The Next Decade of Equity Income

As our strategy comes of age, Baby Boomers are passing their own milestone. We believe the timing for the Strategic Value Dividend franchise couldn't be better.

In 2021, the Strategic Value Dividend (SVD) portfolio marks its 20th year of providing clients with a high and rising income stream. Over the past two decades, the strategy has provided consistently attractive dividend distributions through boom and bust, recessions, bubbles, disasters (financial and natural), recoveries and even a global pandemic. With a 4.5% gross dividend yield and average annual dividend growth rate of 4.17% over the last 10 years (as of 6/30/2021), the portfolio has delivered quite well on its income objectives.

As our strategy crosses the 20-year mark, many Baby Boomers are passing their own milestone. They have begun turning 65 and entering retirement at an increasing pace, a demographic trend that is expected to accelerate in the coming years.

These milestones—two decades of cutting checks for us, and the Baby Boomers starting to collect their checks—make us look to the future, not just dwell on the past. For the retirees, a well-earned sense of satisfaction may be mixed with anxiety, as they consider the challenge of meeting their spending needs while preserving capital over a long and comfortable retirement. For Boomers' parents, bonds were the answer. Many in the Greatest Generation retired into the longest and strongest bond market in modern history, with U.S. Treasuries offering a risk-free yield of 10% or higher for most of the period between 1979 and 1985. And while steadily declining interest rates since the 1980s have generated exceptional bond returns, today's ultra-low yields are delivering a new set of challenges for the next generation of income-collectors.

In stark contrast to the bond market conditions that funded their parents' golden years, today's retirees are faced with a 10-year Treasury yielding below 1.5%. Even the current yield of the Bloomberg Barclays Aggregate Bond Index, a barometer for the fixed income market, is below 2.6%. Rising inflation may be the only similarity that stands out when comparing the two periods, a condition that (if it persists) would erode the spending power of an already-low stream of fixed-income coupons. In contrast, the Strategic Value Dividend portfolio's longstanding goal to produce a high and rising stream of income over time could provide a foil to inflation and help preserve spending power. And with many high-dividend stocks trading at historic discounts to the rest of the equity market, we believe the timing couldn't be better to consider the benefits of equity income in retirement.

<u>The Global Income Problem: A matter of supply and demand</u>

There is a paucity of income on a global scale, with interest rates steadily declining over the last 40 years, and sovereign yields trending toward 0% in more recent years. While this backdrop already sounds dire for income-collectors, it's actually worse than that. Currently there is more than $16 trillion of negative-yielding debt trading in the bond market around the globe.*

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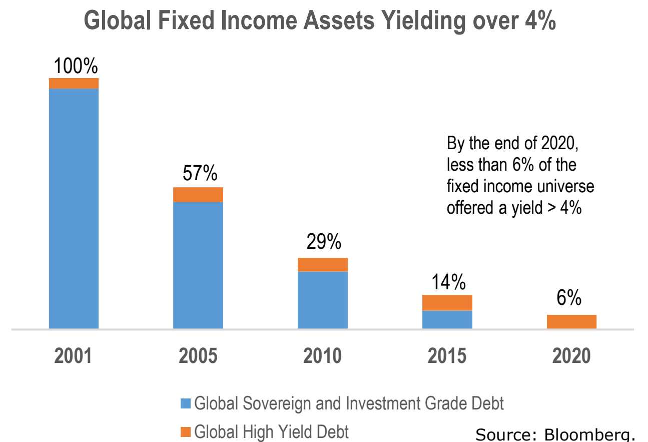
Twenty years ago, there was no income problem. In 2001, 100% of the global fixed income universe, from US Treasuries to Emerging Market junk, offered yields greater than 4%. Today, less than 6% of the fixed income universe around the globe offers a yield better than 4%, consisting almost entirely of sub-investment-grade US and Emerging Market issues.



Source: Bloomberg.

While the supply of attractive-yielding debt instruments has been in retreat, a surge of new retirees highlights a sustained demand for income. The baby boom that followed World War II boosted the birth rate in the U.S. from an average rate of 2.5 million per year to around 3.4 million per year, a pace that was maintained over the next several decades. In 1957 and 1961, the birth rate peaked around 4.3 million births per year, causing a surge in the number of Americans expected to turn 65 between 2022 and 2028. By 2030 all baby boomers will be 65 or older, and this over-65 cohort is projected to make up more than 20% of the U.S. population.**

These retirees face several challenges that many of their parents never had to consider. Beyond anemic bond yields, Boomers have witnessed the decline of the traditional "defined benefit" private pensions which provided lifelong income for retired employees. Baby boomers will live longer than their parents. They must plan for longer retirements and account for rising health care costs. Today's retirees are also starting to receive payments from a Social Security program that is distributing more cash than it collects in taxes, a deficit that will accelerate as a rising percentage of the population starts to draw benefits. As a result of this imbalance, the Congressional Budget Office has concluded that the Social Security trust fund will run out of money by 2032 if the problem is not addressed.

