyst, first with Robinson Humphrey of Suntrust (covering software technology) and later with the Credit Suisse Global Media Team where he was responsible for the US media sector. After Credit Suisse, Dennis joined an emerging hedge fund, Jodocus Capital, that was founded by a former portfolio manager of Pequot Capital. While at Jodocus, Dennis was a sector generalist and focused on high quality small capitalization companies. After leaving Jodocus, Dennis joined the Blue Current team in 2010 and has worked with Harry Jones on the strategy since that time. Dennis became a CFA charterholder in 2010 and is a member of the Atlanta Society of Finance and Investment Professionals.

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Year	Blue Current Gross Return	Blue Current Net Return	MSCI World High Div Yield Net Index Return	MSCI World Net Index Return	Blue Current Standard Deviation	MSCI World High Div Yield Net Standard Deviation	MSCI World Index Net Standard Deviation	Internal Dispersion	Number of Portfolios	End of Period Assets	End of Period Firm Assets
2009	16.11%	14.97%	32.48%	29.99%	NA 2	24.23%	21.70%	NA 1	< 6	$1,565,376	$10,970,324
2010	13.85%	12.71%	6.29%	11.76%	NA 2	25.89%	24.05%	NA 1	< 6	$2,363,654	$32,789,983
2011	9.67%	8.58%	3.89%	-5.54%	14.98%	21.81%	20.44%	NA 1	< 6	$19,499,442	$77,655,266
2012	12.50%	11.40%	12.24%	15.83%	12.58%	15.33%	16.98%	0.49%	16	$30,917,548	$190,942,763
2013	30.14%	28.88%	21.91%	26.68%	10.53%	11.88%	13.73%	0.29%	46	$71,025,142	$267,812,275
2014	4.40%	3.35%	2.48%	4.94%	8.84%	10.44%	10.37%	0.31%	57	$115,318,155	$337,317,537
2015	-1.04%	-2.03%	-3.20%	-0.87%	10.37%	11.16%	10.80%	0.64%	58	$122,654,070	$325,139,286

N.A.1 - Information is not statistically meaningful due to an insufficient number of portfolios in the composite for the entire year.
N.A.2 - The three-year annualized standard deviation measures the variability of the composite and the benchmark returns over the preceding 36-month period. The three-year annualized standard deviation is not presented for periods with less than 36 months of data.

Blue Current Global Dividend Composite includes all fully discretionary, fee paying accounts under management following a common investment objective, including those accounts no longer with the firm. The Composite invests primarily in domestic or international securities the portfolio manager feels have the potential to deliver outperformance due to a combination of price appreciation and current income in the form of a dividend. The composite will typically invest in securities with a current dividend yield in excess of the broad equity markets with a history of consistently increasing the dividend rate and with what we believe to be strong fundamentals at an attractive price (i.e. low use of leverage, operating margins in excess of 5%, free positive cash flow yield, a price to earnings ratio at or below the market average, and earnings growth). The Global Dividend Equity Composite was created on 1 January 2009. The annual composite dispersion presented is an asset-weighted standard deviation calculated for the accounts in the composite the entire year.

The U.S. Dollar is the currency used to express performance. Returns are presented gross and net of management fees and include the reinvestment of all income. Net of fee performance was calculated using the highest allowable annual management fee of 1% applied monthly. The annual composite dispersion presented is an asset-weighted standard deviation calculated for the accounts in the composite the entire year. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.
Past performance is not indicative of future results.

The investment management fee schedule for the composite is 1% on the first $5 million, .7% on the next $5 million, 0.65% on the next $10 million, .55% on the next $30 million, .45 on the next $50 million. Fees for assets over $100 million are at a rate customized to the client. Actual investment advisory fees incurred by clients may vary.

The benchmark MSCI World Index includes 1611 stocks located across 24 developed countries and captures approximately 84% of the free float-adjusted market capitalization in each country. MSCI uses the maximum withholding tax rate applicable to institutional investors in calculating MSCI net dividends

The MSCI World High Dividend Yield Index is based on the MSCI World Index, its parent index, and includes large and mid-cap stocks across 23 Developed Markets countries. The index is designed to reflect the performance of equities in the parent index (excluding REITs) with higher dividend income and quality characteristics than average dividend yields that are both sustainable and persistent. The index also applies quality screens and reviews 12-month past performance to omit stocks with potentially deteriorating fundamentals that could force them to cut or reduce dividends. MSCI uses the maximum withholding tax rate applicable to institutional investors in calculating MSCI net dividends

Blue Current claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Blue Current has been independently verified for the periods January, 2009 to June, 2015 by Ashland Partners. & Company
Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The Blue Current Global Dividend

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