EISNERAMPER
WEALTH MANAGEMENT
CORPORATE BENEFITS

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Hedging Your Equity Exposure

The most common way to think about hedging is a strategy to reduce the volatility of equities. This is most generally done by buying puts on one's stock portfolio or by selling calls. The options market or the futures market can be used to accomplish these hedges, and these markets are very efficient. The purchase of puts is an insurance policy and like all insurance policies has a cost associated with it. So, in years where the stock market rises, buying puts reduces the overall return by the cost of the put; however, in years when markets decline, the puts protect the declines and portfolios fall less than the market.

The other type of hedge is a strategy that sells calls on the portfolio which limits the upside potential of the portfolio, and simultaneously provides cash flow from the sale of the call options. This is a very effective strategy when markets rise or fall slowly because the increase in cash flow from the sale of the calls adds to total return. It does not, however, provide significant protection when we experience a rapid decline. The protection is limited to the cash flow from the sale of the calls. For example, if one sold a call option on a stock that provided 7% cash flow and the stock decline by 30%, this strategy would decline by 23%, less for sure but not great protection.

Both strategies do produce lower volatility than just buying and holding equities.

Dividend Strategies

There are other strategies to reduce the volatility of an all-equity index portfolio, and the ones we favor develop higher income like the use of call options but do so without limiting the upside of one's portfolio. We have been developing these portfolios for over 20 years using growing dividends as the method to develop the portfolios. We retain managers in four areas: large cap domestic, small cap domestic, international, and global. Each manager exhibits an expertise in their specific area and the requirements for success in each of these portfolios is specific to the strategy. The constant, however, remains the same. Each portfolio needs to exhibit a dividend yield that is significantly greater than their respective index, 50% to 100% greater, and the portfolio's expected dividend growth needs to be greater than the index.

There are two ways stocks achieve return: dividends and price appreciation. The long-term history of investing in the U.S. stock market shows a total return in round numbers of 10% annualized, with 7.5% coming from appreciation and 2.5% coming from dividends. Our growing dividend strategy simply changed the arithmetic by focusing the cash flow to a higher level. Today our portfolio which allocates 42.5% to domestic large cap, 42.5% to international and 15% to domestic small cap, has a dividend yield of slightly over 3.5%. If we assume future dividend growth is 7% annualized, the compounded cash flow over the next decade will be 5% and the final dividend yield, assuming no change in stock prices, will be 6.65%. In other words, we have achieved twice the annualized dividends of the long-term dividend average, and thereby could achieve the same long-term average with less appreciation. To get to a 10% total return, the index needed 75% from appreciation, while the dividend strategy will require only 50%. Since

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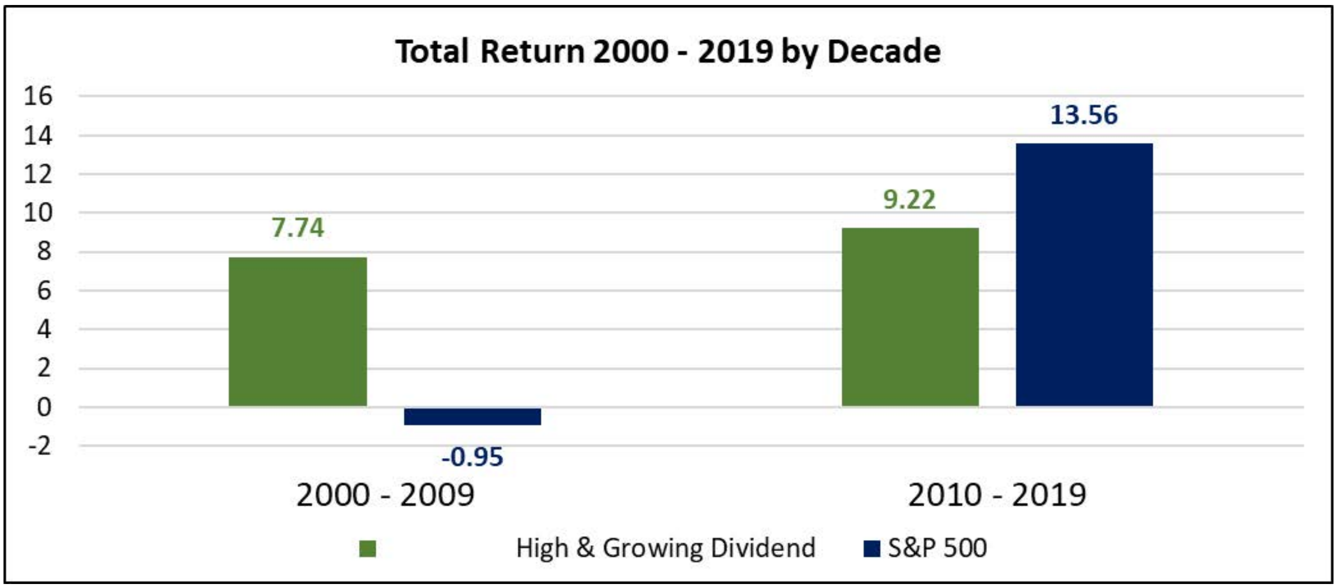
there is no data going back 50 years or longer, we do not know the exact contribution of dividends to a growing dividend portfolio, and it maty have been less than a 50% contribution to total return, but you get the idea.

