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Equity Income Investments for 2011

Author:

Ryan Issakainen
Vice President
Exchange Traded Fund Strategist
First Trust Advisors L.P.

With the dawn of a New Year, as hopes of economic growth become a reality, income-oriented investors find themselves in an uncomfortable position. Not only do relatively expensive, low-yielding bonds fail to meet their income objectives today; the fear of inflation threatens to erode the real value of bond payments in the years ahead. Perhaps this helps explain why investors have pulled $4.7 billion from bond funds since mid-December, while adding over $6.5 billion to stock funds.[1] As investors seek alternatives to traditional fixed-income investments, equity income strategies are a compelling option.

In addition to receiving cash flow from dividends to supplement their income needs, many investors in dividend strategies have been rewarded with superior total returns over the last decade, as dividend-paying stocks in the S&P 500 (equal weight) have outperformed non-payers in 9 out of the last 11 calendar years (2000-2010).[2] Notably, the two exceptions (2003 and 2009) both occurred during the first year recovery following the end of a bear market. For ETF investors, there are a variety of equity income options from which to choose.

The Importance of Index Methodology

While most ETFs track market-cap weighted benchmark indices, equity income ETFs follow a variety of more strategic indices, each designed to emphasize dividend paying stocks. Over the last few years, the disparate returns among these funds illustrates the impact that an ETF's index methodology has on its overall performance. Indeed, all equity income ETFs are NOT created equal, so investors should pay close attention to how an ETF achieves its equity income strategy.

Seek Dividend Increases

Several index methodologies followed by ETFs seek to identify companies likely to raise dividends in the future. This is a sensible goal considering the long-term outperformance enjoyed by such companies over the last four decades. From 1973-2009, companies in the S&P 500 that raised or initiated dividends outperformed dividend-paying companies that did not increase payouts by an average of 2% per year, while both groups substantially outperformed companies that cut or eliminated dividends.[3] However, as many investors learned over the last couple of years, predicting favorable changes to a company's dividend policy is not as simple as it seems. The manner by which equity income ETFs attempt to do so provides an important question for investors to consider.

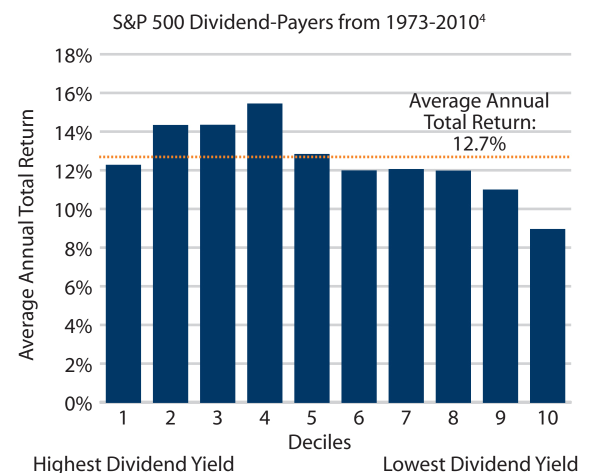
Fundamentals Drive Dividend Policy

One factor utilized by various ETFs to predict dividend increases is a company's track record of raising dividends over a certain period of time. This information is often quite valuable in identifying companies more inclined to reward shareholders in this manner. Unfortunately, a company's *disposition* toward favorable changes to its dividend policy, by itself, actually says very little about its *ability* to do so in the future.

More fundamental to a company's *ability* to raise dividends, and to avoid dividend cuts, is the overall financial condition of the company, including the strength of its balance sheet and its ability to generate free cash flow. To consider dividends before evaluating a company's fundamental strength is to "put the cart before the horse" in your equity income strategy! ETF investors should, therefore, inquire as to how an index methodology identifies companies that are not only more inclined to raise dividends, but also have the financial strength to do so.

