

# Dividend Multiplier: An Innovative Way to Enhance Dividend Income

## *Part 1: Dividends and Dividend Futures*

– Danke Wang, Portfolio Manager

One of investors' most constant and common concerns is finding ways to increase their yield. The Pacer Dividend Multiplier Strategy provides broad-based equity exposure while aiming to deliver a multiple of the index's dividend yield.

*A fundamental knowledge of dividend futures is helpful in understanding how the strategy works. The following Perspective explores just that. If you already have a firm grasp on dividend futures, feel free to check out Part 2 for a more in-depth look at the construction of our Dividend Multiplier Strategy.*

### Key Takeaways

- Over a 35-year period, more than half of the S&P 500's total return has come from dividends and reinvestment.
- The S&P 500 total return can be divided into two parts: (1) the price component, tracking changes in the stock prices. (2) the dividend component, tracking the actual dividends paid by S&P 500 companies.
- By using Dividend Futures, an investor can gain exposure to the amount of actual future dividend payments without the impact of price changes in stocks.

### S&P 500 Dividend

Let's start with the basics.

Besides stock price changes, dividends are the other source of equity returns in investors' portfolios (though dividends are never guaranteed).

In 2023, within the 26.29% total S&P 500 return, 24.23% was due to price appreciation. 1.83% of the returns came from dividends, and the remaining 23 basis points<sup>1</sup> was because of the compounding of dividend reinvestment throughout the year.

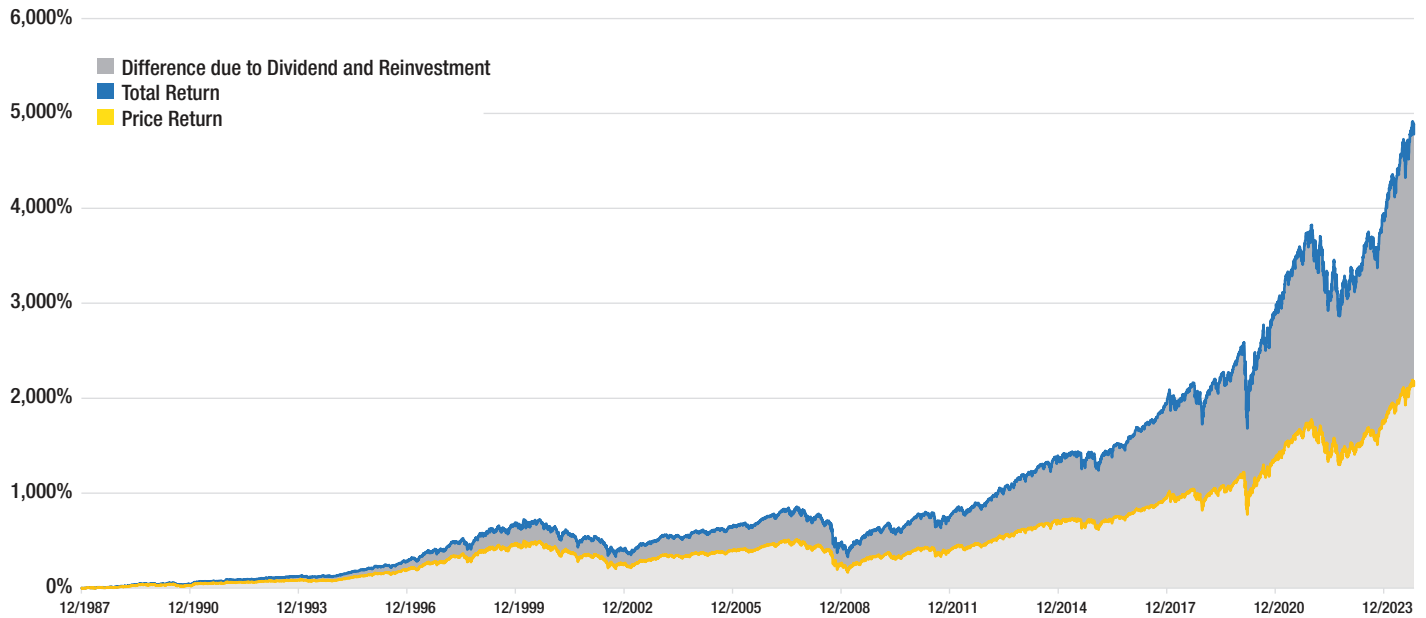
In a single year, the price return can dwarf the dividend yield of the S&P 500. Over the long run, however, dividend and dividend reinvestment has been the primary driver of total investment outcomes.

