

INDEXING 101 | U.S.

## Dividend Strategy With Quality Yields— The Dow Jones U.S. Dividend 100™ Index

### CONTRIBUTORS

Vinit Srivastava  
Senior Director  
Strategy Indices  
[vinit.srivastava@spdji.com](mailto:vinit.srivastava@spdji.com)

Tianyin Cheng  
Associate Director  
Strategy Indices  
[tianyin.cheng@spdji.com](mailto:tianyin.cheng@spdji.com)

Not only does the Dow Jones U.S. Dividend 100 Index seek to track stocks with consistent dividend payouts, but it also applies quality assurance for the sustainability of yields.

Dividend-paying stocks have been in focus in recent years, as many income seekers have turned away from low-yielding fixed income instruments and are looking to equity markets for an attractive level of income. With the stock market returning to a more comfortable trading range in late 2014, a continuing search for yield is expected. However, this search for yield will probably be guided by a focus on quality, and it likely will be against a backdrop of future rising rates.

Among different kinds of income equity indices in the market, the Dow Jones U.S. Dividend 100 Index takes a unique approach. Not only does the index seek to track stocks with consistent dividend payouts, but it also applies quality assurance for the sustainability of yields. The index achieves “quality yields” by requiring stocks to have paid dividends for a minimum of 10 consecutive years, and by ranking stocks by a composite score calculated from the cash-flow-to-total-debt ratio, return on equity (ROE), dividend yield, and five-year dividend growth rate. A focus on dividend growth in an environment where investors are concerned about rising rates is important. Typically, high-yield equity strategies are biased toward rate-sensitive sectors, which pay out high yields because of the leverage that they can take on (mainly because of mature business models, e.g., utilities). Such entities are exposed when rates rise. Selection based on dividend growth ensures that firms that have the ability to develop their business and increase their payouts are favored in the selection process. Such businesses tend to be well-managed companies, both from a capital structure and from an operational perspective.

Another characteristic that differentiates the Dow Jones U.S. Dividend 100 Index from other dividend strategies is its strict size and liquidity screens and its weighting method, which is based on a modified market capitalization approach. These attributes aim to increase tradability, reduce the influence of smaller and more-distressed stocks on the portfolio, and to attain a certain degree of diversification by capping sector- and stock-level exposures at 25% and 4.5%, respectively. A weighting method based on modified market capitalization also has the potential to lead to a lower turnover than alternatively weighted income indices that primarily weight based on yield or total dividends.

Exhibit 1 summarizes the construction methodology and the ideas behind this way of construction for the Dow Jones U.S. Dividend 100 Index. It is an attractive balance of yield, quality, capacity, and diversification.

**Exhibit 1: Construction Methodology for the Dow Jones U.S. Dividend 100 Index**

Index Methodology	Targets Intended to Achieve
<p>Screens for dividend payment consistency, size, and liquidity.</p> <ul style="list-style-type: none"> <li>• Minimum 10 consecutive years of dividend payments.</li> <li>• Minimum float-adjusted market capitalization of USD 500 million.</li> <li>• Minimum three-month average daily trading volume of USD 2 million.</li> </ul>	<p>A prerequisite of tradability by screening for a stock's capacity and liquidity.</p> <p>A requirement of consistent dividends by screening for stocks that have paid dividends for a minimum of 10 consecutive years.</p>
<p>Stocks that pass the screens are ranked in descending order by indicated annual dividend yield. The top half is eligible for selection.</p>	<p>A focus on absolute yield by owning the highest-yielding stocks that pass the size, liquidity, and dividend payment consistency screens.</p>
<p>Stocks are then ranked by a composite score of cash-flow-to-total-debt, ROE, dividend yield, and five-year dividend growth rate. The top 100 are selected as constituents.</p>	<p>An emphasis on the quality factor, which is relevant when considering a company's ability to generate free cash flow so that a dividend can be sustained and, potentially, increased.</p>
<p>Stocks are weighted by market capitalization, and they are subject to a 4.5% individual stock weight cap and a 25% sector weight cap.</p>	<p>An attention to representativeness by using a modified market cap weighting so that distressed smaller-cap firms don't dominate its portfolio.</p>
<p>Annual rebalance in March.</p>	<p>A key element for reducing turnover.</p>

Source: S&P Dow Jones Indices LLC. Table is provided for illustrative purposes.

The Dow Jones U.S. Dividend 100 Index has delivered both better yields and better capital gains over the long term when compared with its benchmark, the Dow Jones U.S. Broad Stock Market Index.

The two things that investors care most about when using any income strategy are yield and capital gain. The Dow Jones U.S. Dividend 100 Index has delivered both better yields and better capital gains over the long term when compared with its benchmark, the Dow Jones U.S. Broad Stock Market Index. For the period between Dec. 31, 1999, and Sept. 30, 2014, the price return of the Dow Jones U.S. Dividend 100 Index was 6.65% per year, with 2.89% outperformance to its benchmark; the total return, which assumes reinvestment of dividends, was 10.38% per annum, outperforming its benchmark by 4.78% (see Exhibit 2).

