Beware the Large Cap Dividend Trap
Passive Money Flows Creating Opportunity for Value Driven Income Investors
Part Two - August 2016

In June 2016, Part One of this series compared the valuation and yield differentials between a Dividend Aristocrat[1], Exxon, and in our opinion a less cyclical non-aristocrat, Macquarie Infrastructure. Our aim was to show that the current low rate environment was pushing people into potentially dangerous situations in their search for yield, while potentially better yielding and safer (in our opinion) income opportunities were being ignored.

Companies such as Exxon, which has not covered its current dividend with internally generated cash flow[2], appear to be adding considerable risk by increasing leverage and reducing investment. Our main contention is that by owning Exxon shares for a 3.2% dividend yield, investors are affording the company an earnings multiple far outside its normal historical band.[3] Even a small reversion to the average earnings multiple for whatever reason could result in losses that dwarfed the benefit of Exxon's dividend.

Building on the Exxon/Macquarie Infrastructure comparison, this report highlights another valuation discrepancy between two companies. Fans of Exxon might justify a valuation discrepancy due to higher credit rating and significantly larger size than Macquarie Infrastructure instead of inclusion in the S&P High Yield Dividend Aristocrat Index. The same argument; however, works against the Aristocrat component in this piece. As in our previous review, the companies are not in the same industry. Both businesses; however, are large players in their industries and are viewed as non-cyclical. Company B, though, can be viewed as much *less* cyclical and more defensive than Company A. Still the valuation discrepancy persists.

Similar to the last report, we will not name the companies until later to avoid any biases. We'll introduce them with a quick table:

	Company A	Company B
Credit Rating (S&P)[4]	BBB+ (Negative)	AA (Stable)
Market Cap	$27.5 bln	$217 bln
Trailing Price/Earnings Multiple	26.7x	18.1x
Forward Price/Earnings Multiple[5]	25.2x	14.6x
Free Cash Flow Yield (TTM)[6]	2.32%	6.10%
Dividend Yield	2.54%	3.43%
Dividend Payout Ratio[7]	106%	52%

Source: Bloomberg (as of June 30, 2016)

[1] The term Dividend Aristocrat refers to The S&P High Yield Dividend Aristocrat Index
[2] Trailing Twelve Months from quarter ending March 31, 2016 results
[3] Dividend yield for Exxon Mobile was as of 6/30/2016
[4] Ratings are on a scale from AAA(best) to D (lowest)
[5] Based on consensus estimates for current year earnings as compiled by Bloomberg
[6] "Free Cash Flow" is defined as Cash Flow from Operations – Working Capital – Capital Expenditure. TTM stands for Trailing Twelve Months
[7] Defined as current dividends as a percentage of Free Cash Flow for the twelve months as of the quarter ending March 31, 2016.

Company A

Company A is a ranking "Dividend Aristocrat". The company is the largest restaurant supplier in the country. Wholesale food distribution is a notoriously low margin business. As such, while the company generates about $49bln of revenue, its free cash has rarely been higher than $1bln. Since the company generates little organic growth, much of this free cash has gone to acquisitions to achieve revenue growth. The Justice Department, however, recently blocked a large acquisition on anti-trust grounds.

Margins have proven difficult to maintain. In fact, while revenue has grown over the years largely due to the company's aggressive acquisitions, earnings have been flat to down due to operating margins being down from around 5% ten years ago to around 3% currently. This margin degradation comes despite the company investing over $1bln and 5 years installing an enterprise resource planning system that was intended to improved productivity.

It is therefore, not surprising that Returns on Invested Capital (ROIC) and Returns on Assets (ROA) have been stuck in the single digits for the past few years.[8] [9]

Dividend Sustainability

While Company A has regularly increased its dividend, its cash flow is not immune to cyclicality. By supplying restaurants, the company is exposed to agricultural commodity prices and also depends on people having discretionary income to dine out. Low commodity prices hurt Company A's ability to squeeze out margin, and a recession hurts the food service industry and thus the company's revenue.