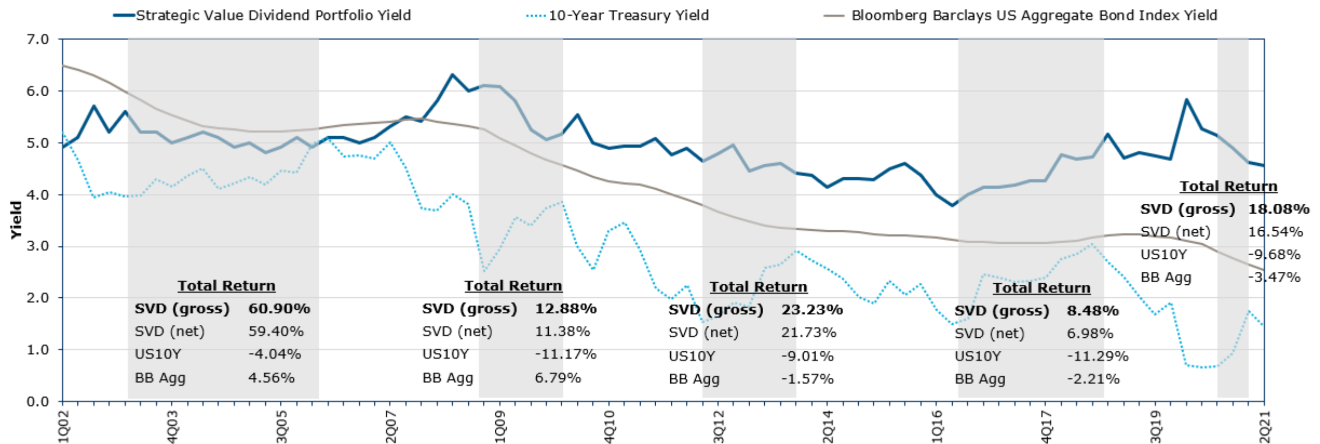
Compared to the Greatest Generation, it's clear that Baby Boomers will rely more heavily on their own investment accounts to generate income for retirement. And the present-day gap between the demand for income and the dwindling supply of it underscores the importance of dividend investing for today's retirees.

Could higher bond yields solve the income problem?

If we were to wake up tomorrow with the 10-year Treasury yielding 3% or 4%, we would expect to see some traditional income investors shift their portfolios toward bonds. But we're nowhere near those levels currently, and the journey from sub-1.5% Treasury yields to 3% or higher would be a painful one for many fixed income investors, as bond returns generally face a performance headwind as interest rates rise. After 40 years of declining interest rates and rising bond valuations, investors have become accustomed to *not* losing money in bonds, and a loss of principal could be quite jarring to retirees looking to preserve capital for the long haul. In other words, if higher interest rates are the party we're all waiting for, then income-oriented investors may want to arrive fashionably late.

But for dividend-paying stocks, periods of rising interest rates have been associated with positive returns. Over the SVD portfolio's 20-year history, we've observed 5 separate periods of notably rising interest rates (denoted by the shaded areas in the chart on the next page). In each of these periods of rising rates, the portfolio delivered positive total returns, handily beating the declines posted by U.S. Treasuries and outpacing the returns generated by the Bloomberg Barclays Aggregate U.S. Bond Index. All the while, our portfolio's income stream has eclipsed that of the two bond benchmarks, with the SVD income advantage increasing in recent years. This is an important distinction that should not be overlooked: As bond yields have steadily declined, the SVD portfolio's gross yield has remained relatively consistent around the 4% to 5% range.

SVD Performance in Rising Rate Environments



Past performance is no guarantee of future results. Refer to the attached GIPS Report for additional information, including total returns over longer time periods. Data reflect the representative portfolio of the wrap composite.

