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Decoding Dividend Funds: Balancing Trade-offs for an Income Portfolio

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With bond yields rising dramatically since early 2022, investors have been piling into money market funds and short-term Treasury Bills to get a risk-free return of more than 5%. Although there's one problem with sitting on cash – no capital growth. As highlighted in our recent blog on cash reinvestment, short-term securities have insufficient inflation-adjusted return to meet most long-term investment goals. The growth of equity dividends over time remains important in the current environment. A well-diversified multi-asset income portfolio, combining both bond income and equity dividends, can more effectively achieve both the current and long-term income objectives for income-seeking investors.

However, with more than 150 dividend-oriented ETFs currently available for US investors, selecting the right ones for the portfolio isn't straightforward. While investors in passive large-cap stock ETFs tend to have similar experiences, income investors can encounter substantial differences in dividend yields, total returns, and expenses among various funds. The table below reveals significant variations across the 10 largest dividend ETFs, with year-to-date and annual returns showing double-digit differences, dividend yields ranging from 1 to 3 times that of the S&P 500, and expense ratios spanning from 6 to 70 basis points.

Top 10 Dividend ETFs by AUM

ETF Name	12M Div Yld	1 Yr Return	3 Yr Return	5 Yr Return	Expense Ratio
Vanguard Dividend Appreciation ETF	1.96	8.33	7.43	10.92	0.06%
Vanguard High Dividend Yield ETF	3.21	-1.64	9.27	7.85	0.06%
Schwab US Dividend Equity ETF	3.7	-4.03	8.38	10.67	0.06%
iShares Core Dividend Growth ETF	2.52	2.79	7.93	9.98	0.08%
SPDR S&P Dividend ETF	2.74	-5.68	7.03	7.02	0.35%
iShares Select Dividend ETF	3.96	-6.6	9.77	6.34	0.38%
ProShares S&P 500 Dividend Aristocrats ETF	2.17	-0.69	6.46	8.96	0.35%
First Trust Value Line Dividend Index Fund	2.42	-0.57	5.68	6.66	0.70%
WisdomTree U.S. Quality Dividend Growth	1.71	11.56	10.55	12.27	0.28%
iShares Core High Dividend ETF	4.18	-4.06	8.2	5.51	0.08%
SPDR S&P 500 ETF	*1.45*	*15.37*	*9.43*	*12.55*	*0.09%*

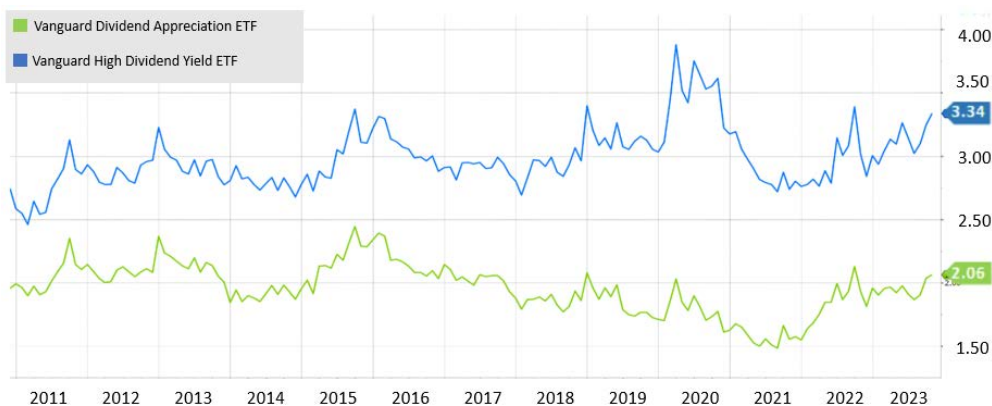
Source: Bloomberg as of 11/14/2023. The 10 largest dividend-oriented ETFs are selected, with the S&P 500 ETF included in the last row as a reference. The 12-month dividend yield and return are expressed as percentages. PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS.

Standard ETF due diligence, the initial step in portfolio construction, involves reviewing investable universe, index representation, total cost of ownership, liquidity, and tracking error. These also apply to dividend ETFs. But there's an added layer with dividend ETFs: we look at the level and consistency of the dividends they offer and weigh the balance between risk and income. To do this right, we need to fully understand their specific objectives and methodologies.

