

Crest Dividend Equity Strategy Conceptual Framework

Executive Summary

- ❑ The total return that a stock investor can earn is made of two components: price appreciation and dividend income. Over the long-term, reinvested dividends are a key factor to growth and preservation of wealth. Over the eight decades between 1930 and 2010, on average, dividends comprised over 50% of total return of the S&P 500.
- ❑ Generally, while share prices fluctuate in response and anticipation of market and company-specific events, the dividend component tends to be more stable as companies' decision to pay dividends is based on their long-term expectations of cash flows. This is particularly true for companies with a long history of paying a dividend.
- ❑ The main mistake investors make when selecting income stocks is to focus mostly on dividend yield. Paradoxically, the very high dividend yield is often a sign of distress and a potential signal of an impending dividend cut or omission.
- ❑ In structuring and managing dividend-oriented portfolios we focus on the sustainability of dividend growth and its fundamental drivers: established dividend policy reflected in a long history of increasing dividends; business stability supported by steady earnings; financial strength as evidenced by liquidity and high creditworthiness; and adequate dividend coverage.
- ❑ As a result of our process that balances dividend growth and yield, the Crest Dividend Strategy is expected to generate a dividend yield of approximately 1.5-2x the S&P 500's. The portfolio is also well-represented across industries and sectors to reduce industry concentration risk and provide enhanced diversification.



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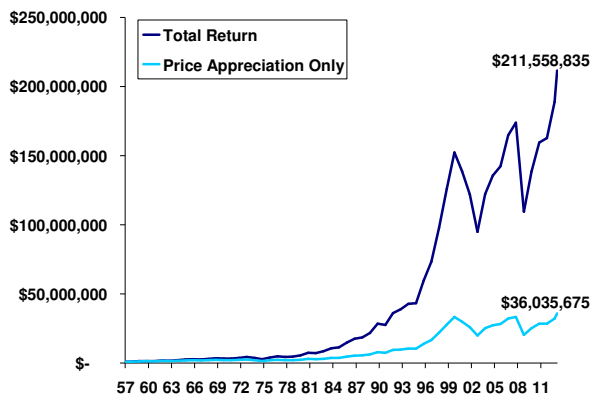


The Importance of Dividends

The total return that a stock investor can earn is made of two components: price appreciation and dividend income. Generally, while share prices fluctuate in response and anticipation of company-specific and market events, the dividend component tends to be more stable as companies' decision to pay dividends is based on their long-term expectations of cash flows. This is particularly true for companies with a long history of paying a dividend.

To understand the importance of dividends to investors, Chart 1 graphs the hypothetical growth of \$1 million invested in March 1957 through April 2013 in the S&P 500. The price appreciation-only index (light blue line) grew from \$1M to over \$36M which corresponds to a compounded average return of 6.6%. The total return index (dark blue line) grew to over \$211M which corresponds to a CAGR of 10%.

Chart 1. Growth of \$1 Million Invested in the S&P500



Source: S&P Dow Jones Indices, Crest Investment Partners

Such a significant growth differential is the result of two important interacting effects: a) dividends directly contribute to total return; b) dividends reduce overall stock and portfolio volatility and in periods of falling market prices dividends are the only contribution to investors returns. Thus reinvested dividends over the long-term are key factor to growth and preservation of wealth. Chart 2 breaks-down the S&P 500 total return in price appreciation and dividend contribution by decade. Over the eight decades between 1930 and 2010 on average, dividends comprised over 50% of total return.

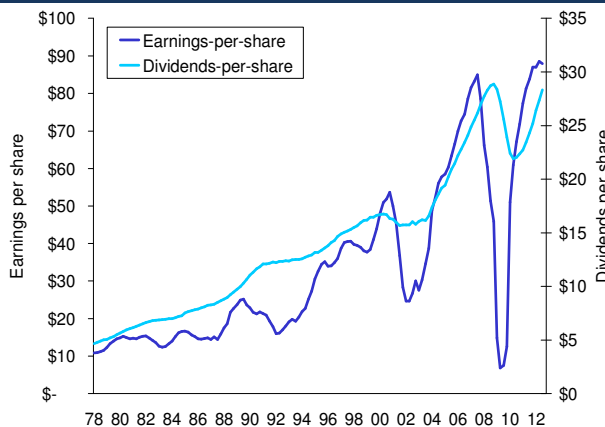
Chart 2. Contribution of Dividends to Total Return

Decade	Price Appreciation	Dividend Contribution	Total Return	Dividends as a % of Total Return
1930s	-41.9%	56.0%	14.1%	NM
1940s	34.8%	100.3%	135.0%	74.3%
1950s	256.7%	180.0%	436.7%	41.2%
1960s	53.7%	54.2%	107.9%	50.2%
1970s	17.2%	59.1%	76.4%	77.4%
1980s	227.4%	143.1%	370.5%	38.6%
1990s	315.7%	116.7%	432.4%	27.0%
2000s	-24.1%	15.0%	-9.1%	NM
Average	104.9%	90.6%	195.5%	51.5%