Durability, growth and active management will be critical for dividend investors:

Much attention is given to SVD's historically high-income stream, but the potential durability of dividend distributions is just as important. While share prices—even for dividend stocks—tend to be more volatile than investment grade bond prices, and while bond payments are contractual rather than discretionary, the SVD portfolio seeks to address these risks by making long-term investments in mature, defensive businesses. We also seek to invest in companies with dividends that are supported by ample cash flow generation through the entire business cycle, high quality balance sheets, and an expectation for high, sustainable, and rising dividend distributions in the future. When investing in income-producing stocks, dividend sustainability and growth have proven to be key elements of long-term capital advancement. This highlights the need for engaged, active managers that seek to identify dividend-growers and avoid companies where fundamentals are unlikely to support future dividend growth. Finally, diversification of holdings can provide a defense against a material decline in a portfolio's income generation, even if an individual holding or two were to cut its distribution in any given period.

While SVD's historical income advantage has been self-evident, a thirteen-year bull market for equities has left stock investors firmly focused on rising share prices to grow their wealth. This relatively uninterrupted wave of capital appreciation has allowed new retirees to simply sell their investments at a gain, and "manufacture" their own income stream without having to rely on bond coupons or dividends. The last five years have been particularly kind to equity investors keen on building their war chest for retirement, with the S&P 500 generating a total return of more than 125% from mid-2016 to mid-2021. In that period of time, many of SVD's high-dividend stocks have gone largely unnoticed (in spite of continuing to generate 4.17% average dividend growth over the last five years). Looking forward, it's possible that the next decade of stock market performance could be just as lucrative as the last. It's a roll of the dice. But for retirees looking to reduce their reliance on stock prices alone, we see an unprecedented valuation disconnect that could bode well for investors looking to build an income stream for the future.

Entry points matter: SVD's greatest relative valuation differential in 20 years

As SVD approaches its 20th Anniversary, we'll grant ourselves just a moment to look in the rear-view mirror. Over the last two decades, the portfolio has executed on its dividend yield and dividend growth aspirations. In that same period the strategy has generated a gross annualized total return of 8.94% and a net annualized total return of 5.73% (net of maximum allowable fee)***. Incidentally, it is no coincidence that SVD's since-inception return matches up pretty closely with the sum of its long-term dividend yield plus its long-term dividend growth rate. That's consistent with our investment math where the expected return is the combination of the upfront yield plus the dividend growth driving capital appreciation. We are gratified to see that result over a twenty-year period.

From a valuation perspective, the portfolio's average Forward P/E ratio has hovered 2-3 turns below that of the S&P 500, a condition that is explained by our preference for large, mature, lower-growth companies with rich dividend distributions. In comparison, the S&P 500 tilts heavily toward growth stocks which typically trade on higher earnings

multiples. In other words, some valuation discount to the broad market is warranted. But five years ago, in mid-2016, the picture was quite different. At its valuation peak in 2016, our portfolio offered a gross yield well below 4% and traded at forward P/E ratio that was 3 turns higher than the S&P 500. Since that relative valuation peak in 2016, the portfolio's stock prices have advanced only modestly. Today its gross yield is back up to 4.5% and its forward P/E ratio is back down to its normal historical range. Continued dividend growth, earnings growth, and active management have all contributed to this recalibration. In the same period following mid-2016 the S&P 500 has generated a nearly 18% annualized return, with growth and big tech stocks (many without any cash distributions) pushing the market to higher valuations. Today, the resulting valuation gap between the S&P 500 and SVD is nothing short of stunning. On a forward P/E basis, SVD now trades more than 8 turns of earnings lower than the S&P 500:

Data reflect the representative portfolio of the wrap composite.

As we consider the implications of this relative valuation chart, we are reminded: Entry points matter. And as our strategy turns 20, in one sense at least, it's our belief that the timing of today's retirees couldn't be better.

Past performance is no guarantee of future results.

Investors should be willing to accept the higher risk of investing in stocks compared to bonds. Stocks offer higher return potential, but their prices are more volatile than those of bonds.

Views are as of 8/12/21 and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

*Source: Bloomberg: https://www.bloomberg.com/news/articles/2019-08-15/negative-yielding-debt-hits-record-16-trillion-on-curve-fright. Past performance is no guarantee of future results. For illustrative purposes only.

**US Census Bureau: https://www.census.gov/library/stories/2019/12/by-2030-all-baby-boomers-will-be-age-65-or-older.html#:~:text=Born%20after%20World%20War%20II,be%20at%20least%20age%2065 and https://www.census.gov/prod/2014pubs/p25-1141.pdf

***Performance data as of 7/30/2021. Returns reflect the representative portfolio of the wrap composite.

Because this is a managed portfolio, the investment mix will change, and the holdings are not indicative of future portfolio composition. Marketplace conditions fluctuate suddenly and frequently, and investment manager's opinions may change.

Because the portfolios may allocate relatively more assets to certain industry sectors than others, the performance may be more susceptible to any developments which affect those sectors emphasized by the portfolios.

