Guinness
Global Equity Income Fund

Why dividends matter

Dr Ian Mortimer, CFA & Matthew Page, CFA

GUINNESS
FUNDS

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Introduction

Many investors are rediscovering the power of dividends as an important element in the pursuit of long-term total returns. In the aftermath of the financial crisis of 2008/9, traditional sources of income such as government or corporate bonds and cash lost their lustre. In this paper we aim to show that, for the long-term investor, the power of dividends from equity investing has never diminished and has, in fact, continued delivering its gradual but potent contribution to long-term total returns, and mitigating the effects of both market falls and inflation.

We will investigate the ability of dividends to:

1	**Both instill and indicate efficient capital management in mature businesses.**	*Dividend policies "leave no room for vanity projects or frivolous uses of capital".*
2	**Provide a simple but powerful stock selection guide for total return investors.**	*"Dividend payers have outperformed the broad market, and non-dividend payers significantly underperformed."*
3	**Deliver a proportion of total return that grows considerably over the life of an investment.**	*"The importance of dividends increases over time. Over a 20 year holding period dividends accounted for an average 60% of total returns."*
4	**Deliver an even greater proportion of total returns in periods of low growth.**	*"The importance of dividends increases dramatically in low growth decades; in the 1940s and 1970s, dividends accounted for over 75% of total returns."*
5	**Deliver an income stream that is much more consistent than company earnings.**	*"Dividends are much less volatile than earnings. Since 1940 there have been 8 years of dividend cuts, versus 22 years where earnings declined."*
6	**Provide a hedge against inflation.**	*"Divided-paying companies can, over the long term, provide an inflation hedge – dividend income grows in line with (or often at a higher rate than) inflation."*

Past performance is not a guide to the future.
The value of investments and any income arising from them can fall as well as rise.

Profits are a matter of opinion, dividends are a matter of fact

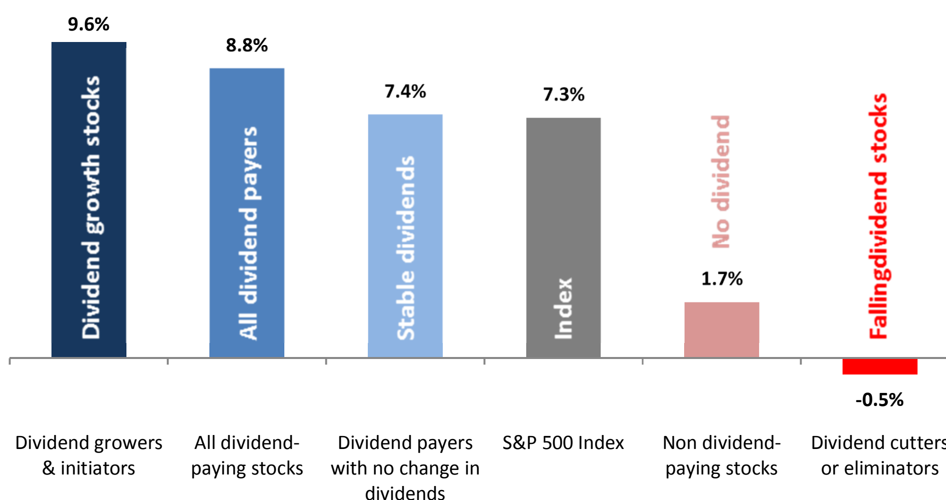
Dividends are paid from real earnings and in 'hard' cash. They cannot be manipulated by creative accounting. A pound paid out to the investor is just that.

If a company has a long history of paying a dividend and the intention to do so in the future, it is highly likely that management will begin each new year by first deciding the dividend payout and then thinking about how best to use the rest of the free cash flow. This leaves no room for vanity projects or frivolous uses of shareholders' capital. A focused management team that uses the cash available to them efficiently is central to creating a well run – and profitable – company that is able to grow and thrive in the future. Steady and constantly growing dividends are a good indication that these elements are in place. Dividend payments can act as a useful identifier of companies that are disciplined and efficient in their capital allocation and cash flow management.