Source: Strategas Research Partners

Chart 2 shows that dividend contribution to total return is not the same in every decade. Specifically, during periods of low growth and or high inflation like in the 1940s and 1970s dividends accounted for over 70% of total returns. The lowest contribution was in the 1990s a decade characterized by the "tech bubble" - a pronounced and unsustainable market rise attributed to increased speculation in technology stocks. Investors dearly paid the excesses of the late 1990s through the prolonged 2000-2002 bear market when the NASDAQ lost over 90% of its value. In the subsequent decade which encompasses the two major bear markets of 2000-2002 and 2008, dividends provided the only positive return from stocks to investors. The inherent stability of dividends contrasts with the cyclicity of earnings which drives stock prices (see Chart 3) . This dividend persistence can mitigate the negative impact of recessions and bear markets on investors' wealth.

Chart 3. Earnings and Dividends – S&P 500



Source: S&P Dow Jones Indices, Crest Investment Partners

Designing a Dividend Strategy

The main mistake investors make when selecting income stocks is to focus mostly on dividend yield. Paradoxically, the very high dividend yield is often a sign of distress and a potential signal of an impending dividend cut or omission. We believe that investors should focus on the sustainability of dividend growth and its fundamental drivers. First of all, companies with long history of increasing dividends are more likely to continue to do so in the future. Commitment to pay a dividend imparts discipline to the capital allocation process by forcing management to only invest in projects with expected positive payoffs. Thus steadily growing dividends are a sign of a well-managed company with confidence in its future growth.

A long history of paying dividends does not guarantee future dividend growth, though. A number of causes may adversely impact companies' future dividends. For example, during business cycle downturns reduced cash flows may force companies to cut the dividend in order to preserve cash. Or increasing government regulation on certain industries may impact companies' profitability and therefore limit dividend distributions. In some cases, in order to retain dividend-seeking investors some companies stretch their finances to maintain their dividend to the point where their financial flexibility, their growth options - and their dividend - are compromised. The dividend coverage defined as earnings-to-dividend ratio measures how well earnings "cover" the dividend and thus provides one metric to evaluate dividends' sustainability.

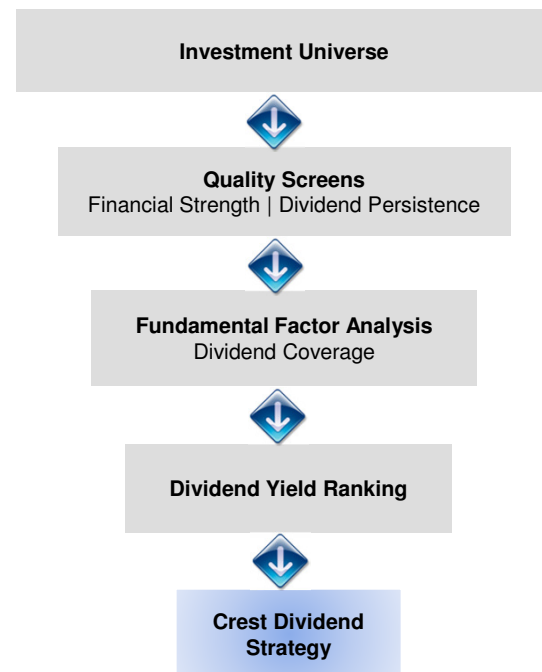
The recognition that debt obligations need to be paid before dividends reminds us of the discretionary nature of dividends and highlights the importance of evaluating companies' financial strength and creditworthiness in conjunction with their dividend growth and policy. Companies with strong financials and high creditworthiness are more likely to have far greater access to sources of low-cost short-term credit and to respond to an unanticipated decline in cash flows by increasing their short-term borrowing. Access to capital markets during periods of distress allow these companies to endure challenging economic environments and more likely maintain their dividend.

So far we have identified the fundamental drivers of dividend growth: an established dividend policy reflected in a long history of increasing dividends; business stability supported by steady earnings; financial strength as evidenced by liquidity and high creditworthiness; and adequate dividend coverage.

Chart 4 illustrates the investment process flow that leads to the final portfolio selection. The sequence reflects our fundamental thinking:

- 1) Select financially strong stocks with a proven record of dividend growth and earnings
- 2) Select stocks with an attractive combination of dividend coverage and yield

Chart 4. Investment Process Flow



Source: Crest Investment Partners

As a result of our process that balances dividend growth and yield, the Crest Dividend Strategy is expected to generate a dividend yield of approximately 1.5-2x the S&P 500's.

The portfolio is also well-represented across industries and sectors to reduce industry concentration risk and provide enhanced diversification.



Portfolio Management Massimo Santicchia is a Co-Founder and Chief Investment Officer of Crest Investment Partners. He directs all aspects of the investment strategy as well as develops and manages quantitative equity portfolios. Santicchia has 16 years of investment experience including: S&P Investment Advisory Services LLC, as creator and portfolio manager of the JNL/S&P 4 funds and co-manager of the JNL/S&P Managed and Disciplined funds.

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