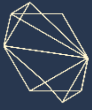

BSAMC

Bocconi Students Asset Management Club

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DIVIDEND GROWTH FUND

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Fund description

Dividend Growth Fund of Bocconi Students Asset Management Club is an investment fund set up in September 2023, with the aim of providing investors income while being exposed to dividend-focused companies. The fund invested mainly in US companies with a long history of high dividend yield, while providing stable returns even in turbulent market conditions.

Investment approach

In shaping the investment portfolio, we're putting a spotlight on the power of dividends and reliable income. Dividends aren't just about cash flows – they're a signal of a company's stability and commitment to its investors. The portfolio must not only grow over time but also deliver a steady income.

As the name suggests, the objective of the fund is the growth of capital through investments in companies that are renowned for distributing dividends. Therefore, the natural approach in selecting target companies has been the evaluation of their historical dividend performance. A large part of our portfolio has thus been allocated to famous dividend kings, that is, companies that have been increasing their dividend payments consistently for the last 50 years. Some examples are Coca-Cola Co. and Northwest Natural Holding Co. Dividend aristocrats, companies meeting the same criterion but for 25 years only, have also played an important role, with Caterpillar Inc. being one of the most famous ones.

However, this fund has also concerned itself with the problem of selecting companies that could provide a stable dividend income but also allow for considerable capital gains. With this objective in mind, the analysts have carried out a thorough fundamental analysis of the target stocks, considering parameters such as the Price-to-Earnings ratio, the Debt-to-Equity ratio, and the current ratio. Companies have been evaluated based on their capacity to meet long-term and short-term obligations, the presence of a catalyst, the confidence of investors, and other relevant information disclosed in financial statements.

As mentioned before, building the base of our fund included investing in dividend kings that give confidence in the stability of future dividend payments. Moreover, to achieve a higher dividend yield, our team included companies with a higher pay-out ratio and naturally, a higher dividend growth rate. Verizon Communications and Northwest Natural Holding and 3 more companies were chosen specifically to increase the yield of the portfolio. It was crucial to make sure that higher dividend flows would not damage the future performance of companies. Our team was checking the products and services of these companies, to make sure that future cash flows would stay unaffected.

Moreover, it was important to find companies able to withstand or be able to quickly recover after severe crises.

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Macroeconomic analysis

Entering 2024, the economic landscape presents a picture of gradual stabilization, recovering from the series of COVID-19 period disruptions. The Federal Reserve's decision to pause interest rate hikes since early November 2023 has brought back optimism among investors, fueling debates over the permanence of high rates versus the possibility of cuts in mid-2024. This cautious approach aims to achieve a "soft landing" for the economy, a goal that appears increasingly attainable.

The past year, marked by elevated interest rates, witnessed a notable economic slowdown. Prominent investment banks like Morgan Stanley and Goldman Sachs reported their lowest profits in four years, reflecting the broader challenges faced by the sector. The expensive operating environment has particularly strained investment banks, leading to a significant dip in M&A deal flow, which fell below $3 trillion for the first time in a decade.

This trend also extended to commercial banks, where reduced deposit activities were observed. The big four U.S. banks — Citigroup, JPMorgan Chase, Wells Fargo, and Bank of America — dominated the industry, accounting for 45% of overall profits. This disproportionate share highlights the struggles of smaller banks in attracting consumer trust during such turbulent times.

Despite these challenges, the dawn of 2024 heralds a promising rebound in financial activities, reminiscent of pre-COVID-19 levels. The M&A landscape is already buzzing with activity, highlighted by ExxonMobil's acquisition of Pioneer and Chevron's purchase of Hess for $60 billion and $53 billion, respectively. The pharmaceutical industry is not far behind, with Bristol Myers Squibb and AstraZeneca spearheading $25 billion in biotech deals. These developments are fueling a resurgence in the stock market, with investors eager to capitalize on equity opportunities before they escalate in value.

Inflation, a dominant theme of the past year, remains a key economic parameter to consider. Its trajectory is uncertain, influenced by unresolved global conflicts and emerging tensions, such as the growing strain between the United States and Yemen, and the still ongoing Russian invasion of Ukraine. These geopolitical dynamics not only impact energy prices but also pose risks to global transport, adding layers of complexity to the economic recovery process.

Portfolio Allocation breakdown

While building our Dividend portfolio, we aimed to curate a portfolio that is stable, growing, and diversified. We picked 20 equally weighted stocks to compose a well-diversified portfolio. The figure below showcases the industry exposure of the dividend portfolio, with stocks from 13 different industries- Machinery, Retail and Consumer Goods sectors accounting to the highest portion.

