

KELLY US CASH FLOW DIVIDEND LEADERS INDEX

Index Insights

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Executive Summary

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- The stock market rally that began in 2023 has continued into 2024 and recently gained some momentum with the Fed reducing interest rates by 50 basis points at its most recent meeting in September.
- The economic outlook continues to be mixed. The recent decline in rates has led to an increase in mortgage refinancing, which offers some strapped homeowners' relief, and employment levels remain high. On the other hand, concerns exist related to the overall level of prices for goods and services, the growing federal deficit (which some believe is not getting the level of attention it should), and the ongoing weakness in the commercial real estate market.
- Companies with high free cash flow and the demonstrated ability to increase dividends have appeal in this uncertain environment.

The Kelly US Cash Flow Dividend Leaders Index, calculated and maintained by Syntax, includes companies with a blend of high trailing and future free cash flow yields that have a history of paying and growing dividends. The index comprises at least 40 and up to 100 large- to mid-cap publicly traded US companies exhibiting characteristics of high free cash flow and consistent dividend growth. The index aims to provide long-term capital appreciation and monthly income distributions.

The index focuses on free cash flow (FCF) as it:

- Represents the ability of a company to generate cash to maintain and support the growth of its business.
- Is a measure of profitability that is not subject to the nuances of expense and revenue recognition used to report a company's accounting earnings.
- Highlights a company's ability to pay dividends and repay its debts.

Rather than focusing just on historical FCF to support stock selection, the index uses a quantitative selection process that combines trailing and forward free cash flow metrics to consider both past and forecasted cash flow potential. Additionally, to support diversification, exposure to any single subsector is capped at 24%.

Ability to Grow Dividends

Many income-oriented public equity strategies focus on stocks that pay high dividends. While this strategy can generate attractive levels of income, it is important to evaluate the impact this approach may have on total return, the sustainability of the dividend stream, and the potential risks tied to economic events. Consider the following examples.

- **Total return impact:** High dividends are attractive, but what if they come at the expense of limiting the growth of a company's share price? A high dividend payout may indicate a lack of opportunities for the firm to reinvest their cash flow back into the business at a desirable level of return, hence the decision to distribute the cash to shareholders in the form of a dividend.

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- **Sustainability:** REITs are often a core component to dividend-focused strategies tied to their requirement to distribute 90% of their income to their shareholders in the form of a dividend. Investors today with exposure to Office REITs are facing declining levels of dividends and depreciating property values as the commercial real estate market struggles in the face of hybrid work schedules as a result of the COVID pandemic.
- **Economic risks:** Utilities are often another tool in dividend-focused strategies based on their ability to pay dividends tied to their regulatory structure. However, as interest rates rise utilities often take on the risk of a fixed income investment with their stock price falling as interest rates rise.

For a dividend strategy to provide the same level of income or purchasing power in the future as the present, it needs a growing stream of dividends that keeps pace with inflation.

The Kelly US Cash Flow Dividend Leaders Index has criteria applied in its selection and weighting procedures to address the concerns highlighted above:

- To avoid companies with limited future growth prospects, the index prefers those that have an estimated dividend payout ratio no greater than 75%.
- The index prefers stocks whose dividend yields rank no higher than in the 89th percentile within the Syntax 1000 universe, reducing the risk that present dividend payouts may be unsustainable.
- To further support dividend sustainability, the index prefers stocks that have grown their trailing-12-month dividends for three consecutive years.
- The index excludes Banks, Insurance, and Real Estate due to the high level of leverage and their interest rate risk.

Free Cash Flow and Incorporating Stock Valuations

The attractiveness of a company's free cash flow is tied to its valuation. This dynamic is captured in the holdings of the index, using the two ratios below, to rank each stock in the universe.

- **Forward Free Cash Flow Yield:** the estimated forward-year free cash flow divided by share price.
- **Trailing Free Cash Flow Yield:** the trailing-12-month free cash flow divided by enterprise value.

These ratios, one based on history and one forward looking, adjust as a company's stock price moves. As a stock's price falls, it becomes more attractive, assuming its free cash flow stays consistent. On a quarterly basis, the index reconstitutes and rebalances to securities and industries that are priced more attractively. This can include selling stocks where the increase in valuation has made the stock less attractive on a forward-looking basis.

In Exhibit 1 we compare the index's primary sector Free Cash Flow Yields to the Syntax 1000 index, the universe of U.S. large- and mid-cap stocks from which the index is created.



