Dividend Quarterly

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Passing Grades at Summer School: Bank Dividends are Going Higher

Investors will soon be receiving more dividend income from their investments in U.S. bank stocks. On June 29, 2016, the Federal Reserve released the results of the sixth annual Comprehensive Capital Analysis and Review (CCAR). This exam combines the Federal Reserve's qualitative assessment of large banks' capital planning capabilities with the quantitative assessment conducted in the Dodd-Frank Act Stress Test (DFAST), the results of which were released a week earlier. In the 2016 tests, the Federal Reserve did not object to the largest U.S.-based banks' plans to meaningfully increase dividend payments (and repurchase their own shares). It may come as a surprise to casual observers, but the U.S. financial sector is now the largest payer of dividends by dollars in the S&P 500, and the banking industry is set to return more capital to shareholders than at any point since 2007.[1, 2]

The Fed's review examined the 33 largest institutions, which collectively comprise over 80% of U.S. banking assets. As the Federal Reserve explains, the CCAR:

> Evulates the capital planning processess and capital adquacy of the largest U.S.-based bank holding companies...When considering a firm's capital plan, the Federal Reserve considers both quantitative and qualitative concerns...The Federal Reserve may object to a capital plan based on quantitative or qualitative concerns. If the Federal Resrve objects to a capital plan, a firm may not make any capital distribution unless expressly authorized by the Federal Reserve. [4]

When introduced in 2009, the CCAR, or stress test process, served an important role in reducing uncertainty in the stability of the banking system. In the years since introduction, the process has served as an annual, and very public, checkup on the health of the banking industry as well as individual institutions. While investors largely anticipated this year's results, in our view the test results are still positive for bank shareholders and, given near-term macro concerns, serve as a useful reminder that the largest U.S. banks are well capitalized, even under dire stress test assumptions. As the Fed press release states:

> U.S. firms have substantially increased their capital since the first round of stress tests led by the Federal Reserve in 2009. The common equity capital ratio—which compares high-quality capital to risk-weighted assets—of the 33 bank holding companies in the 2016 CCAR has more than doubled from 5.5 percent in the first quarter of 2009 to 12.2 percent in the first quarter of 2016. This reflects an increase of more than $700 billion in common equity capital to a total of $1.2 trillion during the same period. [5]

While the quantitative improvements are impressive, there have been near-term costs borne by shareholders, as banks have spent significant time and resources improving internal systems and preparing for increased supervision. Note, for example, that M&T Bank, which posted a profit every quarter during the financial crisis and never cut its dividend, has greatly increased regulatory and compliance spending over the past several years:

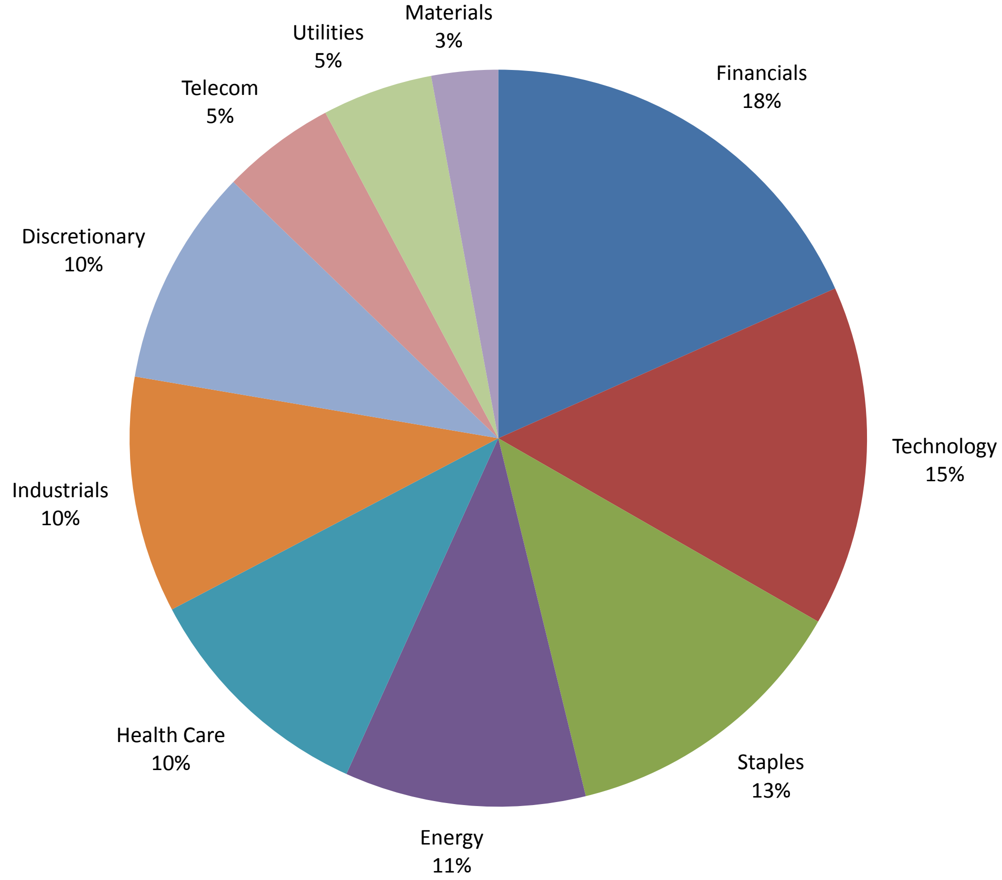
> M&T has engaged 12 consulting firms at an aggregate cost of $178 million [since 2013]. The team handling the anti-money laundering program, consumer and corporate compliance, as well as capital planning and stress testing and other risk management areas increased from 128 to 807. [6]