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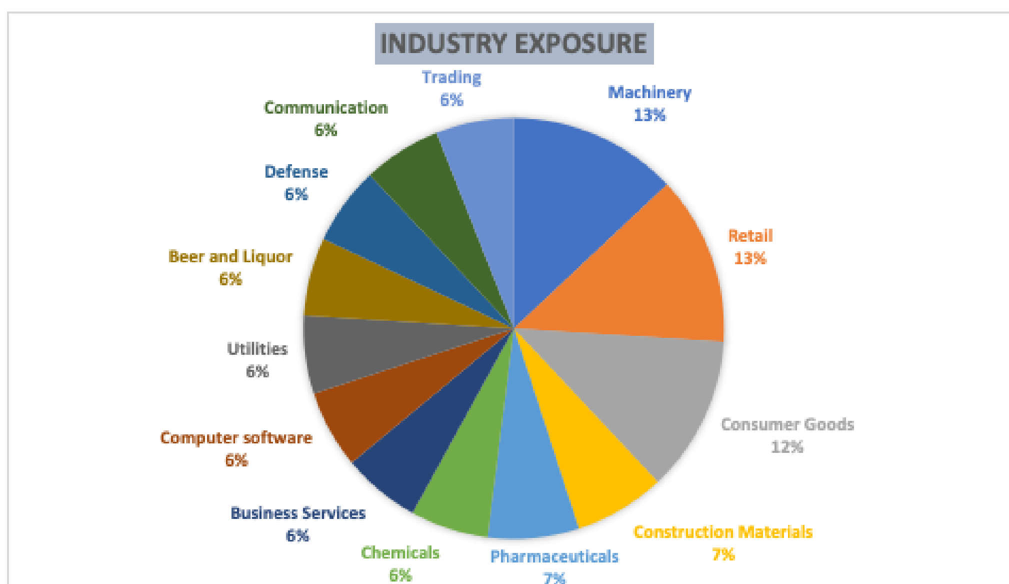
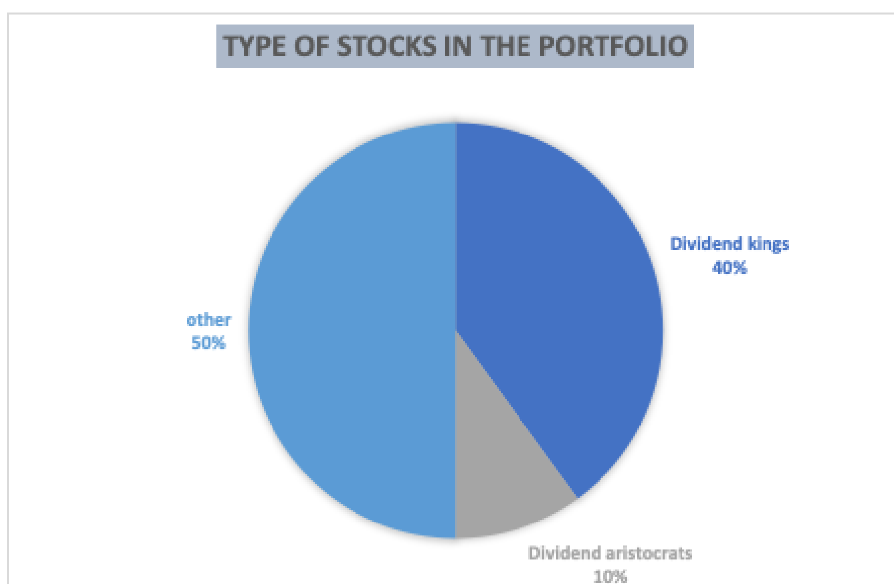


We allocated 40% of the funds to 8 Dividend Kings stocks. Dividend Kings in the portfolio are RPM, Coca Cola, Proctor and Gamble, Target Corp, Abbott Laboratories, Illinois tool workers, Parker- Hannifin Corp and Northwest Natural holdings.

These stocks have increased their dividends for the past 50 years, providing a stable income stream. Another 10% was allocated to the Dividend aristocrats Caterpillar Inc and Ecolab Inc, that have increased their dividends for the past 25 years. While selecting stocks for the remaining 50% we carefully analyzed and picked companies that are close to becoming dividend aristocrats such as Microsoft cop and Verizon Communications amongst others. The graph below shows the breakdown of our portfolio based on Dividend kings, Dividend Aristocrats, and the others.



The weighted average beta of the portfolio is 0.81 and the weighted average dividend yield of all the holdings in the portfolio amounts to 2.6%.

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Performance

The performance evaluation for a dividend fund must take into consideration the achieved average dividend yield and also the capital appreciation of securities in the fund.

In terms of capital appreciation, our securities achieved a 3-months return of 8.96%, almost perfectly in line with our benchmark, the Morningstar US Dividend Growth TR USD MSDIVGT, which achieved a 3-month returns of 8.91%. Best performing securities were Parker Hannifin Corp (+34.4%), followed by Caterpillar Inc. with a +31.6% and CostCo Wholesale Corp (+32.2%).

Figure 1. Caterpillar Coporation Inc 3-months returns

Figure 2. Parker Hannifin Corp 3-months returns

Figure 3. CostCo Wholesale Corporation 3-months returns

The worst performing stock has been Northwest Natural Holding, with a performance of +0.12%, and an extremely high volatility in its price levels, thus with a beta of just 0.46.

