DIVIDEND INVESTING PRIMER

INVESTING CONSIDERATIONS

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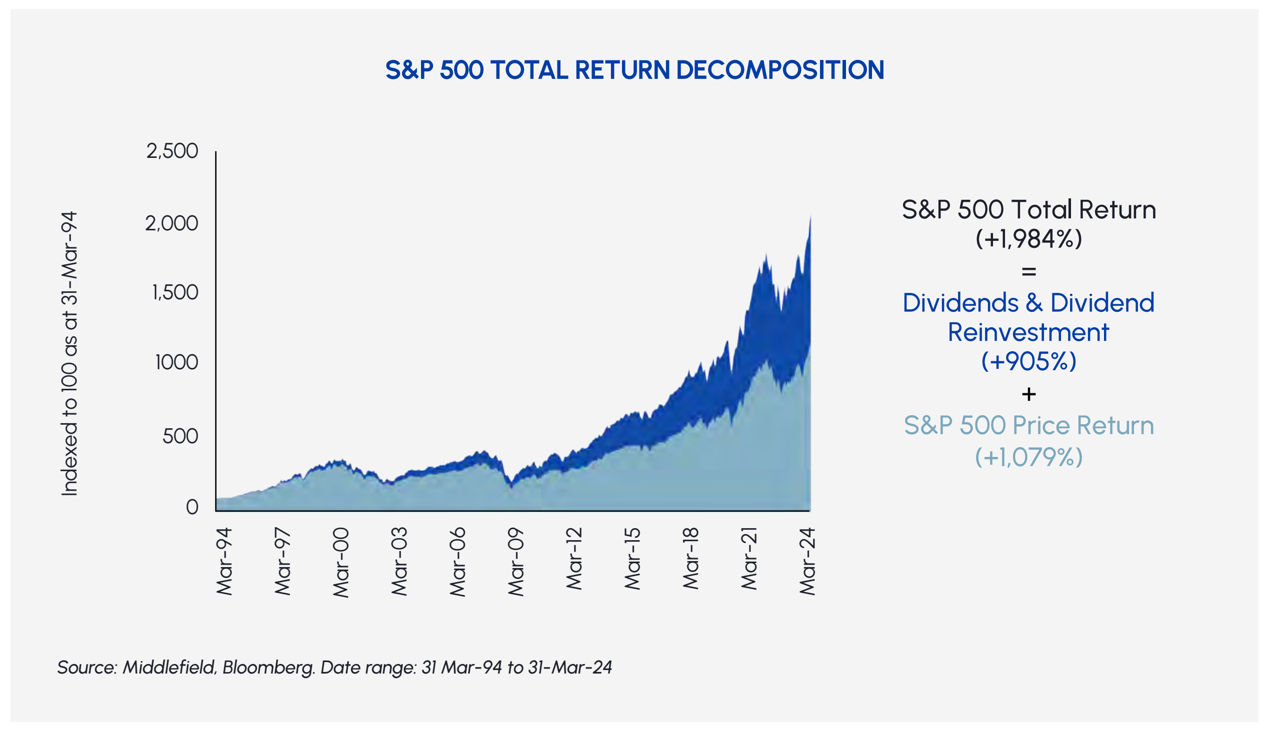
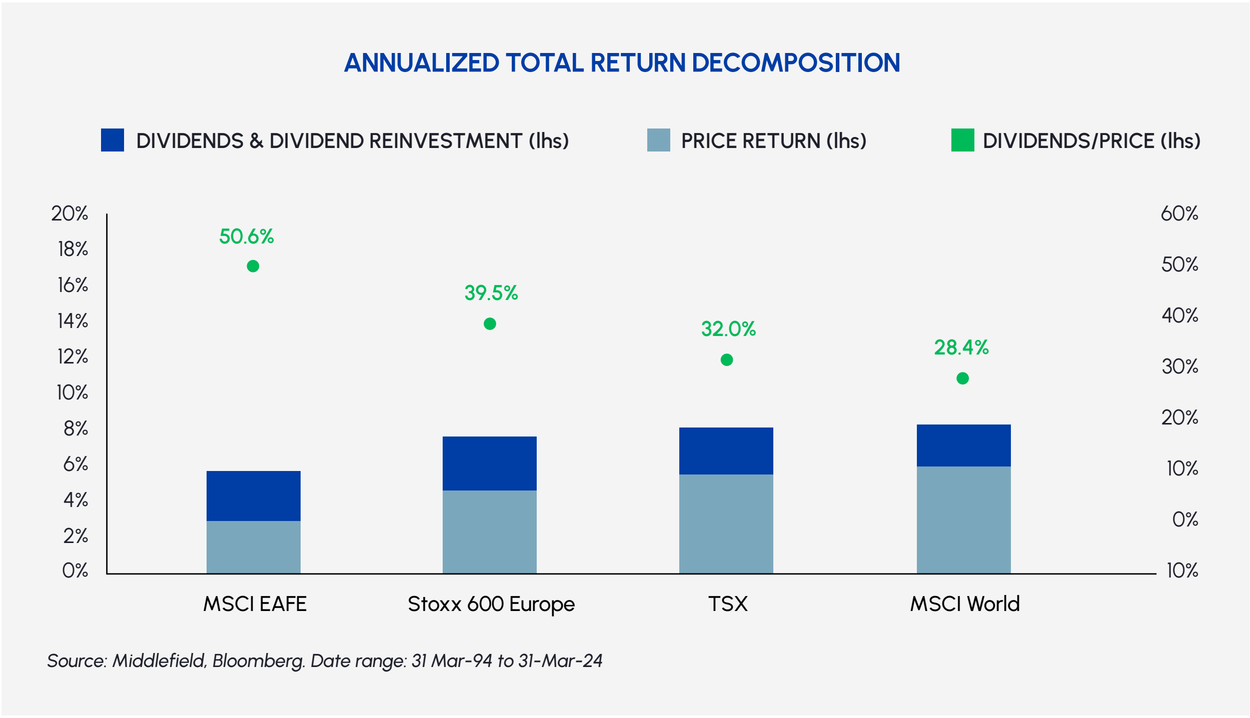
Why Own Dividend Stocks?

