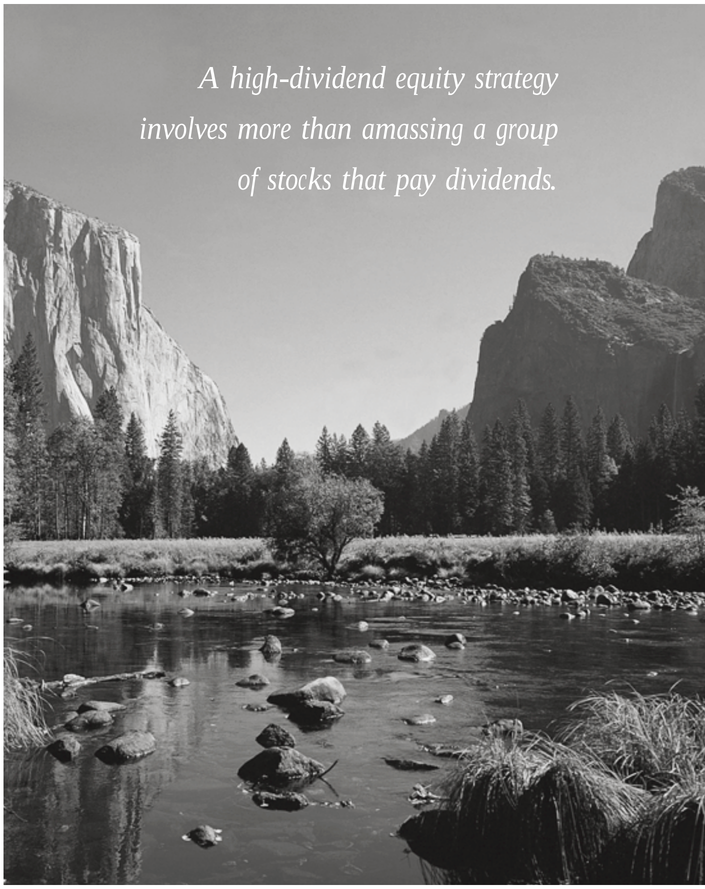
Seeking to Enhance Portfolio Returns With a High-Dividend Equity Strategy

The search for higher returns and lower risk has often left many investors vacillating between different investment styles and vehicles. But one strategy, high-dividend equity investing, has demonstrated consistent outperformance with little added risk, meriting an allocation in a wide range of portfolios. This white paper examines how an allocation to high-yielding stocks can potentially boost performance and actually lower risk in certain portfolios. It also looks at factors to consider when determining an allocation to high-yielding stocks and stock portfolios.



High-Dividend Equity: Identifiable Traits

A high-dividend equity strategy involves more than amassing a group of stocks that pay dividends. Historically, companies that generate significant free cash flow and have a history of maintaining or increasing their dividends have been likely to offer returns that are in excess of the broader market.

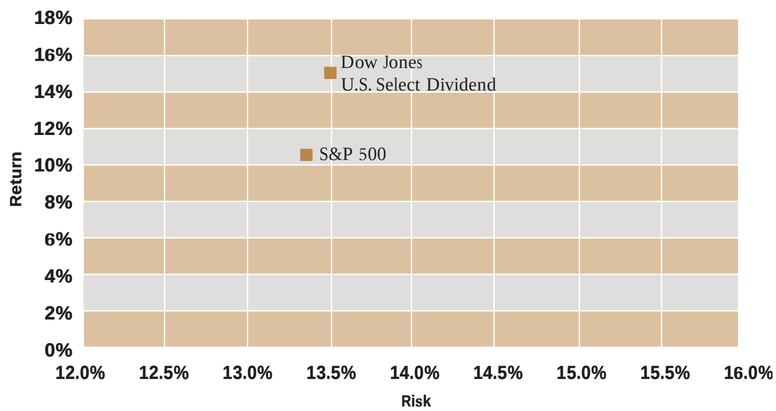
"Companies with healthy dividends typically generate significant free cash flow and have communicated their commitment to using this cash to enhance total return for shareholders," said Walter C. Bean, senior vice president and senior portfolio manager for Federated Investors. "Historically, many of these companies have been found in income-producing sectors of the market such as utilities, financials, consumer staples, telecommunications services, and energy. It is not unusual for high-yielding securities within these sectors to present valuation advantages such as relatively low price/earnings, price/book value and price/cash flow ratios."