There exists an argument, however, that companies who pay a dividend are just struggling to find new growth opportunities and uses for their cash. We think quite the opposite. In the early stages of a company's life it is quite right that cash is used to establish the business. It is often right that the company continues to re-deploy cash into the business as it moves through its early growth phases. However, once at maturity, when competition has entered the market place and the opportunities for continuing high growth have diminished, we think it entirely sensible that the company carefully allocates cash only to those projects where it can achieve high returns, and gives the rest back to shareholders. Why would shareholders want management to plough back all the company's cash regardless of the returns available?

There are always exceptions to any rule, and there will always be examples of companies that have such a unique product or service that they can continue to grow for much longer than the average company. Simple mathematics, however, dictate that even these companies cannot grow forever. Indeed, looking at the historical evidence for the benefits of company management focusing on dividends, there is a strong relation between a company's approach to dividend policy and total return performance. The evidence for this is laid out in Figure 1 below. By dividing all the companies in the S&P500 (the leading index of the US stock market) into separate buckets depending on their approach to dividends, we can see that dividend payers have outperformed the broad market, and non-dividend payers significantly underperformed.

Figure 1 **Annualised total return of rising and falling dividend stocks**
(S&P500 categorised by dividend history, average annual total return, 1972-2010)



Source: Ned Davis Research, 31.12.2011

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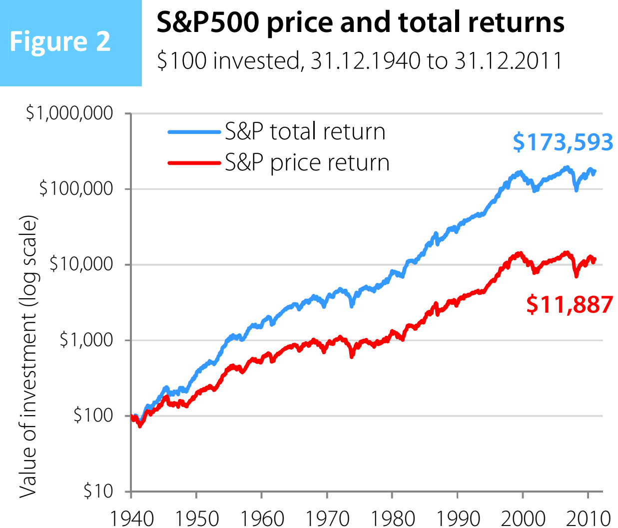
Historical perspective

Over the long term, dividends have been the main contributors to total return in equity investments. Figure 2 illustrates this point by looking back at the S&P500 returns since 1940. In this period dividends and dividend reinvestments accounted for over 90% of the index total return during that time. If you had invested $100 at the end of 1940, with dividends reinvested this would have been worth approximately $174,000 at the end of 2011, versus $12,000 with dividends paid out.

This is a hugely powerful phenomenon, and one that in recent times seems to have been overlooked; investors have chased quick profits through short-term trading strategies, which come with much increased risks. The average holding period for NYSE-listed stocks between 1950 and 1970 was approximately six years. Today it is under one year. We believe investors should once again think about their investments in the long term and return to the 'buy and hold' strategies espoused by Benjamin Graham and others. This way investors can harness the power of dividends and dividend reinvestments.

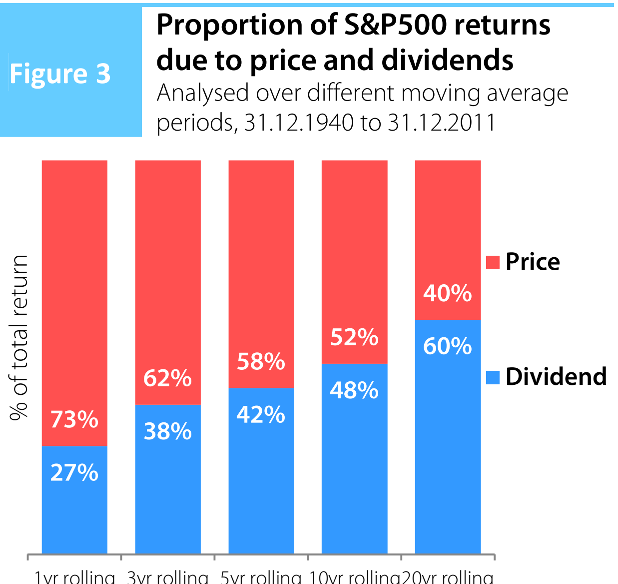
Figure 3 below shows how the importance of dividends to total returns increases over time. For an average holding period of one year, dividends accounted for 27% of total returns for the S&P500 since 1940. If we increase the holding period to three years, dividends account for 38%, five years it increases to 42%, over a ten year period it rises to 48%, and with a 20 year holding period dividends account for some 60% of total returns. It is important to note, too, that here we are just looking at the S&P500 as a whole and not focusing purely on companies that actually pay a dividend. If we did, these results would likely be even more striking.