Starting from the fund objective: High-Dividend vs. Dividend-Growth

Choosing the right dividend fund starts with assessing its alignment with your income objectives. Dividend funds commonly focus on either capturing high dividend yields, dividend growth, or a blend of both. High dividend funds typically select high-yielding stocks based on trailing or recent dividends, whereas dividend growth funds typically restrict themselves to companies with a long history of increasing dividends. Consequently, dividend growth funds often have fewer holdings, more tracking error and lower yields. The reduced yield is illustrated below—over the past 13 years, Vanguard's US high dividend fund has consistently yielded approximately 1% more than their dividend appreciation fund. In general, dividend growth funds are unlikely to be sufficient for investors seeking immediate high income.

12-Month Dividend Yield (%) from 2010-2023



Source: Bloomberg from 10/31/2010 to 10/31/2023.

How to select the underlying stocks: Fundamentals-based Screens vs. Naïve Dividend Selection

The methodology used to choose the underlying stocks plays a critical role in shaping the risk-return and yield characteristics of the fund. Some dividend funds employ fundamental screens, considering factors like dividend consistency, profitability, and quality when choosing companies capable of maintaining consistent dividend payments. This strategy seeks to mitigate the risk associated with financially unstable firms that could lead to a "yield trap." However, excessive screenings and arbitrary rules can muddy the process, tilting the fund towards factors such as quality and diluting the essence of dividend investments.

In contrast, some dividend funds have a more straightforward approach by choosing stocks solely based on dividend yields. While this approach is easy to grasp, it may lead to greater volatility in the fund's composition and risk-return characteristics due to the yield bias and high turnover. Such volatility may be further intensified by temporary fluctuations in yields that arise from idiosyncratic risks, such as financially stressed companies or systematic risks during market downturns. For instance, throughout the 2008 financial crisis and the 2020 Covid outbreak, certain companies saw their yields increase sharply as their share prices fell, a rise unsupported by solid fundamentals, proving to be unsustainable.

Nuances of weighting the selected stocks: Market-cap Weighted vs. Equal Weighted vs. Dividend Weighted

In contrast to the straightforward market-cap-weighted approach of broad equity market funds like the S&P 500 ETF, dividend funds have more nuanced weighting methods, including cap-weighted, equal-weighted, and dividend-weighted strategies.

Intuitively, dividend funds that simply screen desirable dividend paying stocks then use market-cap weighting should be more influenced by large-cap stocks and therefore behave more in line with broad equity markets compared to the alternative approaches. A dividend yield-weighted fund that tilts to higher-yielding stocks naturally yields higher dividends than a cap-weighted fund with the same basket of stocks.

During periods when the dividend factor outperforms the broader market, dividend-weighted funds tend to deliver superior performance. Conversely, when large-cap stocks lead the market, cap-weighted funds are likely to outperform both dividend-weighted and equal-weighted funds.

Each weighting methodology results in different risk-return characteristics for dividend funds. There is no one-size-fits-all approach, and no single winner across various market conditions. Once the characteristics of the funds are correctly understood, a statistical approach should be applied to estimate risk-return and optimize a diversified income portfolio for a reliable investment experience.

Conclusion:

Dividend funds are constructed with trade-offs in mind: balancing dividend consistency against current high dividends, seeking higher dividend yields with more tracking error versus aligning more closely with broad markets while yielding less. More screening criteria could obscure the income purpose, while focusing only on dividends could bring in more unintended volatility. There won't be a single winner. Selecting the right funds is the first step to building a well-diversified income portfolio to help navigate varying market conditions and achieve long-term income objectives.

Learn more about Income Investing with New Frontier.

Disclosures: Past performance does not guarantee future results. As market conditions fluctuate, the investment return and principal value of any investment will change. Diversification may not protect against market risk. There are risks involved with investing, including possible loss of principal. The indices are not investable securities. Any investable security would have performance reduced by fees and expenses. Any distribution must comply with your firm's guidelines and applicable rules and regulations, including Rule 206(4)-1 under the Investment Advisers Act of 1940.