Dividends Are A Critical Component Of Total Returns

Dividend investing is an important strategy that can help investors reach their long-term goals. Dividend-paying stocks provide a steady stream of income, which can be particularly attractive for investors looking for regular cash flow. Further, by reinvesting the total return from dividend income streams, investors can achieve compound growth.

The chart below breaks down the total return of the S&P 500 from March 31, 1994, to March 31, 2024, into two components. Of the aggregate total return of +1,481%, +700% (or 47%) came from dividends and dividend reinvestment with the remaining +781% (or 53%) attributable to price appreciation. As a result, it follows that patient investors significantly benefit from the power of compounding by investing in companies that pay and grow their dividends over time.





Source: Middlefield, Bloomberg. Date range: 31 Mar-94 to 31-Mar-24

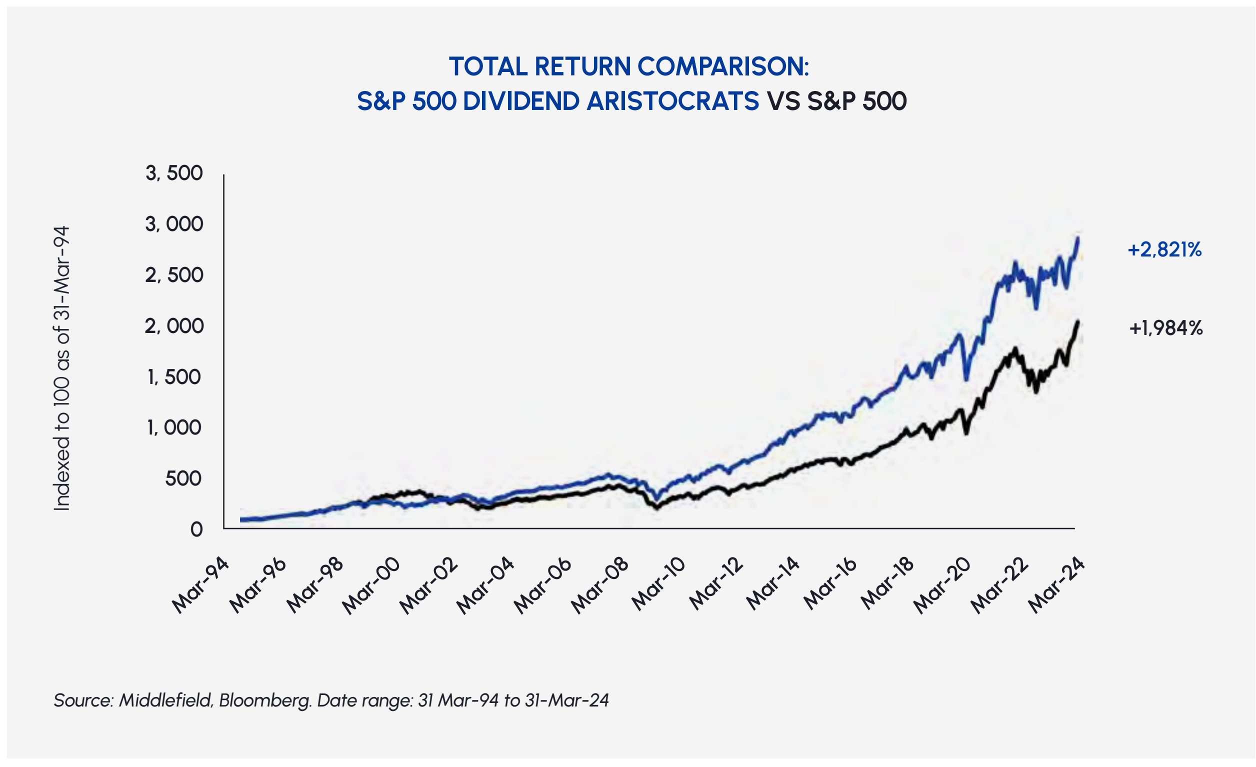
Dividends are also a good hedge against inflation. More specifically, high-quality companies can often raise prices to protect cash flows from inflation and, as a result, support their payout ratios and dividend payments through various market cycles. This is one reason why dividends accounted for a higher percentage of total returns (>50% versus 47% in the aforementioned study) during inflationary decades such as the 1940s, 1970s and 1980s, and why dividends remain an important source of competitive shareholder returns over the long term. In contrast, other yield alternatives, such as fixed income, can see their returns dramatically impaired during periods of high inflation.