Figure 2 **S&P500 price and total returns**
$100 invested, 31.12.1940 to 31.12.2011



Source: Bloomberg, Guinness Asset Management

Figure 3 **Proportion of S&P500 returns due to price and dividends**
Analysed over different moving average periods, 31.12.1940 to 31.12.2011



Source: Bloomberg, Guinness Asset Management

Dividend characteristics

In the previous section we saw how significant dividends were to the total return of the S&P500 over the last 70 years. If we break down this analysis into individual decades, we can see that the significance of dividends to total returns is not the same in every decade; dividends become more important in lower growth periods.

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Figure 4 S&P500 returns for individual decades since 1940

	Total return	Price appreciation	Dividends	Dividends as % of total return
1940s	**143.1%**	34.8%	108.3%	75.7%
1950s	**467.4%**	256.7%	210.7%	45.1%
1960s	**109.5%**	53.7%	55.8%	51.0%
1970s	**76.9%**	17.2%	59.7%	77.6%
1980s	**389.2%**	227.4%	161.8%	41.6%
1990s	**423.2%**	315.7%	107.5%	25.4%
2000s	**-9.1%**	-24.1%	15.0%	*Not applicable*
Average	***228.6%***	***125.9%***	***102.7%***	***52.7%***

Source: Bloomberg, Guinness Asset Management

As Figure 4 shows, the minimum contribution to total return was 25.4% (not an insignificant sum) in the 1990s, when markets rallied strongly up to the peak of the 'technology bubble' at the start of the 2000s. What we find more compelling, however, is that the importance of dividends to total returns increases dramatically in low growth decades, which are defined by some combination of sluggish economic growth, rising inflation, increasing oil prices, and high unemployment. In low growth periods such as the 1940s and 1970s, dividends accounted for over 75% of total returns.

But why should dividends hold up better in difficult markets? There is no magic formula for why this might be the case – companies could stop their dividend payments to reserve cash and protect their balance sheets, and some have in the past. What we see in aggregate, however, is that companies as a group might *reduce* their dividend payments in particularly austere times, but rarely, if ever, collectively cut their dividend dramatically. The market sees a long history of dividend payments as establishing the credentials of a company and its management team, making significant cuts by company management more unlikely. In other words, dividends are a reflection of the long-term earnings power of a company and are therefore set at a level that is sustainable. If we look specifically at the last five recessionary periods in the US, as illustrated in Figure 5 below, we can see that dividends per share (DPS) for the S&P500 dropped by 8% on average, compared to an average drop of 42% in earnings per share (EPS), i.e. dividends were cut by less than a fifth of the percentage fall in earnings over those periods. *(Based on weighted average of total dividends and earnings.)*

Figure 5 S&P500 DPS and EPS falls in the last 5 US recessionary periods

US Recessionary period	Dividend per share (DPS) trough date	Earnings per share (EPS) trough date	Peak to trough (%)	
			DPS	EPS
Nov 1973 to Feb 1975	Dec 1975	Sep 1975	-1%	-15%
Jul 1981 to Oct 1982	No decline in DPS	Mar 1983	-	-19%
Jul 1990 to Feb 1991	Dec 1991	Jun 1992	-1%	-32%
Mar 2001 to Oct 2001	Jun 2001	Dec 2001	-6%	-54%
Dec 2007 to May 2009	Mar 2009	Mar 2009	-24%	-92%
Average			**-8%**	**-42%**

