Breckinridge CAPITAL ADVISORS

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Re(de)fining Quality: The Philosophy Behind High Quality Dividend Investing

The combination of credit analysis and dividend policy assessment offers investors a differentiated approach to Dividend Quality investing.

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SUMMARY

- As fixed-income investors, assessing credit quality is always at the core of our investment philosophy and process at Breckinridge. Credit analysis evaluates financial resilience by assessing the strength of a company's balance sheet, the sustainability of its cash flow, and its capacity to meet ongoing financial commitments through changing economic conditions.
- Dividend analysis asks a related but more demanding question: after meeting those obligations and funding the business, can the company continue to return a reliable and growing stream of cash to shareholders? Dividend policy can help answer that question, but only when it is considered together with financial resilience. This connection between credit worthiness and dividend reliability underpins the philosophy of Breckinridge's rules-based High Quality Dividend (HQD) strategy.
- Breckinridge defines Dividend Quality as a company's demonstrated capacity to provide meaningful income, grow that income over time, and preserve the financial flexibility required for profitable reinvestment. In our view, Dividend Quality offers significant behavioral advantages for investors and should reside in a new and distinct category of dividend equity investing alongside the more familiar styles of high dividend yield and dividend growth.



Evaluating Business Quality Via Dividend Policy

Factor investing has developed broadly accepted definitions for value, momentum and size. The definition of quality, however, remains less uniform, with some quality strategies emphasizing profitability and return on equity while others focus on earnings stability, low leverage, or conservative accounting. These measures are useful, but they do not fully capture what a dividend can reveal about management's confidence, financial capacity, and capital-allocation discipline.

There are few windows into management's confidence as unambiguous as dividends. Academic research has long examined the information contained in dividend policy. John Lintner observed that companies tend to adjust dividends cautiously because management seeks to avoid increases it may later reverse. Research that followed found that dividend changes can contain information about subsequent profitability beyond contemporaneous market and accounting data.[1,2] Broader quality-factor research also recognizes payout policy as a dimension of corporate quality.[3]

> *"One of the most persuasive tests of high quality is an uninterrupted record of dividend payments for the last 20 years."*
>
> — **Benjamin Graham,** *The Intelligent Investor*[4]

At Breckinridge, our investment strategy is about more than simply owning quality companies. It is about identifying quality dividend-paying companies: dividends that we believe are reliable, responsibly funded, and can consistently increase due to growing earnings. An increase in the regular dividend can be a meaningful signal of management's confidence in future earnings and cash flow, as companies understand the consequences of raising a dividend and subsequently cutting it.

Applying a credit lens to dividend policy strengthens this quality case. For investment grade companies (the investable universe for Breckinridge's HQD strategy) that discipline can be especially important because a dividend cut may be of concern to both debt and equity holders.

Dividend Quality as a Category: Not Just Yield nor Simply Growth

A high-dividend strategy generally emphasizes companies with high current yield. A dividend-growth strategy typically rewards historical growth rate or consistency of dividend increases. As noted earlier, a conventional quality strategy generally starts with profitability, leverage, and earnings stability. Dividend Quality integrates all three perspectives but treats none as sufficient on its own.

This integrated perspective addresses a key gap: a high-quality company may pay no dividend, while alternatively, an apparently attractive dividend may be unsupported by the underlying business. Dividend Quality asks whether meaningful current income can be supported and grown without weakening the enterprise or limiting profitable reinvestment. Dividend quality, then, is the link between credit worthiness and dividend reliability, as high quality investment grade companies have the propensity to be reliable dividend payers.

1. John Lintner, "Distribution of Incomes of Corporations Among Dividends, Retained Earnings, and Taxes," *American Economic Review*, May 1956.
2. Doron Nissim and Amir Ziv, "Dividend Changes and Future Profitability," *Journal of Finance,* December 2001.
3. Clifford S. Asness, Andrea Frazzini and Lasse H. Pedersen, "Quality Minus Junk," *Review of Accounting Studies*, March 2019.
4. Benjamin Graham, *The Intelligent Investor*, revised edition, Harper Business.

