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DIVIDEND GROWTH MODEL PORTFOLIO

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The Importance of Dividends

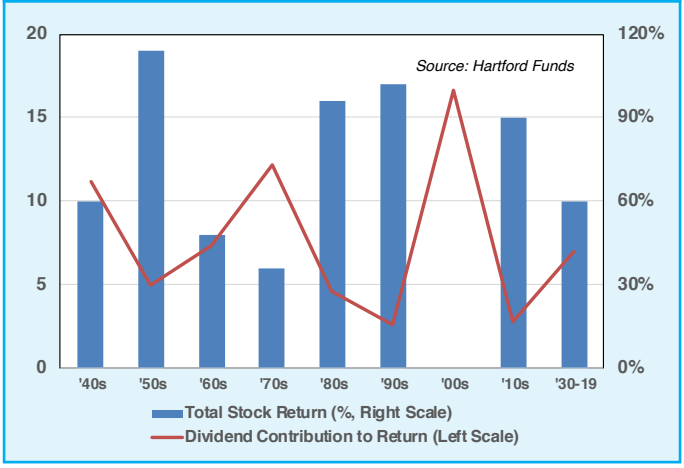
Often overlooked amid gyrations in the stock market is dividend income, which is an important element of total return. Between 1930 and 2012, dividend income accounted for 42% of total return of the S&P 500, according to Hartford Funds. And that's just the average. In some decades, dividends accounted for more than 50% of total returns and even 100% of returns. More recently, dividends have accounted for 15%-20% of returns. Still, in 2018, dividend payments softened the blow when most market indices declined as the Federal Reserve hiked rates.

Not all dividends are created equal, though, and it is important to understand the difference between the two main categories: high-yield stocks and dividend-growth stocks.

High-yield stocks typically have dividends that pay out in the 5%-8% range. Though the income appears attractive, the share prices of high-yield stocks may be at risk. Indeed, if interest rates drift higher, risk-averse equity investors could be drawn to the relative safety of bonds and may sell their high-yield stocks. In addition, it is worth noting that a yield in the 7%-10% range could signal a company is struggling and the dividend is in jeopardy. Former blue chip companies such as General Electric and Kraft Heinz have cut their high dividends in the past few years, as have select Energy sector companies. Lastly, high dividend payouts likely reflect a high level of the cash the company earns, leaving little behind for value-enhancing activities.

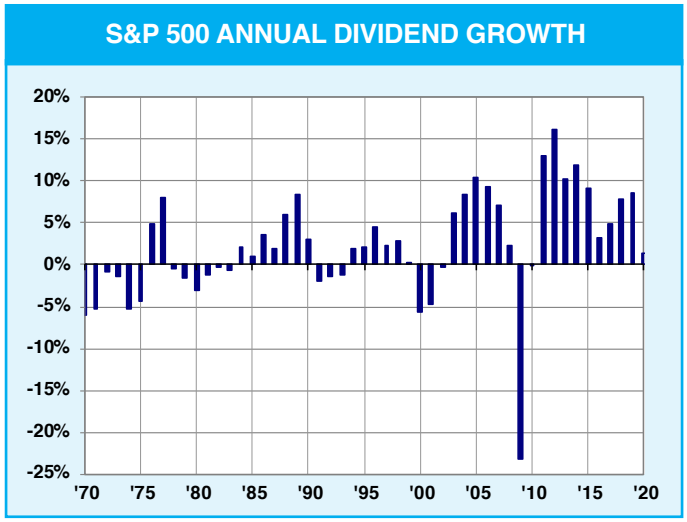
Dividend-growth stocks typically have lower yields, often in the 1.0%-2.5% range. But the lower-yielding dividends are not likely to be a huge component of cash flow, leaving management teams with other value-additive options for deploying cash -- such as share buybacks, M&A, the payment of debt or reinvestment in the core business. Further, while the yields are not as high, management teams may be more likely to boost the payouts over time, as earnings grow.

DIVIDENDS AN IMPORTANT PART OF STOCK RETURNS



Three Signals from Dividend Growth

Since 1970, the dividends of companies in the S&P 500 index have grown 2.1% per year, essentially in line in with long-term GDP growth. But rates have varied sharply over the years, and from year to year. At times, the dividend growth rate has been negative (during economic slowdowns in the early 1970s, 1980s and 1990s, and during the bear markets of 2000, 2008 and 2009. At the other side of the spectrum, the average dividend growth rate been 10% or above in five of the past 50 years. More recently, dividend growth accelerated to 9% in 2019, which was a good year for stocks as trade wars settled down and the Federal Reserve took a dovish stance on interest rates. But dividend growth slowed sharply in 2020, due to the pandemic, with the rate falling below 1.0%.



At this stage of the economic and market cycles (post pandemic and entering a higher-growth period), Argus recommends that investors focus on dividend growth instead of dividend yield. Specifically, we are bullish on companies that have boosted their dividend at high growth rates for many years consecutively.

Even during the pandemic, our analysts noted that a number of high-quality, well-managed companies continued to raise their dividends at double-digit rates, this as part of their value proposition to investors.