Theoretically, this strategy should produce more consistent returns because it is less dependent on appreciation. Reviewing our history of managing this strategy, we can see if we accomplished lower volatility. Chart 1 shows the returns of our growing dividend portfolios as compared to the S&P 500 index for the decades of the 2000s and the 2010s.

Chart 1



Source: Zephyr StyleAdvisor and Morningstar Direct

As you see, the dividend strategy had annualized returns in the two decades of 7.74% and 9.22% while the index had a negative return for the 2000s of -0.95% and then a positive return of 13.56% for the decade of the 2010's. For the total 20-year period, our dividend portfolio achieved an annual return of 8.4% while the index return was 6.0%. In addition, our portfolios over the last 21 years protected when the stock market declined, falling only 80% on average of what the S&P 500 fell.

So, we achieved both a higher return and did so with more consistent returns and lower volatility.

Yes, but the 2010s achieved a higher return!

This is correct, the 2010s saw outperformance by the index when compared to the dividend strategy. It should not be a surprise that indexation will have periods of higher returns. If we start with the premise that we like the dividend strategy as a core equity strategy over the long-term because we think we get both higher returns and less

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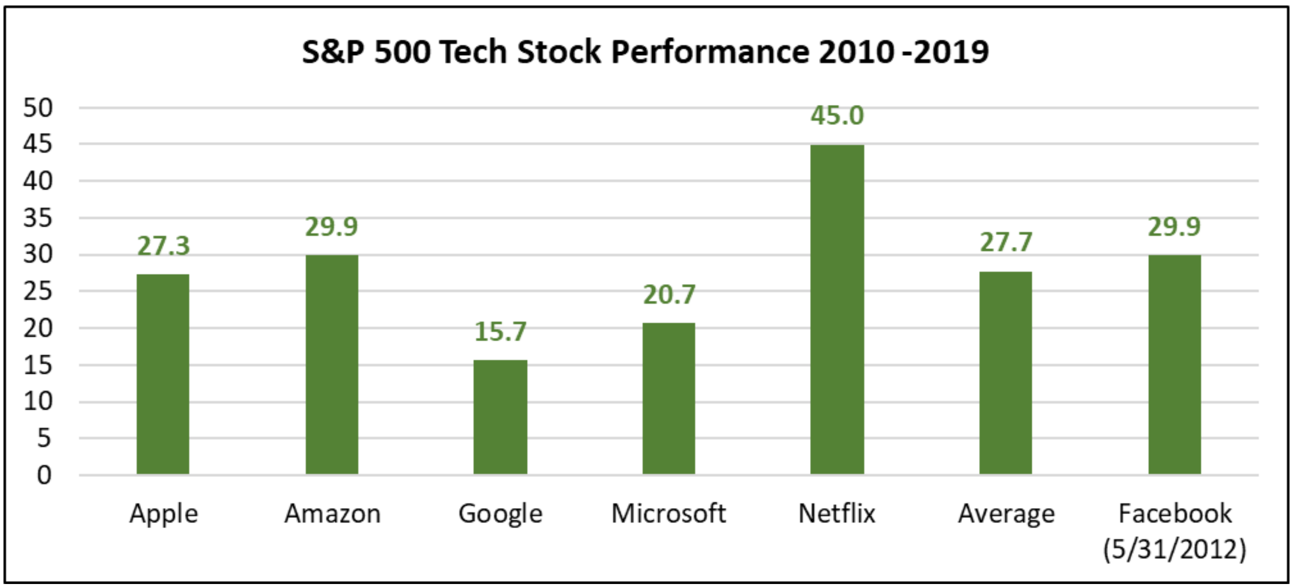
volatility, then we would have to see if there is a way to hedge the periods when the index gets higher returns. In other words, is there a hedge against future higher growth, more return coming from appreciation than from dividends.