From 1987 through October 2024, the S&P 500's total return was 4,780.08% cumulatively, while the price return was 2,129.21%. By taking the difference, we can see that more than half of the total return comes from dividends and reinvestment.

<sup>(1)</sup>Basis Point: One hundredth of one percent

## S&P 500 Cumulative Return

12/31/1987 - 10/31/2024

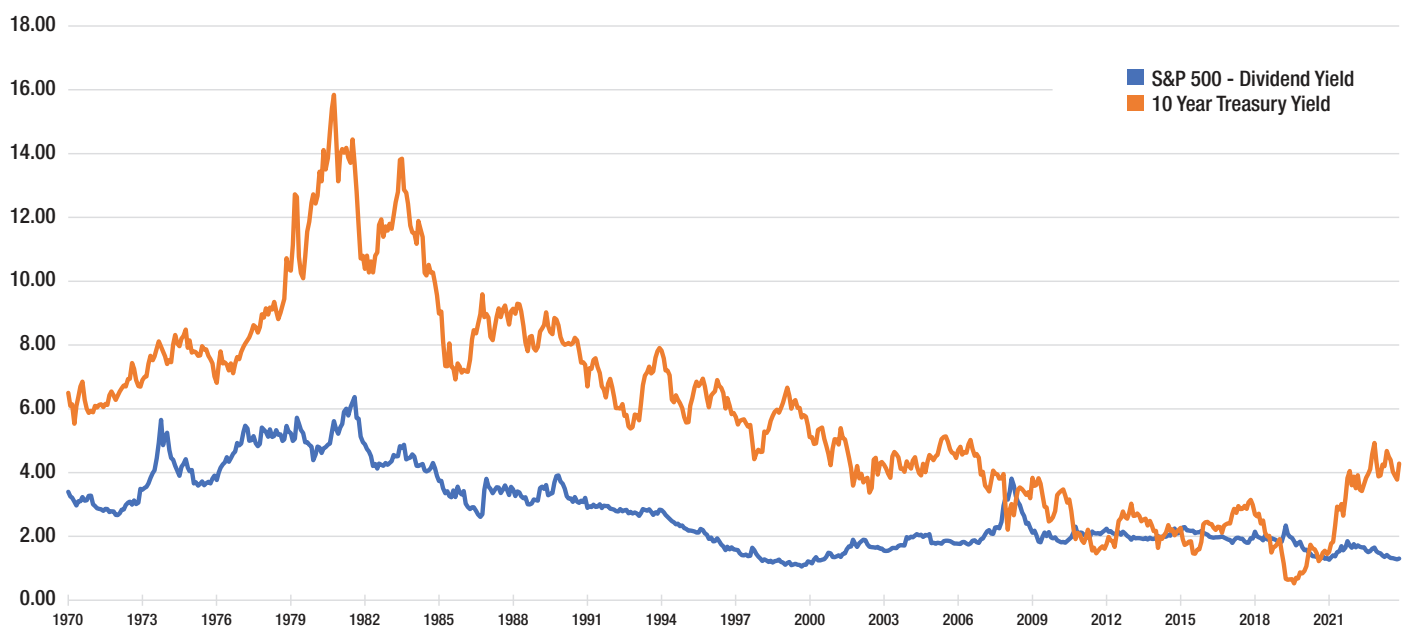


Source: Bloomberg

In the past 40 years, we have witnessed a historic secular bull market in bonds as interest rates have been in a downward trend. Though the Fed's interest rates hiking policy pushed the 10-year treasury yield above 4%, bond yields remain relatively low by historical standards. Meanwhile, the S&P 500 dividend yield is also at its lowest level in history. Sourcing yield (getting current cash flow from investments) is still a challenging task for income-focused investors.