This combination of cash flow and valuation may explain in part why high-dividend equity strategies have offered a positive risk/return differential. "With a substantial portion of the return coming in cash, there is a significant advantage in terms of achieving better risk-adjusted returns than the overall market," Bean said.

When examining the benefits of high-dividend equity approaches, the Dow Jones U.S. Select Dividend Index is a useful proxy. To be included within the index, a company must have a non-negative, five-year dividend-per-share growth rate, a five-year average dividend to earnings-per-share ratio of 60% or less and a three-month average daily trading volume of 200,000 shares or more.[1] Stocks meeting these criteria are ranked by dividend yield, and the top 100 weighted by dividend yield are selected. History is available back to December 31, 1991, and the index is rebalanced annually in December.

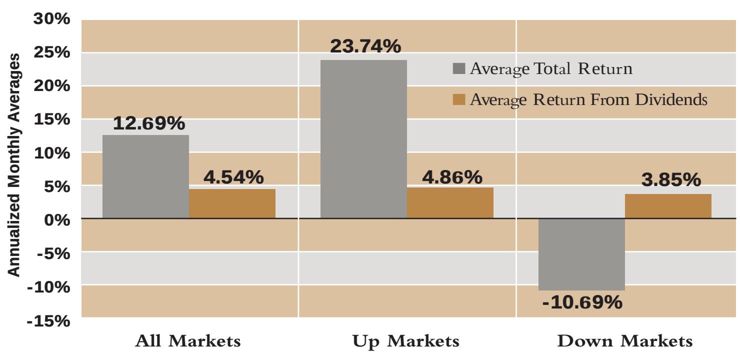
[1] *Source: Dow Jones Indexes, June 30, 2007.*

Chart 1: High-Dividend Equity and the Broader Market[2]



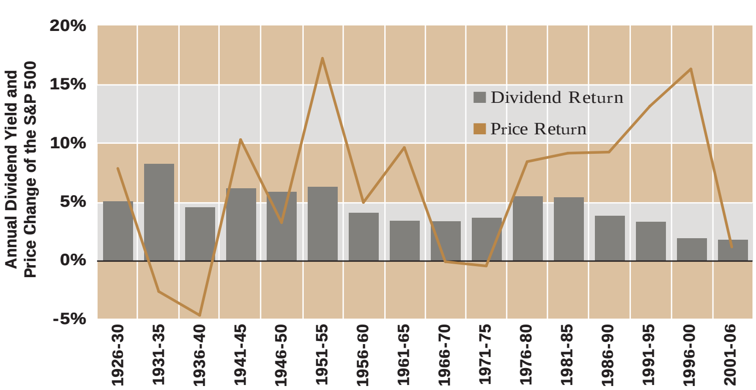
[2]Sources: Standard & Poor's; Dow Jones. High-dividend equity is represented by the total return of the Dow Jones U.S. Select Dividend Index; the broader market by the S&P 500, an unmanaged index of 500 stocks designed to measure the performance of the broad domestic economy through changes in the aggregate value of 500 stocks in all major industries. Investment cannot be made directly in any index. Chart covers the time period beginning January 1, 1992, and ending June 30, 2007.

Chart 2: Dividends Have Supported Returns,[3] Particularly in Down Markets — S&P 500, 1926-2006



[3]Source: Standard & Poor's. For the period beginning January 1, 1926, and ending December 31, 2006.

