Dividends Help Support The Market

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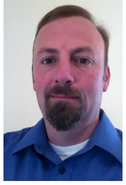
By **Thomas Hughes**
Senior Editor of Global Investor Spotlight



Dividend growth helps drive share prices higher, but where do go to find the best companies with the greatest possibility of increasing distribution?

Negative Earnings Growth And Increasing Dividends

With the trend of negative earnings growth extending to a 3rd quarter it is a little surprising the broad market has not sold off more than it has. Something is supporting the market and if not earnings what? Based on the data it looks like dividends, buy-backs and other cash-return strategies are what's doing it. <p>

The most recent dividend report from the FactSet shows that dividend distributions among S&P 500 companies hit another new high in the 3rd quarter of last year, and are expected to continue hitting news highs at least until the middle of 2016. Total payments in the 3rd quarter were greater than $103 billion with the trailing four quarters total greater than $410 billion, quite a lot of money to attract market participants.

The caveat is that not all companies are increasing their distributions. Some have cut and some have suspended, so knowing where to invest your money in order to capture the payments as well as the capital gains associated with stocks in a cycle of increasing distribution can be difficult to say the least. There are funds and ETF's that specialize in dividend payers but for the most part are very broadly focused. They do not focus on which companies are increasing distributions or seek to wee out companies suspected might cut the dividend. One example is the SDY, S&P 500 Dividend Tracker, which owns all dividend payers in the S&P 500... and has produced little to no capital appreciation over the past 2 years and only yields about 2.5%.

One actively managed fund, the Miller/Howard High Income Equity Fund, does exactly that; targeting only high yielding stocks with the greatest chance of distribution increases. For those unfamiliar with it the HIE it is a closed end fund targeting current income and long term capital appreciation with an exit strategy very few funds of the type can boast; a termination date.

The termination date is good for a number of reasons but the most important is the guarantee of NAV. Most CEF's trade at a discount to their net asset value, offering a chance to buy a portfolio of stocks at discount, but also raising the possibility of value trap. At the end of this funds life span the portfolio will be liquidated and share holders will receive full NAV alleviating any concerns that HIE is a value trap.

The High Income Equity Fund

The High Income Equity Fund is by Miller/Howard Investments. The firm has been in business for over 20 years focusing on dividends and income strategies based on dividends. The goal is twofold; first is income, second is capital appreciation. First the fund targets the strongest dividend payers with the lowest market valuation then it weeds out companies with little to no expectation of increasing the distribution in order to focus on those companies with the greatest expectation of increasing the distribution.

Lowell Miller founder and Chief Investment Officer, explained his investment thesis rather well in a recent interview. "It's only logical that, over time, an increase in cash flows to investors will result in a commensurate increase in the value of the equity producing the dividend, all other things being equal. It's similar to income real estate; the property is valued in large part based on its cash flow. If the rents increase, then the value of the property increases. So the investor benefits from both higher income and from the appreciation that higher income induces."

To date the fund has paid a regular and sustainable dividend that yields over 14% at today's prices. The distributions are paid from earnings, sales of options and a small amount of leverage, only 16%. When I spoke with Steve Chun, spokesman for the company, he assured me that responsible distributions were one of the principles the fund was founded on, the goal being 100% dividend coverage through portfolio earnings and an eventual increase in distributions. There is little reason to fear distributions will be paid through NAV destroying practices.

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From the 2015 annual report … "With these specials, the premiums from selling options, and the regular dividends from the portfolio, as enhanced by our use of leverage, we have generated sufficient income to cover these declared distributions."

The dividend and termination date are reason enough to give this fund a second look, add in a substantial discount to NAV and this fund really begins to look attractive. At current prices the discount is over 14%. Compared to the -11% average and the -1.42 Zee statistic this means that not only is the fund discounted, its offering additional value by trading at a much deeper discount than normal. Long term investors can expect to see share prices trade closer to NAV the closer we get to the termination date.

The Portfolio

The portfolio is broad, there is no sector overlooked and no stock is refused so long as it meets the fundamental requirements of the strategy. Cash flow must be positive, the asset must be undervalued, distribution are above average and a high probability of an increase to distribution must be present. There

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are 45 stocks in the portfolio now with the heaviest weighting in REITs, Financials and MLP's. After that there is a roughly equal weighting, about 9%, in utilities, energy and telecommunications with a smaller weighting of industrials, information technology, consumer discretionary and healthcare.

The allocations have been shifting a little over the past few months. The energy sector has been trimmed somewhat due to ongoing weakness in oil prices and the subsequent havoc playing out in the oil patch. Despite the isolated weakness, and it is isolated, the portfolio strategy is producing results. The ratio of holdings that produced distribution increases in the 2015 was 60%, not counting special dividends, with the top performers adding multiple distribution increases with double digit total returns.

From the 2015 annual report. "During the reporting period, 60% of our stocks have declared dividend increases, with individual increases averaging 9.7% growth year-over-year, excluding special dividends on an unweighted basis."

An Interesting Way To Look At The HIE

I like the HIE for several reasons including the yield, yield health, the discount to NAV and the termination date. The other day I read an article on SeekingAlpha with an interesting view of the HIE that sums it all up with a rather interesting view. The Stanford Chemist says this "By buying this fund at an appropriate discount, you are basically getting Lowell Miller's expertise for free". I don't know about free but I do know that new shareholders could expect to see total returns in excess of 145% if the fund is held to termination.

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