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Technology Dividends: Oxymoron No More

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In recent years, equity income ETFs have gained in popularity, as investors seeking growth and income have poured billions of dollars into these strategies. While each of these ETFs takes a slightly different approach for selecting and weighting stocks, there is one common characteristic shared by all: an underweight position in the technology sector relative to broad equity benchmarks. While this allocation may seem intuitive to some, we believe it's time to include technology stocks in equity income strategies.

In this newsletter, we will consider why many technology stocks have avoided paying dividends in the past, we will discuss why that trend has begun to reverse course, and we will evaluate the potential benefits of utilizing the First Trust NASDAQ Technology Dividend Index Fund (TDIV) to supplement other dividend strategies that are underweight technology stocks.

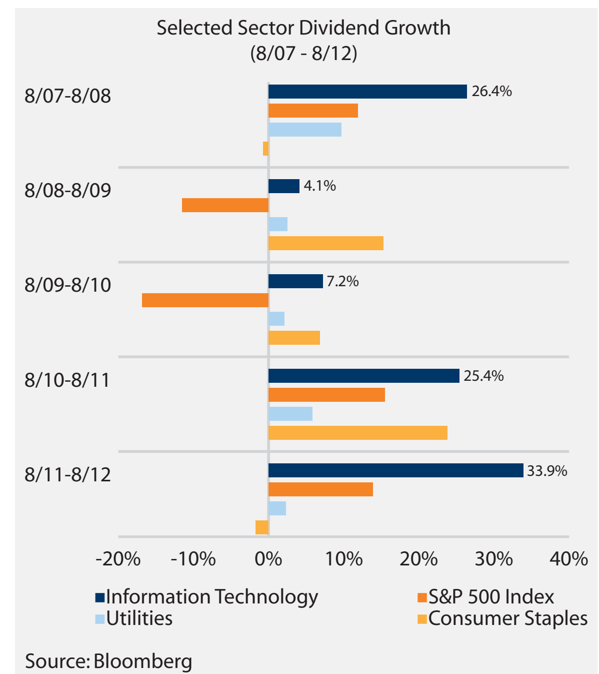
Why have technology stocks avoided paying dividends in the past?

Over the past two decades, many technology companies have chosen to reinvest their earnings in pursuit of future growth opportunities, rather than making regular dividend payments to investors. In effect, investors in these companies agreed to forego current dividend payments in exchange for potential capital appreciation, as well as potentially larger dividends in the future. In many cases, this trade-off has worked out well for investors. For example, in 2002, when Apple had a market capitalization totaling about $5.3 billion, the company paid no dividends. Instead, envisioning future growth opportunities, Apple invested heavily to develop new technologies. A decade later, and with a market capitalization of over $600 billion, Apple began implementing a new dividend policy in 2012, intending to pay out about $10 billion in dividends to investors over the course of its first year. Long-term investors in Apple, and many other technology companies, have been well-compensated for their patience.

Today, there are still certain segments of the technology sector, such as cloud computing, that are poised for growth rates well in excess of the overall technology sector, not to mention the broader economy. Such companies pursue the best interests of their investors by reinvesting heavily to fuel future growth. However, there are also a growing number of technology companies that have reached a point of maturity wherein a smaller percentage of earnings is required to fuel future growth opportunities. For many of these companies, we believe the implementation of a dividend policy represents sound corporate governance, as well as management's confidence in the consistency of future earnings. While some fret over the potential for slower earnings growth that sometimes accompanies the implementation of a dividend policy, others consider the many benefits that often accrue to more mature companies, such as a lower cost of capital and generally less volatile earnings.

Changing trends in technology dividend policies

As recently as 2007, the information technology sector contributed just under 6% to the aggregate dividends paid out by companies in the S&P 500 Index, representing the third lowest contribution of any sector.[1] In a dramatic reversal, by mid-August 2012 the information technology sector made the largest dividend contribution of any sector, representing over 14% of the index's total dividends. This was achieved as dividend payments from the information technology sector grew in each of the last 5 years, at an 18.8% average annual rate, while dividends from the S&P 500 grew in only 3 of the last 5 years, resulting in a 1.6% average annual growth rate.[2]



The S&P 500 Index is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance. The sectors are represented by S&P Sector Indicies which are unmanaged indicies that include the stocks in each respective sector of the S&P 500 Index. The chart is for illustrative purposes only and should not be considered indicative of any First Trust ETF. You cannot invest directly in an index.

Not only has the technology sector offered a robust rate of dividend growth in recent years, we believe many of these companies are well positioned to further increase dividends in the years ahead. In fact, the free cash flow yield[3] for the NASDAQ Technology Dividend Index^{SM} is 8.9%, nearly three times its 3.1% dividend yield.[4] This implies that index constituents generally have plenty of room to increase dividends without necessarily reducing current investments in future growth opportunities or drawing cash from their balance sheets.

Past performance is not a guarantee of future results and there is no assurance that the above mentioned events or improvements will continue.

