

# The Long-Term Potential of Dividend Growth

An Overview of the KFA Small Cap Quality Dividend Index ETF  
(Ticker: KSCD)

# Introduction to KFA Funds

## About KFA Funds

KFA Funds is the premier platform for developing and delivering differentiated, high-conviction investment strategies to global investors. We are passionate about identifying and delivering groundbreaking capital market opportunities. We believe that investors should have cost-effective and transparent tools for attaining exposure to a wide variety of asset classes. Our goal is to become a leading source of non-traditional diversification. KFA Funds are managed by Krane Funds Advisors.



# KSCD

## KFA Small Cap Quality Dividend Index ETF

### Investment Strategy

KSCD is benchmarked to the Russell 2000 Dividend Select Equal Weight Index, which takes a smart beta<sup>1</sup> approach to investing in US Small Cap companies. The strategy seeks to measure the performance of US companies that have successfully increased their dividend payments over a period of at least ten years. The Index is designed to provide a benchmark for investors looking to capture a concentrated portfolio of constituents demonstrating increased dividends and positive momentum.

### KSCD Features

- Exposure to firms with historically reliable dividend growth which have a strong record of stable cash flows, healthy balance sheets and durable business models<sup>2</sup>
- Dividend growth strategies can potentially improve performance in down market environments<sup>2</sup>
- Smart beta strategy which seeks to deliver cost effective alpha<sup>3</sup> by selecting stocks with positive momentum.

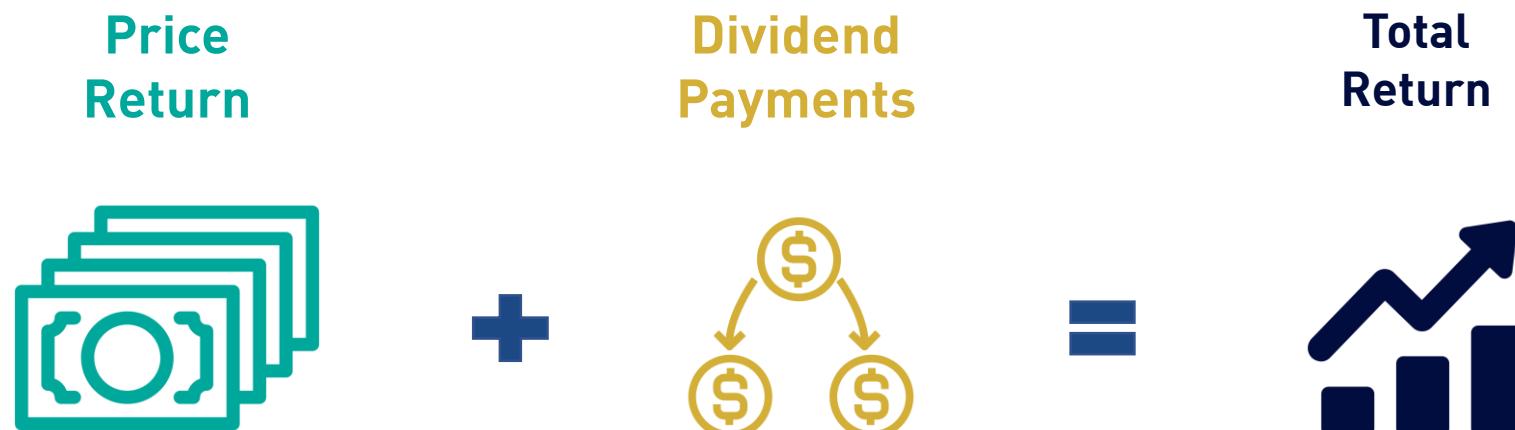
1. Smart beta is an investment style where a manager follows an index designed to take advantage of perceived systematic biases or inefficiencies in the market.

2. "Harnessing the Long-Term Potential of Dividend Growth." FTSE Russell, Nov. 2018. Retrieved 12/31/2019.

3. Alpha is the active return on an investment, gauges the performance of an investment against a market index or benchmark, which is considered to represent the market's movement as a whole.