Dividends also provide tax efficiency. Both the provincial and federal governments provide a non-refundable dividend tax credit applied to dividend income, which can help lower taxes. In comparison, there are no tax credits for interest income, like GICs or bonds.

Further, companies that consistently pay dividends often have stable business models and reliable earnings. These are typically mature companies with a history of generating profits, which can provide stability to an investment portfolio, especially during periods of volatility and market downturns.

Historical Performance: Dividend Growers Have Outperformed Over The Long Run

We cannot underestimate the importance of owning equities that pay regular and growing dividends. The following graph shows that dividend growers have significantly outperformed the broader market over the last 30 years.



Source: Middlefield, Bloomberg. Date range: 31 Mar-94 to 31-Mar-24

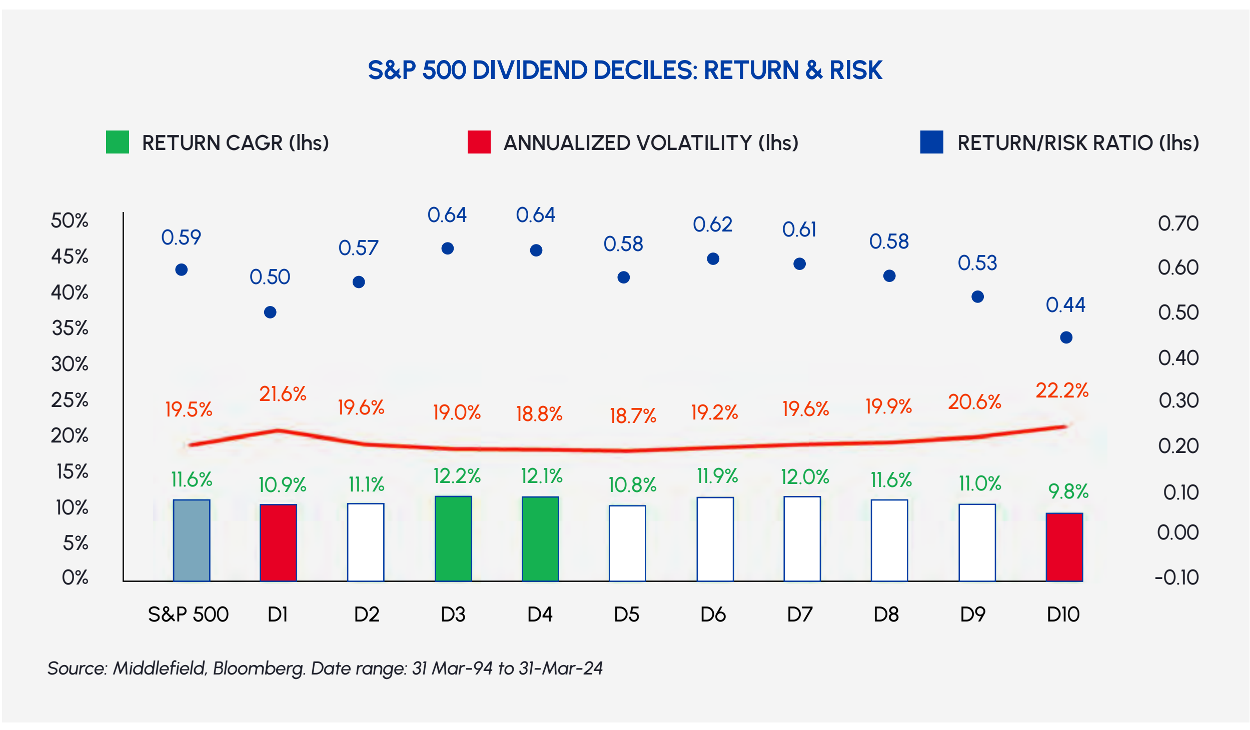
A major reason behind this outperformance is that dividend growers are committed to capital discipline. Companies that pay and grow dividends over time need to be profitable and generate excess amounts of cash flow. In addition, management teams that are committed to paying and growing dividends are highly focused on selecting capital expenditure projects, which will create value for shareholders (i.e., generate returns in excess of the cost of capital) while sustainably growing cash flows in order to support dividend growth.

Owning dividend-paying companies can serve to dampen investment risk since these companies are often mature businesses with more predictable earnings. The stability in earnings is reflected in a sustainable dividend stream, which can serve to offset the volatility in a company's stock price. In addition, historical research proves that dividend growers and initiators exhibit significantly less volatility than companies that do not pay dividends, and especially so for those that cut or eliminate dividends. That's because the income from dividends provides a cushion during market downturns.

