Bahl&Gaynor
Dividends Pay Dividends®

Capping Risk Redux

THE VALUE OF DIVIDEND GROWTH INVESTING IN A GROWTH-DOMINATED LANDSCAPE

In December 2023, Bahl & Gaynor published the first version of this white paper which highlighted:

- Narrowness of S&P 500 returns in 2023 and the need to manage this risk amid this backdrop.
- Even an allocation to an equal-weighted S&P 500 index does little to alter the risk profile of a portfolio versus a cap-weighted index.
- The value a dividend approach can provide in terms of managing portfolio risk while providing income and income growth potential.

This redux examines portfolio risk management in another context: *the recent dominance of the growth style across major indexes*. Viewed through a risk management lens, Bahl & Gaynor continues to view the application of a dividend strategy as highly complementary to the preponderance of large cap growth style exposure among advisor client portfolios.

Executive Summary

- Though S&P 500 index concentration reflects the dominance of the growth style over the last decade, the Russell 1000 Growth index puts this trend in even starker contrast, with significant holdings concentration that could reasonably reflect similar position concentration across active growth managers utilizing the Russell 1000 Growth index as a benchmark.
- Concentration within the Russell 1000 Growth index has driven impressive returns over time periods stretching back as far as 15 years, but these returns have been delivered with observably higher risk and volatility profiles, even versus the S&P 500 index, which is affected by its own growth style concentration dynamics.
- Investors seeking a strong total return profile also need to consider the risk taken in capturing these returns and the potential benefits of managing or constraining risk to preserve gains, diversify future return sources, and combat recency bias.
- A subset of S&P 500 index constituents possessing a dividend yield greater than 2% (heretofore referred to as the Dividend Screen[1]), when blended with the Russell 1000 Growth index, registers compelling return and risk outcomes, with the added utility of income generation and income growth potential.
- If many investors are risk averse, structuring portfolios to manage drawdown risk can potentially provide both behavioral and wealth preservation utility.
- Bahl & Gaynor's dividend growth approach can potentially serve the purpose of constraining blended portfolio risk and offering income and income growth utility, which can allow investors to own highly complementary assets that may carry higher return potential, but also possess higher risk and volatility profiles.

Large Cap Equity Index Concentrations

If an investor formed a portfolio based on the constituent weightings of either the S&P 500 or Russell 1000 Growth indexes (shown below), they would have significant difficulty marketing it as a "diversified fund" under the 1940 Investment Company Act. Indeed, even many sophisticated institutional investors utilizing either index as a benchmark may be faced with the limitations of traditional investment policy language limiting investment in a single security to no more than 5% or 10% of portfolio principal.

Large Cap Equity Index Concentration Summary			
S&P 500 Index		Russell 1000 Growth Index	
Company	*Weight*	*Company*	*Weight*
Apple (AAPL)	7.03%	Apple (AAPL)	11.98%
Microsoft (MSFT)	6.98%	Microsoft (MSFT)	11.81%
Alphabet (GOOG/L)	3.82%	Alphabet (GOOG/L)	6.49%
Amazon (AMZN)	3.45%	Amazon (AMZN)	5.77%
NVIDIA (NVDA)	3.06%	NVIDIA (NVDA)	4.96%
Meta Platforms (META)	1.96%	Meta Platforms (META)	3.30%
Tesla (TSLA)	1.72%	Tesla (TSLA)	2.89%
Berkshire H. (BRK/B)	1.62%	Eli Lilly (LLY)	2.08%
JPMorgan (JPM)	1.23%	Broadcom (AVGO)	2.03%
Broadcom (AVGO)	1.22%	Visa (V)	1.75%
Total	32.09%	Total	53.06%

Source: Bahl & Gaynor and Factset, 2023. All periods as of 12/31/2023.

To the extent that active managers across investment styles tend to benchmark themselves to broadly known indexes, it would not be unsurprising to find that many active growth style managers could carry even more significant concentrations than the Russell 1000 Growth index, in an effort to deliver meaningful active share.