The difference between the total return and the price return is represented by the dividend received, although the effect is a bit magnified due to capital appreciation of the reinvested dividend portion. For the Dow Jones U.S. Dividend 100 Index and the Dow Jones U.S. Broad Stock Market Index, the difference is 3.72% and 1.84%, respectively. The Dow Jones U.S. Dividend 100 Index has provided a better yield over time, indicating that the strategy has properly identified and weighted the companies that are able to maintain or increase their dividend payouts. Besides that, the strategy has held on to its constituents long enough so the yields have actually been received, rather than only seen on paper.

<b>Exhibit 2: Risk/Return Profiles</b>				
<b>Annual Return (%)</b>	<b>Dow Jones U.S. Dividend 100 Index</b>		<b>Dow Jones U.S. Broad Stock Market Index</b>	
	<b>Total Return</b>	<b>Price Return</b>	<b>Total Return</b>	<b>Price Return</b>
3-Year	21.28	17.59	23.02	20.55
5-Year	17.55	13.87	15.86	13.61
7-Year	9.14	5.49	6.38	4.23
10-Year	10.97	7.35	8.63	6.53
Dec. 31, 1999-Sept. 30, 2014	10.38	6.65	5.60	3.76
<b>Annual Volatility (%)</b>				
3-Year	9.11	9.18	11.05	11.06
5-Year	11.23	11.28	13.72	13.72
7-Year	15.68	15.73	17.42	17.43
10-Year	13.60	13.64	15.20	15.20
Dec. 31, 1999-Sept. 30, 2014	14.09	14.08	15.66	15.65
<b>Information Ratio</b>				
3-Year	2.34	1.91	2.08	1.86
5-Year	1.56	1.23	1.16	0.99
7-Year	0.58	0.35	0.37	0.24
10-Year	0.81	0.54	0.57	0.43
Dec. 31, 1999-Sept. 30, 2014	0.74	0.47	0.36	0.24
<b>Maximum Drawdown (%)</b>				
Dec. 31, 1999-Sept. 30, 2014	-44.5	-47.4	-50.8	-52.3

Source: S&P Dow Jones Indices LLC. Data as of Sept. 30, 2014. Past performance is no guarantee of future results. Table is provided for illustrative purposes and reflects hypothetical historical performance. Please see the Performance Disclosures at the end of this document for more information regarding the inherent limitations associated with back-tested performance.

The Dow Jones U.S. Dividend 100 Index shows a reduced risk measured by volatility and drawdown.

Exhibit 2 shows that the Dow Jones U.S. Dividend 100 Index outperformed its benchmark over the past 5, 7, 10 and 14 years. Over the past three years, however, it has not been able to outperform the benchmark. The Dow Jones U.S. Dividend 100 Index shows a reduced risk measured by volatility and drawdown. As a result, the historical outperformance is even bigger in terms of risk-adjusted return. For the period between Dec. 31, 1999, and Sept. 30, 2014, the information ratio (the ratio of annual return to annual volatility) of the index is 0.74, which is more than double that of the benchmark. We believe this effect comes from the defensive nature of an income strategy and the quality tilt that is uniquely carried by the Dow Jones U.S. Dividend 100 Index.

The Dow Jones Dividend 100 Index's focus on quality of dividend payers and dividend growth causes a fairly uniform distribution of names across sectors over time. As noted before, this is a desirable characteristic in the backdrop of rising rates.

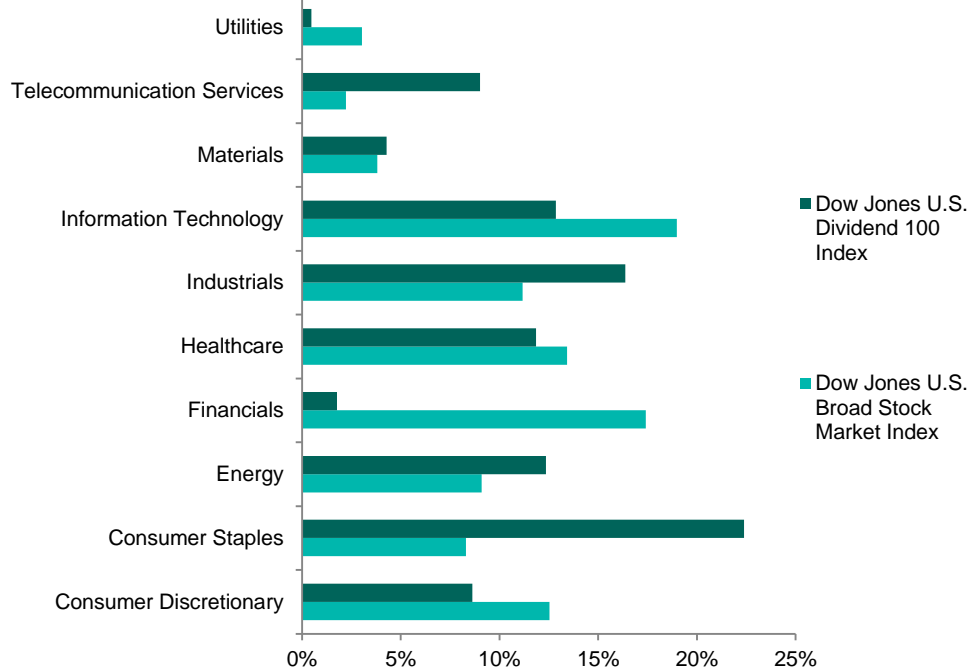
As noted earlier, the turnover for the Dow Jones U.S. Dividend 100 Index over the 10-year period is 28% annually on average, which is a fairly moderate rate (see Exhibit 6).