Do Not Chase Yield

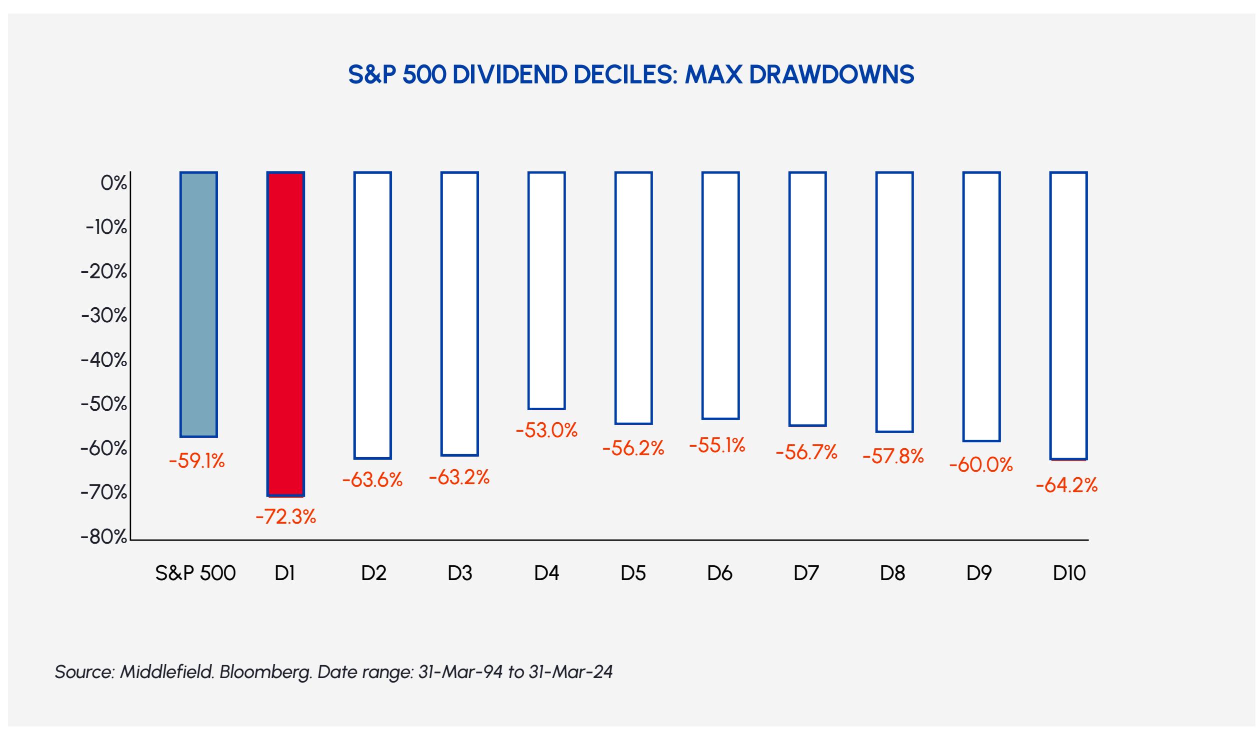
Value traps are investments that appear undervalued but are actually in financial distress or, for a variety of reasons, may never trade at their expected value. Many of these companies have high dividend yields that are eventually proven to be unsustainable. Value traps are dangerous for investors because their stock prices may decline further, which can often provide management with a reason to cut or eliminate dividends.

In the graph below, we analyze the S&P 500 for the 30 years ending March 31, 2024, broken down into 10 deciles based on dividend yield. Specifically, D1 (the first decile) represents those constituents with the highest dividend yields, while D10 (the 10th decile) includes those with the lowest dividend yields. The bottom line is that the stocks with the highest yields reflect a below-index return (see the S&P 500's stats on the left-hand side) with much higher risk. Further, D1 also has the third worst reward-to-risk ratio. Interestingly, the best reward to risk is generated by D3 and D4. In other words, investors must exercise real diligence and scrutiny to identify companies that pay high dividends, which are supported by superior fundamentals.



Source: Middlefield, Bloomberg. Date range: 31 Mar-94 to 31-Mar-24

We can draw similar conclusions by examining the drawdown stats from the same 30-year study. Again, purchasing the stocks with the highest yields, D1, would have resulted in a -72.3% drawdown — the worst of all the deciles and more than 13% below the S&P 500's over the period. The lesson here is plain and simple: Investors should not blindly chase yield.