With all this in mind, Breckinridge's philosophy behind the High Quality Dividend strategy is as follows:

> *"We believe a company's quality and dividend growth are mutually reinforcing. Quality businesses support reliable, growing dividends while consistent dividend growth affirms underlying, enduring quality."*
>
> — **Peter Coffin,** *Breckinridge Capital Advisors*

We also believe that Credit Quality informs Dividend Quality because creditors have a senior claim on cash. A company that can comfortably meet its contractual obligations is more likely to have the residual capacity to pay a dividend, but it may choose not to do so or prioritize reinvestment and repurchases.

Dividend Quality can signal strength in business fundamentals because a well-funded, consistently growing dividend may provide evidence of enduring cash flow generation and capital-allocation discipline. Yet a company may temporarily maintain a dividend through borrowing, asset sales, or an excessive payout, which is why the dividend cannot be interpreted independently.

DIVIDEND QUALITY is the capacity of a financially resilient and profitable company to sustain and grow an appropriately sized dividend while continuing to reinvest in the business. It balances the income available today with the capacity to grow income tomorrow.

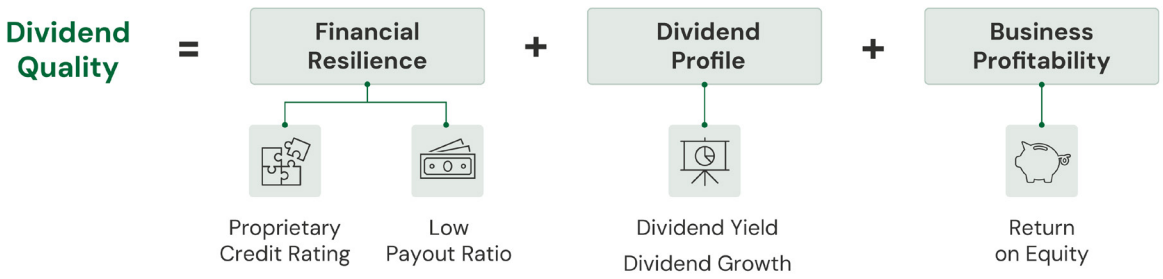
Credit and Dividend Quality thus offer complementary evidence of corporate quality. Their intersection represents a distinct style of investing.

From Investment Philosophy to Process

Our investment philosophy is transformed into a repeatable security-selection framework through Breckinridge's proprietary Dividend Internal Scoring Model (i.e., Dividend ISM). The Dividend ISM evaluates securities based on their capacity to sustain and grow an appropriately sized dividend while continuing to reinvest in the business.

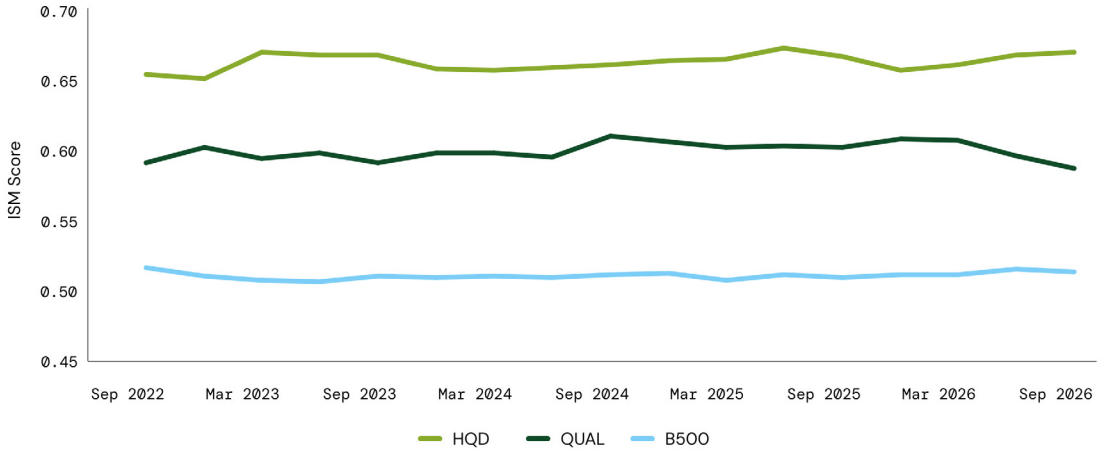
Breckinridge defines the eligible universe to include U.S. large cap investment grade companies with an established history (10+ years) of continuous dividend payments. Each company meeting initial screening criteria is then quantitatively scored across five dimensions, and the resulting signals are evaluated together rather than used as independent screens.