Chart 3: Dividend Returns Have Been Much More Stable Than Price-Only Returns — S&P 500, 1926-2006 in 5-Year Periods[3]



These charts are for illustrative purposes only and are not representative of the performance of any particular investment. Past performance is no guarantee of future results.

Chart 1 illustrates how the risk/return differential of high-dividend equities and the broader market have played out historically. For the period beginning January 1, 1992, and ending June 30, 2007, a high-dividend equity strategy generated an average annualized total return of 15.5% — 474 basis points higher than the 10.76% annualized return realized by the S&P 500.[2] At the same time, risk, as measured by standard deviation, was only 14 basis points higher for high-dividend equity, suggesting that significantly higher returns more than justified the slightly higher risk.

The Advantages of Dividend Yield

The outperformance of high-dividend equities stems from several advantages posed by dividends and dividend-paying companies. For one, because a sizeable portion of their return is in cash, dividend-paying stocks may help to cushion a portfolio's downside when the broader market is posting losses. As Chart 2 indicates, dividend yield has generated an average positive return of 3.85% in the down markets since 1926, which has helped to offset the average negative total return of -10.69% during these periods.[3]

The ability of dividends to mitigate a portfolio's downside stems, in part, from their relative stability. Although high-dividend equity portfolios may underperform during strong growth markets, historically, dividend returns have been much more stable than price-only returns, as Chart 3 illustrates. This relative stability is crucial for investors building portfolios to finance retirement, higher education and other long-term goals.

In addition to displaying more stability than price-only returns, dividends offer an important tax advantage. The reduction in the federal tax rate on qualified dividends to 15%, enacted in 2003, enables high-dividend equity investors to keep a larger percentage of their returns. Prior to the change in the tax law, dividends had been taxed as ordinary income, at a maximum rate of 38.6%.

Because the change in the tax law had the effect of equalizing the tax rate on qualified dividends and long-term capital gains, investors suddenly had an incentive to enhance their allocations to high-dividend equities. Also, the tax law reduced taxes on qualified stock dividends to the point where they were less than taxes on bond interest, which continue to be taxed as ordinary income.

It's important to note that unless Congress changes the tax rate on dividends, it is set to revert back to the old rate — where dividends were taxed as ordinary income — after December 31, 2010. Investors may want to monitor developments on the tax front to determine whether any amendments are likely to affect their personal situation.

Determining Allocations to High-Dividend Equity

Many investors understand the benefits of a high-dividend equity strategy but are uncertain about how to allocate their portfolios to capitalize on it. An appropriate allocation depends on an investor's goals, risk tolerance and time horizon. Although past performance does not guarantee future results, historical returns may shed light on the potential advantages of high-dividend equities within aggressive, moderate and conservative portfolios.

Within each of the hypothetical allocations that follow, high-dividend equities enhanced average annual total return and reduced volatility.[4] There's a clear message here for investors and financial advisors: High-dividend equities may have appeal that goes beyond occupying a small slice of a conservative portfolio. A high level of reinvested dividends typically cushions a portfolio during down markets and contributes significantly to long-term total return — factors that are important to almost all investors.

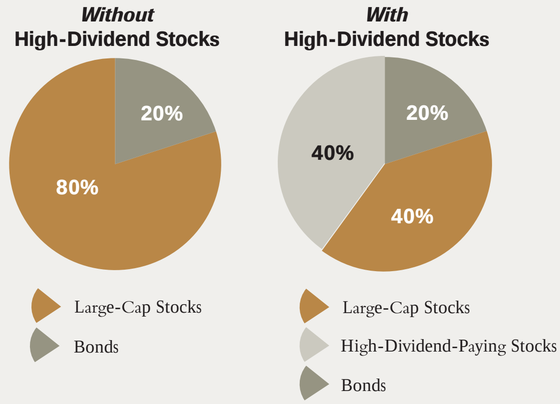
Aggressive Portfolios

High-dividend equities may help aggressive investors deal with one of their most vexing challenges — mitigating the potential downside of a portfolio weighted mostly to stocks. Changing the equity allocation from 80% stocks of the S&P 500 to 40% stocks of the S&P 500 and 40% high-dividend equities (see top Aggressive Portfolio) improved the annualized total return by almost 200 basis points and reduced risk in the hypothetical examples shown.