The annual report goes on to note that the overall cost of compliance peaked in 2014 at $441 million.

Other banks tell a similar story. As the Wall Street Journal recently noted, bank spending on consultants was $29 billion in 2015, compared with just $16 billion in 2007; sometimes the spending can be redundant, with the article noting that large banks have even hired consultants to _manage their consultants.[7] While these costs are borne by shareholders, we believe the outsized growth of these expenses is largely complete, and that going forward regulatory and compliance spending will likely scale with bank size. Importantly, in our view, recent efforts by regulators and banks lay the groundwork for a more stable banking sector, one that can support growing shareholder dividend payouts over time. We view this as a very positive development for dividend investors.

This year's stress test results drove home the notion that bank dividends are rising and payouts are relatively safe, and in our view, U.S. banks remain an underappreciated and undervalued source of dividend yield and growth. This is particularly noteworthy given the current investor focus on high dividend paying stocks, as investors have bid up traditional sources of dividend yield, such as the Electric Utility and Consumer Staples sectors, with valuations now at or above the high end of their historical ranges. In many cases, banks offer higher dividend yields, while bank stock valuations are near the low end of their historical ranges. We believe this creates a rare opportunity for income-oriented investors to add dividend-paying stocks to their portfolios at reasonable valuations. In our Equity Income Strategy, we favor M&T Bank, PNC Financial, Wells Fargo, and U.S. Bancorp, which all recently announced dividend increases, and have dividend yields meaningfully above the S&P 500, while valuation measures remain attractive.

S&P 500 Dividend Payments by Sector



CTC Equity Income Holdings: Recent Dividend Increases

				Consective Years Dividend	
Date	Company	Increase	Dividend Yield	Paid	Increased
6/29	M&T Bank*	7.1%	2.64%	36	1
6/29	PNC Financial	7.8%	2.74%	38	5
6/29	U.S. Bancorp	9.8%	2.82%	37	5
6/24	Medtronic	13.1%	2.01%	45	39
5/16	Clorox	3.9%	2.46%	40	39
5/9	FactSet Research	13.6%	1.31%	18	17
4/28	Johnson & Johnson	6.7%	2.68%	45	44
4/27	ExxonMobil	2.7%	3.40%	106	40
4/26	Wells Fargo	1.3%	3.24%	40	5
4/26	Apple	9.6%	2.33%	5	4
4/1	Bank of the Ozarks	14.8%	1.60%	20	6

Source: Bloomberg, company reports
Notes: International holdings are on a local currency basis
*Announced June 29, 2016; takes effect in the first quarter of 2017.

[1] Evercore IS Group, Compustat/S&P. Other sectors have higher dividend yields, but the financials are the largest payer of dividends by total dollars.
[2] Barclays, "CCAR 2016 Review: Total Payout Ratio Exceeds Pre-Crisis Levels," June 30, 2016.
[3] Banks with over $50 billion in assets are subject to the CCAR, while all banks with over $10 billion in assets must conduct the DFAST.
[4] Board of Governors of the Federal Reserve System, Comprehensive Capital Analysis and Review 2016: Assessment Framework and Results, June 2016.
[5] Ibid.
[6] M&T Bank, 2015 Annual Report.
[7] Tracy, Ryan. "Stress Test Inc.: Billions of Dollars, Bank Consultants to Manage Other Consultants: Multi-billion dollar industry has developed around the annual exercise created to make U.S. banks stronger," Wall Street Journal, June 28, 2016.

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