For Equity Income Investors, Sustainability Has Many Dimensions.

The Morningstar Developed Markets Large Cap Dividend Leaders Screened Select Index considers both dividend durability and ESG risk.

The shares of dividend-paying companies normally represent a means of achieving both regular income and capital appreciation. While many investors value dividends for their cash payouts, the high-yield section of the equity market has also quietly outperformed over the long term. Companies with the wherewithal to distribute some of their earnings to shareholders are generally more stable, their management teams more disciplined, and their shareholder bases more loyal than non-payers.

Yet, equity income investing is far from risk-free. Attractive-looking yields can ultimately prove illusory. Dividend payments may be reduced, suspended, or eliminated at any point, and dividend cuts are often accompanied by share price depreciation. Screening for the sustainability of the shareholder payout is imperative, from the perspectives of income and total return.

Another aspect of sustainability has come to the forefront in recent years. Investors increasingly view environmental, social, and governance (ESG)-related issues as financially material. Many dividend-paying companies are in economic sectors, such as energy, utilities, and industrials, that face risks related to carbon emissions and health and safety. Others offer products with objectionable societal impact, such as tobacco or weapons. Balancing equity income and ESG can be challenging.

These dual dimensions of sustainability – dividend durability and ESG—can both be effectively captured in a rules-based passive index methodology. The Morningstar Developed Markets Large Cap Dividend Leaders Screened Select Index[1] represents a selective approach to equity income. The index includes the shares of 100 consistent dividend payers from various geographies, with the capacity to sustain payouts. It also seeks to mitigate ESG risk.

Key Takeaways:

- Dividend-paying stocks represent a source of income, but also have a strong performance history relative to global equity markets.
- Yield traps are a key risk for equity income investments.
- Dividend-focused investment strategies must screen for capacity to sustain shareholder payouts.
- Environmental, social, and governance risks are especially relevant in dividend-rich areas of the market.
- Morningstar Developed Markets Large Cap Dividend Leaders Screened Select Index screens for both dividend durability and ESG risk. Index screens maximize yield and mitigate ESG risk.

[1] For a full discussion of index methodology, see: Morningstar Developed Markets Large Cap Dividend Leaders Screened Select Index Rulebook | Morningstar Indexes

Dividends for the Long Term?

For many investors, dividends enable a reliable income stream from a portfolio. Retirees and others, such as asset owners with long-term liabilities, use the cash stream from regular dividend payments as a funding source. Income is a key point of appeal for dividends compared with share buybacks and other forms of cash distribution.

Dividends are also an important component of the total return story for equities. Over the short term, dividend-paying stocks tend to be overshadowed by high-flying growth stocks. But when long-term stock market returns are decomposed, the impact of dividends can be better appreciated. Exhibit 1. compares two variants of the Morningstar Developed Markets Index, which includes the shares of equities from Europe, North America, and some markets in the Asia Pacific region. The Gross Return index variant assumes reinvested dividends, while the Price Return variant does not. Over the 10-year period through late 2023, reinvested dividend payments accounted for roughly 20% of the total return from developed market equities.