## What is dividend growth?

- Dividend growth refers to the consistent increase in dividend payments over consecutive years, focusing on repeated increases not necessarily high dividend.
- Breaking down a company's sustainable growth rate\* uncovers drivers of dividend growth. The sustainable growth rate of a company is the rate at which earnings, and thus potential dividends, can theoretically grow indefinitely if the firm's debt-equity ratio is unchanged and no new equity is issued.
- By understanding that dividend growth companies have increased dividends at a sustainable rate (which may allow them to do so over multiple years), an investor can assume that the return on equity has historically been high for these companies.
- A high return on equity implies that these companies have exhibited a preferable combination of profit margins, asset turnover and financial leverage<sup>2</sup>.



\*Sustainable Growth Rate = Return on Equity x (1 – Dividend Payout Ratio)

## Advantages of Dividend Growth Strategies

	<b>Historical outperformance with lower volatility</b>	<b>Compounded growth on dividend reinvestment</b>	<b>Dampened drawdown in declining markets</b>
<b>Dividend Growth Analyses</b>	When observing US stocks that raised their dividend payouts over a ten-year period or more, FTSE found that stocks averaged 13.9% returns from 1987 – 2014, 380 bps higher than dividend payers not increasing dividends <sup>1</sup> .	From 1990-2018, dividend payments accounted for approximately 50% of the returns in the S&P 500. <sup>2</sup>	When observing S&P 500 dividend growers <sup>3</sup> during the market declines in 2007 – 2009 and 2018, we found the max drawdown to be 21.5% and 6.1%, comparing favorably to the S&P 500 Total Return Index max drawdown of 35.0% and 10.2% <sup>2</sup> .
<b>Analysis Summary</b>	Companies that grew or initiated dividends have historically exhibited superior performance and lower volatility <sup>1</sup> .	The contribution of dividend income to the total return of the S&P 500 has been significant and cannot be ignored. <sup>2</sup>	Lower drawdown may help prevent investors from making rash decisions regarding their portfolio and achieve investment goals <sup>1</sup> .

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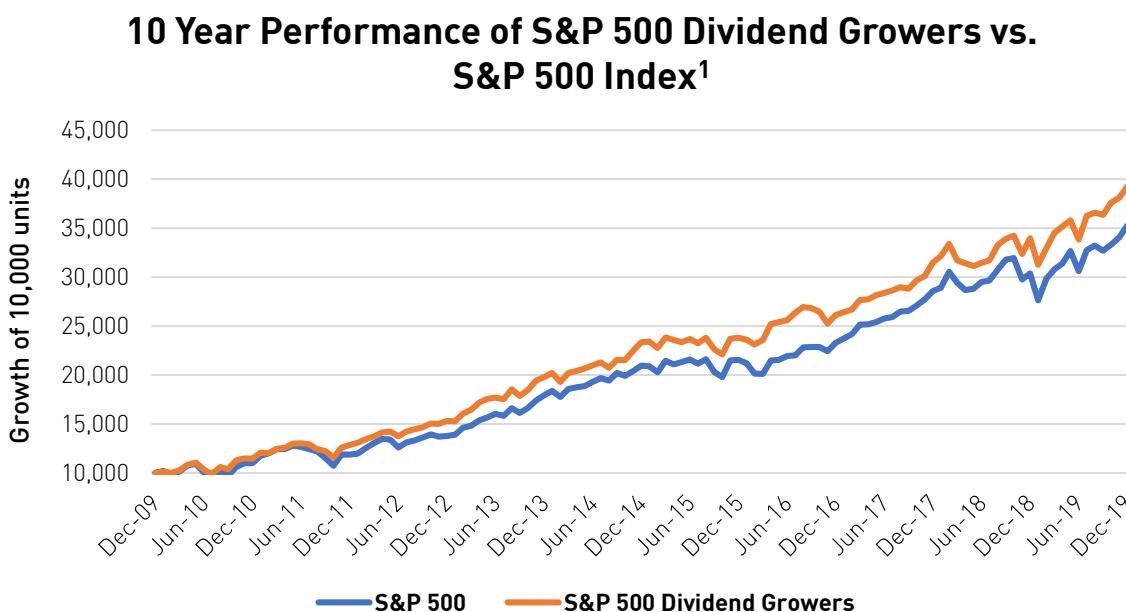
2. Data from Bloomberg as of 12/31/2019.

3. S&P 500 Dividend Growers is defined by the S&P 500 Dividend Aristocrats Index

Index returns are for illustrative purposes only and do not represent actual Fund performance. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results. For actual fund performance visit our website [www.kfafunds.com](http://www.kfafunds.com).

