Equity Income ETFs and the Importance of Dividend Growth

Author:

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

The increase in interest rates during the months of May and June provided a wake-up call for many investors. As the yield on the 10 Year US Treasury Note rose by nearly 1 percentage point from trough to peak (5/2/13-6/25/13), many investors in bond ETFs were caught flat-footed, suffering substantial price declines. At the same time, certain high-dividend yielding equity ETFs also fell in price, leading some to declare the beginning of the end for the "dividend trade". While such concerns are understandable, especially in light of the strong performance of many equity income ETFs over the past few years, such broad assertions fail to grasp important differences between high-yielding dividend payers with below average dividend growth, and other dividend payers with lower current yields, but above average dividend growth.

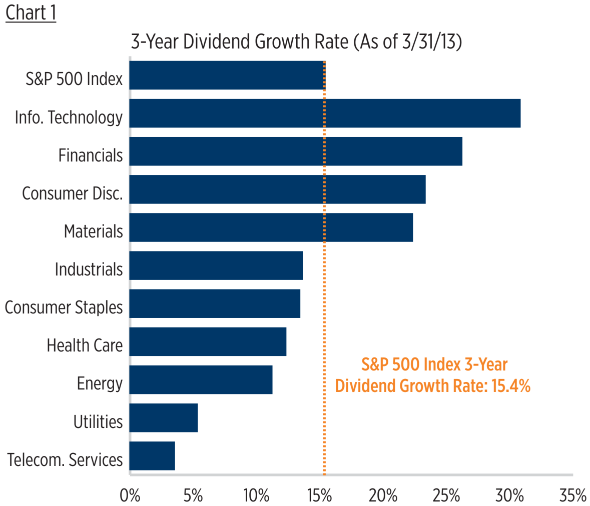
In this newsletter, we will consider the importance of dividend growth for equity income ETFs, reviewing the recent period of rising interest rates. We will then take a closer look at which sectors we believe provide better opportunities for dividend growth, and offer suggestions for equity income ETF investors looking to reposition their portfolios for potential future dividend growth.

High Yield vs. Dividend Growth

As interest rates rise, income-oriented investors begin to require higher dividend yields from stocks to compete with higher bond yields. As was observed in May and June, higher dividend yields from stocks can generally be attained in two ways: dividend increases or stock price decreases.

Before interest rates began edging higher during the month of May, and while many investors expected relatively stable interest rates until at least 2014 or 2015, the two highest-yielding sectors of the S&P 500 Index[1] had each enjoyed substantial year-to-date outperformance versus the broader stock market. From 12/31/12-5/1/13, while the S&P 500 posted a total return of 11.7%, the utilities and telecom services sectors posted total returns of 18.6% and 16.0%, respectively, despite paltry rates of dividend growth offered by both sectors over the previous 3 years (see Chart 1 below that shows the comparison of the S&P 500 Index and all of its component sectors).[2] However, as interest rates began to rise in May, these non-cyclical sectors began to underperform. From 5/1/13-6/25/13, while the S&P 500 posted a gain of 0.72%, the utilities and telecom services sectors suffered losses totaling -9.0% and -5.6%, respectively.

Chart 1



Past performance is not a guarantee of future results and there is no assurance that the above mentioned events or improvements will continue.

Meanwhile, as interest rates began to rise, the two sectors with the strongest rate of dividend growth over the previous 3 years provided outperformance versus the S&P 500. The information technology sector, which grew dividends at a rate of 30.8% posted a total return of 1.0% and the financials sector, which grew dividends at a rate of 26.2%, returned 3.8%.

The relative ability of stocks from these sectors to provide future dividend growth, however, is more important than past growth, in our opinion. In this regard, we believe both the information technology sector and the financials sector are well positioned.

The information technology sector contains a number of large, mature companies with ample cash on their balance sheets and relatively low levels of debt. This provides greater flexibility during periods of rising borrowing costs. Moreover, many of these companies are generating free cash flows[3] well in excess of the dividends currently paid to shareholders. As of 6/28/13, the free cash flow yield for the S&P 500 Information Technology index was 7.9%, about 4.6 times higher than the sector's 1.7% current dividend yield. Together, these attributes are supportive of the information technology sector's ability to extend its current trend of above average dividend increases.

The fundamental outlook for the financials sector, which contributed more dividends to the S&P 500 Index than any other sector leading up to the financial crisis in 2008, is aided by the recent steepening of the yield curve. On 5/1/13, the spread between the 10-Year US Treasury (1.63%) and the 2-Year US Treasury (0.20%) was 1.43%; by 6/28/13, the spread had widened by 0.70% to 2.13%. Since banks borrow funds in the form of deposits at short-term rates, and make loans to consumers and businesses at longer-term rates, the net interest spread between short-term and long-term rates is an important driver of banks' earnings. After spending much of the last few years firming up their balance sheets, and working through "problem" loans from the housing bubble, many banks are now well-positioned to rejoin the ranks of dividend growers in our opinion.