As the bottom Aggressive Portfolio illustrates, high-dividend equities may also add value to a portfolio with a sizeable allocation to a more volatile equity such as small caps. In this case, including high-dividend equities within the stock allocation increased the annualized total return by more than 120 basis points and reduced risk.

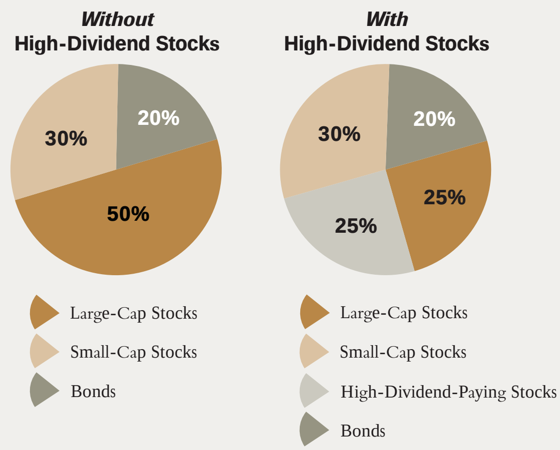
Aggressive Portfolios

Large-Cap Stock and Bond Portfolio[4]



	Without	With
Return:	**10.38%**	**12.33%**
Risk:	**10.76%**	**10.09%**

Large-Cap, Small-Cap and Bond Portfolio



	Without	With
Return:	**10.79%**	**12.03%**
Risk:	**11.03%**	**10.48%**

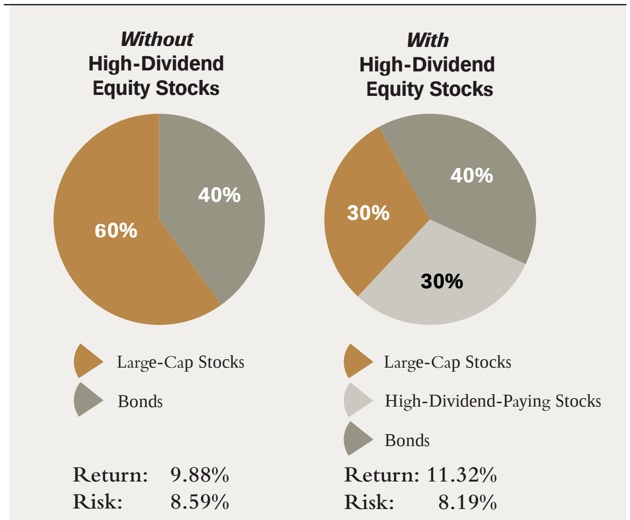
[4]*Sources: Standard & Poor's; Dow Jones; Lehman Brothers; Frank Russell & Company. For the period beginning January 1, 1992, and ending June 30, 2007. Large-cap stocks are represented by the total return of the S&P 500, high-dividend-paying stocks by the Dow Jones U.S. Select Dividend Index, small-cap stocks by the Russell 2000 Index, bonds by the Lehman Brothers Long-Term Government Bond Index. Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices. Small-cap stocks may be more volatile than large-cap issues. Asset allocation does not ensure a profit or protect against loss.*

Past performance is no guarantee of future results. *These charts are for illustrative purposes only and are not indicative of any particular investment. Charts are for a select time period. Other time periods may not result in the same favorable returns.*

Moderate Portfolios

A portfolio crafted for a moderate risk tolerance does not have to settle for middle-of-the-road returns. Allocating 30% of the portfolio to high-dividend equities improved annualized total return by more than 140 basis points while reducing risk. In this case, the return exceeded both of the aggressive portfolios that did not include high-dividend equities — with a considerably lower standard deviation.

