Brown ADVISORY
Thoughtful Investing.

THIRD QUARTER 2016 BULLETIN

Asset Allocation: Caution Toward High Dividend Yielding Stocks

With interest rates near historic lows, investors have gravitated toward stocks with high dividend yields in sectors such as utilities, telecommunications and consumer staples. Demand for stocks offering income and implied lower volatility, as well as strong inflows into passive funds, has led to stretched valuations compared to other segments of the equity market. In our view, the risk/reward ratio for high dividend yielding stocks is increasingly skewing to the downside.

WHY HAVE HIGH DIVIDEND YIELDING SECTORS DONE WELL THIS YEAR?

Reach for yield. In response to weak nominal growth, central banks have maintained accommodative monetary policies, pushing interest rates to historic lows. Given this low-yield environment, investors have flocked to stocks that yield more than traditional U.S. Treasuries.

Perceived Stability. Generally, companies with higher dividend yields tend to be slower-growing and more stable, with enough excess cash to pay out dividends. Investors view these stocks as relatively safe defensive havens that offer a bulwark against declining or volatile markets.

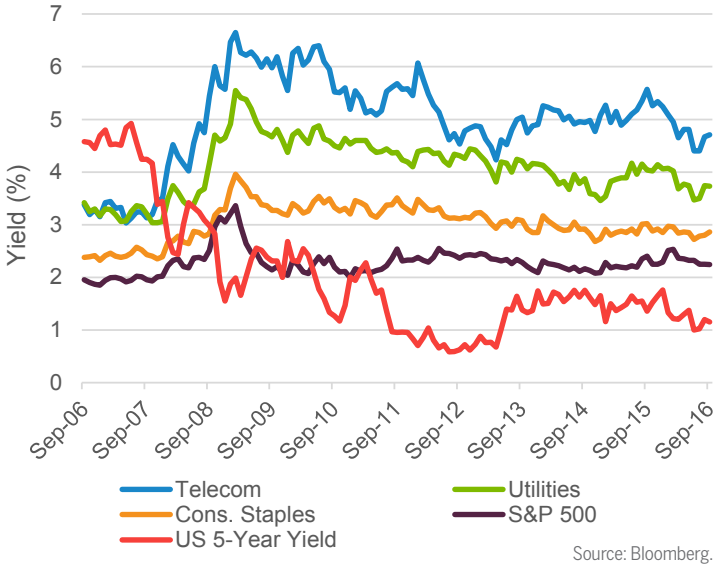
Positive fund flows. Dividend-oriented stocks and funds have experienced large capital inflows this year. According to Morningstar, overall assets in dividend-focused ETFs and mutual funds have ballooned to $672.6 billion, nearly double the $367.3 billion in assets they held in 2011.

While the factors above have buoyed dividend-rich stocks this year, such stocks now pose a rising risk in portfolios for several reasons:

1. **Their valuations have stretched beyond what is justified by the fundamentals in many cases.**
2. **Companies with unsustainable dividend growth run the risk of cutting dividends and suffering significant underperformance as a result.**
3. **A negative change in sentiment could lead to major outflows from focused mutual funds and ETFs.**
4. **Dividend stocks and funds are typically highly sensitive to interest-rate movements.**

Yields in defensive equity sectors have notably exceeded those of U.S. Treasuries...

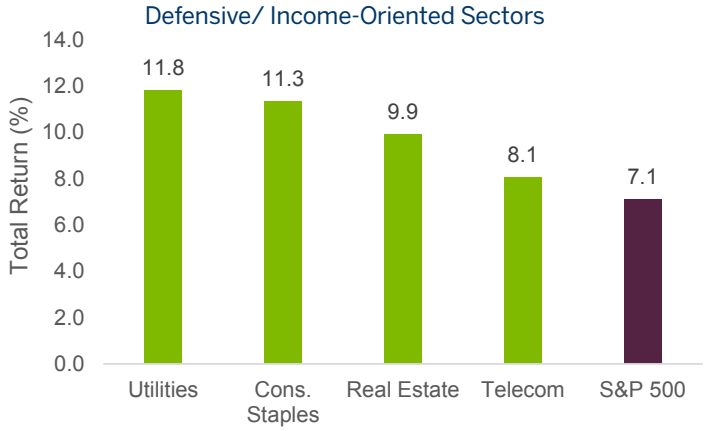
Sector Yields vs. Five-Year U.S. Treasury Yield, 09/30/2011 – 09/30/2016



Source: Bloomberg.

