

# Index Insights: Kelly US Cash Flow Dividend Leaders Index



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## Executive Summary

- The stock market has gained momentum driven in part by the notion the Fed is on hold and may even lower rates in 2024. Since its most recent low on Oct 27th, the S&P 500 is up ~16% through December 31st.
- The economic outlook is mixed. While some believe the rally will continue based on expected corporate earnings growth in 2024 and a more accommodating Fed, others express concerns tied to the growing deficit, persistent weakness in the commercial real estate market, rising credit card delinquencies, and the risk of recession.
- 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.
- **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

Primary Sector	# Companies In Index	Free Cash Flow Yield - Trailing			Free Cash Flow Yield - Forward		
		COWSETF	SY1000	Difference	COWSETF	SY1000	Difference
Industrials	15	7.0%	2.4%	4.6%	9.6%	4.5%	5.1%
Information	14	9.4%	3.7%	5.7%	12.8%	5.1%	7.7%
Energy	15	11.1%	1.7%	9.5%	12.3%	6.7%	5.6%
Consumer	13	9.3%	1.9%	7.4%	12.2%	4.3%	7.9%
Information Tools	2	7.6%	2.4%	5.2%	25.3%	3.4%	21.9%
Healthcare	2	7.0%	2.9%	4.1%	12.0%	5.4%	6.6%
Food	0	NA	1.7%	NA	NA	4.5%	NA
Financials	0	NA	6.5%	NA	NA	5.4%	NA
<b>Totals</b>	<b>61</b>	<b>8.9%</b>	<b>3.0%</b>	<b>5.9%</b>	<b>12.3%</b>	<b>4.7%</b>	<b>7.6%</b>

As of index rebalance on 12/15/2023. 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: COWS ETF) with a trailing-12-month free cash flow yield of 8.9%, roughly triple the 3.0% yield on the Syntax US 1000 index (SY1000). The index's yield advantage for the six primary sectors where it holds securities relative to the Syntax US 1000 ranges from 4.1 to 9.5 percentage points. The free cash flow yield results are similar on a forward-looking basis, with the index at 12.3% and the Syntax 1000 at 4.7%.

The COWSETF index holds no exposure to the Syntax FIS Financials sector (which includes Banks, Insurance, and Real Estate) by design. Presently, there are no companies 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 2.13% compared to 1.42% 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.