Source: Robert J. Shiller, stock market data used in "Irrational Exuberance" Princeton University Press, Guinness Asset Management

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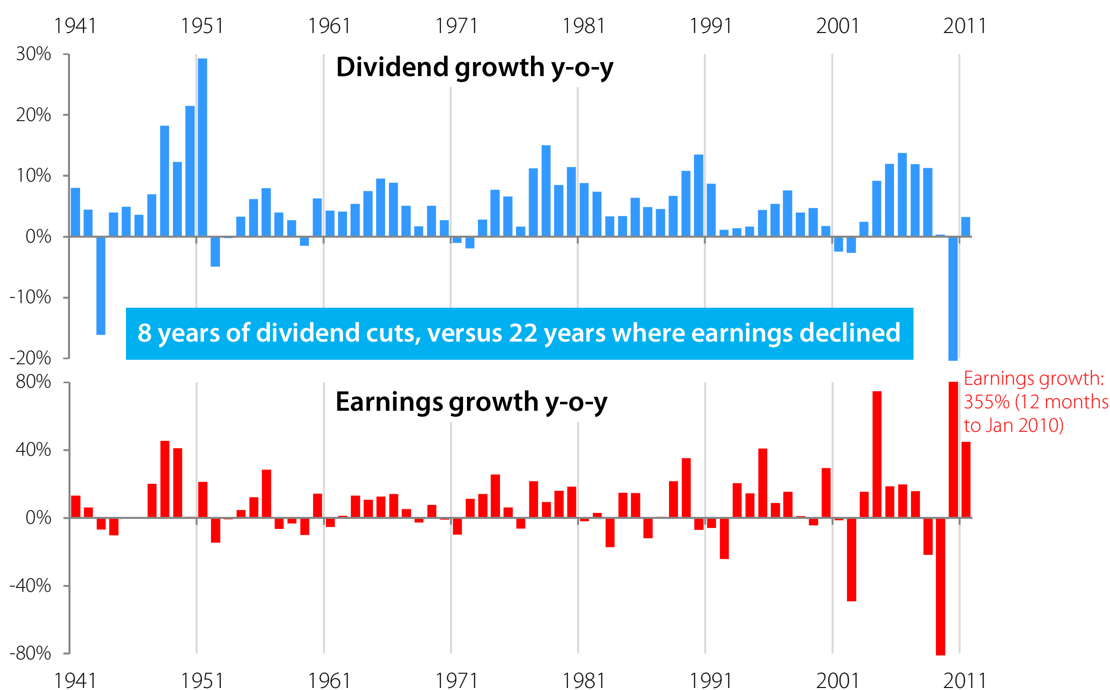
Looking at the historic year-on-year growth (or decline) in the earnings per share and dividends per share of the S&P500, it is clear that dividends are much less volatile than earnings, as shown in Figure 6 below. Not only can this provide the investor with a kind of 'cushion' during recessionary and/or low growth periods; it can also allow long-term investors to take automatic advantage of short-term periods of low stock prices if they re-invest their dividends throughout the business cycle (a subject we look at in detail in the next section).

Figure 6 **S&P500 dividends per share and earnings per share year-on-year growth**

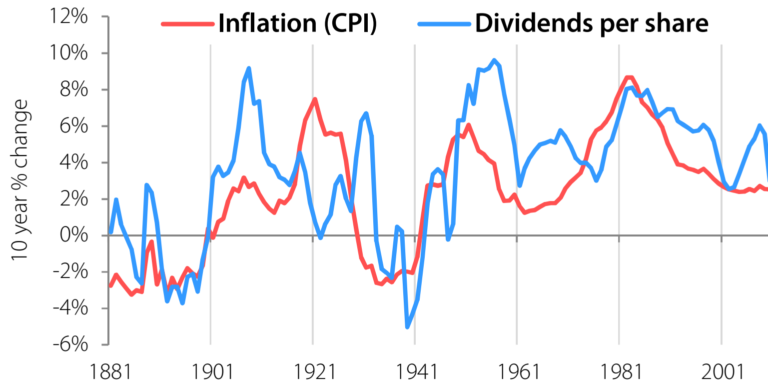
12 months to 1st January each year.