## S&P 500 Dividend Yield and 10 Year Treasury

12/31/1970 - 10/31/2024



Source: Bloomberg

Other popular income-focused strategies, including dividend stocks and covered calls, indeed offer solutions for investors to maximize the income potential of their portfolios. But those strategies have their own drawbacks.

For example, a high dividend yield stock strategy may lack growth and share buyback exposure or be too concentrated in specific sectors<sup>1</sup>. Dividend growth funds may also exclude recent dividend-paying companies, particularly those in the Technology and Healthcare sectors<sup>1</sup>. Additionally, covered call strategies always force investors to consider the risk of missing the upside beyond their caps.

Against this backdrop, the Pacer Metaurus Dividend Multiplier Strategy (DMS) has emerged as a possible solution. The strategy aims to deliver higher dividend income while still allowing investors to benefit from the long-term growth and diversification of the broader market.

How does it work?

### Deconstructing S&P 500 returns

For a portfolio tracking the S&P 500 Index, the investment return can be unbundled into a **price component** and a **dividend component** (or the Dividend Strip). The price return over time represents the price component, and the dividend component tracks the actual dividends paid by S&P 500 companies.

Put differently, consider there are two accounts: A and B. Account A includes a portfolio tracking the S&P 500 Index. Over time, dividends received are withdrawn from account A and subsequently deposited into account B. This would result in the market value of account A tracking the S&P 500 price component, while account B's value reflects the dividend component.

When held in a 1:1 ratio (one dividend component for one price component), the aggregate value of the two should replicate the total return of the S&P 500 (without reinvestment compounding).

Alternatively, by applying a different weighting ratio between the components, an investor can re-allocate their mix of exposure between the dividend and price components to meet specific investment objectives. For example, income-seeking or conservative investors can scale up the dividend portion of their investment returns by holding more of the dividend component relative to the price component.

Institutional investors sometimes use futures, forwards, or swaps to establish the S&P 500 price component. The dividend component is most efficiently created using S&P 500 dividend futures contracts. Dividend futures allow investors to gain exposure to the actual amount of S&P 500 dividends in a given year, irrespective of the price movement of the benchmark index. Dividend futures offer a way to gain exposure to “dividends in isolation.”

### Dividend futures

Dividend futures are exchange-traded, cash-settled futures contracts that allow investors to get exposure to the amount of actual future dividend payments. By going “long” on a dividend future, an investor agrees to pay a prespecified price today in exchange for receiving a future payment equal to the actual dividends paid during a specified period – typically a given calendar year. An annual dividend future, as indicated by the name, is based on one year.

<sup>(1)</sup>See more details in Pacer Perspective September 2024: Dividend Multiplier Series: How Dividend Multipliers Stand Out

For example, on 12/18/2020 (dividend futures always settle on the 3rd Friday), an investor took a long position in the S&P 500 2021 dividend future traded at \$56.70. One year later, on 12/17/2021, the settlement date, the investor received the S&P 500 dividend of \$60.14 (the actual dividend paid out for the year), while paying \$56.70.

All dividend futures, including those tied to the S&P 500 Index, reference a dividend points index to determine their final cash settlement value. The S&P 500 dividend points index (or DPI) tracks the cumulative amount of S&P 500 dividends paid during the year. At the end of the year, the DPI resets to zero, and the whole process starts again for the following year.

In the earlier example, the dividend points index started to track the cumulative S&P 500 dividends from the close of 12/18/2020 to the close of 12/17/2021. The total dividend amount for the period ended at \$60.14 which became the settlement value of the 2021 contract.