Avoid Reaching For Yield

Among the most common misinterpretations of the link between dividend policy and equity returns is the erroneous conclusion that higher dividend-yielding companies should, therefore, produce the better long-term total returns. Unfortunately, this is rarely so. In fact, when considering dividend paying stocks in the S&P 500 from 1973-2010, the average annual total return of the highest yielding decile of stocks was actually the fifth best performing group with an average annual total return of 12.25%, underperforming the average annual total return of the universe at 12.7% (see chart below).



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One significant factor that helps explain the underperformance of the highest yielding group of stocks is its exposure to superficially attractive "dividend traps". While an extraordinarily high dividend yield occasionally signals an attractive entry point for opportunistic buyers, it may also indicate fundamental weakness on the horizon, eventually leading the company to reduce dividend payouts. Once again, this reinforces the importance for an equity income strategy to consider a company's fundamentals, apart from its dividend yield.

Beware of Stock, Sector, and Geographical Concentration

In addition to considerations related to dividend policy, investors should be mindful of the risks that may be associated with an equity income ETF's concentration in individual stocks, sectors, or countries. Few predicted the severity of the financial panic that began in the fall of 2008, but many equity income funds were hit especially hard due to substantial overweight allocations to financial companies. ETFs that limit stock, sector, or geographical concentration can help to mitigate this risk, while still providing meaningful exposure to above average dividend-yielding stocks.

In summary…

Index methodology is generally the most important factor in determining how an ETF performs relative to its peers. As such, this should be an investor's primary focus in choosing between a wide range of equity income ETFs. For the reasons outlined above, we suggest looking for funds that seek above average dividend yields, from companies that are likely to maintain or raise dividends in the future. However, rather than focusing solely on a company's *historical* dividend policy, which primarily provides insight on a company's *disposition* to maintain or increase dividends, we believe that it is most important for an equity income strategy to consider a company's financial strength, as this ultimately determines its *ability* to raise or maintain dividend payments in the future.

Finally, investors should avoid the temptation to place too much importance upon dividend yield itself when choosing between equity income ETFs. While the highest yielding decile of dividend paying stocks in the S&P 500 has underperformed since 1973, the second, third, and fourth highest yielding deciles have provided significant outperformance. As a reference point, the average dividend yield of deciles two, three, and four were 3.85%, 3.01%, and 2.43%, respectively, as of 12/31/10.[5]

[1] Barrons, 1/8/2011

[2] Standard & Poors.

[3] Ned Davis Research

[4] Universe includes the S&P 500 index, eliminating stocks which paid no dividend. Stocks are annually sorted into deciles by dividend yield and equally weighted. Dividends are reinvested monthly.

[5] Bloomberg.

RISKS

A fund's shares will change in value, and you could lose money by investing in a fund. An investment in a fund involves risks similar to those of investing in any fund of equity securities traded on exchanges. One of the principal risks of investing in a fund is market risk. Market risk is the risk that a particular stock owned by a fund, fund shares or stocks in general may fall in value.

You should anticipate that the value of a fund's shares will decline, more or less, in correlation with any decline in the value of its underlying index. A fund's return may not match the return of its index. A fund may not be fully invested at times. Securities held by a fund will generally not be bought or sold in response to market fluctuations and the securities may be issued by companies concentrated in a particular industry. A fund may invest in small capitalization and mid capitalization companies. Such companies may experience greater price volatility than larger, more established companies.

Investors buying or selling fund shares on the secondary market may incur customary brokerage commissions. Investors who sell fund shares may receive less than the share's net asset value. Shares may be sold throughout the day on the exchange through any brokerage account. However, shares may only be redeemed directly from the fund by authorized participants, in very large creation/redemption units.

You should consider a fund's investment objectives, risks, and charges and expenses carefully before investing. Contact First Trust Portfolios L.P. at 1-800-621-1675 or visit www.ftportfolios.com to obtain a prospectus or summary prospectus which contains this and other information about a fund. The prospectus or summary prospectus should be read carefully before investing.

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