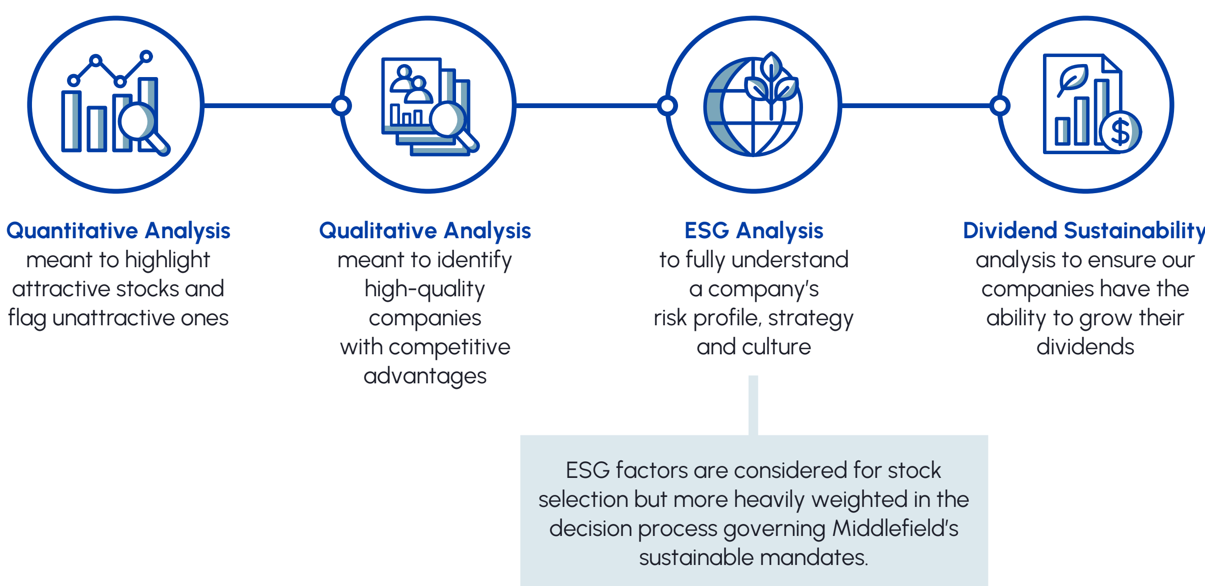


Source: Middlefield. Bloomberg. Date range: 31-Mar-94 to 31-Mar-24

Dividends Done Differently

At Middlefield, we are focused on expertly selecting companies that meet our investment criteria. In light of our focus on businesses that generate consistent and growing levels of cash flow and dividends, we gravitate to larger capitalization, higher quality issuers led by proven management teams. These are typically global businesses that earn uninterrupted levels of income for investors. This process helps us to avoid chasing yield and falling into value traps.

Our multi-disciplinary investment process for identifying superior dividend-paying stocks is as follows:



Quantitative Analysis – This investment framework involves the use of various models and screens to identify attractive vs. unattractive companies. For example, we use multifactor models to identify the leading and lagging companies within each sector in the S&P 500 and TSX. This helps to complement our qualitative analysis.

Qualitative Analysis – This process mainly focuses on identifying companies with sustainable competitive advantages that allow for continued revenue, earnings and free cash flow growth. Sources of competitive advantage come from three broad categories: Production advantages, consumer advantages and external factors.

- Production advantages include complexity and protection. Complexity could relate to a machine that is only produced by one company in the world, while protection may come from having various patents protecting a firm's process.

- Production advantages may also come from supply-side advantages (i.e. economies of scale), such as having the best distribution network or most efficient R&D program in a certain industry.

- Consumer advantages include switching costs & customer lock-in, as well as network effects. Both of these could come from having interconnected products and services that not only make it harder for consumers to leave, but also improve the user experience as more people join the ecosystem.

- External factors represent the last source of competitive advantage. These are often related to government intervention. For example, one company may enjoy outsized benefits from subsidies, while another suffers more than peers due to targeted regulation.

- Other factors that we consider important are management's skill in running the business, as well as determining what stage of the competitive life cycle a company is in (e.g. innovation or mature).

ESG Analysis – This multi-faceted process involves integration (alongside our fundamental, quantitative and qualitative research), scoring (using data from several reputable third-party data providers), negative screening and positive screening. In doing so, we review public disclosures, conduct research on ESG policies & practices, obtain third-party research on companies, engage with companies, monitor shareholder meetings and vote proxies according to our ESG guidelines.

Please see our full ESG policy **here**.

Dividend Sustainability Analysis – After determining whether or not a company has a competitive advantage, as equity income investors, we also need to ascertain the sustainability of its dividend policy. This involves careful analysis of a company's cash flow profile, dividend payout ratio and balance sheet strength. The ideal company would generate sufficient cash flow to cover its operations & growth initiatives, while having enough cash to comfortably cover its dividends. A red flag would occur when a company uses debt financing to cover its dividend payout obligation over an extended period.

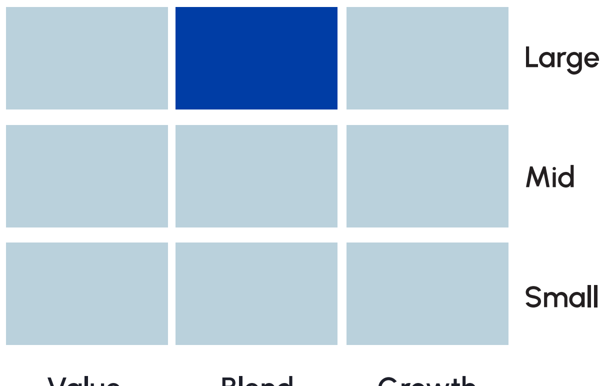
We firmly believe these are necessary steps for dividend investors who want to maximize their chances of positive outcomes, while also reducing the likelihood of adverse ones.