Index Concentration has Driven Attractive Returns

No doubt the index concentration highlighted above has driven attractive returns for investors following the index or seeking to mirror it. But greater return could signify greater risk-taking, and this may very well be the case across growth style exposures given index concentration dynamics. Pictured below, the Russell 1000 Growth index has exceeded the return of the still-concentrated S&P 500 in all listed historical timeframes but the trailing 3-year period (note the trailing 3-year period contains 2022, a recent and significant drawdown year for risk assets that we will revisit in the final section of this note).

Russell 1000 Growth vs. S&P 500 Index Return Comparison					
	1 Year	*3 Years†*	*5 Years†*	*10 Years†*	*15 Years†*
Russell 1000 Growth Index	42.68%	8.86%	19.50%	14.86%	16.68%
S&P 500 Index	26.29%	10.00%	15.69%	12.03%	13.97%

Source: Bahl & Gaynor and PSN, 2023. †Annualized. All periods as of 12/31/2023.

But this strong performance record has come at a cost – **in all historic periods, the risk profile (as measured by standard deviation of return) of the Russell 1000 Growth index has exceeded that of the S&P 500, in some cases by greater than 40% – outlined in the table below.** Though some investors are risk-loving, most could be considered behaviorally averse to risk. Because the return profile of the Russell 1000 Growth index has been strong for 15 years, Bahl & Gaynor also suspects many investors, though still fundamentally risk averse, have become numbed to the concentration and risk profile of indexes like the Russell 1000 Growth (and S&P 500 for that matter). *Recency bias* is a powerful behavioral bias. It is human nature to extrapolate experiences from the past into the future indefinitely and linearly.

Russell 1000 Growth vs. S&P 500 Index Standard Deviation Comparison					
	1 Year	*3 Years†*	*5 Years†*	*10 Years†*	*15 Years†*
Russell 1000 Growth Index	15.89%	20.51%	20.64%	16.89%	16.32%
S&P 500 Index	14.11%	17.29%	18.37%	15.13%	15.33%

Source: Bahl & Gaynor and PSN, 2023. †Annualized. All periods as of 12/31/2023.

But we live in a world possessing mean reversion and a degree of randomness. Therefore, constructing portfolios for an unknowable future should consider a wider range of outcomes than those mirroring the recent past. Better yet, portfolio allocation adjustments should consider mean reversion, which tends to operate in the financial world as gravity does in the physical world.

Managing Risk While Seeking Return

Dividend strategies can lead to significantly different portfolio composition and characteristic outcomes from the Russell 1000 Growth index – indeed that index is not an appropriate measurement tool of the dividend investing style. This is obvious in the table below, which illustrates divergent return, risk, and risk-adjusted return outcomes over various time periods between the growth equity style reflected in the Russell 1000 Growth index and the subset of S&P 500 index constituents possessing a dividend yield greater than 2% (heretofore referred to as the Dividend Screen[1]).

In viewing this table, the dividend investing and growth equity investing disciplines *should not* be viewed as an "either/or" decision, but rather as *complements*: dividend investing *<u>and</u>* growth equity investing.

Dividend Screen[1] & Russell 1000 Growth Index Return, Risk, and Risk-Adjusted Return Metric Comparison					
	1 Year	*3 Years†*	*5 Years†*	*10 Years†*	*15 Years†*
Dividend Screen[1] Return	6.27%	11.59%	11.77%	9.64%	12.18%
Russell 1000 Growth Index Return	42.68%	8.86%	19.50%	14.86%	16.68%
Dividend Screen[1] Standard Deviation	14.17%	15.51%	17.52%	14.35%	14.42%
Russell 1000 Growth Index Std. Dev.	15.89%	20.51%	20.64%	16.89%	16.32%
Dividend Screen[1] Beta	0.63	0.48	0.63	0.66	0.72
Russell 1000 Growth Index Beta	1.00	1.00	1.00	1.00	1.00
Dividend Screen[1] Sharpe	0.07	0.59	0.56	0.58	0.78
Russell 1000 Growth Index Sharpe	2.35	0.31	0.85	0.80	0.97

Source: Bahl & Gaynor and PSN, 2023. †Annualized. All periods as of 12/31/2023.

Indeed, the Russell 1000 Growth index, and strategies benchmarked to it, are highly complementary to the dividend investing discipline. As can be seen below, a hypothetical portfolio invested 50% in the Dividend Screen[1] and 50% in the Russell 1000 Growth index delivers not only compelling returns but also reflects significantly constrained risk attributes.