## Historical outperformance combined with lower volatility

- Over the past 1, 5, and 10 years, S&P 500 dividend growers have outperformed the S&P 500 Index with lower volatility.
- We believe this outperformance is a testament to the fact that dividend growing companies are firms with enduring investment value, particularly for investors with long-term horizons.



## 10 Year Annualized Return and Volatility<sup>1</sup>

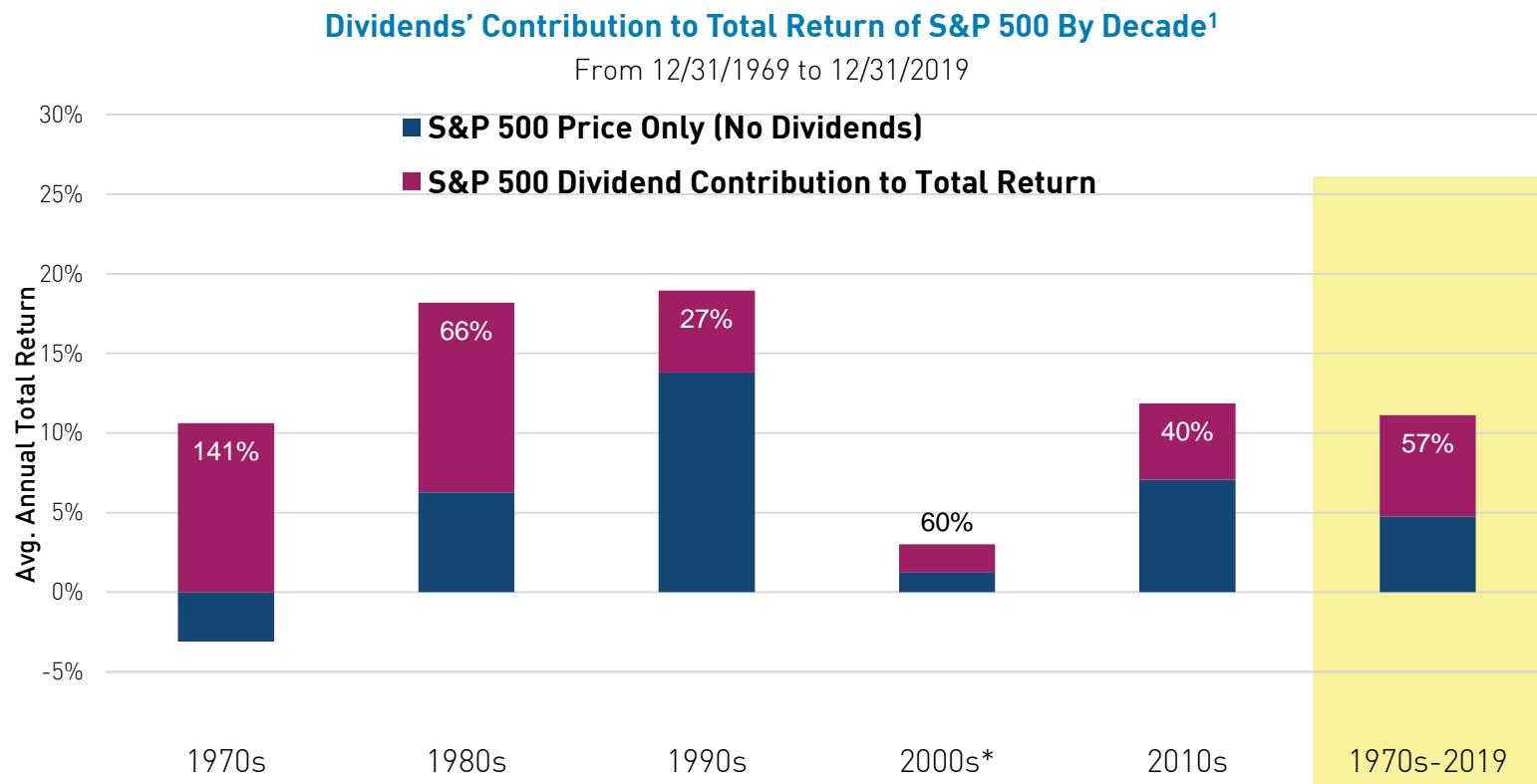
	Annualized Returns			Annualized Volatility		
	1-Year	5-Year	10-Year	1-Year	5-Year	10-Year
<b>S&amp;P 500 Dividend Growers</b>	27.97%	11.33%	14.75%	11.15%	11.01%	11.18%
<b>S&amp;P 500 Index</b>	31.48%	11.69%	13.43%	12.89%	11.98%	12.46%