Source: Robert J. Shiller, stock market data used in "Irrational Exuberance", Princeton University Press, Guinness Asset Management

Figure 6 also illustrates the striking phenomenon that, over the long term, dividend growth is not only positive but is sustained at a reasonably high rate. Since the 1940s, over rolling ten year periods to each year end, the average growth in the S&P500 dividends per share is 6% per year. Over the same period, inflation grew at 4% (consumer price index (CPI) calculated by the US Bureau of Labor Statistics). Indeed, looking at the correlation of dividend growth to inflation over rolling ten year periods, as shown in Figure 7 below, we can see a strong relationship. This shows that investing in divided-paying companies can, over the long term, provide an inflation hedge, in the sense that the income received in the form of dividends grows in line (or often at a higher rate) than inflation.

Figure 7 **Rolling 10-year growth in inflation (CPI) and S&P500 dividends per share**



Source: Robert J. Shiller, stock market data used in "Irrational Exuberance", Princeton University Press, Guinness Asset Management

The benefit of compounding

One counter-intuitive phenomenon of dividend investing is that an investor might often be pleased if the share price of the company they own actually *decreases* in value. Why? The idea is that investors should benefit from the fact that, if the company they own continues to pay a dividend despite the fall in its share price, the shareholder will receive a greater number of shares upon reinvestment of their income than they would have if the share price had not fallen, i.e. the investor gets to buy more shares for their account per dollar they are re-investing. This combination of income distribution and reinvestment *at more attractive valuations* can be an extremely effective way to accumulate capital with relatively low risk over the long term.

The key to this approach is three-fold:

1) Investors must be prepared to invest over the long term – so the day-to-day fluctuations in the value of their investments due to short-term market movements do not require the investor to sell down their holdings.

2) The investor can identify a good quality company that can generate sustainable cash flows through a variety of market environments.

3) The company invested in maintains a disciplined approach to its dividend policy and is able to continue to pay a dividend even if its share price is falling.

As an example, Aflac, an insurance business, has increased its dividend payment every year for the last 28 years. If we invested $10,000 ten years ago, on January 1st 2002, we can calculate the number of shares we would have bought initially and also the number of shares we would subsequently have acquired by re-investing any dividends received. Figure 8 illustrates the share price performance of Aflac over the period and Figure 9 breaks down how our shareholding would have changed with the reinvestment of dividends in each year over the period.

Figure 8 **Share price of Aflac Inc**

USD, 1.1.2002 to 31.12.2011

Source: Bloomberg, Guinness Asset Management

Figure 9

Price history and dividend payments for Aflac Inc.

1.1.2002 to 31.12.2011

Aflac	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Average share price for year ($)	29.37	32.79	39.58	42.71	45.76	53.16	57.44	34.44	50.59	46.90
Dividend per share in year ($)	0.23	0.30	0.38	0.44	0.55	0.80	0.96	1.12	1.14	1.23
Dividend growth y-o-y		*30%*	*27%*	*16%*	*25%*	*45%*	*20%*	*17%*	*2%*	*8%*
Initial investment: $10,000										
# Shares held at start of year	418	421	425	429	433	438	445	452	467	476
Total dividend income received in year ($)	96.15	125.42	158.86	183.95	229.93	334.45	401.34	468.23	476.59	514.21
# Shares purchased with re-invested dividends in year	3	4	4	4	5	6	7	15	9	12
# Shares held at end of year	421	425	429	433	438	445	452	467	476	488

Source: Bloomberg, Guinness Asset Management

Looking at the table, three things become apparent:

1) Aflac increased its dividend per share payout in every single year;

2) The number of Aflac shares held gradually increased throughout the holding period from our initial purchase of 418 shares in 2002 to 488 shares at the end of 2011; and,

3) The number of shares we were able to buy with our re-invested dividends fluctuated between three shares in 2002 and a peak of 15 shares in 2009.