<b>Exhibit 3: Index Characteristics</b>		
<b>Index Fundamentals</b>	<b>Dow Jones U.S. Dividend 100 Index</b>	<b>Dow Jones U.S. Broad Stock Market Index</b>
Dividend Yield (%)	3.08	1.93
ROE Trailing	0.20	0.13
Number of Constituents	100	2499
<b>Constituent Market Cap (USD Million)</b>		
Mean Total Market Cap	50,422.4	9,378.7
Largest Total Market Cap	401,094.3	603,277.6
Smallest Total Market Cap	644.4	154.0
Median Total Market Cap	14,754.9	2,081.1
<b>Component Weight (%)</b>		
Weight Largest Constituents (%)	4.6	2.8
Weight Top 10 Constituents (%)	44.0	14.5
<b>Turnover Rate (%)</b>		
Turnover Rate at March 2013 Rebalancing	12.2	-
Turnover Rate at March 2014 Rebalancing	21.3	-

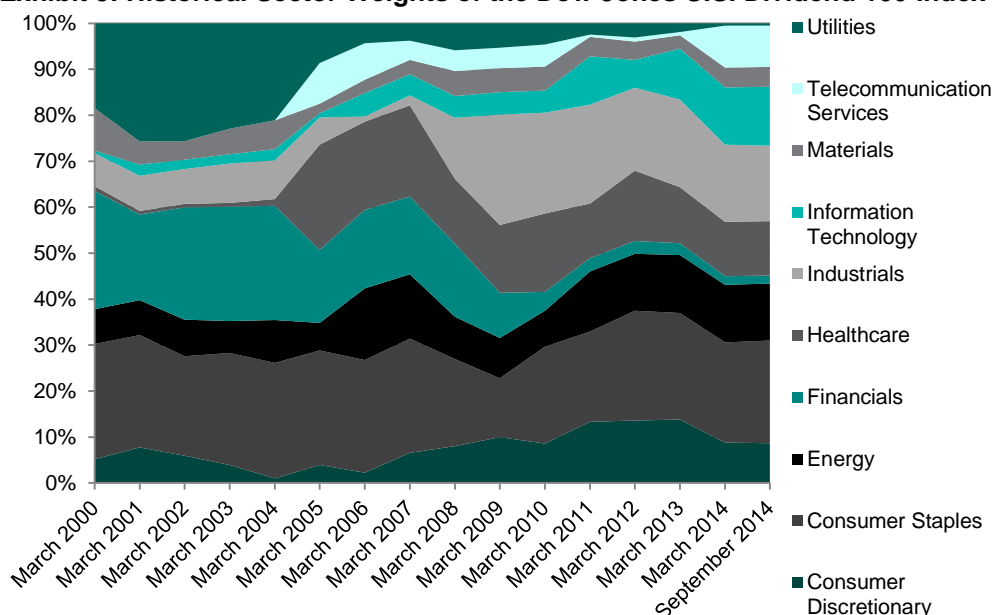
Source: S&P Dow Jones Indices LLC. Data as of Sept. 30, 2014. Table is provided for illustrative purposes. Past performance is no guarantee of future results.

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**Exhibit 4: Sector Weights**



Source: S&P Dow Jones Indices LLC. Data as of Sept. 30, 2014. Chart is provided for illustrative purposes.

**Exhibit 5: Historical Sector Weights of the Dow Jones U.S. Dividend 100 Index**

Source: S&P Dow Jones Indices LLC. Data from Sept. 30, 2000, to Sept. 30, 2014. Chart is provided for illustrative purposes.

**Exhibit 6: Historical Annual Turnover of the Dow Jones U.S. Dividend 100 Index**

Year	2006	2007	2008	2009	2010	2011	2012	2013	2014
Turnover (%)	33.73	33.61	44.50	26.71	27.04	31.04	20.86	12.65	20.54

Source: S&P Dow Jones Indices LLC. Data as of Sept. 30, 2014. Table is provided for illustrative purposes.

The Dow Jones U.S. Dividend 100 Index is designed to measure dividend payers in the U.S. market through focusing on quality and dividend growth. These characteristics are important in an environment where interest rates are expected to rise. The market capitalization weighting approach also provides the index with a higher capacity and reduced turnover rate when compared with other alternatively weighted strategies.

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