The company paid out 66% of its earnings per share and over 100% of its cash flow.[10] While leverage is relatively low, we believe there is little room for the company to materially increase its payout without incurring more leverage.

Share Price Sustainability

Company A's mean earnings multiple is around 17.37x since 2009 versus the current 26.42x. While the company is projected to grow adjusted diluted earnings per share in 2016, earnings in 2015 were lower than they were in 2007 despite 30% higher revenues.

To justify today's share price of $50.74[11] with the historical multiple of 17.37x, earnings per share (EPS) would have to increase from $1.72 in 2015 to $2.92—almost 70% higher. Company A's adjusted earnings per share have ***never*** been higher than $2.14. GAAP[12] earnings per share have never exceeded $2.00. Essentially a valuation based on historical earnings multiples should result in a 30%+ price decline.

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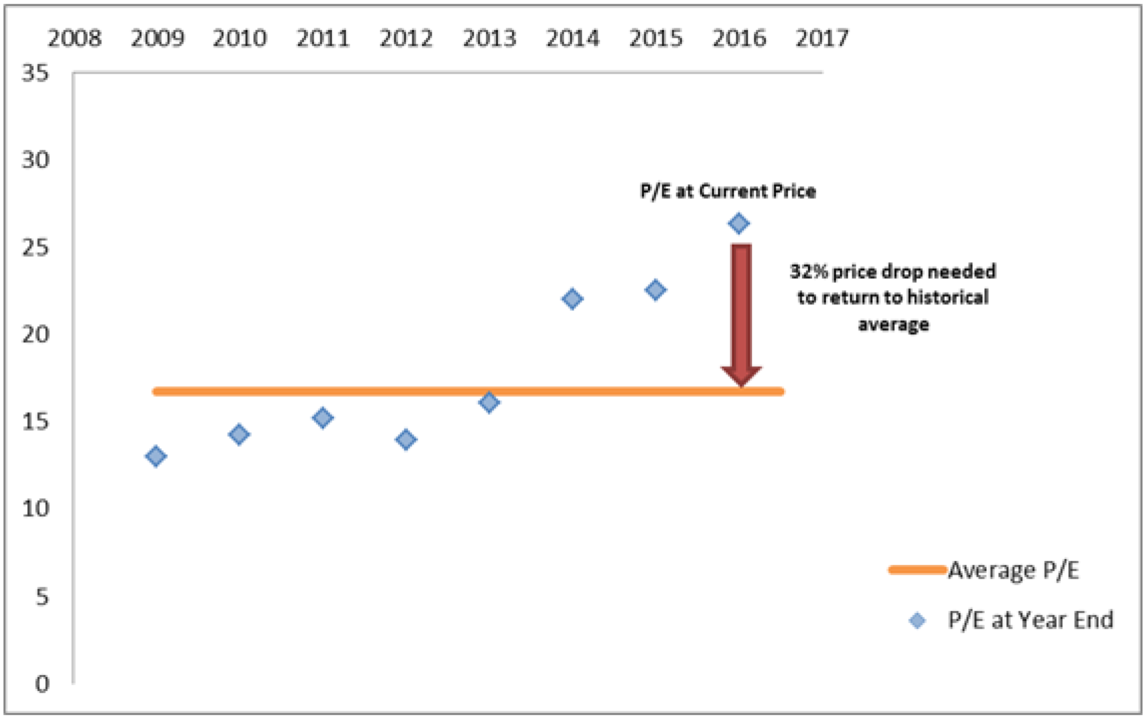
[8] Return on Invested Capital defined as (Operating Cash Flow – Capital Expenditure)/(Debt + Common Equity)

[9] Return on Assets defined as Operating Cash Flow – Capital Expenditure/Total Assets

[10] Based on 2015 earnings, cash flow and revenue

[11] As of June 30, 2016 sourced from Bloomberg

[12] GAAP=Generally Accepted Accounting Principles. Some companies report GAAP earnings and "adjusted" earnings wherein certain items are excluded or included. GAAP is the audited financial statement format.