Exhibit 1: Kelly US Cash Flow Dividend Leaders Index Free Cash Flow Ratios vs. Syntax 1000

	# Companies In Index	Free Cash Flow Yield - Trailing			Free Cash Flow Yield - Forward		
		COWSETF	SY1000	Difference	COWSETF	SY1000	Difference
Consumer	13	6.8%	1.1%	5.8%	11.7%	4.7%	7.1%
Information	12	7.5%	1.8%	5.7%	9.1%	4.0%	5.1%
Industrials	12	15.7%	3.5%	12.2%	10.5%	4.5%	6.0%
Information Tools	10	5.7%	1.8%	3.9%	8.6%	4.1%	4.5%
Healthcare	3	5.7%	1.7%	4.0%	12.4%	4.4%	8.1%
Energy	2	5.2%	2.4%	2.8%	6.8%	3.2%	3.6%
Food	1	5.2%	1.1%	4.1%	7.8%	3.7%	4.1%
Totals	53	8.3%	2.6%	5.7%	9.5%	4.1%	5.4%

As of index rebalance on 9/20/2024. Primary sectors are based on Syntax Functional Information System (FIS®) industry classification system. Source: Syntax

The results show the Kelly US Cash Flow Dividend Leaders Index (index symbol: COWSETF) with a trailing-12-month free cash flow yield of 8.3%, more than triple the 2.6% yield on the Syntax US 1000 index (SY1000). The index's yield advantage for the seven primary sectors where it holds securities relative to the Syntax US 1000 ranges from 2.8 to 12.2 percentage points. The free cash flow yield results are similar on a forward-looking basis, with the index at 9.5% and the Syntax 1000 at 4.1%.

The COWSETF index holds no exposure to the Syntax FIS Financials sector (which includes Banks, Insurance, and Real Estate) by design. Presently, there is one company held in the Food sector tied to its free cash flow yield characteristics, though backtested historical allocations have ranged from 0% to 7% based on its relative attractiveness to companies in other sectors.

The dividend yield for the index is 2.03% compared to 1.25% for the Syntax 1000. The strength of the index's free cash flow yields supports the underlying companies' ability to grow their dividends, which is also supported by the stock selection criterion that a candidate has grown its trailing-12-month dividends for three consecutive years.

Performance Comparison

The Kelly US Cash Flow Dividend Leaders Index's focus on free cash flow yield translates to strong live and backtested performance. The goals of the index are to provide long-term capital appreciation and monthly income distributions.

To assess the effectiveness of the index, Syntax conducted a backtest from September 2007 through the index's July 26, 2023, inception date. Exhibit 2 shows the growth of a hypothetical \$1,000 investment tracking the index, gross of fees and implementation costs, compared against the Syntax 1000 index; the results include the backtest starting from September 21, 2007 together with live performance from July 26, 2023 through September 20, 2024. Since the start of the backtest, the index posted an annualized return of 13.46% vs 10.25% for the Syntax 1000. This 3.21 annual percentage point outperformance produces an ending value of the index of \$8,440 compared to \$5,283 for the Syntax 1000 index, a 60% cumulative difference.

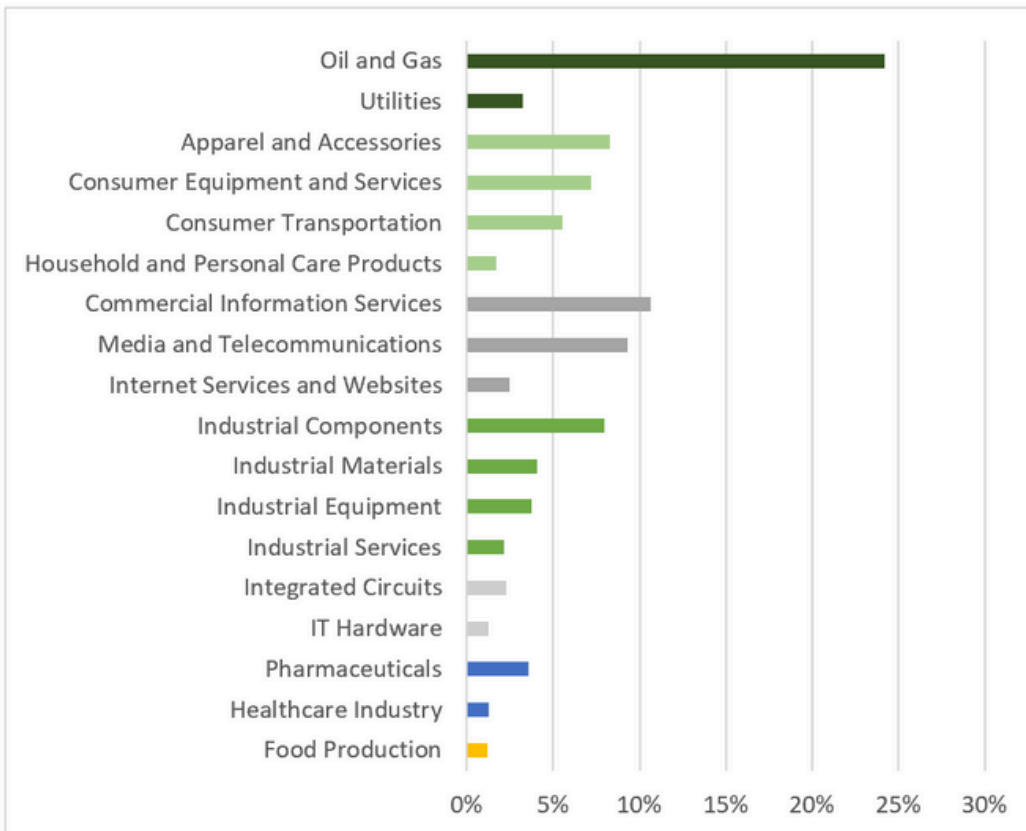


Exhibit 2: Hypothetical Growth of \$1,000 Investment: Kelly US Cash Flow Dividend Leaders Index vs. Syntax US 1000 Index



Total Return, 9/21/2007 - 9/20/2024. Performance does not reflect fees or implementation costs as an investor cannot directly invest in an index. Please see important disclaimers regarding back-tested data prior to inception on 7/26/2023. Source: Syntax.