There is no guarantee that dividend paying stocks will continue to pay dividends. In addition, dividend paying stocks may not experience the same capital appreciation potential as non-dividend paying stocks.

The dividend yield represents the average yield of the underlying securities within the portfolio. The average yield is a weighted average calculated by assigning a weight to each of the underlying securities in the portfolio based upon the portion of total assets of the portfolio each underlying security represents.

International investing involves special risks including currency risk, increased volatility, political risks and differences in auditing and other financial standards.

Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices.

Stocks offer higher return potential, but their prices are more volatile than those of bonds.

Bloomberg Barclays US Aggregate Bond Index is an unmanaged index composed of securities from the Bloomberg Barclays Government/Corporate Bond Index, Mortgage-Backed Securities Index and the Asset-Backed Securities Index. Total return comprises price appreciation/depreciation and income as a percentage of the original investment. Indices are rebalanced monthly by market capitalization. Investments cannot be made in a index.

S&P 500 Index is an unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Dividend yield and other portfolio information is for a representative portfolio and does not reflect expenses.

Diversification does not assure a profit nor protect against loss.

Refer to the attached GIPS report for more information.

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Schedule of rates of return and statistics

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Composite	Federated Hermes Strategic Value Dividend SMA
Index	Dow Jones Select Dividend (1/07) from Russell Midcap Value
Periods Ending	06/30/2021

Returns (%)

	Composite Pure Gross Return^	Composite Net Return (Assuming Maximum Fee)	Index
Q2 21	5.27	4.49	3.33
YTD	14.83	13.16	23.69
1 Year	27.82	24.11	50.71
3 Years (Annlzd)	7.19	4.04	10.60
5 Years (Annlzd)	5.50	2.39	10.74
7 Years (Annlzd)	6.51	3.37	10.31
10 Years (Annlzd)	9.47	6.26	12.48
15 Years (Annlzd)	7.09	3.94	8.49
Oct 01 - Jun 21 (Annlzd)^^	8.95	5.75	10.42

	Composite Pure Gross Return(%)^	Composite Net Return(%)	Index Return(%)	Composite* 3-Yr Std Dev	Benchmark* 3-Yr Std Dev	Number of Portfolios	Dispersion**	Composite Assets (mil)	Firm Assets (bil)
2011	16.85	13.44	12.42	14.33	19.86	5869	1.10	1678.9	363.9
2012	7.53	4.37	10.84	10.48	11.50	6300	0.47	1817.0	371.3
2013	21.59	18.05	29.06	8.53	9.36	7420	0.42	2444.2	366.8
2014	12.34	9.05	15.36	8.92	9.04	6412	0.23	2223.3	349.3
2015	4.00	0.93	(1.64)	9.97	9.91	6982	0.21	2303.9	343.4
2016	10.05	6.82	21.98	9.93	9.31	11970	0.25	3189.3	342.3
2017	15.64	12.26	15.44	9.11	7.69	13884	0.16	3918.8	354.7
2018	(7.89)	(10.64)	(5.94)	9.83	8.92	10330	0.21	2526.3	377.2
2019	20.43	16.91	23.11	9.64	10.68	11038	0.24	3037.4	503.1
2020	(6.94)	(9.71)	(4.56)	15.60	19.30	9585	0.87	2497.4	585.7

^Pure gross returns are shown as supplemental and do not reflect the deduction of transaction costs.
^^Represents composite inception period. See page 2 for additional notes to the schedule of rates of return and statistics

*Represents the 3-year annualized standard deviation for both the gross composite and the index returns. Statistic is used to measure the volatility of composite returns.
**Standard deviation is calculated using gross returns. Standard deviation is not applicable ("N/A") for any period if fewer than five accounts are in the composite for that period. (See footnote 5)