2016 is based on estimated earnings
Source: Bloomberg as of June 30, 2016[13]

Given the aforementioned exposure to various cycles and scant evidence of regular cash flow or earnings growth, we struggle to understand recent multiple expansion, particularly given a dividend yield around 2.5%. It would seem just being part of an aristocrat index has resulted in price increases.

Company B

Company B is one of the largest pharmaceutical companies in the world. Pharmaceuticals are a relatively high margin business, which allowed company B to generate $14.5bln of free cash on $50bln in revenue (a comparable amount to Company A's revenue).[14]

A regular dividend raiser for decades, Company B committed the mortal sin of cutting its dividend in 2009 to finance an acquisition. Although the deal proved lackluster and led to a management overhaul, we see a few positives in management's action. This CEO has cut costs, navigated losses of patents on key drugs, overseen the development of new blockbuster drugs, and negotiated some savvy acquisitions. The company's cash flows are near their highest ever, and their dividend is almost back to its 2009 level.

Dividend Sustainability

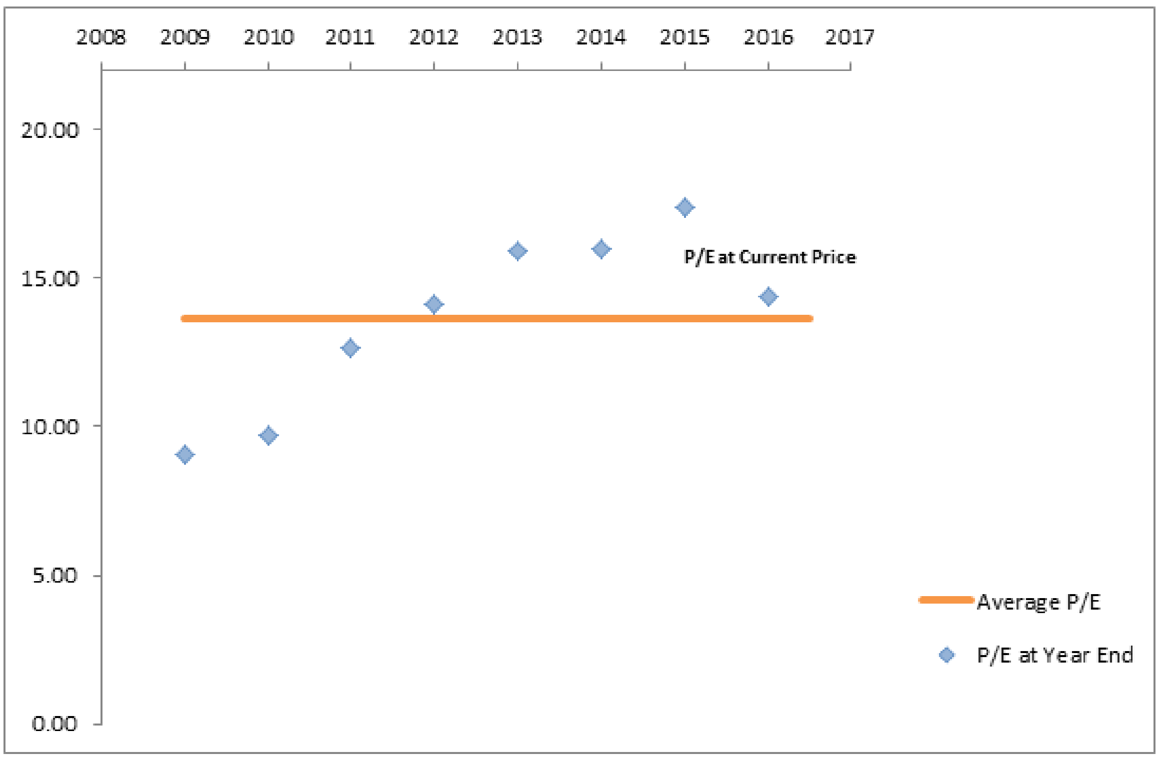
We respect Company B's decision to cut its dividend in 2009 for the large acquisition. It demonstrates a commitment to the long term health of the business rather than short term