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## Compounded growth on dividend reinvestment

- Data from Bloomberg and NYU Stern shows that from 1970 to 2018, an average of 57% of total return of the S&P 500 can be attributed to compounding growth on reinvested dividends<sup>1</sup>.
- In fact, a \$10,000 investment in the S&P 500 in December of 1960 would have yielded a \$3.232MM investment value in December of 2019, accounting for price return, dividends and reinvested dividends; while the same \$10,000 investment resulted in an ending investment value of \$546,000 if the S&P 500 had price return only<sup>1</sup>.

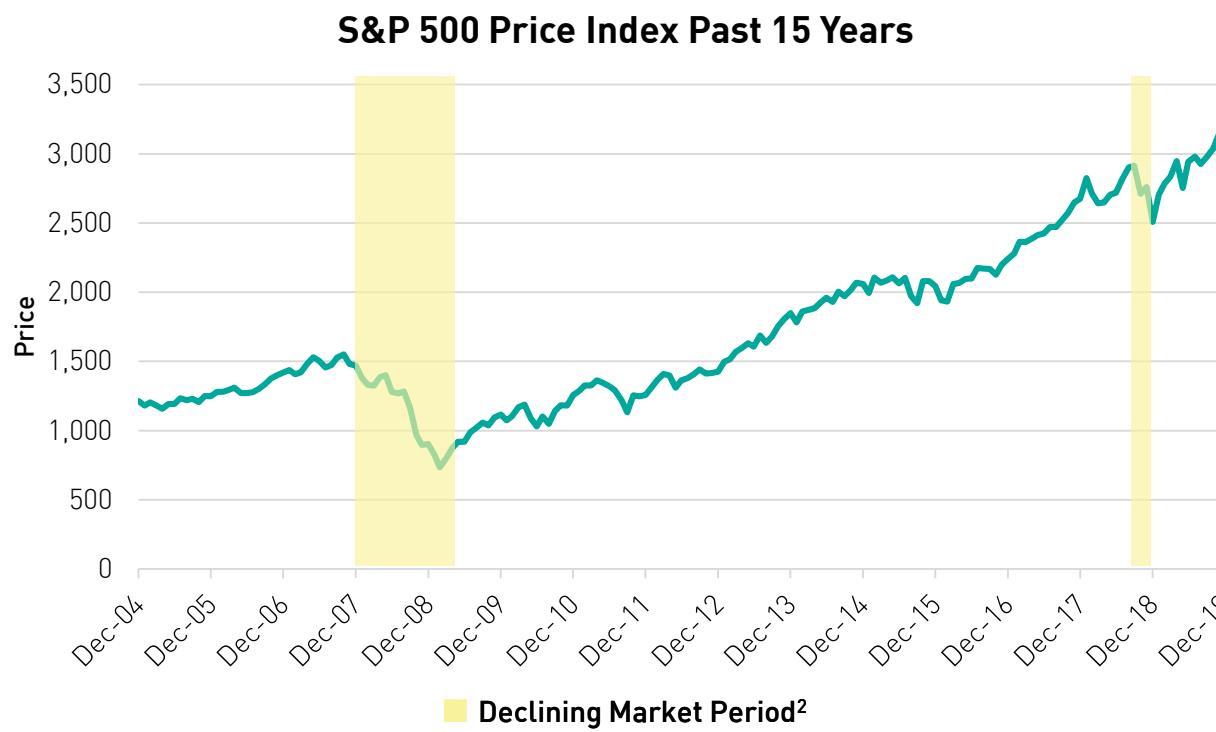


1. Data from Bloomberg and NYU Stern as of 12/31/2019.

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## Dampened drawdown in declining markets

- Lower drawdown may help prevent an investor from making emotional decisions regarding their portfolio during market turmoil. Greater discipline results in dedication to the investment plan and an increased likelihood of achieving investment goals.
- Dividend growers have shown evidence of lower drawdown. In the past 15 years, dividend growers in the S&P 500 have outperformed the broader market by nearly 10% in two periods of declining markets.
- This history of downside mitigation has contributed to long-term outperformance.