50% Dividend Screen[1] + 50% Russell 1000 Growth Index (Combined Portfolio) Return, Risk, and Risk-Adjusted Return Metric Comparison					
	1 Year	*3 Years†*	*5 Years†*	*10 Years†*	*15 Years†*
Combined Portfolio Return	23.68%	10.71%	16.02%	12.47%	14.60%
Russell 1000 Growth Return	42.68%	8.86%	19.50%	14.86%	16.68%
Combined Portfolio Std. Dev.	13.91%	16.31%	17.80%	14.70%	14.63%
Russell 1000 Growth Std. Dev.	15.89%	20.51%	20.64%	16.89%	16.32%
Combined Portfolio Beta	0.82	0.74	0.82	0.83	0.86
Russell 1000 Growth Beta	1.00	1.00	1.00	1.00	1.00
Combined Portfolio Sharpe	1.32	0.50	0.79	0.76	0.94
Russell 1000 Growth Sharpe	2.35	0.31	0.85	0.80	0.97

Source: Bahl & Gaynor and PSN, 2023. †Annualized. All periods as of 12/31/2023.

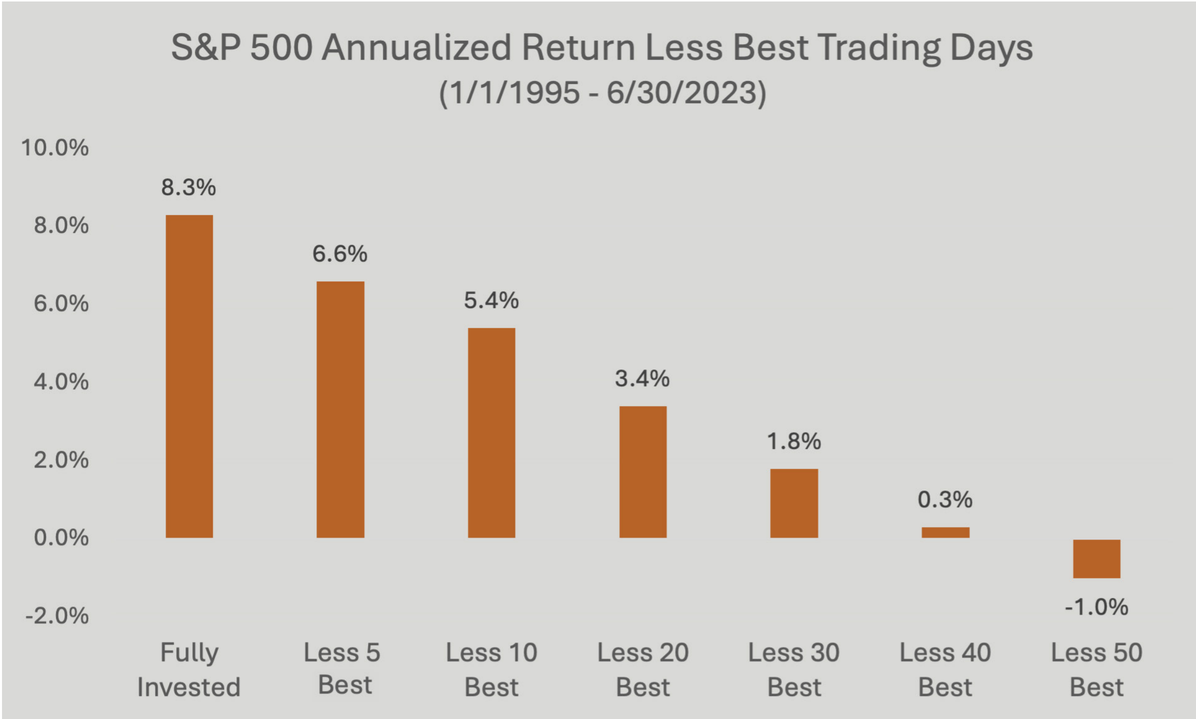
Max Drawdown Management

If most investors are behaviorally risk-averse, particularly when market volatility is rising, the structuring of a portfolio to avoid heavy losses can be an important behavioral and wealth preservation attribute. Investors have witnessed several drawdown-inducing crises in the last 15 years with the Russell 1000 Growth index experiencing drawdowns of up to -30% during this time. But blending the Dividend Screen[1] with the Russell 1000 Growth index can reduce maximum drawdown across the listed time periods by over 30% in relative terms.