[13] Average P/E is for the period from 2009 through June 30, 2016. P/E is based on share price at the end of Q2 divided by that that previous year's earnings per share.
[14] For the trailing twelve months as of the quarter ending March 31, 2016

technical concerns. This commitment is evident as the company has regularly generated twice the free cash needed to pay its dividend. This excess cash flow provides tremendous financial flexibility. We appreciate and take comfort in this approach. As opposed to Company A, Company B has significant discretionary cash flow for opportunistic actions. We would also like to stress that company B has a higher dividend yield, a better credit rating and a much higher margin business than Company A.

Share Price Sustainability

Ironically, the 2009 dividend cut marked low point in Company B's stock despite the impacts of the lackluster deal and the subsequent loss in sales from expiring patents. Strangely, though, while sell side analysts project revenue and earnings growth this year and next, the company's multiple has not expanded like that of broader markets and Dividend Aristrocrats. Company B's constrained relative multiple is even more bizarre when compared to its projected earnings growth versus the S&P 500 and Company A. Consensus estimates call for 25% earnings growth in 2016 versus less than 10% for Company A and much less for the S&P.



2016 is based on estimated earnings
Source: Bloomberg as of June 30, 2016[15]

Looking Forward

Company A is Sysco (SYY). Chances are you have seen their trucks out and about. It is the 800 pound gorilla of its industry. Its size gives it some purchasing power with suppliers, which

[15] Average P/E is for the period from 2009 through June 30, 2016. P/E is based on share price at the end of Q2 divided by that that previous year's earnings per share.

translates to some marketing power with its customers. It is still a low return business, with few truly proprietary, defensive characteristics. Paper towels and sugar do not vary much between providers. Local, smaller operators might be able to procure fresher fruits, meats and vegetables than a big national company like Sysco.

We believe these competitive factors are evident in low return metrics and compressed margins despite increased scale. Moreover, the factors seem to be getting more pronounced. Consequently, we see little reason why SYY trades at an elevated multiple to its historical average and the market, simply because it is ***lower-yielding*** Dividend Aristocrat.

Company B is Pfizer (PFE). Pfizer seems to have the qualities a dividend-oriented investor seeks: strong balance sheet, large revenue base and currently stable cash flows that more than cover dividends. There is much to like about Pfizer outside those metrics as well. The company has an excellent ***organic*** growth profile and possible corporate actions could unlock significant value for shareholders.

Conclusion

We struggle to come up with a compelling reason for the significant valuation premium between Pfizer and Sysco. Although highly speculative, we have a very sneaking suspicion that had the 2009 dividend cut not taken place, there would be a tighter relationship between the two. We feel the risk/reward potential seems highly skewed toward Pfizer and we have so far received a healthy dividend to wait for the market to recognize the discrepancy.

As of 6/30/16, Pfizer (PFE) represented 2.19% of the Fund's net assets, Sysco (SYY) represented -1.19% of the Fund's net asset, Macquarie Infrastructure (MIC) represented 2.74% of net assets, and Exxon Mobil (XOM) represented -2.05% of net assets. Holdings are subject to change. With short sales, you risk paying more for a security than you receive from its sale. Short sales losses are potentially unlimited and the expenses involved with the shorting strategy may negatively impact the performance of the Fund. There is no guarantee these holdings will have the intended effect on the Fund's performance.

Carefully consider the Fund's investment objectives, risks, and charges and expenses. This and other information can be found in the Fund's prospectus which can be obtained by calling 866-202-3573 or by visiting www.ccmalternativeincome.com. Please read the prospectus carefully before investing.

The S&P High Yield Dividend Aristocrats Index is comprised of the 50 highest dividend yielding constituents of the stocks of the S&P Composite 1500 Index that have increased dividends every year for at least 25 consecutive years. These stocks have both capital growth and dividend income characteristics, as opposed to stocks that are pure yield, or pure capital oriented.