We think this type of consistent -- and accelerated -- dividend growth gives three important signals:

1. a company's balance sheet is strong enough to pay a dividend;

2. management is mindful of shareholder returns, which include dividends; and

3. a significant dividend increase can be a message from management that the near-term outlook for the company is promising.

Dividend Growth Link to Total Return

We have already explained the risks of income investing in an uncertain rate and macroeconomic environment: dividend payments may be at risk during these uncertain times.

Why then go anywhere near dividend stocks at such a time? Because investors need income.

Moreover, we have found that dividend-growth stocks tend to hold their value better in periods of rising rates and deliver solid total returns in all markets. Looking at historical return of stocks within the S&P 500 between 1972 and 2010, average annual return was 7.3%; but average annual return for companies that initiate or grow their dividends was 9.6% (source: Ned Davis Research).

To test this hypothesis, we examined the recent performance of the Argus Universe of Coverage, which is approximately 500 companies. We started by excluding stocks that have not paid dividends over the past five years. This left us with approximately 370 companies. We then cut the list into four different tranches, distinguished by dividend growth over that five-year period.

The results were interesting (see our table). We found that the top two tranches -- which each averaged close to or higher than double-digit dividend growth -- delivered solid double-digit returns even though they did not have the highest average yields. Moreover, they had above-average cash-flow coverage ratios -- a key financial strength measure. Tranche 4 -- with the lowest dividend growth -- had the lowest returns, along with an above-average yield and a negative FCF coverage ratio, indicating that dividends from companies in this group may be at risk.

HISTORICAL RETURNS & DIVIDEND GROWTH FOR ARGUS UNIVERSE OF COVERAGE

	Avg Dividend Growth	Avg 5-Yr Return	Avg Yield	Avg FCF Coverage Ratio
Tranche 1	22%	19%	2.0%	3.6
Tranche 2	9%	16%	2.2%	3.3
Tranche 3	4%	9%	3.1%	1.8
Tranche 4	-15%	-6%	2.4%	-2.3

Turning Research into a Portfolio

Of course, a diversified portfolio is more than just a list of companies linked to a theme. And simply investing in the top two tranches from our study would be difficult, as the resulting portfolio would include more than 180 stocks.

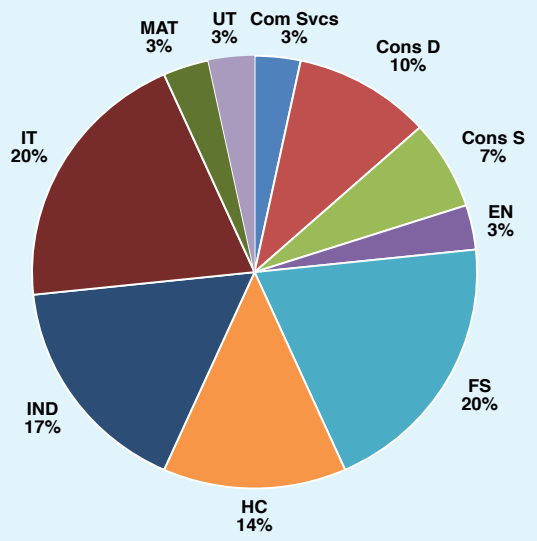
To build the Argus Dividend Growth Model Portfolio, we applied financial concepts such as industry diversification, income generation, risk reduction and growth at a reasonable price. Also, all stocks must be on the Argus BUY list.

The good news is that our double-digit dividend growth approach does not limit investors to just one or two sectors; we have broad sector representation and thus solid diversification. Our latest Argus Dividend Growth Model Portfolio includes representation in 10 of the 11 GICS sectors, with over-weights in Technology, Healthcare, Financial and Industrial.

On the metrics, we note that the portfolio is not a value portfolio -- the P/E ratio of 26 is higher than the average of 23 for companies in the S&P 500. But for the high price, we do expect strong growth. The average five-year dividend-growth rate for the stocks in the portfolio is 17%. Meanwhile, we have taken steps to reduce risk, including the industry diversification as well as a focus on large-cap stocks, as the average market cap for the stocks in the portfolio is $176 billion. We also generate income from this portfolio: the average yield is 1.9%. The average beta is 1.04.

Investors learned in 2008 that there are no more "buy 'em and forget 'em" securities. But if you own this diversified group of dividend growers, you likely can be confident you own companies whose finances are strong, whose boards are committed to shareholder return, and whose management teams have provided a confident signal about the company's near-term outlook through a record of double-digit dividend hikes.