Equity Income ETFs and Sector Exposure

Equity income ETFs have been popular vehicles for dividend seeking investors in recent years, and ETF sponsors have been prolific in producing dozens of options from which to choose. While the strategies by which these funds select and weight their portfolios are diverse, most share a common theme when it comes to sector allocations; namely, an overweight allocation to dividend payers from non-cyclical sectors, such as utilities, telecom services, and consumer staples, and an underweight allocation to dividend payers from the information technology and financials sectors. As of 6/28/13, the five largest US-listed equity income ETFs were overweight the utilities sector by an average of 9.4 percentage points (an especially large overweight considering the fact that utilities only account for 3.3% of the S&P 500 index!), the telecom services sector by an average of 2.2 percentage points, and the consumer staples sector by an average of 7.1 percentage points, while underweight the information technology sector by an average of 10 percentage points and the financials sector by 7 percentage points, relative to the S&P 500. Largely related to these sector biases, many equity income ETFs underperformed the S&P 500 during the months of May and June.

First Trust

Repositioning for Potential Dividend Growth

While current dividend yields are generally lower than equity income ETFs that overweight low-growth, non-cyclical stocks, we believe that attractive valuations, along with the potential for greater future dividend growth, represent a better opportunity in preparation for a period of rising interest rates. We believe the First Trust NASDAQ Technology Dividend Index Fund (TDIV) and the First Trust NASDAQ® ABA Community Bank Index Fund (QABA) may benefit from this environment.

[1]As of 12/31/12.

[2]Based on the 3-year period ending on 3/31/13, data acquired from Bloomberg.

[3]"Free cash flow" represents the cash generated by a company, net of its investments to maintain or grow its business.

Past performance is not a guarantee of future results and there is no assurance that the above mentioned events or improvements will continue.

ETF Characteristics

The funds list and principally trade their shares on The NASDAQ Stock Market LLC.

The funds' return may not match the return of their underlying index. The funds may not be fully invested at times. Securities held by the funds will generally not be bought or sold in response to market fluctuations.

Investors buying or selling fund shares on the secondary market may incur customary brokerage commissions. Market prices may differ to some degree from the net asset value of the shares. 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, unlike mutual funds, shares may only be redeemed directly from the fund by authorized participants, in very large creation/redemption units.

RISKS

The funds' shares will change in value, and you could lose money by investing in a fund. 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.

The funds may invest in small capitalization and mid capitalization companies. Such companies may experience greater price volatility than larger, more established companies.

TDIV is concentrated in stocks of companies in the technology sector. You should be aware that an investment in a portfolio which is concentrated in a particular sector involves additional risks, including limited diversification. The companies engaged in the technology sector are subject to fierce competition, high research and development costs, and their products and services may be subject to rapid obsolescence.

TDIV also invests in companies in the telecommunications sector. The companies engaged in the telecommunications sector are subject to fierce competition, government regulations, substantial research and development costs, and their products and services may be subject to rapid obsolescence.

An investment in a fund containing equity securities of foreign issuers is subject to additional risks, including currency fluctuations, political risks, withholding, the lack of adequate financial information, and exchange control restrictions impacting foreign issuers. These risks may be heightened for securities of companies located in, or with significant operations in, emerging market countries.

TDIV invests in securities of non-U.S. issuers. Such securities are subject to higher volatility than securities of domestic issuers. Because the fund's NAV is determined on the basis of U.S. dollars and the fund invests in foreign securities, you may lose money if the local currency of a foreign market depreciates against the U.S. dollar. Additionally, the fund invests in depositary receipts, usually in the form of ADRs or GDRs. Investment in ADRs or GDRs may be less liquid than the underlying shares in their primary trading market.

QABA is concentrated in the securities of NASDAQ® listed community banks as defined by the index which involves additional risks, including limited diversification. These companies are subject to certain risks, including the adverse effects of volatile interest rates, economic recession, increased competition from new entrants in the field, and potential increased regulation. The financial performance of these companies may also be highly dependent upon the business environment in certain geographic regions of the U.S. and may be adversely impacted by any downturn or unfavorable economic or employment developments in their local markets and the U.S. as a whole. These companies may also be subject to interest rate risks and changes in monetary policy as their earnings are largely dependent upon their net interest income and lending risks that could further increase because of increases in interest rates and/or economic weakness.

The funds are classified as "non-diversified." A non-diversified fund generally may invest a larger percentage of its assets in the securities of a smaller number of issuers. As a result, the funds may be more susceptible to the risks associated with these particular companies, or to a single economic, political or regulatory occurrence affecting these companies.

First Trust Advisors L.P. is the adviser to the funds. First Trust Advisors L.P. is an affiliate of First Trust Portfolios L.P., the funds' distributor.

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.