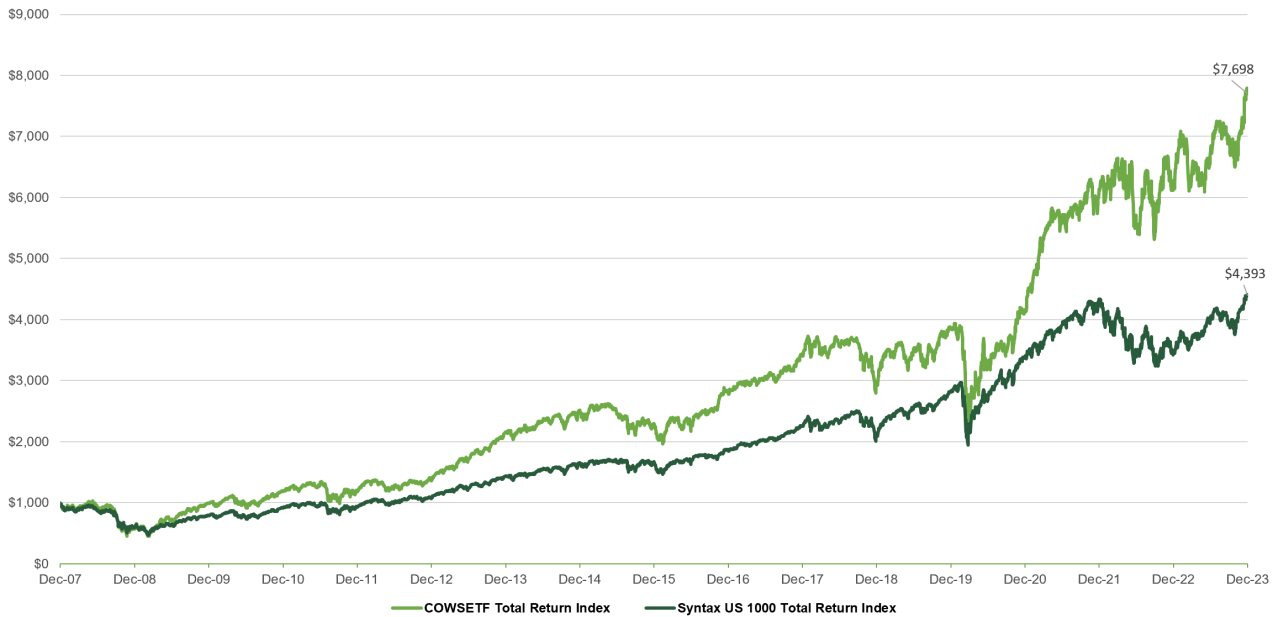
### Performance Comparison

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

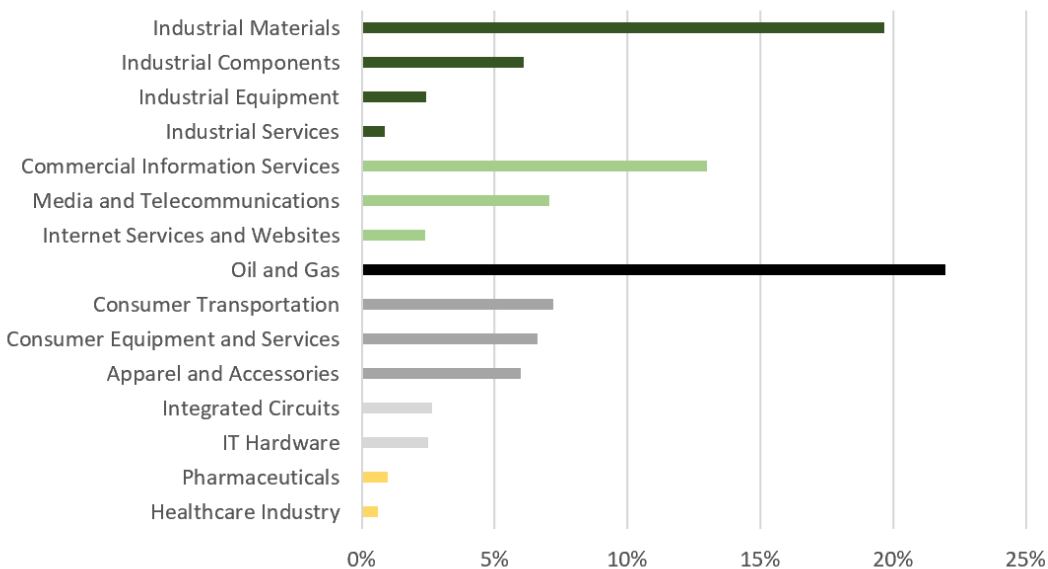
from September 21, 2007 together with live performance from July 26, 2023 through December 31, 2023. Since the start of the backtest, the index posted an annualized return of 13.35% vs 9.52% for the Syntax 1000. This 3.83 annual percentage point outperformance produces an ending value of the index of \$7,698 compared to \$4,393 for the Syntax 1000 index, a 75% 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 - 12/31/2023. 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 12/15/2023. 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 December 15, 2023 reconstitution. The index is invested in 61 companies spread across 15 sub-sectors that can be found in six 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 22% allocation to the Energy sector, all of which can be found in the Oil and Gas subsector. In September of 2019 the Energy sector held a weight of just 2.3% 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 22% exposure to this sub-sector is diversified into three different types of businesses.

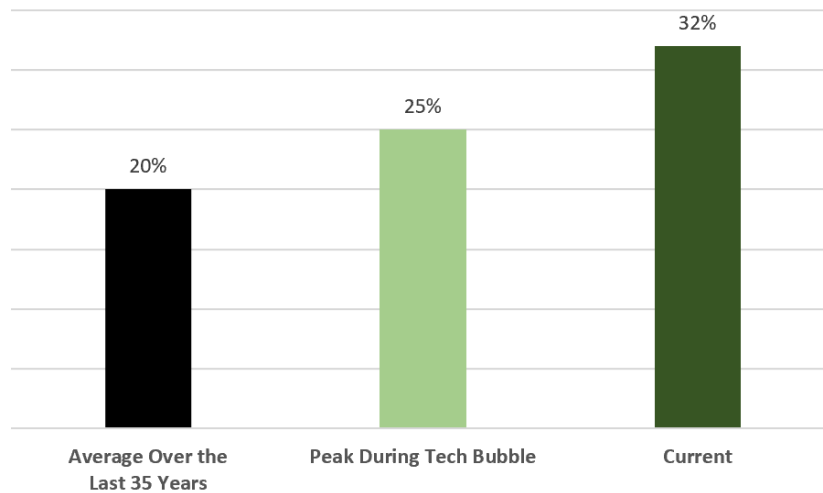
- 12.5% is invested in Upstream companies involved in the extraction of primary energy resources including exploration, production, and manufacturing of extraction equipment.
- 7.2% is allocated to Downstream companies involved in the transportation or storage of hydrocarbon products.
- 2.3% of the index is invested in Midstream 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.