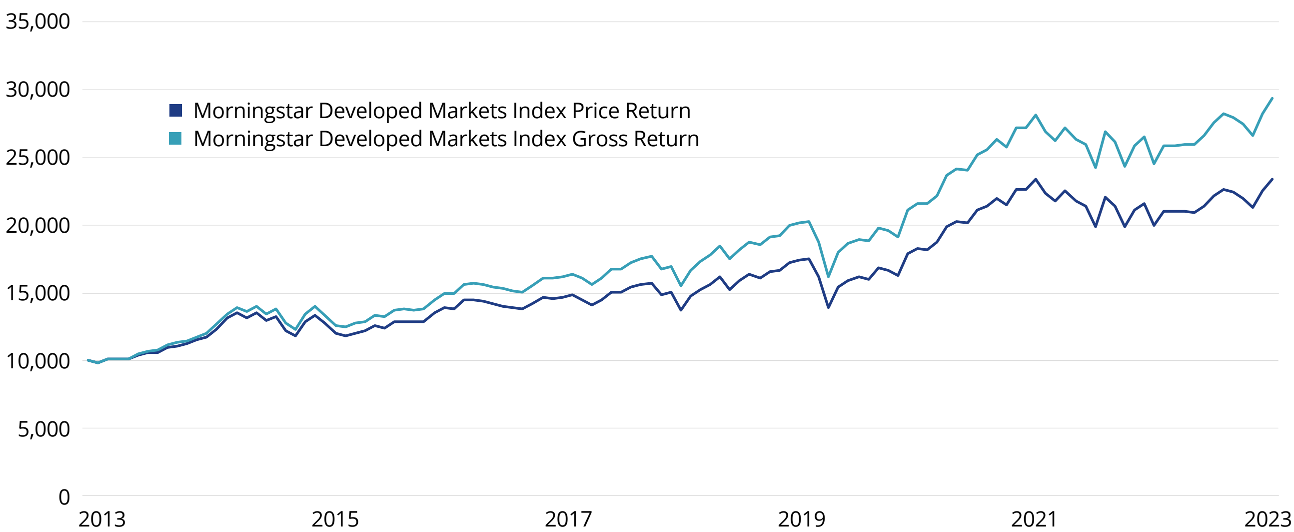
It is also the case that over many decades of equity market history, the high-yield section of the equity market has recorded an enviable track record. Exhibit 2. shows that the highest-yielding European equities outside of the U.K. have outperformed the overall market, while non-dividend payers underperform dramatically. High-yield equities have also been one of the most volatile segments (measured by the standard deviation of return). This data comes from the French Data Library's website and the portfolios are formed based on dividend yields at the end of December and reconstituted annually. Like the market indexes they are compared against, they are weighted by market capitalization.

Results for Europe are so far consistent with those from the U.S., the U.K., and the Asia Pacific region. They also mirror academic research demonstrating that stocks with above-average yields have produced superior performance.[2]

Why have dividend-paying companies historically outperformed? Several factors are likely at play. Screening for dividends weeds out speculative stocks. Dividend payers tend to be established, steadier-than-average companies, confident enough in their cash flows to commit to returning cash to shareholders. Because investors are extracting income from their stock holdings, they are less likely to sell on bad news.

Perhaps most importantly, the dividend commitment instills discipline. Corporate managers and directors find cash piles tempting. Rather than use excess cash to fund acquisitions that may or may not create value, repurchase shares at prices that may or may not be

Exhibit 1. Reinvested Dividends Contribute to Total Returns from Equities



Source: Morningstar Direct. Morningstar Index Returns in EUR terms through 31 December 2023.

[2] See: Litzenberger, Robert H., and Krisha Ramaswamy, June 1979, "The Effect of Personal Taxes and Dividends on Capital Asset Prices: Theory and Empiral Evidence," Journal of Financial Economics 7, 163-195. and Dimson, Marsh, and Staunton, Triumph of the Optimists (Princeton University Press, 2002).

Exhibit 2. European Dividend Payers Have Outperformed Non-Payers, While High-Yield Equities Have Beaten the Market, Albeit with More Risk

1975-2022	Return %	Risk %	Value of Euro Invested in 1975
Non-Payers	5.8	22.2	14.85
Low Yield	9.3	18.4	72.21
High Yield	12.1	19.0	242.20
Market	10.0	17.9	97.46

Source: French Data Library. 'Risk' measured by Standard Deviation of Returns.

attractive, or fund risky growth initiatives, paying dividends transfers cash to shareholders. Management must act as a careful steward to maintain the dividend payment. Especially in the world's largest equity market, the U.S., companies that withdraw a dividend typically see their share price punished.

Facing Up to Risk in Equity Income Investing

Interest rates are sometimes cited as a key risk for dividend-paying stocks. In theory, rising rates increase yields on less volatile instruments like cash and bonds as well as lifting borrowing costs. But in practice, dividend paying stocks have performed well in rising rate environments. In 2022, for example, dividend payers outperformed despite dramatic rate hikes in the U.S. and other markets.

A bigger risk for equity income investors is the yield trap. High yields are often found in risky pockets of the market. When a stock's price declines, its yield rises. Therefore, healthy payouts are common in unhealthy sectors, industries, and securities, where business challenges have weighed on share prices.

Dividends are not guaranteed. Owners of regular shares lack the kind of claims on a company's assets enjoyed by debtholders. Companies in distress are quick to suspend, eliminate, or reduce their dividends. This often comes amid share price depreciation—an altogether unpleasant investment experience.