...which has attracted investors and driven strong performance this year.

2016 YTD Total Return across S&P 500® Index Sectors, as of 09/30/2016



Source: Bloomberg. Other sectors include technology, health care, consumer discretionary, financials, energy, materials and industrials..

CAUSE FOR CAUTION: *Why Dividend-Rich Stocks Pose A Greater Risk*

Stretched Valuations. Defensive, high-yielding sectors are trading at a premium to the U.S. stock market (chart 1). Companies in these sectors tend to grow slowly and require meaningful capital investment, which typically leads to higher leverage (chart 3). Higher yields theoretically compensate investors for these growth and leverage drawbacks. However, these stocks may sell off if interest rates rise, or if they are forced to cut dividends due to unsustainable payout ratios, weak earnings growth or both.

In comparison, sectors such as technology, health care and consumer discretionary generally offer better growth and more attractive valuations (table 1).

Passive Inflows. Dividend stocks have been lifted by investor demand for lower volatility ETFs and index ETFs. Remember that when investors buy a passive, market-cap-weighted ETF, they inherently buy expensive parts of the market that have been performing well, and heavy purchasing of such ETFs can push elevated valuations even higher.

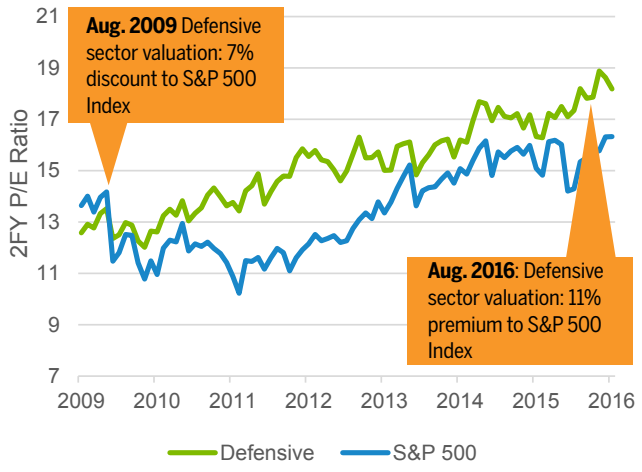
Interest-rate sensitivity. Dividend stocks are typically also highly sensitive to interest rate and bond yield movements. In 2013, as the Fed ended its bond-purchasing program, U.S. Treasury yields surged and utilities, telecommunications and consumer staples stocks as well as REITs lagged the S&P 500 Index (chart 2).

Investors with exposure to these stocks should carefully consider the interest-rate sensitivity within their equity allocations. As central bank actions lead to market volatility, dividend-rich stocks are likely to be disproportionately impacted.

For example, throughout September of this year, volatility spiked as investors focused on potential Fed rate hikes, and dividend stocks fell more than the broader market. From August 31st to September 21st, the S&P 500® Dividend Aristocrats® Index (an index of 50 stocks with 25 consecutive years of dividend growth) returned -1.78%, versus -0.26% for the S&P 500 Index.

CHART 1: Defensive sector valuations have been elevated since the end of the crisis.

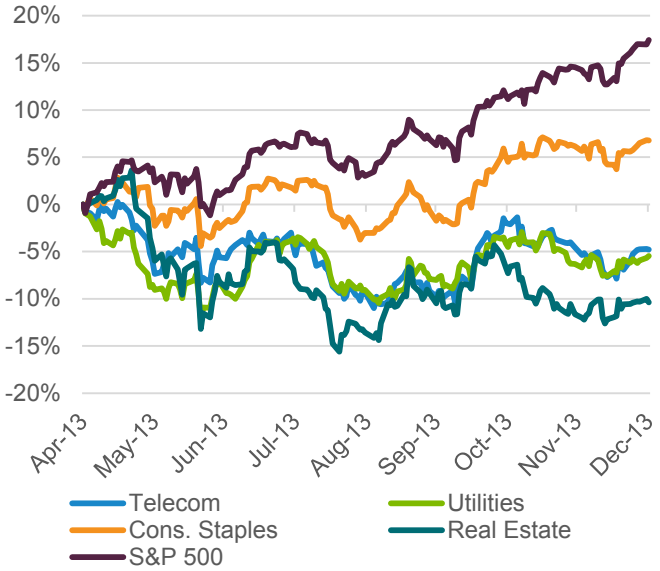
FY2 Price-to-Earnings Ratio, 09/30/2009 – 09/30/2016



Source: Bloomberg. "Defensive" refers to the blended PE of the Utilities, Telecom and Cons. Staples Sectors.