Please see the Notes to the Schedule of Rates of Return and Statistics.
This composite is comprised of all domestic portfolios investing in U.S. and foreign stocks that management believes will provide high yield, reasonable dividend growth and lower volatility in falling equity market environments, yet will provide potential participation in rising markets. Eligible portfolios are managed with wide latitude to choose the sectors and securities to fulfill the mandate. Within eligible portfolios, securities are selected based on a fundamental assessment of their financial strength, dividend yields, dividend growth rates, and performance during periods of market weakness. Portfolios in this composite implement the strategy using American Depositary Receipts (ADR) versus directly purchasing shares of companies on foreign exchanges. Investments in ADRs entail risks related to daily fluctuations in the value of currency, which may be more volatile in times of increased market risk. There are no guarantees that dividend-paying stocks will continue to pay dividends. The benchmark was changed January 2007 to the Dow Jones U.S. Select Dividend Index which proved to be more representative of the current strategy. The Dow Jones U.S. Select Dividend Index aims to represent U.S. leading stocks by dividend yield. One hundred stocks are selected to the index by dividend yield, subject to screens for dividend-per-share growth rate, dividend payout ratio and average daily dollar trading volume. Components are weighted by indicated annual dividend. The Russell Midcap Index measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap Index is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. Indexes are unmanaged and cannot be invested in directly. Effective July 2013, performance for this composite is calculated in U.S. dollars net of foreign withholding taxes on dividends, interest, and capital gains. Individual tax rates may vary dependent on individual residency. Effective January 2016 accounts previously assigned to a platform-restricted composite may be eligible for inclusion in this composite. Accounts deemed by the portfolio manager to have a category restriction shall be excluded from this composite. A category is defined as a collection of investments with similar attributes such as industry classification, business sensitivity, social theme, or security features. Separate accounts eligible for this composite generally have a minimum of $100,000 at the time of opening and are a part of an asset-based pricing program. Wrap fee accounts make up 100% of this composite for all time periods. This composite was created in December 2001. Federated Hermes has managed portfolios in this investment style since July 1997. Performance shown for 2001 is for a partial period starting on October 1, 2001. Federated Hermes claims compliance with the Global Investment Performance Standards (“GIPS®”) and has prepared and presented this report in compliance with the GIPS® standards. Federated Hermes has been independently verified for the period of January 1, 1992, through March 31, 2021. The verification report is available upon request. A firm that claims compliance with the GIPS® standards must establish policies and procedures for complying with all the applicable requirements of the GIPS® standards. Verification provides assurance on whether the firm’s policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS® standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report. Performance results are presented both net and gross of total wrap fees and reflect the reinvestment of income. “Pure” gross returns are shown as supplemental and do not reflect the deduction of transaction costs. Net returns reflect the deduction of a maximum fee. A fee equal to the highest anticipated wrap fee that a client could pay (3.00% annually as charged by the program sponsor, inclusive of up to a maximum investment advisory fee of 0.70%) is used. This total wrap fee includes all charges for trading costs, portfolio management, custody and other administrative fees. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size.

Notes to the Schedule of rates of return and statistics

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1. Federated Hermes is a global, independent, multi-strategy investment management firm. For GIPS® purposes, Federated Hermes is defined to include the assets of registered investment companies that are advised or sub-advised by the various Federated Hermes advisory companies. Effective September 30, 2020, for GIPS® purposes the name of the firm was officially changed to Federated Hermes. Firm assets on this report exclude assets affiliated with Hermes GPE and the advisory-only, model-based assets that may be included in other reports providing total firm assets.
2. Interest income and dividends are recognized on an accrual basis. Returns include the reinvestment of all income.
3. All market values and performance information are valued in USD unless currency is denoted in composite description.
4. Annual composite dispersion is measured and presented using the asset weighted standard deviation of the gross returns of all of the portfolios included in the composite over the entire year. Quarterly dispersion is measured using all portfolios included in the composite for that quarter. Prior to March 2020 with regard to Federated Clover Investment Advisors composites, annual dispersion was measured using the equal weighted standard deviation of the returns of all the portfolios included in the composite over the entire year.
5. Composite dispersion does not measure the risk of the product presented, it simply measures the return variance among portfolios managed in a similar fashion. This variance can be affected by variations in cash flow or specific client parameters among the portfolios comprising the composites, as well as by execution of strategy across accounts.
6. See the composite description language for a discussion on appropriate fees currently applied to calculate composite performance. With regard to the institutional composites not managed by the MDT Advisers and Federated Hermes International teams, for the period July 1, 1992 through September 30, 2009, net of fee performance was calculated monthly by reducing the gross composite return by the highest actual fee of any account in the composite for that month, regardless of investment vehicle. Prior to July 1992, the maximum management fee for third quarter 1992 was used to calculate net of fee performance historically to inception of the composite. For those composites managed by the Federated Hermes International investment team, net composite results are based off model fees using the stated fee schedule. In addition, further fee information can be obtained from the firm's respective Forms ADV Part 2 Brochure Item 5.
7. Additional information regarding the policies for valuing investments, calculating performance, and preparing GIPS ® reports, as well as a complete list and description of the firm's composites and pooled funds is available upon request.
8. Past performance is not indicative of future results.
9. GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein.
10. See disclosures on the Schedule of Rates of Return and Statistics Reports for additional information.