Exhibit 3: Kelly US Cash Flow Dividend Leaders Index Weight By Sub-Sector



Weights as of 9/20/2024. Sub-sectors of the same sector are colored the same. Source: Syntax.



Present Sector Allocation

Exhibit 3 above shows the sub-sector allocation for the index as of its September 20, 2024 reconstitution. The index is invested in 53 companies spread across 18 sub-sectors that can be found in seven primary sectors.

It is important to note that the asset allocation of the index will migrate over time to sectors and companies as they become more attractive. For example, the index presently has a 27% allocation to the Energy sector, of which 24% can be found in the Oil and Gas subsector. In September of 2019 the Energy sector held a weight of just 2.7% of the index as the free cash flow characteristics of energy companies did not rank highly.

Another consideration is diversification within sub-sectors. Using the present Oil and Gas allocation as an example, the 24% exposure to this sub-sector is diversified into three different types of businesses.

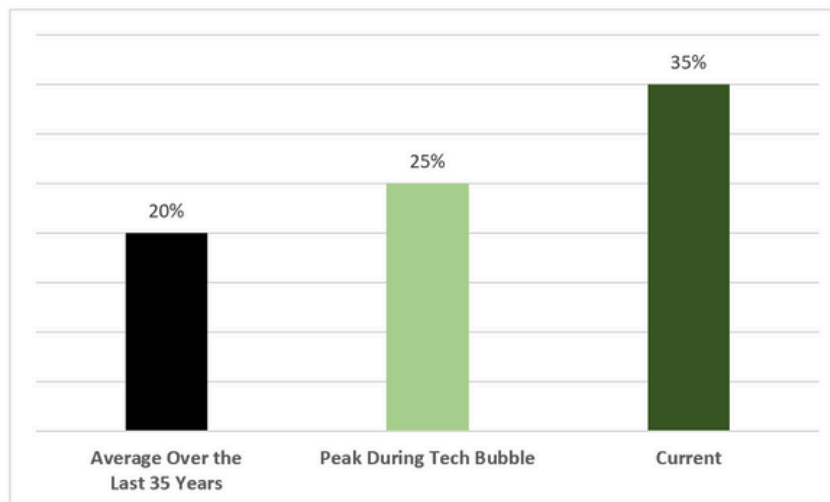
- 13.3% is invested in Upstream Energy Extraction companies.
- 9.0% is allocated to Oilfield Services and Equipment companies which includes firms that provide drilling services, and manufacturers of valves and compressors used in the extraction process.
- 1.9% of the index is invested in Energy Refining and Retail companies involved with producing, distributing, or marketing refined fuels.

This type of diversification within sub-sectors occurs often within the index construction process.

Role Within a Portfolio

The S&P 500 is the core public equity position within many investor portfolios. It has been well documented that the index has become increasingly more concentrated. Exhibit 4 highlights this trend.

Exhibit 4: Weight of Top Ten Stocks in the S&P 500



Data as of 10/23/2023. Source: S&P, Bloomberg and Goldman Sachs Multi Asset Solutions. Current as of 8/31/2024., Source Syntax Data



The performance of this index continues to be driven by technology related stocks including the The Magnificent Seven. To quantify the diversification benefits of the Kelly US Cash Flow Dividend Leaders Index, we calculated its active share relative to the S&P 500 as of 9/20/24. The analysis shows the Kelly US Cash Flow Dividend Leaders Index has an active share of 98.6%. Stated alternatively, there is roughly a 2% overlap in the stocks held between these two indices, meaning an allocation to the Kelly US Cash Flow Leaders Index complements a portfolio by providing exposure to stocks not found in the S&P 500.

Conclusion

This paper highlights the uncertainty associated with the current economic environment and the prospective benefits offered by an indexing approach focused on free cash flows and companies that can grow their dividends. We discussed the need to focus on the sustainability of dividend streams, to understand the economic risks associated with certain industries and types of companies often associated with dividend strategies, and the need to focus on total return. Our analysis highlighted the superior free cash flow and dividend characteristics of the Kelly US Cash Flow Dividend Leaders Index relative to the broad US market, the favorable performance history, and the diversification benefits relative to the S&P 500.

With potential storm clouds on the horizon, the Kelly US Cash Flow Dividend Leaders Index may appeal to those seeking a balanced approach to both capital appreciation and income.



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