CHART 2: Defensive stocks lagged the broader market in 2013 as the Fed wound down its quantitative easing program

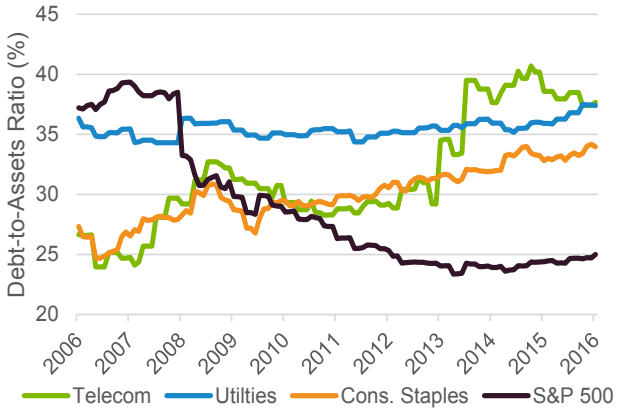
Cumulative Total Return, 04/30/2013 – 12/31/2013



Source: Bloomberg.

CHART 3: Defensive sectors have levered up, while the S&P 500 Index has broadly de-levered.

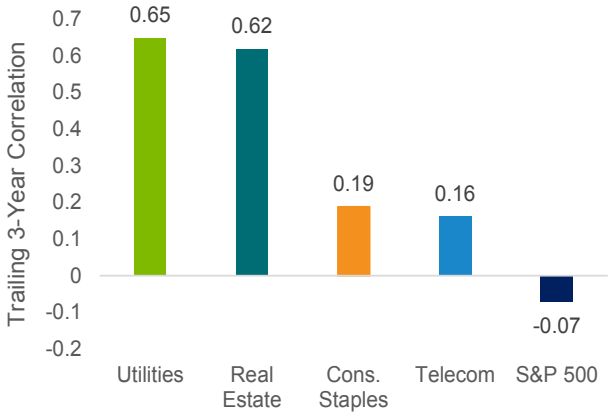
Debt-to-Assets Ratio (%), 09/30/2009 – 09/30/2016



Source: Bloomberg.

CHART 4: Defensive stock returns are more correlated to bond returns.

Trailing Three-Year Correlation of Equity Sector Returns to the Bloomberg Barclays Aggregate Bond Index as of 09/30/2016



Source: Bloomberg.

TABLE 1: Earnings growth and valuations across the telecommunications, utilities and consumer staples industries are less attractive compared to sectors such as technology, health care and consumer discretionary.

Sector	Dividend Yield (%)	Trailing Three-Year Annualized Return	FY2 PE Ratio	Trailing Five-Year Cumulative EPS Growth (%)
Telecommunications	4.6	9.7	12.5	55.5
Utilities	3.6	13.5	17.0	7.2
Consumer Staples	2.7	13.0	19.0	36.4
Consumer Discretionary	1.6	11.5	16.6	93.7
Financials	2.0	8.2	12.1	118.9
Health Care	1.7	14.3	14.2	73.6
Information Technology	1.5	15.1	15.9	72.7
S&P 500 Index	*2.1*	*11.1*	*16.1*	*49.3*

Source: Bloomberg.

Conclusion. High dividend-yielding stocks have been the primary drivers of recent stock-market performance. However, we have avoided these stocks because of their overly-rich valuations as well as their sensitivity to interest-rate movements, central bank policies and reversals of trends in ETF and mutual fund flows. We were wary of these sectors at the beginning of the year and are even more so now. We continue to favor companies within sectors that are structurally more attractive and are reasonably valued compared to the rest of the equity market.

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One cannot invest directly in an index.

S&P 500® sector characteristics using GICS Level 1 Sectors, as of 09/30/2016.

Price-Earnings Ratio (P/E Ratio) is the ratio of the share of a company's stock compared to its per-share earnings. P/E calculations presented use FY2 earnings estimates; FY1 estimates refer to the next unreported fiscal year, and FY2 estimates refer to the fiscal year following FY1.

Dividend yield for the underlying stocks is calculated by dividing the total dollar amount the security paid out as income to shareholders by the share price.

Annualized total return is the geometric average amount of money earned by an investment each year over a given time period.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock.

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