Middlefield Diversified Dividend-Focused Strategies

Solutions Overview

Strategy	Fund Structure	Ticker / Fund Code	Investment Focus	Risk Rating
MIDDLEFIELD INCOME PLUS CLASS	MUTUAL FUND	MID 800 | 801	Global Dividend	Medium
MIDDLEFIELD SUSTAINABLE GLOBAL DIVIDEND ETF	ETF	MDIV	Global Dividend	Medium
MIDDLEFIELD GLOBAL DIVIDEND GROWERS CLASS	MUTUAL FUND	MID 181 | 182	Global Dividend	Medium

Equity Characteristics



Income

All Middlefield dividend funds provide investors with significant levels of monthly income and attractive capital appreciation potential.

Holdings

Middlefield's dividend strategies are actively managed portfolios holding approximately 25 to 40 names with an emphasis on large-cap companies with leading market positions that have the ability to pay and grow their dividends over time.

Investment Processes

Guiding Principles

- Superior security selection is the best way to consistently achieve alpha
- Investment team collaboration, talent and process discipline is necessary for long-term success
- Risk controls govern portfolio construction and ongoing monitoring

Investment Principles

- Focus on companies with strong business models and sustainable advantages over competitors
- Leading businesses take market share and are exposed to end-market growth
- Execution based on reasonable valuation in the context of the long-term outlook (GARP tilt)
- Great management teams are governed appropriately, operate in a sustainable/socially responsible matter and make ethical strategic decisions through a long-term lens

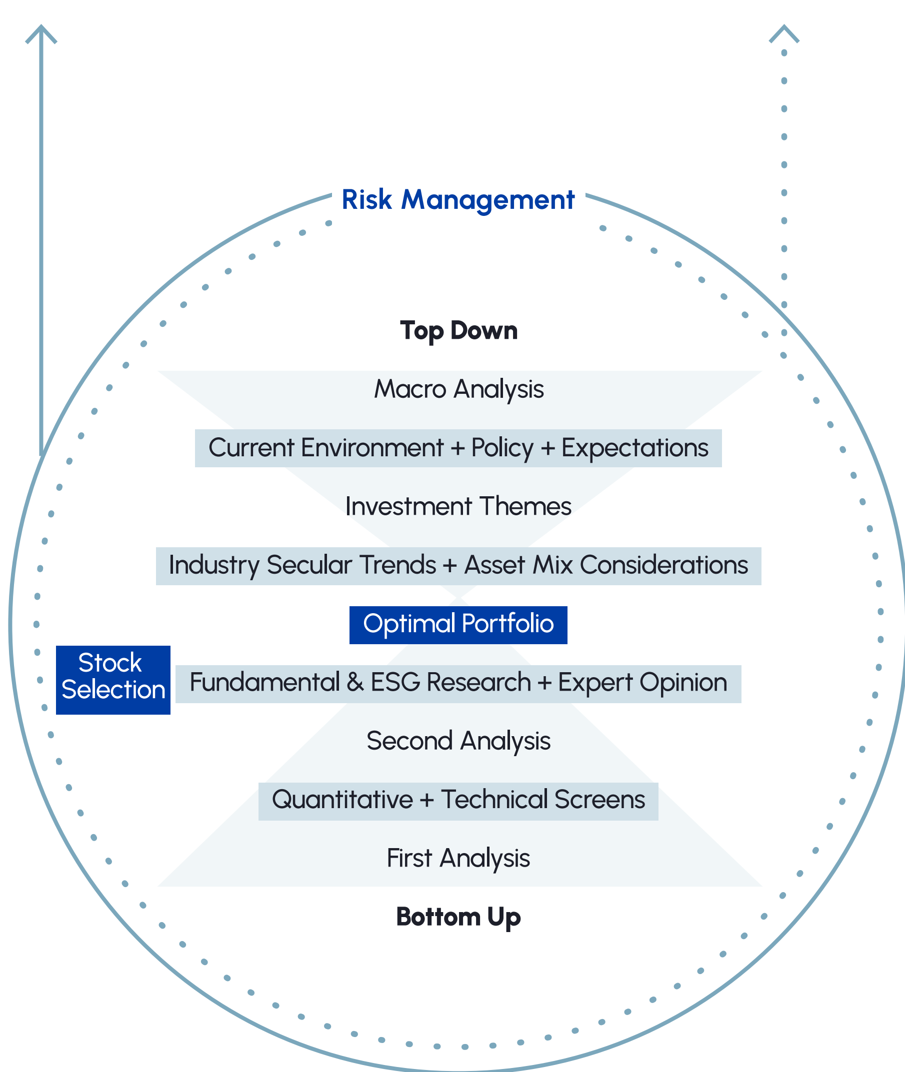
Portfolio Risk Oversight

Construction Discipline

- Optimize allocations for ideal portfolio-level stats
- Scenario analysis and stress testing
- Investment policy to control security

Ongoing Active Management

- Investment committee and CIO/CCO oversight
- Real-time monitoring of portfolio risk and return
- Continuous attribution analysis



Global Dividends: Areas We Like

Strong fundamentals are driving opportunities in the following industries:

Global Brands

Large companies in select industries where a handful of globally recognized brands produce essential products & create ecosystems that consumers regularly use and rely on. These brands will continue to have pricing power, allowing them to pay and grow dividends.