Moderate Portfolio



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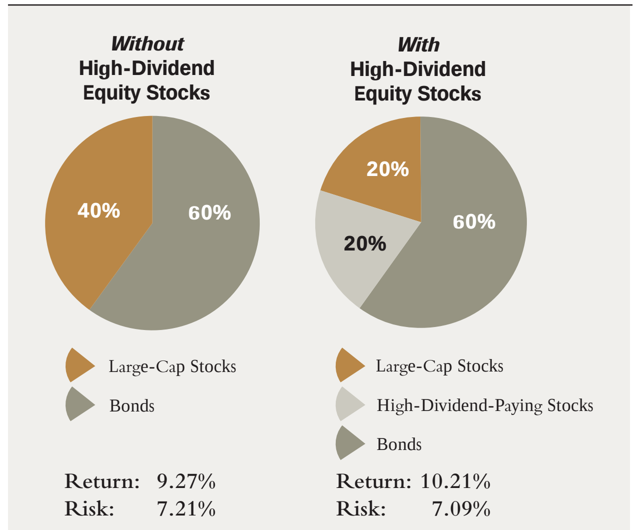
Conservative Portfolios

High-dividend equities traditionally have been associated with conservative portfolios designed to pursue growth with reduced risk. Allocating half of the stock portion of a conservative portfolio to high-dividend equities, as the example below illustrates, may help an investor pursue these dual objectives.

It's interesting to note that the return of the conservative portfolio with high-dividend equities nearly matches both of the aggressive portfolios without high-dividend equities — but with significantly less risk. The relatively low standard deviation of the revised conservative portfolio stems from an 80% allocation to a combination of bonds and high-dividend equities, two investments that historically have offered lower downside risk.

Conservative Portfolio



Dividend Growth and Inflation

The risk and return associated with the aggressive, moderate and conservative portfolios assume that all dividends are reinvested to enhance total return. But many investors instead rely on cash dividends to supplement other sources of income. When constructing portfolios for these investors, it's important to consider not only risk and return but also how the portfolio's potential for income compares with historical trends in inflation.

"Inflation is the enemy of income investors," noted Federated's Bean. "There are portfolio managers who create income-oriented portfolios by making them bond-like. But the problem with this approach is that there is little likelihood of an increase in the income stream. By investing in stocks with the potential for growth in dividends, the income stream may move higher, which benefits investors who expect their need for income to rise over time."

High-Dividend Equity Investing at Federated

The Federated Strategic Value (Equity Income) strategy pursues income and long-term capital appreciation by investing primarily in high-yielding, undervalued stocks with dividend growth potential. The strategy seeks to deliver a dividend yield that is substantially higher than the broader market, to pursue competitive performance in both strong and weak markets and to target less volatility than the S&P 500.

The portfolio invests primarily in large- and mid-cap stocks with strong value, high-dividend yield and potential dividend growth characteristics. Because of this orientation, the strategy historically has had a low correlation with the S&P 500, which may make it a strong complement to a core equity strategy.

"Our goal is to maintain yield significantly higher than the broad market index," explained Bean. "We're looking at three-, four- and five-year trends in sectors where companies historically have built up free cash flow. Because of this long-term focus, this is not a product where trading is based on short-term considerations. High-dividend equity strategies like this should have low turnover."

Federated invests solely in common stocks — there are no preferred stocks, bonds or convertible securities. This approach, Bean said, is designed to produce a dividend stream that increases over time.

Balancing Risk and Return

A high level of dividend income provides a distinct advantage when fixed-income yields are low, the outlook for inflation is uncertain and the broader equity market is volatile. While a specific allocation depends on individual circumstances, high-dividend equities are clearly justified in a wide range of portfolios. With increasing numbers of investors looking to enhance returns while financing retirement, higher education and other long-term goals, interest in high-dividend equity investing is likely to remain strong in the years ahead.

Federated

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