This is not how we traditionally think of a hedge, but there is no reason not to think of it that way. If we get lower returns from the dividend strategy at times, can we add a small amount of a more aggressive strategy to boost return during these periods without dramatically changing the long-term advantage? So, let's start with an analysis of the decade of the 2010s to see why the S&P 500 outperformed our dividend strategy. Chart 2 shows the returns of six stocks: Amazon, Apple, Facebook, Google, Microsoft and Netflix.

Chart 2



Source: Morningstar Direct

As you can see, these six stocks compounded at higher rates than the index which compounded at 13.5%. If you equally weighted these stocks for the decade, your compounded return would have been over 27%. Now it is worth noting that Facebook went public in 2012, so it was not available in 2011. Interestingly by adding it to the other five stocks when it went public the annualized return is still 27%. So, if we could have foreseen in 2011 that these six stocks were going to lead the market and we used just a portion of them in our portfolio to complement our dividend strategy, they would have added to our return of 9.2%. If we can figure out which stocks may have high returns and add them to our steady dividend portfolio, we would have a combination that would get us higher returns without dramatically increasing risk. There is one similarity among the six stocks, they are all disruptive technology companies. Each in their own way created a new industry or disrupted an existing industry. The contribution of these stocks to the index return was most prevalent last year as the S&P 500 rose over 18% and

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these six stocks contributed over 14% of the 18% return. So, last year, the general stock market did not rise 18%, the index did, driven by these six stocks. The general stock market, that is the S&P 500 without these six stocks, was up just over 4%.

What is the Hedge?

The missing piece from the growing dividend strategy is a growth component that focuses on disruptive technology companies. While we have three such managers, we will use Ark Investment Management for illustration purposes. Ark was started in 2014 in New York by Cathie Wood. They have 10 analysts, a head of research and Cathie, that is 12 people in total attempting to find the next disruptive technology companies that will make our world faster, cheaper, better. Ark has been running ETF portfolios, and we have a separate account of their best ideas, but the data we will show is taken from their flagship disruptive technology ETF. For the six years ending 2020, that ETF compounded at 37.53%. Using that as an example, if we had combined just 10% of that ETF with 90% of our dividend portfolio, we would have significantly increased our return, but with only 10% in these volatile stocks, the increase in volatility would have been minimal. The history of our growing dividend strategy shows that in stock market declines our portfolio only declines 80% of what the general stock declines. We do not have good data on the disruptive technology ETF declines run by Ark, but if we assume the declines will be 50% greater than the general market declines, the declines would be 87% of the S&P 500 by combining a 90/10 portfolio of our growing dividend strategy and Ark. The returns would have enhanced those of the growing dividend portfolio. The 90/10 portfolio last year would have achieved a return greater than the S&P 500.

It is worth pointing out that all investors are not alike, so a 10% allocation for some might be too large while for others it may be too small. If our assumption is correct that our dividend strategy continues to capture only 80% of the downside of the general market and Ark has downside of twice the market, then a 90/10 portfolio would have a downside capture of 87, an 80/20 portfolio would have a downside capture of 94 and a 70/30 would have a downside capture of 101. Will these be the downside capture numbers precisely? Absolutely not. Our dividend downside capture is an average over 21 years not specific to one market downturn, so we could have a higher downside capture.

What is the Future?

We think we have entered a period of dramatic technological change in our country and around the world. Artificial Intelligence, Autonomous Vehicles, Fintech, DNA Sequencing, Robotics and 3D Printing will combine to change our world over the next decade in ways we cannot imagine. What Ark does is to identify the companies that will benefit from these technological innovations. They will be the growth component of portfolios and will continue to have high returns. The Ark portfolio will produce the next FAANG or FAAAM stocks that will be part of our stock indices like the S&P 500 and will drive the returns. We recommend thinking of these as the hedge for the future. Disruptive technology will change our world, and we think the change these technologies bring need to be part of our equity allocations. When combined with our growing dividend strategy, we can achieve consistent and yet high returns.

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As always, information provided should be considered based on your personal needs to accomplish your goals. At EisnerAmper, we will be happy to discuss with you any questions and how these principals can be applied to meeting your financial plan. Feel free to contact Marc Scudillo, Managing Partner of EisnerAmper Wealth Management & Corporate Benefits, LLC; 908-429-0025 or email at mscudillo@eawmcb.com.

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