The ability to increase dividends, and avoid dividend cuts, has been shown to be an important predictor of relative performance. From 1972-2011, S&P 500 stocks that initiated or increased dividend payments subsequently achieved a 9.1% average annual total return, not only outperforming the 7.0% average annual total return achieved by dividend payers that made no changes, but also markedly outperforming companies that cut or eliminated dividends, which had a -0.9% average annual total return.[5] There is, however, no guarantee that companies will declare dividends in the future or that, if declared, they will either remain at current levels or increase over time.

Equity income ETFs are underweight technology

Despite the recent trend of technology companies choosing to reward shareholders with increased dividends, equity income ETFs remain dramatically underweight technology stocks. For example, the five largest equity income ETFs, which represent over $38.5 billion in assets, are underweight the technology sector by an average of 15 percentage points, as compared to the S&P 500. Not surprisingly, the same five ETFs are overweight the utilities sector by an average of 10 percentage points, and overweight the consumer staples sector by an average of 9 percentage points.[6]

Moreover, most equity income ETFs will likely remain underweight technology stocks for many years to come, due to certain dividend longevity requirements included in their respective index methodologies. For example, the S&P 500 Dividend Aristocrats Index requires companies to have followed a policy of increasing dividends every year for at least 25 consecutive years. This implies that a company like Apple, which initiated a new dividend policy in 2012, will not be eligible for inclusion until 2037!

We believe that the First Trust NASDAQ Technology Dividend Index Fund (TDIV) provides an attractive vehicle for investors to gain exposure to some of the more stable, dividend-paying stocks in the technology sector. In addition, TDIV may provide a useful complement to equity income strategies that are underweight technology stocks, and overweight defensive sectors, such as utilities and consumer staples. In such instances, the addition of technology stocks may enhance a portfolio's diversification, while potentially increasing its anticipated rate of dividend growth. As the landscape of dividend-payers evolves, we expect the trend of technology stocks initiating and raising dividends to continue, providing investors with a new source of equity income, with the potential for above average growth.

[1]Standard & Poor's.

[2]Bloomberg.

[3]"Free cash flow" represents the cash generated by a company, net of its investments to maintain or grow its business.

[4]12 month dividend yield for the NASDAQ Technology Dividend Index℠ as of 9/12/12, according to Bloomberg. This is not necessarily indicative of the dividend yield for the First Trust NASDAQ Technology Dividend Index Fund, which has not yet declared a dividend.

[5]Ned Davis Research.

[6]Bloomberg, 9/12/12.

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ETF Characteristics

The fund lists and principally trades its shares on The NASDAQ Stock Market LLC.

The fund's return may not match the return of the NASDAQ Technology Dividend Index℠. The fund may not be fully invested at times. Securities held by the fund will generally not be bought or sold in response to market fluctuations.

Investors buying or selling fund shares on the secondary market may incur customary brokerage commissions. Market prices may differ to some degree from the net asset value of the shares. Investors who sell fund shares may receive less than the share's net asset value. Shares may be sold throughout the day on the exchange through any brokerage account. However, unlike mutual funds, shares may only be redeemed directly from the fund by authorized participants, in very large creation/redemption units.

RISKS

The fund's shares will change in value, and you could lose money by investing in the fund. One of the principal risks of investing in the fund is market risk. Market risk is the risk that a particular stock owned by the fund, fund shares or stocks in general may fall in value.

The fund may invest in small capitalization and mid capitalization companies. Such companies may experience greater price volatility than larger, more established companies.

The fund is concentrated in stocks of companies in the technology sector. You should be aware that an investment in a portfolio which is concentrated in a particular sector involves additional risks, including limited diversification. The companies engaged in the technology sector are subject to fierce competition, high research and development costs, and their products and services may be subject to rapid obsolescence.

The fund also invests in companies in the telecommunications sector. The companies engaged in the telecommunications sector are subject to fierce competition, government regulations, substantial research and development costs, and their products and services may be subject to rapid obsolescence.

An investment in a fund containing equity securities of foreign issuers is subject to additional risks, including currency fluctuations, political risks, withholding, the lack of adequate financial information, and exchange control restrictions impacting foreign issuers. These risks may be heightened for securities of companies located in, or with significant operations in, emerging market countries.

The fund invests in securities of non-U.S. issuers. Such securities are subject to higher volatility than securities of domestic issuers. Because the fund's NAV is determined on the basis of U.S. dollars and the fund invests in foreign securities, you may lose money if the local currency of a foreign market depreciates against the U.S. dollar. Additionally, the fund invests in depositary receipts, usually in the form of ADRs or GDRs. Investment in ADRs or GDRs may be less liquid than the underlying shares in their primary trading market.

The fund is classified as "non-diversified." A non-diversified fund generally may invest a larger percentage of its assets in the securities of a smaller number of issuers. As a result, the fund may be more susceptible to the risks associated with these particular companies, or to a single economic, political or regulatory occurrence affecting these companies.

You should consider a fund's investment objectives, risks, and charges and expenses carefully before investing. Contact First Trust Portfolios L.P. at 1-800-621-1675 or visit www.ftportfolios.com to obtain a prospectus or summary prospectus which contains this and other information about a fund. The prospectus or summary prospectus should be read carefully before investing.

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