Healthcare

Leading edge businesses that generate consistent cashflows by selling needs-based drugs, treatments and technologies to developing and wealthy end-markets. Larger companies in this space have branched out to provide more than just pharmaceuticals or biopharma. This innovative growth is providing shareholder returns, as well as growing dividends.

Energy Infrastructure

Companies supporting the multi-decade transition toward sustainable energy by integrating cleaner technologies into essential, long-life infrastructure assets, such as pipelines and storage facilities. These stable businesses will continue to experience long-term growth through innovation.

Real Estate

Balance between stable assets generating high-levels of tax-efficient cash flow and selective exposure to properties with high-growth potential due to secular trends such as urbanization, e-commerce adoption, immigration and supply/land scarcity. Retail and apartment owners that lease properties continue to experience solid fundamentals as rent increases will allow for growth. Meanwhile, industrial continues to experience good occupancy, supported by immigration and the need for these facilities in urban areas. Fund flows that have left real estate will come back as interest rates continue to decline.

Technology

Mature businesses that directly or indirectly support the world's next great transformational technologies such as AI, genomics, cybersecurity, cloud, 5G, self-driving cars and more. Exponential growth in innovation will lead this sector through the next decade and beyond, creating a larger bullpen of dividend payers and growers.

Financials

Stable companies ranging from banks, insurers, mortgage lenders and REITs are based on strong fundamentals and long-standing growth. IPOs and M&As will dominate this sector, providing exposure to additional markets, and creating an environment for continued dividend growth.

Global Dividends: Regions We Like

Opportunities Abound Across Various Regions

Canada

As the market broadens, Canada will see continued growth in energy, financials and real estate. Valuations in these sectors tend to be cheaper compared to other regions.

The U.S.

Offering low costs for business owners, the U.S. is geographically the most business friendly. Further, the region is supported by dynamics, including a larger population, capitalistic opportunities and diversification. Healthcare and technology are expected to outperform in this region.

Japan

On the cusp of a renaissance, Japan is now offering shareholder-friendly actions, like dividend increases, share buybacks and management restructuring.

Europe

Various countries in Europe are backed by strong fundamentals and growth. The key is to watch for volatility due to geopolitical risks or market factors. However, there is opportunity to under- or overweight certain areas.

3 Trends Impacting the Macro Outlook

Dividend investing will continue to be a key strategy to diversify portfolios, hedge against inflation and help investors meet long-term goals. And as the economy returns to a new normal, the Canadian market is forecast to grow its regular base dividend payouts. The average year-over-year increase is 6%, according to S&P Global Market Intelligence.

It's important to note three key trends impacting dividends going forward:

1. Broadening Market

Over the last decade, fund flows went into high-growth industries that didn't provide dividends, and investors were rewarded with returns. However, the macro outlook has now changed as rates have risen drastically, causing volatility in those sectors. Funds are now flowing out of those sectors and back into dividend growers and payers, like financials, healthcare, infrastructure and real estate.

2. Interest Rate Decreases

Another impact of rising rates has been more funds flowing into GICs and bonds, which investors considered safer investments since they were guaranteed an income stream. That's now changing as interest rates are expected to begin declining at a measured pace as inflation targets are met. This will make bonds and GICs less attractive, and push investors back into dividends that provide higher returns.

3. Declining Recession Fears

Following a few smaller sector-related recessions, like that of technology in 2022 and banking in 2023, the economy is likely in for a soft landing. Investors are no longer fearing a national recession. The GDP is expected to remain resilient and steady, growing annually at 2% or 3% moving forward. This makes dividend investing attractive as investors get back to the old normal.

Sector Breakdown

The macro outlook for all dividend sectors is strong. Banks and energy will continue to lead, paying out more than 50% of total Canadian aggregated dividends, according to S&P Global Market Intelligence.

Banks will likely offer a 5% increase in payouts, noted S&P Global Market Intelligence. Middlefield is positive on financials, including big banks, which have exposure to capital markets, mergers and investment banking. These companies pay growing dividends, so it's a sector Middlefield is allocating more money to.

The energy sector is expected to grow 8% compared to 2023, according to S&P Global Market Intelligence. Canada is on the cusp of an energy transition, according to Middlefield, which is more than simply moving toward renewables. There is also a movement toward natural gas and solar power. Additional infrastructure needs to be built to meet the power and demographic demands as more companies move to onshoring following the Covid-19 pandemic. Items such as semiconductors will be made in North America, so Canada no longer has to rely on shipping from overseas. This has created a large infrastructure spend for utilities, which in turn will create opportunities for investors.

