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INVESTING FOR INCOME? DON'T OVERLOOK SMALL AND MIDCAP STOCKS

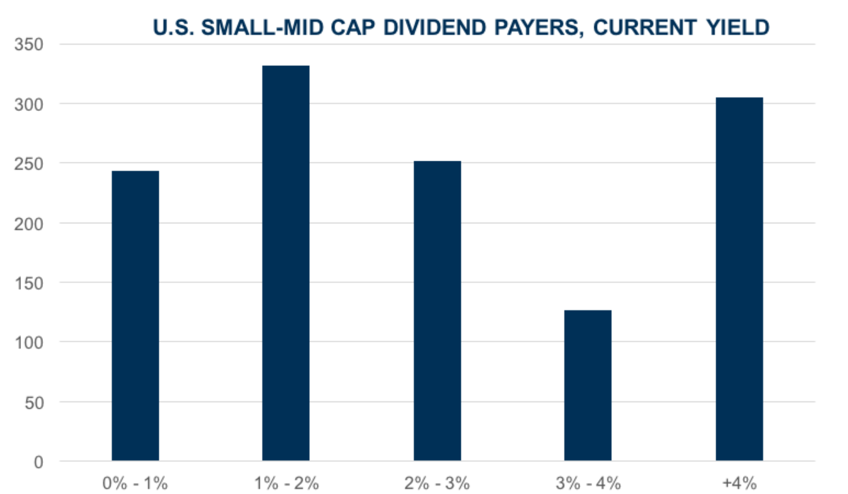
Small cap stocks typically conjure up notions of high growth or new IPO opportunities, but rarely does an investor stop to consider the idea of dividends. Dividends usually call to mind comforting, if not stodgy, mega-cap blue-chip companies suitable for "widows and orphans," such as ExxonMobil (XOM), Proctor & Gamble (PG), or IBM (IBM). However, most people are unaware of just how widespread dividends are in small and midcap U.S. stocks.

After the 2008 market crash and corresponding collapse in the yield curve, many companies underwent a revolution in how they look at capital allocation. As a result of investor pressure originating from the new low-yield environment and a dearth of feasible ideas for capital investment, many companies shifted their free cash flow allocation toward dividends. This was particularly prevalent in the midcap space, where many companies initiated new dividends for the first time, altered their dividend policy to target higher payout ratios, or simply reallocated more of their free cash flow growth to dividend increases. As a result, of the 2,723 U.S. companies ranging from $150 million up to $10 billion in market capitalization trading on major U.S. exchanges, a surprising 46% pay a regular dividend.[i]

And the yields are higher than you might think.

With an average current yield greater than 2%, this is on-par with large cap yields (stocks in the S&P 500 Index yield an average of 1.98%).[ii] Not surprisingly, the Russell 2500 Index, which measures the performance of the 2,500 smallest companies tracked by the Russell 3000 Index, currently yields 1.45%, which is still fairly attractive when one considers the current yield of a 10-year U.S. Treasury is just 2.3%.[iii]

The investment potential for income is available in small and midcap stocks. However, as you can see from the chart on this page, the population distribution of yield is bimodal, with a second "hump" in the +4 percent yield category. This is because, similar to a bond, there are a number of factors involved in determining a stock's current yield. One of the most important factors is the payout ratio, which can be a measure of the quality or stability of the dividend. Another factor is the credit quality of the company and corresponding default risk, which not only affects the yield of a company's bonds, but also the yield of its equity. Therefore, a stock could be high yielding because of strong cash flow growth, or because the company and/or its dividend is "junk" and a high-risk investment.



Source: Bloomberg

[i] Bloomberg data, as of 12/31/2016
[ii] Standard and Poor's data, as of 9/29/2017
[iii] FTSE Russell, as of 9/30/2017; U.S. Department of Treasury, as of 9/30/2017

That's why it is absolutely critical, especially in the small/midcap investment space, to have a solid handle on risk in comparison to yield, and to effectively balance these two levers when seeking high-yielding equity. Boston Private's investment process places this requirement at the forefront of its stock selection. The process rigorously screens out high yielding investment options that have characteristics of excessive investment risk. Nevertheless, we are able to obtain a respectably yielding 2.40% portfolio as of Sept. 30, 2017* while providing the broad market diversification expected from modern asset allocation techniques.

Specifically, Boston Private's Small-Midcap Equity Income strategy utilizes a two-pillared approach of managing risk while selecting for yield. The structure of the portfolio (that is, the number and types of industry and sector exposure it holds) is tightly controlled in order to minimize active risk, while the stock selection process is used to select for yield while balancing the results of a rigorous corporate quality risk analysis to keep individual security risk to a minimum.

This process produces a high-yielding, high-beta portfolio with an overall lower volatility than its benchmark. Incidentally, stocks selected for this strategy often end up acquisition targets in M&A deals, most likely because of their high-quality balance sheets and solid underlying cash flow. Since inception, over 20% of the stocks sold out of this strategy were sold due to them being acquired in an M&A deal.

Our offering is fairly unique: Out of the 668 mutual funds and 82 ETFs in the Morningstar U.S. Small Cap Fund database, only 9 funds and 2 ETFs have the words "dividend, "income," or "total return," in their names, with just $4.4 billion in total capital allocated to these strategies.

We believe that income investing can be beneficial not only to individuals requiring income, but to all types of investors, due to the powerful effects of compounding. Over a 10-year period from October 2007 to October 2017, the S&P 500 Index's total return topped 100%, and reinvested dividends accounted for 40 percentage points of the gain.[iv]

Over time, we believe outperformance is driven by enhancing the dividend versus the benchmark and taking advantage of the power of compounding. This investment strategy can not only be applied to large cap stocks, but through Boston Private's Small-Midcap Equity Income Strategy, applied across the cap spectrum in your asset allocation. Please speak with your advisor to find out more.

[iv] Bloomberg, as of 10/9/2017

*The portfolio characteristics shown above (including dividend yield) represent BPW's internally managed Small-Midcap Equity Income strategy (SMIDCEI). All data is shown as of the specified date and is subject to change. There is no guarantee that the SMIDCEI strategy will meet its investment objectives. All investment strategies have risk of loss. Please see BPW's Small-Midcap Equity Income strategy Fact Sheet for more details. Past performance is no guarantee of future results.

The opinions expressed and information contained in this article are given in good faith, may be subject to change without notice, and are as of the date issued. The accuracy and completeness of this information is not guaranteed. Since each client's situation is unique, please review your specific investment objectives, risk tolerance and liquidity needs with your advisor before a suitable investment strategy can be selected.

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