Simply buying the shares of dividend payers based on their payout history is an inherently limited approach. Consider these cautionary tales from the past 15 years:

- The Global Financial Crisis of 2007-2009 saw a rash of prominent dividend payers run into trouble because of their exposure to the U.S. housing market and linked financial instruments. Citigroup, which consistently grew its dividend, from 9 cents per share in 1998 to 54 cents in 2007, cut its dividend and saw its share price plummet. Bank of America, whose track record of dividend payments reached back to the 1980s, was another victim.
- Falling Commodities Prices in 2014-2015 pressured margins of companies in the energy and basic materials sectors and saw dividend stalwarts like Rio Tinto, Conoco Phillips, and Freeport-McMoRan slash their shareholder payouts.
- The Covid-19 Pandemic and associated economic downturn led more than one third of dividend payers in the Morningstar Global Markets Index to cut their payouts. Energy companies, consumer businesses, and financial services were especially hard hit. To take the most shocking example from 2020, Royal Dutch Shell reduced its dividend for the first time since World War II.

Many equity income investors were blindsided by these cuts. Active managers have long conducted fundamental research to gauge dividend durability and sidestep traps. Rules-based passive equity income strategies must employ screens to weed out companies at risk of reducing their payouts and falling into distress. Dividend sustainability is paramount.

Environmental, social, and governance-related risks are also increasingly relevant to investors. As stakeholder capitalism becomes a more mainstream concept, businesses face rising expectations—not just from shareholders but also consumers, communities, and employees—to address ESG sustainability challenges. Issues like climate change, diversity, and business ethics are seen to have an impact on enterprise value.

Many dividend payers are in economic sectors, such as energy, utilities, and industrials, that face elevated levels of ESG risk. Carbon emissions, health and safety, and community relations are all germane. Some dividend payers offer products with objectionable societal impact, such as tobacco or weapons. Balancing equity income and ESG considerations can be challenging.

A Selective Approach to Dividend Investing

The Morningstar Developed Markets Large Cap Dividend Leaders Screened Select Index[3] represents a selective approach to equity income investing. It targets 100 companies from developed markets in Europe, North America, and the Asia Pacific regions. As shown in Exhibit 3., dividend payers are screened for their capacity to sustain dividend payments.

To explain the screens in further detail:

- Dividend payers — The index screens for securities that have paid a dividend in the trailing 12 months.
- Real Estate Investment Trusts are ineligible because their dividends are taxed at a higher rate.
- Dividend growth — The company must have grown its dividend per share over the trailing five-year period. Dividend growth is a sign of financial health and improving business fortunes.
- Dividend sustainability — Companies must have a forward dividend payout ratio of less than 75%. The payout ratio measures the percentage of net income used to fund the dividend. Higher payout ratios may ultimately prove unsustainable if the company needs cash.

Also employed are a number of ESG sustainability-oriented screens. These rely on data and research from Morningstar Sustainalytics. Securities are excluded if they carry:

- ESG Risk Ratings of Severe & ESG Controversy Scores of 4 and 5. ESG risk and ESG-related incidents can become financially material for companies.
- United Nations Global Compact principles noncompliance
- Companies involved in Tobacco, Controversial Weapons, Small Arms, or Thermal Coal

The index includes the top 100 eligible constituents by trailing 12-month dividend yield. Security weight is determined by available dividend, which aims to maximize yield and macro-consistency by multiplying dividend per share by free-floating shares outstanding. As a risk control measure, individual security weight is capped at 5% and sector weight at 40%[4].

Maximizing Yield and Minimizing ESG Risk

The Morningstar Developed Markets Large Cap Dividend Leaders Screened Select Index has underperformed the large-cap segment of the broad developed markets equity universe since its December 2015 live inception, as displayed in Exhibit 4.. It's important to note that this 10-year period was unfavorable to the dividend-paying section of the global equity market. Many top-performing stocks over the time frame, including Alphabet, Meta Platforms, and Tesla, do not pay dividends. Other high-flyers, including Apple, Microsoft, and ASML, are low-yield stocks. That said, there have been periods, including 2016, when dividend-rich value stocks outperformed, and 2022, when the index produced positive returns amid a painful correction for equities overall.