- **The proprietary credit rating** assesses balance-sheet strength, business resilience and cash-flow durability.
- **The payout ratio** evaluates the cushion supporting the dividend and the capital retained for reinvestment.
- **Dividend yield and dividend growth** measure the income delivered and the record of increasing that income.
- **Return on equity** indicates whether the company can use shareholder capital productively.



The resulting Dividend ISM score reflects these measures as controls on each other. For example, an unusually high yield would be counteracted by deteriorating credit quality; fast historical dividend growth would be countermanded by an excessive payout ratio; and high profitability does not produce dividend quality when capital allocation is inconsistent or unsupported. In total, we believe the Dividend ISM is a true differentiator on quality (See Figure 1), where HQD consistently ranks higher than both the overall market, represented by the Bloomberg 500 (B500) Index, and a well-known quality proxy in QUAL.[5]

FIGURE 1: BRECKINRIDGE PROPRIETARY DIVIDEND ISM FACTOR



Source: Bloomberg and Breckinridge calculations as of September 30, 2026.

The ISM factor equally weights return on equity, payout ratio, dividend yield, dividend growth and Breckinridge proprietary credit rating, and is recalculated quarterly. To be eligible, a company must have >$10B market cap, possess an investment grade rating, and have a 10-year history of consistent dividend payments. Where Breckinridge investment grade ratings were not available, S&P current ratings were used. Dividend history for companies were added from either QUAL ETF or B500 indices determined by evidence of dividend yield > 0% as of each respective period's quarterly end date and 10 years prior to that. The B500 list of constituents was gathered every other quarter (except for 06/30/2026 and 09/30/2026 periods which were both used as is) and QUAL holdings were updated every quarter. QUAL is the MSCI iShares MSCI USA Quality Factor ETF. It was selected because HQD has a quality bias and QUAL is one of the most well recognized quality ETFs in the industry and has about $48B in assets.

5. This analysis compares historical scores calculated using Breckinridge's proprietary Dividend Internal Scoring Model ("Dividend ISM") for the High Quality Dividend ("HQD") strategy, the Bloomberg 500 Index ("B500"), and the iShares MSCI USA Quality Factor ETF ("QUAL"). The scores reflect characteristics evaluated under Breckinridge's methodology, rather than investment returns or an independent assessment of investment quality. Because the HQD investment process incorporates the Dividend ISM, the comparison emphasizes characteristics that the strategy is specifically designed to favor. There are material differences between HQD, B500, and QUAL, including their investment objectives, eligible universes, security selection and weighting methodologies, holdings, sector exposures, and rebalancing practices. B500 provides broad exposure to large-capitalization U.S. companies, while QUAL seeks to track an index emphasizing high return on equity, stable earnings, and low debt. Neither applies HQD's particular combination of proprietary credit analysis and dividend-related selection criteria. These differences can materially affect the scores shown and limit the comparability of the analysis. B500 is an unmanaged index in which investors cannot invest directly; QUAL is an investable ETF with its own fees, expenses, and investment risks. The Dividend ISM reflects Breckinridge's judgments and assumptions and is subject to data and model limitations. Higher scores do not necessarily indicate higher future returns, lower investment risk, or more reliable dividend payments. Historical scores may change and are not predictive of future scores or investment results. There is no assurance that HQD will achieve its objectives or outperform B500 or QUAL. Dividend payments are not guaranteed.