50% Dividend Screen[1] + 50% Russell 1000 Growth Index (Combined Portfolio) Maximum Drawdown Comparison				
	3 Years	*5 Years*	*10 Years*	*15 Years*
Combined Portfolio	-21.25%	-21.25%	-21.25%	-21.25%
Russell 1000 Growth Index	-30.66%	-30.66%	-30.66%	-30.66%

Source: Bahl & Gaynor, PSN, and Zephyr, 2023. All periods as of 12/31/2023.

One of Bahl & Gaynor's enduring maxims in conversations with clients and their advisors is: "It's time *in* the market, not *timing* the market that builds wealth." Illustrated empirically, the graph on the next page denotes the reduction in realized return when between five and 50 of the *best* daily market advances are excluded from the return compounding calculation of S&P 500 returns. Often, significantly positive equity returns, such as those witnessed in an economic recovery, follow deeply negative equity returns, such as those experienced in a crisis – this is an example of mean reversion. It may be fair to say it is one of an investment professionals' core duties to keep clients invested over time so they may enjoy the totality of equity return exposure.



Source: Strategas Securities, 2023. As of 6/30/2023.

Bahl & Gaynor continues to believe the dividend investing discipline can provide significantly complementary value to other risk assets held in client portfolios. This blended positioning can permit clients to capture returns across a diverse array of risk asset exposures while also managing the headwinds that can accompany high return profiles – namely high-risk exposure. Despite the excellent recent return record of the growth equity style, Bahl & Gaynor encourages advisors and their clients to remain focused on capturing the potential long-term benefits of compounding *in all its forms*, especially among companies exhibiting intrinsic business quality with an underappreciated ability to compound capital and grow dividends over time.

Bottom Line Conclusions

- Large cap growth style equity exposure, especially exposure that is cap-weighted or mirrors a cap-weighted index, may present underappreciated risks to investors, especially given index constituent weighting concentration.
- High trailing returns of the growth equity style may expose otherwise risk-averse investors to recency bias, the behavioral tendency for humans to extrapolate past experiences indefinitely into the future, despite unknowable future returns and the observed tendency of risk asset return series to be mean reverting.
- Bahl & Gaynor believes a dividend investment philosophy may present an opportunity to meaningfully shift an investor's portfolio risk profile, particularly in the current environment dominated by the growth style. This can be done with the added utility of income generation and income growth potential.
- A hypothetical portfolio that equally weights a subset of S&P 500 index constituents possessing a dividend yield greater than 2% (the Dividend Screen[1]) and the Russell 1000 Growth index (a proxy for the large cap growth style) has delivered attractive trailing returns with a meaningful reduction in risk-related measures vis-à-vis 100% Russell 1000 Growth index exposure.
- The benefits of drawdown mitigation potentially available in a dividend approach can provide behavioral and wealth preservation utility to risk-averse investors.

WHY BAHL & GAYNOR?

Our Team

- We, as a team, own the firm and are therefore personally aligned with our Clients' interests.
- We make investment decisions through a diverse, experienced, stable Investment Committee.
- Since founding, we have consistently applied our focused approach through multiple cycles.

Our Philosophy & Process

- Our philosophy focuses on owning companies we value both for their intrinsic qualities and for what they tell us about how the business is run.
- We believe these traits play an important role in providing the potential to compound capital internally and share excess capital with our Clients via a growing dividend.
- Our process is designed to capture the power of compounding dividend income and downside protection to drive multiple-cycle risk-adjusted returns to achieve our Clients' goals.

Our Outcomes

- The wide-ranging use of income generation and potential for growth of income as a source of return.
- The value of downside protection, which quality companies can potentially provide.
- A compelling total return experience offering possible attractive risk vs reward profile for long-term investors.

Footnotes:
[1]Dividend Screen consists of companies with a 2% or greater dividend yield at the beginning of the year in the S&P 500. The return figures are calculated as a cap-weighted, float adjusted index, rebalanced on a calendar year basis.

Disclosures:
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