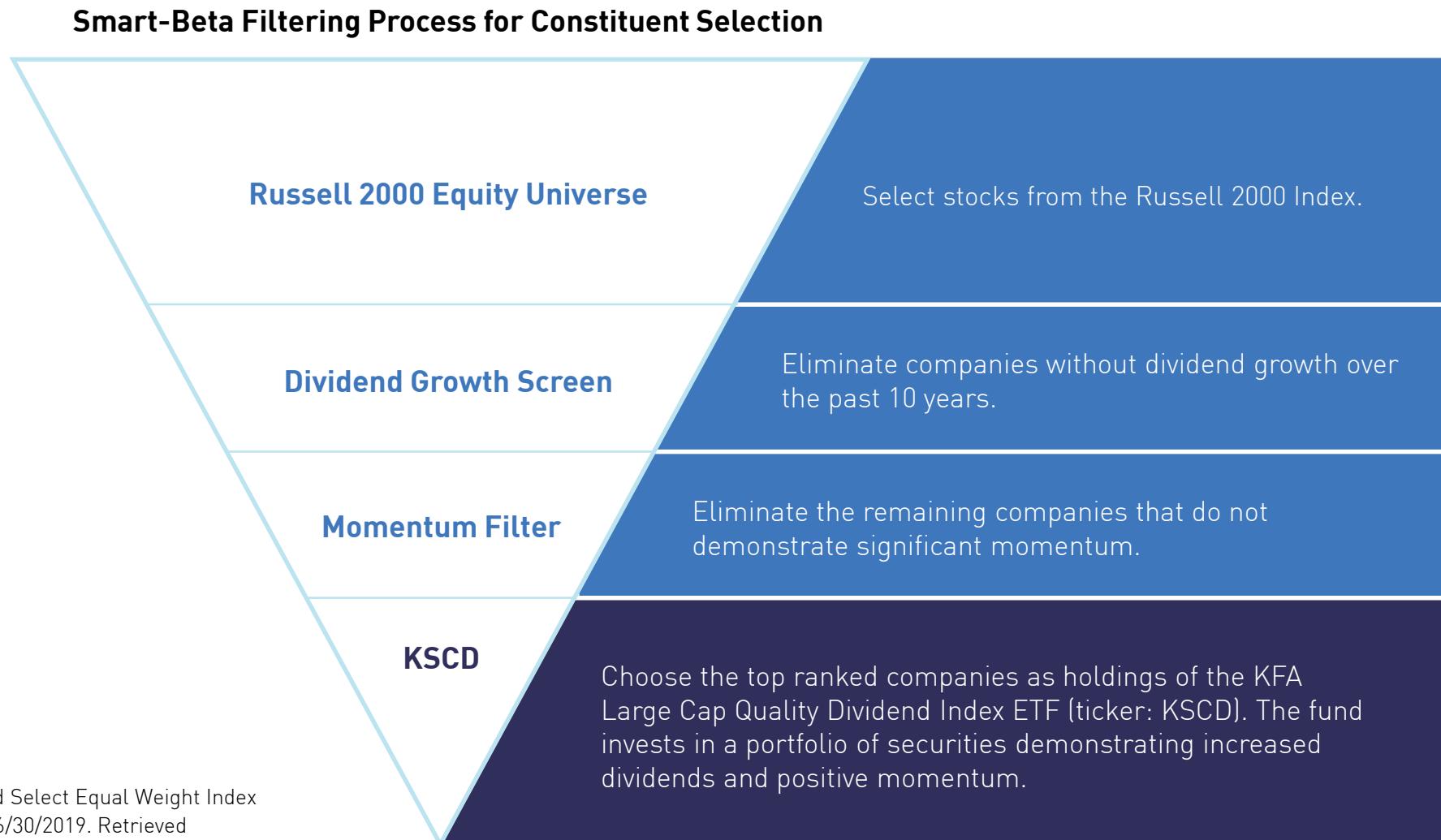
Total Return in Declining Markets in the Past 15 Years <sup>1</sup>		
Declining Market Period <sup>2</sup>	S&P 500 Dividend Growers Total Return	S&P 500 Index Total Return
Dec. 2007 – Jun. 2009	-21.5%	-35.0%
Sept. 2018 – Dec. 2018	-6.1%	-10.2%

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1. Data from Bloomberg as of 12/31/2019. S&P 500 Dividend Growers is defined by the S&P 500 Dividend Aristocrats Index

2. Declining Market Period is defined as a period where security prices fall 10% or more.

The KFA Small Cap Quality Dividend Index ETF (ticker: KSCD) uses smart-beta approach that not only holds securities demonstrating increased dividends but also those with positive momentum.