Importantly, we believe these characteristics can provide strong evidence of the quality of the underlying business and the consistency of its earnings. Reported earnings are an accounting measure, necessarily shaped by assumptions, estimates, and judgments. Instead, we focus on dividends. Dividends are different. Dividends are definitive. Dividends are cash. A company that regularly pays and increases its dividend is quite literally walking the walk and not just talking the talk.

The (Counter)intuitive Payout Ratio

Breckinridge's HQD investment process favors companies with lower dividend payout ratios. This distinguishes our philosophy from many other dividend equity strategies, where higher payout ratios are intentionally part of the design plan, or as they say in the technology sector: viewed as a "feature, not a bug."

Our objective is not to maximize yield, but to own high-quality businesses capable of consistently growing a dividend while retaining substantial earnings for future growth. A lower payout ratio can cushion the dividend during difficult periods, create capacity for future increases, and retain capital for business growth. We therefore do not view dividends and growth as competing objectives. Ultimately, we believe that most equity investors want to own businesses capable of growing their earnings over time. High-quality, dividend-paying companies are able to satisfy both objectives: investing sufficiently in their business to support future growth while returning a growing stream of cash to shareholders.

Lesson from Behavioral Economics: Quality's Underappreciated Benefits

A critical benefit of holding Dividend Quality stocks for investors is that the receipt and growth of dividends are observable outcomes. During periods of market stress or temporary underperformance, those outcomes can reinforce the investment thesis and help investors distinguish a change in stock price from a deterioration in business quality. Said differently, stock prices are typically far more volatile than the underlying businesses they represent. For an investor, consistent dividend policy and growth can offer true insight into the stability of the underlying business.

Behavioral benefits of Dividend Quality help support the very important "sleep well at night" test. Every strategy, held long enough, will have a period of cyclical underperformance and/or face a punishing bear market. The question is how do investors manage their own behavior during those periods? Capital is often destroyed by buying at euphoric highs and selling near panic-driven lows. This has been well illustrated by Morningstar's "investor return gap" calculation, which shows the average dollar-weighted returns based on when investors purchased and redeemed U.S. mutual funds rather than total returns based on an initial lump sum purchase. As expected, average dollar-weighted returns lag total returns, with the most recent study showing the former at 8.7 percent vs. the latter at 9.9 percent for the 10-year period ending 12/31/2025.[6] This equates to a significant 12 percent total loss over 10 years, likely because investor behavior is impacted by market volatility and their emotional swings.

It is during down markets, in particular, that understanding the anatomy of an investment is critical to avoiding common behavioral mistakes. Dividends cannot prevent losses, guarantee positive returns, or substitute for valuation discipline. High quality dividends can, however, provide a timely reminder of the defensive nature typically exhibited by quality businesses that continue to generate cash, display financial strength, and, at times, raise their distributions during periods of market stress.[7,8] As such, the cash flow from a growing dividend stream provides tangible evidence of financial strength, which may benefit investors behaviorally by helping them stay the course through unsettled markets.

6. Jeffrey Ptak, "Mind the Gap US 2026", *Morningstar,* August 6, 2026. Past performance is not indicative of future results.
7. Eugene Lim, et al., "Quality Time – Understanding Factor Investing," MSCI Research, June 2023.
8. Kathleen Fuller and Michael Goldstein, "Do Dividends Matter More in Declining Markets," Journal of Corporate Finance, December 2010.

Conclusion

The companies held in Breckinridge's HQD strategy have historically grown their dividends well above the S&P 500's average dividend growth rate, while tending to exhibit more defensive characteristics in aggregate.

We believe that the value of a dividend lies not only in the income it provides, but in what it reveals about the quality of the underlying company. That lens, along with the thorough assessment of a company's financial resilience, provides for a narrower, but more robust, measure of business quality. These philosophical tenets underpin Breckinridge's Dividend Internal Scoring Model and translate into a repeatable, rules-based investment process for constructing and managing the portfolio. For investors and advisors, Breckinridge's HQD strategy may be well-suited to deliver current income, dividend growth, capital appreciation and attractive risk-adjusted returns. As such, it may be a differentiated option as they (re) assess large cap core, quality or dividend equity allocations.

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