Dividend paying stocks hold mass appeal, but caveats apply.

Everybody loves a juicy dividend, and why not? Consider that the risk-free rate on 10-Year Treasurys shockingly dipped below 1.4% in July of 2016. Not many pundits predicted that. Even as 10-year Treasury rates have risen over the last few months, rates remain low by historic standards, and not many investors can rely on such paltry fixed income yields to meet all of their investment objectives.

Is it any surprise, then, that investors are looking high and low for income alternatives? We believe that select equity income strategies can play a valuable role in a broadly diversified portfolio, not only for their yield potential, but also for their total return and risk mitigating benefits.

Nevertheless, investors should understand that naively selecting equities with the highest yields is not always a winning strategy. Rather, building a portfolio of dividend stocks needs to be carried out with precision, research insights, and a meticulous focus on underlying company fundamentals.
Do dividends matter?

Yes, dividends really do make a difference. For evidence, consider that yield has been a significant contributor to total large company stock returns over the past several decades. Since January of 1996, the S&P 500® Index has returned an average of 8%, but 40% of this total return is represented by dividends and capital appreciation on reinvested dividends.

“No question about it dividends have been — and will likely continue to be — an important driver of total returns,” states William Cazalet, head of Active Equity Strategies with Mellon Capital Management and portfolio manager of the Dreyfus Equity Income Fund (Class A DQIAX). “We’re very engaged in building a strategy focused on companies that have the capital discipline to pay attractive dividends. This tends to be an attractive pool of companies and a great starting point. Plus, research shows that higher-yielding strategies tend to hold up better in down markets. That’s important seven years into an aging bull market and in an environment where geopolitical risks appear elevated.”

Figure 1: Average Annual Return and Risk

Since January of 1996 the top 100 dividend payers in the S&P 500® produced a higher annual return with similar volatility. Equally importantly, high dividend paying stocks also exhibit very attractive downside performance relative to benchmark.

Data sources: FactSet and Mellon Capital.

Past performance is no guarantee of future results. Charts are provided for illustrative purposes only and are not indicative of the past or future performance of any Mellon Capital or Dreyfus strategy or product.

The S&P 500® Top 100 Dividend Payers is a capitalization weighted basket of the 100 highest yielding stocks in the S&P 500® Index. The basket was calculated by Mellon Capital and FactSet and is reconstituted on an annual basis.
But in pursuing an equity income strategy, perhaps the most important takeaway for investors is that selecting the highest-yielding companies is not a particularly savvy way to build a portfolio. For proof, look no further than the past ten years. If an investor bought only 20% of companies in the S&P 500® with the highest dividend yields, that investor would have underperformed the index.

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Cazalet reminds us that the dividend yield rises as company share price declines, all else being equal. Thus if a company has poor fundamentals and its share price gets punished, the yield will still appear lofty. However, the logical next step for any company with deteriorating fundamentals might be to cut the dividend. So in practice, it would not be uncommon to see yields rise just before being reduced or even eliminated completely. That’s why we believe chasing yields alone amounts to a value trap, and building a portfolio exclusively predicated on dividend yield is much riskier than it might appear.

In addition to underperformance, chasing yield can also manifest itself in a portfolio with unwanted sector concentrations and unintended risk. A few years ago a portfolio heavy on energy master limited partnerships (MLPs) would have captured many of the top-yielding domestic companies. But plummeting oil prices raised questions about the health of energy MLPs’ balance sheets and their ability to service their debt. Fears of widespread bankruptcies hampered the entire sector, which was severely punished in 2015, over 30%.* Thus the pursuit of high yields exclusively might generate high income in the short term, but it can also result in sector concentration and unacceptable levels of volatility.

**Figure 4: Don't Be Nearsighted**

Warning: Chasing yields may be hazardous to your investment goals. In fact, when forecast yields are highest, it’s not uncommon to see a dividend cut within the next 12 months. Fundamentals are always more important than the headline number when it comes to dividend payers.

1996–2015

Data sources: FactSet and Mellon Capital.

Data shown represents the 20 year equal weighted average for all of the stocks in the S&P 500.*

*Measured by the Alerian MLP Index.
A Better Way

How, then, should investors build a portfolio that seeks to capture the potential benefits of higher-dividend paying equities? “We prefer to identify companies with strong and sustainable fundamentals, along with above average dividend yields,” explains Mellon Capital Global Investment Strategist Syed Zamil, “It’s not either-or. Having one without the other just won’t work over the long term.”

This is where the Dreyfus Equity Income Fund — which offers a monthly dividend payout — can leverage the Mellon Capital Active Equity Research platform to systematically identify and evaluate attractive portfolio candidates based on fundamental drivers of equity returns. The platform not only aims to help control risk at the sector level, but it also helps identify areas to seek potential outperformance based on valuation, quality of earnings and fundamental growth.

“But with so many investors seeking equity income, it’s imperative to pay close attention to valuations and to follow disciplined risk protocols,” warns Zamil. “These are hallmarks of our Active Equity Research platform, which has helped the Dreyfus Equity Income Fund build a portfolio that stacks up favorably to the broad market in terms of trailing and forward-looking valuation metrics.”

Figure 5: Don’t Lose Your Balance

As of September 30, 2016, the energy, telecom, utilities and consumer staples sectors accounted for over 60% of the Top 100 dividend payers in the S&P 500.® A strategy focused on chasing the highest yields would have resulted in an unbalanced and risky portfolio, and significant underweight allocations to the information technology, financials and consumer discretionary sectors.
Figure 6: Bargain Hunting

Despite the heavy interest in equity income strategies, many dividend stocks offer attractive relative valuations by some metrics.

December 2006–September 2016
Data sources: FactSet and Mellon Capital.

So while the S&P 500® is trading at approximately 17.9 times earnings projections for each company’s next fiscal year (as of the end of the third quarter 2016), the Dreyfus Equity Income Fund portfolio is trading at 13.8 times on the same basis. “In our strategy we explicitly pay attention to valuations, and we are quite comfortable buying quality names at current levels,” adds Zamil.

The Dreyfus Equity Income Fund also aims to manage risk at the sector level. Using the S&P 500® as the benchmark, the team aims to be within roughly 3% to 5% of that sector allocation in the portfolio. This helps us avoid unwanted bias and is another example of the team’s risk-aware approach.
Disclosure

Investors should consider the investment objectives, risks, charges, and expenses of a mutual fund carefully before investing. Contact your financial advisor or visit dreyfus.com to obtain a prospectus, or summary prospectus, if available, that contains this and other information about the fund, and read it carefully before investing.

Equities are subject to market, market sector, market liquidity, issuer, and investment style risks to varying degrees. There is no guarantee that dividend-paying companies will continue to pay dividends.

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Standard Deviation is a statistical measure of the degree to which an individual portfolio return tends to vary from the mean, based on the entire population. The greater the degree of dispersion, the greater the degree of risk.

The Standard & Poor’s 500® Composite Stock Price Index (the “S&P 500® Index”) is a widely accepted, unmanaged index of overall U.S. market performance. An investor cannot invest directly in any index.

The Dreyfus Corporation serves as investment adviser to the fund. Mellon Capital investment professionals manage Dreyfus-managed funds pursuant to a dual-employee arrangement, under Dreyfus’ supervision, and apply their firm’s proprietary investment process in managing the funds.