Source: "FTSE Dividend Select Equal Weight Index Series" FTSE Russell, 6/30/2019. Retrieved 12/31/2019.

## Momentum is key to unlocking potentially high returns from dividend growing companies.

- Many of the companies that have consistently increased their dividends tended to be large, old, and slow-growing.
- A momentum strategy looks at acceleration in stock prices and seeks investment in companies that exhibit high growth rates even if their stock prices are already high.
- The KFA Small Cap Quality Dividend Index ETF combines a smart-beta momentum strategy with a dividend growth strategy to help ensure that the companies included in the fund grow more than just their dividends.
- The chart below shows that dividend yield and return on equity in the Russell 2000 Dividend Select Equal Weight Index are an improvement over the general Russell 2000 Index.

Russell 2000 Dividend Select Equal Weight Index vs Russell 2000 Index Characteristics (as of 9/30/2019) <sup>1</sup>		
	Russell 2000 Dividend Select Equal Weight Index	Russell 2000 Index
Market Cap (\$ Wgt. Avg in \$Bil)	2.5	2.5
Number of Holdings	44	1,997
Dividend Yield	2.1	1.4
Price/Earnings	24.7	19.0
Price/Sales	1.9	1.1
Price/Cash Flow	12.5	9.3
Return on Equity (%)	12.2	5.3

## Conclusion

- We believe dividend growth is an attractive investment theme that should be considered when constructing a portfolio.
- Companies exhibiting dividend growth have historically shown the ability to pay and commitment to paying these dividends and increasing them each year, thereby allowing an investor to potentially reap the benefits of compounded dividends and returns.
- Through these dividend growth companies, the investor gains exposure to two factors that may help dampen risk in a portfolio: quality and historically low volatility.
- Investors who seek opportunities to gain or replace equity exposure by focusing on high-quality companies dedicated to returning money to their shareholders should consider incorporating dividend growth strategies into their portfolios.

## Advantages of Dividend Growth Strategies

<b>Historical outperformance with lower volatility</b>	<b>Compounded growth on dividend reinvestment</b>	<b>Dampened drawdown in declining markets</b>
Companies that grew or initiated dividends have historically exhibited superior performance and lower volatility <sup>1</sup> .	Dividend income's contribution to the total return of the S&P 500 has been significant, and cannot be ignored.	Lower drawdown may help prevent investors from making rash decisions regarding their portfolio and achieve investment goals <sup>1</sup> .

1. "Harnessing the Long-Term Potential of Dividend Growth." FTSE Russell, Nov. 2018, Retrieved 12/31/2019.

## KFA Small Cap Quality Dividend Index ETF

### Investment Strategy:

KSCD is benchmarked to the Russell 2000 Dividend Select Equal Weight Index, which takes a smart beta approach to investing in US Large Cap companies. The strategy seeks to measure the performance of US companies that have successfully increased their dividend payments over a period of ten years. The Index is designed to provide a benchmark for investors looking to capture a concentrated portfolio of constituents demonstrating increased dividends and positive momentum.

### Key Fund Information

Ticker	KSCD
Index Name	Russell 2000 Dividend Select Equal Weight Index
Primary Exchange	NYSE
Total Annual Fund Operating Expense	0.51%
Inception Date	6/12/2019
Distribution Frequency	Annually

Top Ten Holdings as of 12/31/2019	% of Fund
The Fund's Holdings Are Subject to Change.	
Northwest Natural Holding Co.	2.40
Atrion Corporation	2.40
Badger Meter, Inc.	2.40
Stepan Company	2.40
Community Bank System, Inc.	2.30
Tompkins Financial Corporation	2.30
Ensign Group, Inc.	2.30
BancFirst Corporation	2.30
Southside Bancshares, Inc.	2.30
Chesapeake Utilities Corporation	2.30

### KSCD Performance History as of 12/31/2019

	Cumulative %			Average Annualized %			
	3 Mo	6 Mo	Since Inception 6/12/2019	1 Yr	3 Yr	5 Yr	Since Inception 6/12/2019
Fund NAV	4.32%	5.56%	6.95%	–	–	–	–
Closing Price	4.36%	5.56%	6.99%	–	–	–	–
Index	4.54%	5.95%	7.39%	–	–	–	–

The performance data quoted represents past performance. Past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when sold or redeemed, may be worth more or less than their original cost and current performance may be lower or higher than the performance quoted. For performance data current to the most recent month end, please visit [www.kraneshares.com](http://www.kraneshares.com)

Index returns are for illustrative purposes only. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index.