Meanwhile, retail will remain attractive and offer 10% growth, according to S&P Global Market Intelligence. Middlefield is positive on retail real estate, including companies like RioCan, which is anchored by grocery stores. That's because these companies are fully occupied and providing positive cash flows as they push through rent increases.

Another positive sector within real estate is apartments, which also enjoy full occupancy rates due to an increase in immigration, as well as pricing power. Most Canadians are under rent control, so landlords can only raise rent a certain amount unless a tenant is new. So many renters are staying and paying their bills because if they move, they could face higher rental rates.

Looking to industrial real estate, Middlefield is seeing very good occupancy as businesses continue to grow and immigration increases. The need for industrial space is especially high near urban centres like Vancouver, Montreal and Toronto, where companies like FedEx and Amazon are prevalent.

Technology is another sector that will experience growth as a result of innovation. The need for cloud computing and high-powered storage through the cloud, new apps that will launch in the coming years, and improved artificial intelligence tools provide an avenue of growth for tech companies. New companies will sprout and investors will have more investment choices, so Middlefield is positive on technology. While before there may have only been four or five dividend-paying tech companies, there will now be 10, 15, or 20 to choose from. This booming growth will benefit investors.

Risks To Watch

There are several red flags for investors to be wary of. The biggest is chasing high yield that might not correlate with the best return. An 8% yield, of course, looks more attractive than a 2% yield, but there could be reasons why. Perhaps the sector is out of favour at the moment, or there's an issue with the balance sheet, for instance. Dividends have to be declared every quarter by the company's board, so they're not guaranteed. The key is to look under the hood and research the company.

One way to do that is to review the company's annual financials. There will be a section on payout ratios. Look at what the dividend per share is on the company and compare it to the earnings per share. The payout ratio (which is the dividend per share divided by the earnings per share) should be under 60% to 70%. For instance, if the dividend per share is one dollar, the earnings per share should be at least $1.40.

Also, look at how much debt the company has, which can differ depending on the industry and how stable cash flows are. Generally, look for companies without high debt-to-equity ratios.

Another risk is investing only in one sector or region. If an investor wants a basket of dividend payers, ensure those companies aren't concentrated in only Canadian banks, for instance. That's because if Canadian banks decline, the investor's portfolio is at risk. Diversification in a variety of sectors and regions is important.

Also, beware of interest rate risk. If rates rise, there may be more sellers than buyers as investors switch to more guaranteed investments, like GICs or bonds. This can cause a stock to decline, which means decreased dividends. So, even if the fundamentals are fine, interest rate risk impacts dividends, further making a case for diversification.

Overall, with solid long-term macro fundamentals, investors can expect dividend payouts to increase across most sectors and regions as inflationary pressures decrease and growth returns to normal.

Tips When Investing

As the economic fundamentals continue to support dividend growth and opportunities, investors can look to various sectors to reach long-term goals. Here are some tips when investing in dividends.

Focus On Dividend Growers

These companies are confident they can grow over time, and have excess free cash flow after they reinvest in the business. Pay attention to companies like this that tend to outperform dividend and non-dividend payers.

Don't Chase Yield

Companies with high yield tend to be unsustainable over the long term. Instead, look for companies that provide steady yield in growing sectors.

Assess Company Financials

Be sure to look at the company's dividend per share and compare it to the earnings per share. The dividends paid divided by earnings is the payout ratio, which is an important metric to evaluate whether a company can sustain its dividend payments. Ensure the payout ratio is less than 60% or 70%.

Pay Attention To Dividend Cuts

Review company announcements and pay attention to signs the company may be cutting dividends, which could be a red flag that the company is in trouble.

Avoid Overconcentration

Diversification is key when it comes to dividends. Don't concentrate all your holdings in one sector or region. Ensure you are balancing dividend investments in various types of companies and locations.

Reinvest Dividends

Consider reinvesting dividends through a dividend reinvestment plan (DRIP) or manually into the same stock or other investments. Reinvesting can accelerate the growth of your investment over time through the power of compounding.

Look For Stable Companies

Focus on companies with a history of stable earnings and dividend payments. Companies with strong fundamentals, consistent cash flow, and a history of increasing dividends over time can usually withstand market fluctuations.

Understand The Tax Implications

Each region has different tax implications, so make sure you talk to your accountant and understand how that will impact your income at tax time.

Stay Informed

Watch for any developments related to the companies in your dividend portfolio, as well as broader economic and market trends that could impact those stocks.

Monitor Interest Rates

Changes in rates can impact the attractiveness of dividend-paying stocks relative to other income investments, like bonds or GICs. Generally, when interest rates rise, dividend yields may become less attractive, potentially impacting stock prices.

Invest For The Long Term

Investing in dividends is often best suited for investors with a long-term perspective. These investors can take advantage of reinvesting dividend income and be rewarded through compound growth. Focus on the underlying strength of the companies you're investing in and their ability to generate sustainable returns over time.

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