In terms of dividend yield, the fund achieved a ratio exactly equal to its benchmark, with an average dividend yield of 2.49%, and an estimated 12-month forward cash flow of $15,769 over the $1,000,000 initial investment. The company with the highest yield has been Verizon Communications (VZ), with an impressive 6.6%, followed by Northwest Natural Holding Co with a 5.3%. Lowest dividend yield comes from Microsoft Corporation, with an annual dividend yield of 0.67%. Anyway, as stated in the investment approach, the team agreed on buying the security to push on the capital appreciation side, but still bearing in mind that it started disbursing dividends to stockholders early in February 2003. As a matter of fact, quarterly dividends have started from $0.08 per share in 2003 to $0.75 per share currently, with an annual growth rate of 11.3%.

Risk Management

To improve diversification, stocks have been selected from a total of 13 industries, comprising but not limited to Consumer Goods, Utilities, and Retail Services. A total of 20 stocks has been picked, with each constituting around 5% of the portfolio value. This

has created the need for a continuous monitoring and rebalancing of the portfolio in the case of capital appreciation.

A regulatory change in certain industries, innovation or geo-political development can impact industries differently, while a well-diversified portfolio can mitigate the impact of such adverse events. Nevertheless, it is also important to mitigate the impact of other risks towards our team's portfolio.

Interest rate risk is one of the main factors that can make dividend paying stocks less attractive in comparison to fixed-income instruments. To mitigate this scenario of rising interest rates, our portfolio dedicates a relatively small proportion into interest rate sensitive sectors such as utilities, real estate and financials. Furthermore, by choosing companies with low debt levels and high interest coverage we were able to achieve an interest risk resistant portfolio.

Second most important obstacle that can damage the performance of chosen companies is an extreme pay-out ratio. High pay-out ratio indicates that a company directs a smaller proportion of the overall revenue flow to the further development of the company. It creates vulnerability towards economic downturns and raises concerns of sustainability of the prospected dividend payments. Our team targeted companies with a moderate pay-out ratio and the average of the portfolio is 54.53% .

Another important risk that the portfolio sought to mitigate is geopolitical risk: given the current instability in the Middle East region and the continuation of the conflict in Ukraine, our team decided to leverage the opportunity presented by the increased spending in the defense industry by investing in the defense engineering company Lockheed Martin.

In addition, our team aimed at exploiting the seasonal increase in consumer spending caused by the Christmas Holidays. Thus, the portfolio comprises numerous companies operating in the retail and consumer goods industries, such as Coca-Cola Co., Target Corp, Costco Wholesale Corp, and Procter & Gamble Co. This allowed for the hedging of seasonality risk.

The stability of companies' revenue sources is a critical factor in determining dividend payments and their growth potential. We deeply analyzed primary revenue streams of firms before making allocation decisions for the portfolio. While stalwart companies (characterized by large market cap and stable growth) like Coca-Cola and Target exhibit robust and consistent revenue flows, firms in the pharmaceutical sector often rely heavily on the ownership of production licenses and patents.For instance, AbbVie Corporation delivered remarkable returns last year, boasting a dividend yield of 4%. However, the company's significant dependency on patents, notably its blockbuster patent Humira and associated products, posed a concern. With the expiration of Humira's patent and related patents in 2023, AbbVie faced heightened uncertainty regarding future revenue streams.

Despite AbbVie's established reputation as one of the pharmaceutical industry's innovation leaders, we opted to refrain from including it in the fund. This decision reflects our commitment to prioritizing companies with stable and diversified revenue sources, minimizing exposure to risks associated with patent expirations and their potential impact on dividend stability and growth.

Improvements for the future

The fund's commitment to diversification has served to be useful, spreading investments across 13 distinct industries to mitigate risk. While diversification is a crucial factor of any successful investment strategy, a dividend-focused fund must also maintain the balance between yield and stability. This insight has become evident as we've observed consistent

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performance from equities within industrial manufacturing, utilities, construction, pharmaceuticals, and established tech sectors. This reliability is crucial, as a company's promise to pay dividends is contingent upon its

financial health; a challenging fiscal year can lead to unanticipated dividend adjustments, impacting our portfolio.
One possible update for the future could be to integrate Real Estate Investment Trusts (REITs) into the portfolio. By regulatory mandate, REITs must allocate at least 75% of their assets to real estate—a sector known for its relative stability—and are obligated to distribute 90% of their income to shareholders as dividends. This requirement aligns perfectly with our dividend-centric investment philosophy, offering both yield and a measure of security.

Conclusion

The journey into dividend fund investing has been enlightening, teaching us valuable lessons about industry selection and analysis. As we move forward, our focus will sharpen on the previously mentioned industries and REITs like funds that offer the blend of yield and stability essential to our strategy's success. This approach will better position us to navigate the complexities of the market, ensuring a more measured and informed path in achieving our investment objective.

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