Exhibit 3. Morningstar Developed Markets Large Cap Dividend Leaders Screened Select Index – Construction Process:

Starting Universe
- Securities from the Morningstar Developed Markets Large Cap Index.

Eligibility
- Screen for dividend payers.
- REITs are excluded.
- Dividend growth screen.
- Dividend sustainability screen.
- Remove companies with Severe ESG Risk Rating and Severe controversies.
- Product Involvement screens.

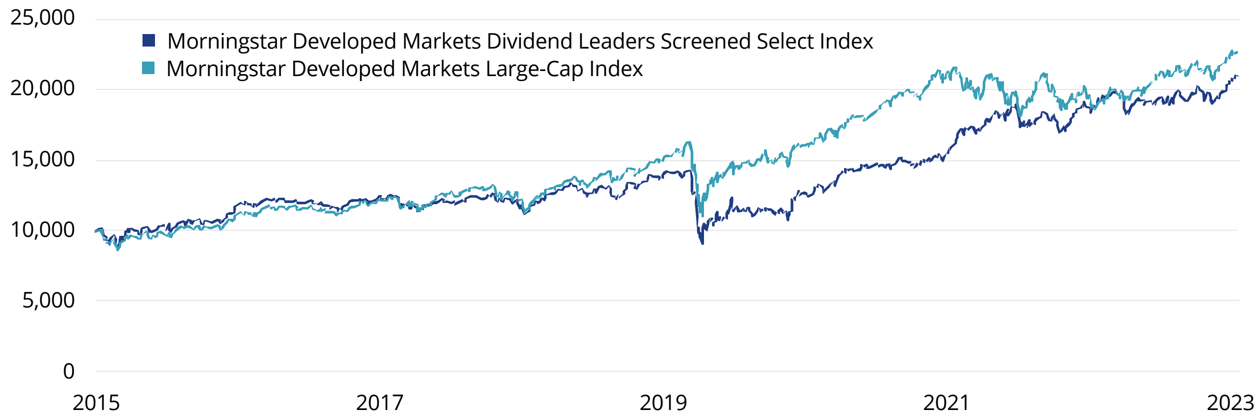
Portfolio Construction
- Select top 100 securities by 12-month trailing dividend yield.
- 5% individual security capping
- 40% sector capping

Morningstar Developed Markets Large Cap Dividend Leaders Screened Select

Source: Morningstar Indexes.

[3] For a full discussion of index methodology, see: Morningstar Developed Markets Large Cap Dividend Leaders Screened Select Index Rulebook | Morningstar Indexes
[4] It is not possible to invest directly in an index

Exhibit 4. An Unfavorable Period for Dividend Payers, With Some Periods of Outperformance



Source: Morningstar Direct. Morningstar Index Returns in EUR terms through 31 December 2023.

While relative return rankings will wax and wane depending on the market environment, the index's twin aims of maximizing yield and minimizing ESG risk are constant. Exhibit 5. compares the index both to the broad equity market segment from which it is derived, as well as a dividend benchmark that does not screen on any ESG criteria. As displayed, the Dividend Leaders Index's yield is well above market. The index's ESG risk level is also above market, which is to be expected given its emphasis on dividend-rich sectors like basic materials, energy, and utilities, which are inherently riskier from an ESG perspective than technology, which is dividend light. Its risk level is much lower, however, than a dividend benchmark employing no ESG screens.

Sustainability is Critical for Dividend Investors

Dividend investing is a proven means of participating in equities over the long term—from the perspectives of both income and total return. Yet, sustainability is a key consideration, from two perspectives. First, dividend payers must be carefully screened for durability of their shareholder payouts. Second, environmental, social, and governance-related risks are increasingly viewed as material by a growing cohort of sustainable investors. The Morningstar Developed Markets Large Cap Dividend Leaders Screen Select Index balances equity income and ESG considerations.

Exhibit 5. Maximizing Yield and Minimizing ESG Risk

Index	Dividend Yield %	ESG Risk Level
Morningstar Developed Markets Large Cap Index	2.1	21.6
Morningstar DM Large Cap Dividend Leaders Screened Select Index	5.6	23.1
Morningstar Developed Markets Dividend Yield Focus Index	4.5	24.0

Source: Morningstar Direct. Dividend Yield Data as of Nov. 30, 2023. Portfolio Sustainability Scores from Sept. 30, 2023.

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