So, although the share price fall during the 2008/9 recession was painful when we were looking at our account balance at that time, we actually benefitted from being able to purchase the largest amount of 'extra' shares with our dividend income in those years. The compounding benefit of purchasing those shares at much reduced valuations then continued into 2010 and 2011 (and beyond if we remained holders), as the increased share balance provided a greater dollar amount of income in subsequent periods.

This is just one example of the powerful compounding effects of dividends and dividend re-investments, but there are always others out there from which the astute, long term investor can benefit.

Summary

In our opinion, when looking over the long term, dividends' contribution to total return is compelling. We therefore believe investors should buck the recent trend for investing in short-term themes; they should instead focus on investments which, by their very nature, maintain and even grow their income over time. Investors should also recognize that it's not just the blue-chip stalwarts which pay a dividend. We see more companies initiating dividend payments around the globe on a near daily basis. These 'new' dividend-paying companies can also provide the investor with the ability to capture a potentially *growing* income stream, which acts to further compound many of the positive effects such as inflation hedging, or the benefits of compounding over the long term, as we have illustrated in this paper.

The key benefit to investors of such a dividend strategy is that it offers a more systematic approach to reach financial goals over the more common 'buy low, sell high' strategy.

Dr. Ian Mortimer & Matthew Page, CFA
March 2012

Appendix 1

Guinness Global Equity Income Fund

A high conviction equity fund managed in accordance with our intelligent investment process for high quality income portfolios.

Aim — Dividend and capital growth

We don't chase yield, we want capital and dividend growth. Our aim is long-term capital growth and a steady rising dividend stream, balanced with a yield higher than the global market average. We expect the Fund to yield around 3-4%.

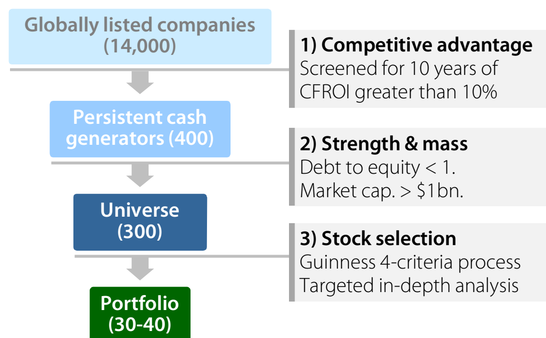
Process — Quality before yield

Although the Fund is designed to invest in dividend-paying companies, our starting point in identifying our investment universe is sustainable Cash Flow Returns on Investment (CFROI). Our analysis shows that companies with persistently high CFROI are highly likely to earn high CFROI in the future, and thereby continue to create shareholder value. We invest in companies that have delivered CFROI over 10% for ten consecutive years.

10% CFROI	On average, 25% of companies achieve a CFROI over 10% each year. 10%, at almost twice the average real cost of capital, represents true value creation.
every year	Consistency each year excludes highly cyclical companies or those with high but declining or volatile earnings.
for ten years	Business cycles tend to last less than ten years. Our ten year rule picks companies able to weather the global economy's fluctuations over an entire business cycle.

On average, only 3% of globally listed companies achieve our threshold of10% CFROI every year over ten years. We then exclude companies less than $1 billion in size or with a debt to equity ratio greater than one to give us a pool of c. 300 companies from which to build our portfolio.

From our pool we select candidates for extended research on the basis of value, earnings sentiment and earnings and price momentum. Research on companies' cash flow, capital budgeting, dividend policy and potential for dividend growth identifies our final portfolio selection.



This process gives us a portfolio of companies that have maintained top quartile returns on capital every year over a business cycle, are likely to continue to achieve top quartile returns on capital in the near future, are well managed and able to adapt to changing circumstances, and often generate significant amounts of cash.

Portfolio — Equally-weighted, high conviction, low turnover

We run an equally-weighted portfolio of around 35 quality companies. This ensures no closet indexing, avoids undue stock risk, and instils a strong sell discipline.

Overall, the Fund is designed to be an equally-weighted, high conviction, low turnover portfolio of high quality, persistent cash generators.

