Dividend Momentum Rotation (DMR)

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Investment Decision: Do Not Invest

Introduction

Our group analyzed the Dividend Momentum Rotation (DMR) strategy within the Financial Select Sector (XLF) to test whether rising dividends and strong price momentum could produce consistent outperformance. The concept was grounded in the idea that firms increasing payouts and showing recent strength may continue to reward shareholders. However, empirical testing revealed inconsistent performance across multiple timeframes, indicating weak persistence and unreliable alpha generation. As a result, the DMR approach did not justify inclusion in the Davidson Fund portfolio.

Strategy and Origin

DMR targets financial companies within the XLF universe that demonstrate both dividend growth and above-median six-month total returns. This dual signal aimed to capture quality momentum—firms exhibiting both capital strength and market confidence.

The theoretical basis drew from established research:

- Keim (1985) linked dividend yields to abnormal seasonal returns.
- Korganbekova (2018) observed short-lived price effects following dividend announcements.
- Fasano (2018) found that policy changes could trigger modest abnormal returns.
- Wang (2020) showed evidence of momentum persistence in cross-sectional data.

Together, these studies formed the foundation for testing whether combining dividend momentum and price strength could systematically outperform the benchmark.

Historical Performance

DMR was backtested across 1-, 3-, 5-, 10-, and 20-year windows on XLF constituents using both Dividend Growth Rate (DGR) and Dividend Yield (DY) variations. The results revealed a lack of robustness:

- Positive results: 10-year and 5-year periods modestly outperformed.
- Negative results: 1-, 3-, and 20-year windows underperformed SPY and XLF.

Risk-adjusted metrics such as the Sharpe ratio and maximum drawdown also lagged the benchmark in most windows. While certain timeframes hinted at strength, the lack of consistency and weak risk compensation undermined confidence in the signal's durability.

Portfolio Impact

If implemented, the DMR strategy would increase volatility without a corresponding rise in returns. Sharpe ratios were inferior to XLF's, suggesting higher uncompensated risk exposure. Because of its sector concentration and weak risk-adjusted profile, DMR would likely erode diversification benefits within the Davidson Fund's portfolio.

Investment Thesis and Recommendation

Despite its appealing theoretical foundation and relevance to dividend-seeking investors, the Dividend Momentum Rotation strategy did not meet the fund's performance or risk standards. The lack of consistency across timeframes, coupled with insufficient compensation for drawdown risk, led us to issue a NO BUY recommendation.

Summary

The Dividend Momentum Rotation strategy offers valuable insights into dividend-based momentum investing but fails to demonstrate persistent alpha in practice. Results suggest that dividend momentum within the financial sector is not a robust predictor of future outperformance, and its implementation would elevate portfolio risk without clear reward.

Recommendation: Maintain current holdings and avoid DMR allocation.