HERITAGE PERSPECTIVE

A QUARTERLY PUBLICATION OF HERITAGE INVESTMENT GROUP INC.

SUMMER 2017

Heritage Update

INVESTING WISELY

At Heritage, our research and insight have concluded that one of the most effective ways to invest is to focus on a rules-based, unemotional approach that uses the power of the markets to generate returns. Over many market and political cycles, we have met our clients' goals and helped them to build wealth over time.

INDUSTRY RECOGNITION

Heritage Investment Group is proud to announce that for the second time it has been named to the Financial Times 300 Top Registered Investment Advisers. The list recognizes the top independent registered investment advisory firms from across the US.

RELAXING IN THE SUMMERTIME

Summer may be the time to relax, but while you're taking a break, your investments should be working hard for you. A well-structured portfolio designed specifically around your objectives continues to provide peace of mind while you take time out to enjoy the summer!

EMPLOYEE PROFILE

Tamara Zamora

Tamara joined Heritage in 2015 as part of our operations team. She enjoys working with our clients and supports portfolio managers in our regional and main offices. Tamara's big news is that she was married earlier this year. She and her husband (and their dog Bruno) also just purchased their first home. Congratulations Tamara!

ABOUT HERITAGE

Successful long-term investing rarely depends on stock picking or market timing. That's why we scientifically engineer portfolios to harness the power of thousands of stocks, bonds, and commodities from around the world. Above all, we believe that success is in the implementation. We do what we say, in your best interest, consistently, and without emotional reaction.

Inside this Issue

"The secret of success is making your vocation your vacation."

– MARK TWAIN

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Dividends: A Strange Love Affair

"It is an extra dividend when you like the girl you've fallen in love with."

– CLARK GABLE

Investors seem to love dividends, and this love affair is as old as stock markets themselves. The first publicly-traded company, the Dutch East India Company, paid dividends to its shareholders for over 100 years from its inception in 1602, although payments were sometimes made in the form of spices or cloves in lieu of cash. Investors were eventually heartbroken when the dividends ended and the company was dissolved at the end of 1799, but the infatuation for dividends lives on to this day.

No free lunch

Investors who are infatuated with dividends are often shocked when they learn that the object of their infatuation is not what it appears. This is because most of the perceived benefits of dividends are merely an illusion. The payment of a dividend by a corporation is not a separate and distinct source of earnings as many investors believe. Rather, when a company pays a dividend, it is merely giving the shareholders back some of their own money.

If you find this notion bizarre, you are not alone; most investors have never paused to reflect upon this necessary fact of market pricing. Consider the following example: Suppose Company XYZ has a share price of $10 today and it pays a cash dividend of $1 tomorrow. All else being equal, the price of the stock will fall by the amount of the dividend as soon as it is paid, because the remaining assets of the company are now worth only $9. In other words, investors who own XYZ stock will still have $10 after the dividend is paid, only now they will have $1 of cash and $9 of stock.

Despite this necessary price adjustment, many investors still exhibit a strong attraction to dividend-paying stocks. Perhaps some view the dividend as a separate and distinct source of income, in addition to capital gains, which makes the dividend appealing as a sort of consolation prize if the capital gains do not materialize. Dividends also may appeal to "principal preservationists" – those investors who are willing to spend income from their portfolio, but who are hesitant to dip into principal. Although a dividend is actually a return of principal to the investor, it *feels* like an interest payment, and spending this "interest" seems to be less stressful than spending principal.

Dangerous liaisons

Even if you can come to terms with the true nature of dividends, a strong preference for dividend-paying stocks does have other implications. Since nearly half of all global stocks pay no dividends, if you only own dividend-paying stocks you are placing an unnecessary restriction on your ability to diversify. Also, the receipt of a dividend deprives the investor of *choice*. If you need cash flow from your portfolio, you can sell some shares of stock at any time and pay taxes only on the capital gains. But, if you do not need the cash flow, the payment of a dividend *forces* you to take a tax liability on the entire amount of the dividend in order to receive cash that you did not even want.

"...most of the perceived benefits of dividends are merely an illusion."

Also, most investors who favor dividends perceive the cash payments as a form of safety. However, high-dividend stocks are not a proper substitute for conservative investment-grade bonds. Unlike bond interest payments, dividends can be reduced or eliminated whenever the company sees fit to do so, and this usually happens in times of financial crisis – just when the income and safety is needed most.

What's love got to do with it?

We should clarify that we do not believe that investors should completely avoid dividend-paying stocks. A well-diversified portfolio will hold many companies that pay dividends and many that do not. If a company has excess cash flow and no immediate use for that cash, a dividend payment is a reasonable way to put that cash back into the hands of its investors.

It is, however, important to understand that there is nothing magic about dividends and that many investors love dividends for all the wrong reasons. Instead of depending on dividends to pay the

bills, a wise investor will focus on *total portfolio cash flow*, which can include dividends as well as interest, capital gains, or even a withdrawal of principal. A hard and fast rule that favors dividends over these other sources of cash places unnecessary constraints on a portfolio that usually result in lower diversification, higher risk, and higher tax bills.