The performance of this index continues to be driven by technology related stocks, most recently referred to as The Magnificent Seven, and not too long ago as the FAANG stocks. 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 12/31/23. The analysis shows the Kelly US Cash Flow Dividend Leaders Index has an active share of 97.2%. Stated alternatively, there is roughly a 3% 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.

## About Syntax

Syntax LLC is a financial data and technology company that codifies business models into a relational system we call Affinity Data™. Syntax operates through three segments: Affinity Data™, Syntax Direct™, and Syntax Indices™. Using its patented FIS® technology inspired by systems sciences, the Affinity Data™ segment offers the most comprehensive, granular, and accurate product line revenue data available on the market. The Syntax Direct™ segment then uses this abundance of data to facilitate the near instantaneous creation and ongoing management of boundless direct indexing solutions and rules-based equity portfolios through a fully automated platform. The Syntax Indices™ segment offers customized and proprietary indices, including core global benchmarks and micro- and macro-thematic, smart beta, defined outcome, and target volatility indices. These indices are foundational for a range of financial products, such as ETFs, UITs, and structured products.

## About Kelly Indexes

Kelly Indexes is the self-indexing arm of Kelly Intelligence. Kelly Intelligence is an SEC registered investment advisor that seeks to bring cutting-edge products with forward-looking exposure. Its growing suite of strategies and indexes provide highly liquid, pure-play access to the best-in-class companies identified in each investment factor, theme, or sector

## Important Disclaimers

Past performance is no guarantee of future results. All performance presented prior to the inception date is backtested performance. Backtested performance is not actual performance but is hypothetical. The inception date of the Kelly US Cash Flow Dividend Leaders Index (“the Index”) was July 26, 2023. The backtest calculations for the Index are based on the same methodology that was in effect when the index was launched. Back-tested data may reflect the application of the index methodology with the benefit of hindsight, and the historic calculations of an index may change from month to month based on revisions to the underlying economic data used in the calculation of the index. Charts and graphs are provided for illustrative purposes only. The Index is the property of Kelly Indexes, LLC (“Kelly”), and is administered and calculated by Syntax, LLC (“Syntax”). Kelly has contracted with Syntax to provide a license to use said index weightings. The Index or financial products based on it are not sponsored by the third-party licensors of Syntax. Syntax® and FIS® are registered trademarks of Syntax or its affiliate Locus LP. Index performance does not represent actual fund or portfolio performance and such performance does not reflect the actual investment experience of any investor. An investor cannot invest directly in an index. In addition, the results actual investors might have achieved would have differed from those shown because of differences in the timing, amounts of their investments, and additional fees and expenses associated with an investment in a portfolio invested in accordance with an index. None of the indices portrayed herein charge management fees or incur brokerage expenses, and no such fees or expenses were deducted from the performance shown; provided, however, that the returns of any investment portfolio invested in accordance with such indices would be net of such fees and expenses. Additionally, none of such indices lend securities, and no revenues from securities lending were added to the performance shown. This report is for informational purposes only and is not intended to be, nor should it be construed or used as an offer to sell, or a solicitation of any offer to buy, any security. Additionally, the information herein is not intended to provide, and should not be relied upon for, legal advice or investment recommendations. You should make an independent investigation of the matters described herein, including consulting your own advisors on the matters discussed herein. In addition, certain information contained in this presentation has been obtained from published and non-published sources prepared by other parties, which in certain cases have not been updated through the date hereof. While such information is believed to be reliable for the purpose used in this presentation, such information has not been independently verified by Syntax and Syntax does not assume any responsibility for the accuracy or completeness of such information. This report may contain forward-looking statements involving risks and uncertainties. Actual results may differ materially from any forwardlooking statement. Syntax LLC, its affiliates and their independent providers are not liable for any informational errors, incompleteness, or delays, or for any actions taken in reliance on information contained herein. This presentation and the information herein may not be reproduced (in whole or in part), distributed or transmitted to any other person without the prior written consent of Syntax. Distribution of Syntax data and the use of Syntax indices to create financial products requires a license with Syntax and/or its licensors. Investments are not FDIC insured, may lose value and have no bank guarantee.