SECTOR CHART



Dividend Growth Portfolio

SecurityName	Symbol	Sector	Price/ Share	Div Growth Rate %	Div Yield (%)	PriceTo Earnings	Beta	Mkt Cap (USD MIL)
COMCAST CORP-CLASS A	CMCSA	Communication Services	57	13	1.66	19	0.9	254,043
HOME DEPOT INC	HD	Consumer Discretionary	330	20	2.13	26	1.2	311,245
DR HORTON INC	DHI	Consumer Discretionary	101	21	0.90	10	1.3	30,416
STARBUCKS CORP	SBUX	Consumer Discretionary	116	19	1.62	38	1.1	125,194
COSTCO WHOLESALE CORP	COST	Consumer Staples	379	52	0.85	37	0.7	145,554
ESTEE LAUDER COMPANIES-CL A	EL	Consumer Staples	289	14	0.69	46	1.0	103,466
ENBRIDGE INC	ENB	Energy	39	11	7.10	18	0.9	73,467
ALLSTATE CORP	ALL	Financials	128	15	1.50	10	1.1	34,297
BLACKROCK INC	BLK	Financials	826	11	1.99	23	1.2	112,073
CITIZENS FINANCIAL GROUP	CFG	Financials	47	31	3.50	10	1.4	18,934
JPMORGAN CHASE & CO	JPM	Financials	153	16	2.32	12	1.1	473,411
PRUDENTIAL FINANCIAL INC	PRU	Financials	101	12	4.78	9	1.5	36,516
S&P GLOBAL INC	SPGI	Financials	394	16	0.80	32	1.0	83,610
ABBOTT LABORATORIES	ABT	Health Care	120	12	1.27	24	0.9	213,026
AMGEN INC	AMGN	Health Care	245	14	2.60	15	0.7	142,047
ELI LILLY & CO	LLY	Health Care	186	13	1.61	23	0.7	176,733
STRYKER CORP	SYK	Health Care	263	11	1.02	29	1.2	86,526
FASTENAL CO	FAST	Industrials	53	20	2.94	34	1.0	27,356
HONEYWELL INTERNATIONAL INC	HON	Industrials	223	10	1.70	28	1.2	148,079
ILLINOIS TOOL WORKS	ITW	Industrials	234	16	2.02	30	1.1	69,251
NORTHROP GRUMMAN CORP	NOC	Industrials	361	13	1.84	15	0.8	51,458
OLD DOMINION FREIGHT LINE	ODFL	Industrials	262	31	0.26	37	1.0	26,967
AUTOMATIC DATA PROCESSING	ADP	Information Technology	191	13	1.99	32	1.0	78,711
CORNING INC	GLW	Information Technology	45	13	2.13	22	1.2	31,751
MASTERCARD INC - A	MA	Information Technology	379	20	0.45	46	1.2	354,144
MICROSOFT CORP	MSFT	Information Technology	252	10	0.93	32	0.9	1,737,349
TEXAS INSTRUMENTS INC	TXN	Information Technology	179	22	2.11	26	0.9	162,431
INTUIT INC	INTU	Information Technology	411	15	0.59	48	1.1	104,410
SHERWIN-WILLIAMS CO/THE	SHW	Materials	278	15	0.76	30	1.0	63,004
WEC ENERGY GROUP INC	WEC	Utilities	98	13	2.85	24	1.0	28,017
AVERAGE				**17**	**1.90**	**26**	**1.0**	**176,783**

Company Highlights from the Dividend Growth Model Portfolio

Abbott

Abbott Laboratories (ABT): This Healthcare company's yield of 1.5% is in the sweet spot for the portfolio; management has increased the annual payout for 49 consecutive years.

Allstate

Allstate Corp. (ALL): This is a new addition to the Trust. In February, the company raised its dividend 50%. The current yield is 2.5%.

AMGEN

Amgen Inc. (AMGN): This is a new addition to the Trust. In December 2020, the company raised its dividend 10%. The current yield is 2.9%.

Automatic Data Processing Inc. (ADP): This Technology company has increased its dividend for 47 consecutive years. The current yield is 1.9%.

COSTCO WHOLESALE

Costco Wholesale Corp. (COST): This retail company's yield may be low at 0.8% -- but management's five-year track record of dividend growth is 52% and average annual returns over the past five years have been 19%.

D·R·HORTON America's Builder

D.R. Horton Inc. (DHI): This is a new addition to the Trust. In November 2020, the company raised its dividend 14%. The current yield is 0.8%.

ENBRIDGE

Enbridge Inc. (ENB): Many Energy companies have been reducing or eliminating dividends. Not Enbridge. The company has grown its dividend at a CAGR of 10% over the past five years. The current yield is a rich 6.8% -- the highest in the Trust.

Home Depot Inc. (HD): In February, HD again boosted its payout 10%. The current yield on this blue chip home-improvement retailer is an above-market 2.0%, signaling value.

ITW Illinois Tool Works Inc.

Illinois Tool Works Inc. (ITW): ITW has increased its dividend for 50 consecutive years. The current yield is 1.9%.

Microsoft

Microsoft Corp. (MSFT): More and more Technology companies are paying dividends. Software giant Microsoft has grown its dividend each year for the past 17 years.

NORTHROP GRUMMAN

Northrop Grumman Corp. (NOC): This is a new addition to the Trust. In May 2020, the company boosted the payout by 10%. The current yield is 1.6%.

S&P Global

S&P Global Inc. (SPGI): This Financial Services company has increased its dividend for 48 consecutive years. The current yield is 0.8%.

SHERWIN WILLIAMS

Sherwin-Williams Co. (SHW): Sherwin Williams has increased its dividend for 42 consecutive years. In February, the company raised the dividend 23%.