And, while we advocate simplicity in investing, in the case of dividend stocks we want to caution against over-simplification. With the help of an experienced financial planner, you can develop a plan that uses dividends as well as other sources of cash to generate exactly the funds you need, only when you need them, in the most efficient way possible.

The original version of this article was written by Heritage for the July 2017 edition of The Light, a local magazine serving Broward County, Florida.

An Overview of Indexing

Legend has it, a pharmacist named John Pemberton was searching for a headache cure when he tried blending coca leaves with cola nuts. Who knew his recipe was destined to become such a smashing success, even if Coca-Cola® never did become the medicine Pemberton had in mind?

In a similar vein, when Charles Dow launched the Dow Jones Industrial Average (the Dow), his aim was to better assess stock prices and market trends, hoping to determine when the market's tides had turned by measuring the equivalent of its incoming and outgoing "waves." He chose industrials (mostly railroads) because, as he proposed in 1882, "The industrial market is destined to be the great speculative market of the United States."

While the actively-minded Dow never did achieve market-timing clairvoyance (and neither has anyone else we're aware of), he did devise the world's first index. We would like to think his creation turned into something even greater than what he had intended; especially since Vanguard founder John Bogle and other pioneers leveraged Dow's early work to create a more efficient way to invest in today's markets: the index fund.

Bogle launched the first publicly available index fund in 1976. Initially dismissed by many as "Bogle's folly," its modern-day rendition, the Vanguard 500 Index Fund, remains among the most familiar funds of any type.

Index investing is born

In defense of Dow's quest to forecast market movements, it is worth remembering that his was a world in which electronic ticker tape was the latest technology, there were no open-ended mutual funds or fee-only financial advisors, and safeguards and regulations were few and far between. Essentially, speculating was the only way one could invest in late-nineteenth century markets.

Compared to actively-managed solutions, index funds lend themselves well to helping investors diversify, cut costs, and minimize taxes.

Index investing: Room for improvement

One of the problems with index investing is that indexes were not specifically devised to be invested in. There is often a lot going on underneath their seemingly simple structures that can lead to inefficiencies by those trying to overlay their investment products on top of popular indexes.

Index dependence – Whenever an index "reconstitutes" by changing the underlying stocks it is following, any fund tracking that index must change its holdings as well – and relatively quickly if it is to remain true to its stated goals. In a classic display of supply-and-demand pricing, this can generate a "buy high, sell low" environment as index fund managers hurry to sell stocks that have been removed from the index and buy stocks that have been added.

Compromised composition – Asset allocation is based on the premise that particular market asset classes exhibit particular risk and return characteristics over time. That is why your investment "pie" should be carefully managed to include the right asset class "slices" for your financial goals and risk tolerances. If you are invested in an index fund and you are not sure what its underlying index is precisely tracking, you may end up with off-sized pieces of pie.

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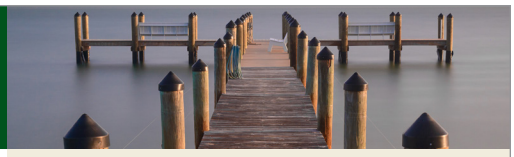

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Introducing "rules-based" investing

So, yes, index investing has its advantages, but it also has inherent challenges. No wonder academically-minded innovators from around the globe soon sought to improve on index investing's best traits and minimize its weaknesses. In fact, many of these thought leaders were the same early adopters who introduced index fund investing to begin with. Building on index investing, they devised rules-based investment funds, to offer several more advantages:

Index-independence – Instead of tracking an index that tracks an asset class, why not just directly capture the asset class itself as effectively as possible? Rules-based fund managers have freed themselves from tracking popular indexes by establishing their own parameters for cost-effectively investing in most of the securities within the asset classes being targeted. This reduces the need to place unnecessary rebalancing trades at inopportune times simply to track an index

Improved concentration – Untethering themselves from popular indexes also enables rules-based fund managers to more aggressively pursue targeted risk factors; for example, a rules-based small-cap value fund often has more flexibility to hold smaller and more value-tilted holdings than a comparable index fund.

Focusing on innovative evidence – Rules-based investing shifts the emphasis from tracking an index to continually improving our understanding of the market factors that contribute to the returns we are seeking. By building portfolios using fund managers who apply this same evidence to their funds, you can make best use of existing academic insights, while efficiently incorporating credible new ones as they emerge.

"passively-managed index funds offer a more solid solution for sensibly capturing available market returns."

Indexing, revisited

It is important to remember that indexes do **not** help forecast what will happen next in the markets, nor do high-water index values such as "Dow 20,000" foretell whether it's a good or bad time to buy, hold, or sell your own market holdings. And, while low-cost, well-managed index funds may still play a role in your overall investment portfolio, you should ensure that you are selecting them because they are the best fit for your rules-based investment strategy, not simply because they are a popular choice at the time.

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Heritage Investment Group would like to thank all of our clients for their continued support. We are here to help you plan for your future. If you have any family members or friends who might benefit from our help, we would welcome the opportunity to speak with them. Please contact us at 954-785-5400.

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