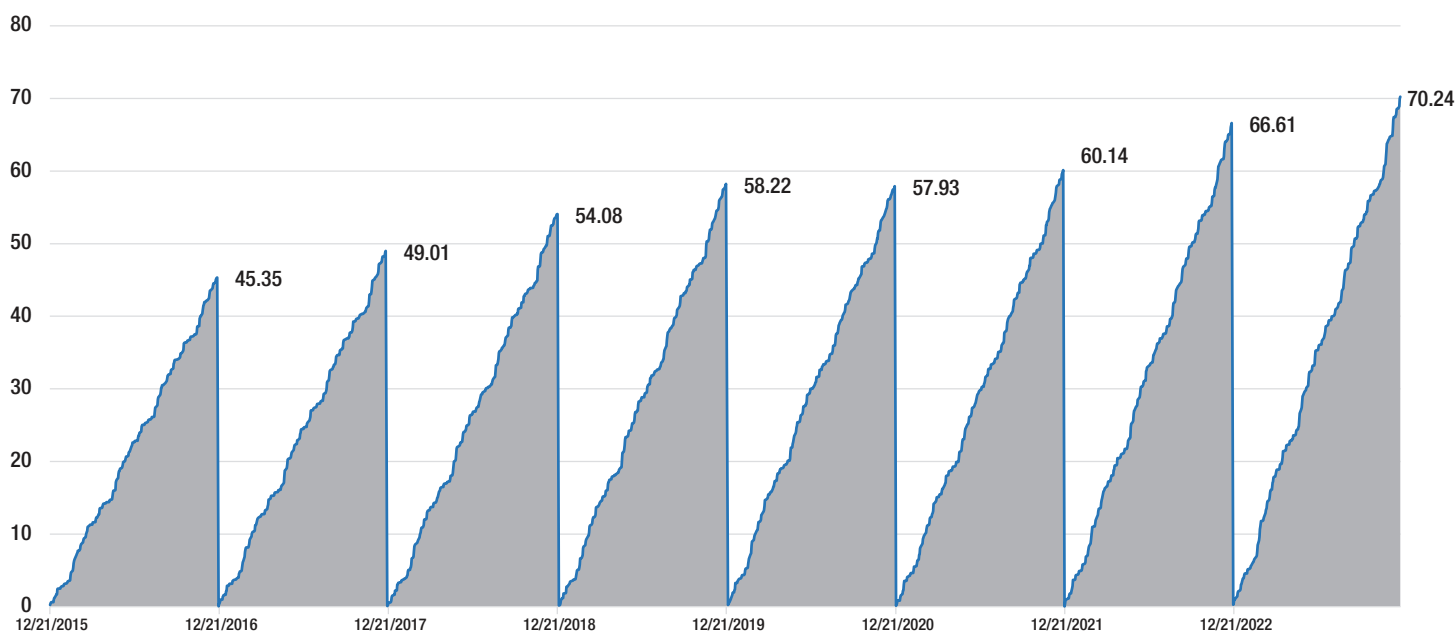
For dividend futures investments, the up-front payment an investor must commit is the margin required by the exchange (typically, 3%-5% of the contract's notional value). For example, if the notional price of the dividend futures contract was \$56.70, the margin requirement would be around \$2, which serves as collateral at the time of purchase to cover potential losses. That is how dividend futures provide leverage.

The dividend futures position can also be taken without employing any leverage. An investor can pledge the collateral amount equivalent to the notional amount, \$56.70, of the dividend futures contract, which would be full collateralization.

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### S&P 500 Dividend Points Index (Annual)

12/21/2015 - 12/15/2023



Source: Bloomberg

The Pacer Metaurus Dividend Multiplier Strategy (DMS) is based on the concept of the S&P 500 price component and dividend component. By utilizing the S&P 500 dividend futures contract, the strategy aims to scale up the dividend yield of a portfolio tracking the S&P 500 Index.

Next, we'll dive into the construction of the dividend multiplier strategy and explore how it enhances the portfolio's income-potential.

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**Dividends Risk:** There can be no assurance that a dividend-paying company will continue to make regular dividend payments. The ability for a company to pay dividends is dependent on the economic climate and the companies' current earnings and capital resources. Changes in economic conditions or a company's earnings or financial resources could cause a company to reduce its dividend payments or suspend the payment of dividends altogether. The possibility that such companies could reduce or eliminate the payment of dividends in the future, especially if the companies are facing an economic downturn, could negatively affect the Fund's performance.

The **S&P 500® Index** is a popular gauge of large-cap U.S. equities and includes 500 leading companies, capturing approximately 80% coverage of available market capitalization.

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**Futures** are derivative financial contracts that obligate parties to buy or sell an asset at a predetermined future date and price.

A **forward contract** is a customized contract between two parties to buy or sell an asset at a specified price on a future date.

A **swap** is a derivative contract through which two parties exchange the cash flows or liabilities from two different financial instruments.

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