## Terminology Definitions

Dividend Growth Rate: A company's dividend growth rate is the rate at which that company is expected to increase its dividend payments. The dividend growth rate is the annualized percentage rate of growth that a particular stock's dividend undergoes for a period of time.

Sustainable Growth Rate: The sustainable growth rate is the rate at which a company is expected to grow without significant additional capital investment. The sustainable growth rate is represented by the formula: Return on Equity x (1 – Dividend Payout Ratio)

Free Cash Flow: Free cash flow is the amount of cash left over after a company has paid all its expenses and capital expenditures.

Smart Beta: Smart beta is a rules-based system for selecting investments to be included in a fund portfolio. Smart beta is generally used to ensure that investments exhibiting a certain, measurable characteristic are automatically included in a fund.

Dividend Yield: The ratio of a company's annual dividend compared to its share price. Dividend yield is expressed by the formula: annual dividend/share price.

P/E: The ratio of a company's share price compared to its earnings per share over a period of time. P/E is expressed by the formula: market value per share/earnings per share

Price/Cash Flow: The ratio of a company's share price to its operating cash flow per share. Price/Cash flow is expressed by the formula: Share price/operating cash flow per share.

ROE: A measure of how effectively management is using a company's assets to create profits. ROE is expressed by the formula: net income/shareholders' equity.

## Index Definitions

S&P Total Return Index: This index tracks the performance of securities in the S&P 500 index based on both price changes and reinvested dividends.

S&P Aristocrats Index: This index is designed to measure the performance of S&P 500 index constituents that have followed a policy of consistently increasing dividends every year for at least 25 years.

Russell 2000 Index: This index is comprised of the smallest 2000 companies in the Russell 3000 Index, representing approximately 8% of the Russell total market capitalization. The real-time value is calculated with a base value of 135.00 as of December 31, 1986. The end-of-day value is calculated with a base value of 100.00 as of December 29, 1978.

Russell 2000 Dividend Select Index: This index is designed to measure the performance of US companies that have successfully increased their dividend payments over a period of ten years. On a quarterly basis the highest ranking companies based on momentum are selected and equally weighted to form the final index, capturing the small cap domestic market. The index is designed to provide a benchmark for investors looking to capture a concentrated portfolio of constituents demonstrating increased dividends and positive momentum.

Disclosure (Slide 11): Index returns are for illustrative purposes only and do not represent actual Fund performance. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results. For actual fund performance visit our website [www.kfafunds.com](http://www.kfafunds.com).



## Important Notes

Carefully consider the Funds' investment objectives, risk factors, charges and expenses before investing. This and additional information can be found in the Funds' full and summary prospectus, which may be obtained by visiting [www.kfafunds.com](http://www.kfafunds.com). Read the prospectus carefully before investing.

Investing involves risk, including possible loss of principal. There can be no assurance that a Fund will achieve its stated objectives. ETF shares are not redeemable with the issuing fund other than in large Creation Unit aggregations. Instead, investors must buy or sell ETF Shares in the secondary market with the assistance of a stockbroker. In doing so, the investor may incur brokerage commissions and may pay more than net asset value when buying and receive less than net asset value when selling. The NAV of the Fund's shares is calculated each day the national securities exchanges are open for trading as of the close of regular trading on the New York Stock Exchange ("NYSE"), normally 4:00 p.m. Eastern time (the "NAV Calculation Time"). Shares are bought and sold at market price (closing price) not NAV. Market price returns are based on the midpoint of the bid/ask spread at 4:00 pm Eastern Time (when NAV is normally determined).

KSCD invests in small-capitalization companies. In addition to the nominal risks associated with investing, investments in small companies typically exhibit higher volatility. KSCD is subject to liquidity risk, meaning that certain investments may become difficult to purchase or sell at a reasonable time and price. If a transaction for these securities is large, it may not be possible to initiate which may cause the Fund to suffer losses. There is no guarantee that issuers of the stocks held by the Fund will declare dividends in the future or that, if declared, such dividends will remain at current levels or increase over time. The Fund is non-diversified. The Funds may invest in derivatives, which are often more volatile than other investments and may magnify the Funds' gains or losses.

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