Appendix 2

Dr. Ian Mortimer, CFA

Dr. Ian Mortimer, CFA, joined Guinness Asset Management in December 2006 and is co-manager of the Guinness Global Equity Income Fund and the Guinness Global Energy Fund. Prior to joining Guinness, Ian completed a D.Phil. in experimental physics at Christ Church, Oxford in 2006. He graduated from University College London with a First Class Honours Master's degree in Physics in 2003. He has completed the IMC and is a CFA charterholder.

Matthew Page, CFA

Matthew Page, CFA, joined Guinness Asset Management in 2005 and is the co-manager of the Guinness Global Equity Income Fund and the Guinness Alternative Energy Fund. Previously, Matthew joined Goldman Sachs in 2004, working in Foreign Exchange and Fixed Income. He graduated from New College, Oxford with a Master's Degree in Physics. He has completed the IMC and is a CFA charterholder.

Appendix 3

Guinness Asset Management Limited

Long term, long only

Guinness Asset Management, the Investment Manager of Guinness Global Equity Income Fund, offers a range of specialist, quality funds that focus on compelling global investment areas and ideas for long-term investors.

We believe that active investment management, when coupled with the discipline and intellectual integrity of our investment process, is the best way to achieve superior returns in our specialist areas. Our portfolios are intelligently constructed to enable investors to benefit from the new structural drivers of growth in today's economy.

Our investment approach

Our core investment process, applying intelligent use of screening tools to identify a pool of potential value investments with good growth potential, enables us to:

identify… anomalies and value opportunities in the market that other investors haven't yet noticed;

control… the impact of emotion or sentiment-driven investing in our portfolios;

prioritise… our fundamental research by narrowing and defining the list of candidates for potential purchase or sale, while screening out the impact of short-term noise;

and deliver… clear and simple portfolios that we believe will achieve superior returns in the long term.

All our funds are run as concentrated portfolios with a value bias, low turnover and strong sell discipline. We seek to invest with conviction for the long term.

Our structure

Guinness is wholly independent, and has a strong, stable management team. The company is 100% owned by employees and management.

IMPORTANT INFORMATION

Guinness Global Equity Income Fund is an equity fund. Investors should be willing and able to assume the risks of equity investing. Investment in the Fund carries with it a degree of risk and investors should read the risk factors section in the prospectus before investing.

Past performance is not a guide to the future. The value of this investment and any income arising from it can fall as well as rise. This will be as a result of market, currency and exchange rate fluctuations as well as other factors both directly and indirectly related to the stocks in which it is invested.

Shareholders should note that all or part of the fees and expenses will be charged to the capital of the Fund. This will have the effect of lowering the capital value of your investment.

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The full Fund documentation contains more complete and detailed information of risk, fees, charges and expenses that are to be borne by an investor. The documentation should be read carefully before investing. The full documentation needed to make an investment, including the Prospectus, the Simplified Prospectus and the Application Form are available, free of charge, from the Manager: Capita Financial Managers (Ireland) Limited, Montague House, Adelaide Road, Dublin 2 Ireland or the Promoter and Investment Manager: Guinness Asset Management Ltd, 14 Queen Anne's Gate, London SW1H 9AA. **Documentation is also available from the website guinnessfunds.com.**

THIS INVESTMENT IS NOT FOR SALE TO U.S. PERSONS.

The Guinness Global Equity Income Fund is a sub-fund of Guinness Asset Management Funds PLC (the "Company"), an open-ended umbrella-type investment company, incorporated in Ireland and authorised and supervised by the Central Bank of Ireland. The Fund has been approved by the Financial Services Authority for sale in the UK. The Company and the Fund have been recognised in the UK by the FSA pursuant to section 264 of the FSMA. Guinness Asset Management Ltd is authorised and regulated by the Financial Services Authority.

The prospectus for Switzerland, the simplified prospectus for Switzerland, the articles of association, the annual and semi-annual reports, as well as the list of the buying and selling transactions can be obtained free of charge from the representative in Switzerland, Carnegie Fund Services S.A., 11, rue du Général-Dufour, 1204 Geneva, Switzerland, Tel. +41 22 705 11 77, Fax: + 41 22 705 11 79, www.carnegie-fund-services.ch. The paying agent is Banque Cantonale de Genève, 17 Quai de l'Ile, 1204 Geneva, Switzerland

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