Not All High Dividend ETFs Are Taking A Breather

Numerous stock selection strategies have been tried; few have stood the test of time. Focusing on high growth and above average price momentum is a strategy that works well during periods of market strength, but it's a double-edged sword. That's because the kinds of stocks that fit this description have high betas, i.e., they are unusually sensitive to movements of the market. So their movements are magnified both ways.

With that kind of approach, the hitch is the need to bail out or jump in when they change direction. Not surprisingly, there's a pretty good chance of getting whipsawed as prices move up or down in quick succession.

The high dividend strategy is completely different. There is no jumping in or bailing out. In contrast, it's a matter of periodically (annually is fine) rebalancing one's stock portfolio with the highest dividend paying stocks. Over time, the results of doing so will provide above-average total returns, but the emphasis has to be on the phrase "over time."

Low Expectations, High Returns

This is a value strategy that works because the stocks held are generally those for which expectations are not high. Yet each year there are always a few that do far better than expected. So even though the average stock held may not do well, the standouts will do the heavy lifting, raising the overall result to levels that are worthwhile.

As time passes, increasing numbers of investors are adopting this strategy, in some cases pushing these stocks up to unsustainable valuations. When valuations get too rich, we all know what happens. The stocks either go sideways for extended periods or they collapse. The former outcome is likely for the high dividend stocks.

With almost five months of 2017 under our belts, it's clear that the high dividend stocks, as a group, are lagging an otherwise robust market advance. We looked at five of the best-known high dividend ETFs to see what's going on:

- DVY – iShares Select Dividend
- HDV – iShares Core High Dividend
- SCHD – Schwab U.S. Dividend Equity
- SDY – SPDR S&P Dividend Aristocrats
- VIG – Vanguard Dividend Appreciation

Only one of these five well-known, high dividend ETFs has been keeping up with the market. That's VIG, the Vanguard Dividend Appreciation ETF. The others are all lagging by about five percentage points.

The reason for the disparity is not immediately obvious. Yes, there are differences in the expense ratios. HDV, SCHD, and VIG have expense ratios below 0.10% whereas DVY and SDY come in at 0.39% and 0.35%, respectively, but that's not the answer.

For that matter, between 80% and 90% of the holdings in the three with the lowest expense ratios are large cap companies, compared with 40% to 50% for the other two. This information doesn't help either.

Many Holdings Is The Answer

The difference, it turns out, is largely a reflection of the number of stocks held in each of the portfolios. VIG has 181 holdings, which is about the double the number held by the other ETFs. So although the fund has a bias toward dividend-paying stocks, the broad spread of its commitments could easily earn it the label as a closet indexer of large-cap, dividend-paying companies.

That's not to disparage VIG, but it does help explain why its returns are close to those of the S&P 500 while the dividend ETFs with narrower bases of holdings have fallen well behind the major market averages.