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BEST ETFS & MUTUAL FUNDS

Top Fund Manager Welcomes Volatility

Integrity Dividend Fund seeks to hold up while others suffer big losses

Q&A

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FOR INVESTOR'S BUSINESS DAILY

Making money in an up market is easy. But showering investors with gains when stocks are in a protracted downdraft is far more challenging, even for the best mutual funds.

But that's exactly what the Integrity Dividend Harvest Fund **(IDIVX)** did in the bear market.

The fund, which takes a low-risk approach by investing in stable, income-producing dividend stocks, posted a total return of 2.9% last year, according to Morningstar Direct. That gain might seem puny. But when you compare it to the 18.2% decline for the S&P 500, it's akin to investing nirvana.

Sure, loading up on riskier high-octane stocks can deliver bigger returns than stodgy dividend payers — if the market behaves itself (as it has so far in 2023). But when the market behaves badly, less sexy stocks start to look a lot more attractive.

Mutual funds that invest in stocks that pay dividends don't normally shoot to the top of the performance charts like they did last year. But for funds like Integrity Dividend Harvest Fund that's more by design. Holding up better (or going down less) than the broad market during market swoons is part of the plan. Earning a nice chunk of income and buffering market volatility is a bonus.

IBD caught up with Michael Morey, co-manager of Integrity Dividend Harvest Fund, who talked with us from the office of his boutique fund firm Integrity Viking Funds in Minot, N.D.

IBD: Why do you prefer steady dividend stocks over sexier stocks?

Michael Morey: Dividends are a much more reliable source of investment income versus capital appreciation, especially when you're investing in companies that have a long history of consistently raising their dividend on an annual basis. By focusing on companies that have that long, rich history of raising their dividend, we feel comfortable that we're going to increase our shareholders' stream of income each year, too. And we have accomplished that since the fund's inception in 2012. We have raised the shareholder dividend payout on a per share basis every single year.

IBD: What is the fund trying to accomplish?

Morey: There are three primary objectives: maximizing current income, growing that income over time, and minimizing the risk that we take on.

IBD: Sounds like a sleep-better-at-night type of fund?

Morey: Yeah, it allows investors a little bit more peace of mind. The fund is not going to be nearly as volatile. But when you look at the strategy over the full cycle, returns are very compelling, especially when you factor in how much less risk you're taking. Last May, we celebrated the fund's 10-year anniversary. And the fund has produced greater than 10% annualized returns since inception.

IBD: What does posting a positive return in the bear tell us about the fund?

Michael Morey of Integrity Dividend Harvest finds durable stocks.

Morey: One area where this fund shines is during market pullbacks. A lot of the alpha (excess returns above a market benchmark) that has been generated since the inception of the fund is during market pullbacks. And that's because we have an exceptionally low downside capture ratio versus the broader market. That means the fund goes down less than the market in tough times, such as the coronavirus sell-off in 2020 and last year's bear market caused by the spike in inflation and rising rates.

IBD: Describe how you screen for stocks.

Morey: We use four key portfolio metrics to narrow down the universe. We're looking for companies with a dividend yield of at least a quarter of a percentage point, or 25 basis points, higher than the S&P 500. The fund's (trailing 12-month) yield is currently just over 3% (versus 1.7% for the S&P 500, according to Morningstar Direct). We're looking for dividend history, too. The threshold is 10 consecutive years of dividend increases.

We also focus on larger companies with market capitalizations of $10 billion or more. You're going to take a little bit of risk off the table, as large-cap stocks tend to hold up better when the markets get rocky. Finally, we target low beta stocks simply because we don't want to take on excessive risk. (Beta measures how volatile a stock or fund is relative to the S&P 500, which has a beta of 1.0.)

IBD: What's the fund's beta and what does it mean for investors?

Morey: At the end of January the beta was 0.73 and over longer time frames it's 0.75. That means hypothetically the fund should fall about 25% less than the S&P 500 in down markets. However, on the other hand, we expect to trail the benchmark in rising markets.

IBD: What's your 2023 market outlook amid talk of recession?

Morey: I see a lot of volatility. The market is very efficient when looking at the economic data. I certainly don't think we are out of the woods. Whether we retest last year's market lows is up for debate. But I don't think it's going to be as smooth sailing back to the upside like we saw coming out of Covid-19.

IBD: So, what's the message for investors?

Morey: You're going to want to continue to focus on companies with strong balance sheets and strong free cash flow profiles. And that fits right into the wheelhouse of this fund. Looking at the market action that we've seen through the first month of this year, it's very evident that there's a little bit of a rotation going on. Some people are starting to deploy some money into riskier assets, such as technology stocks.

But I do think there needs to be a lot more pain in this market before we can get kind of past the whole recession narrative. With that said, our process kind of takes a lot of that concern off the table for us. We can invest in companies within this portfolio comfortably and not get overly concerned about whether we're going to be facing a recession or not. That's because we own companies that are of very high quality that have strong dividends and that are likely going to continue to grow that dividend whether we're in a bull market or a bear market or recession.

AbbVie attracts dividend-focused investors with its alluring 4% yield.

IBD: Let's dig into your portfolio. What sectors do you like?

Morey: Right now, we have a few sectors that are fairly close in terms of percentage weightings. Financials. Health care. Technology. And consumer staples. Those are our top four sectors. What's unique about our top sectors is you're almost getting a barbell approach when investing in the market. You have a decent mix of growth, cyclicality, and defensiveness in there.

IBD: What do you like about financials now?

Morey: You get healthy cyclicality out of financials. This is probably the first quarter where financials have been our top sector. That's partially due to the fact we have been tactically adding to financials. It's unclear what's going to happen with this recession. But with the move higher in rates and the wider yield spreads that we're seeing, we're looking at more of a longer-term advantage, primarily for the banks. You know, as the consumer picks up as we come out of the recession, we do think financials are going to do incredibly well.

IBD: What's your favorite bank stock?

Morey: JPMorgan Chase (JPM) is probably the standout. It's just an absolute juggernaut within financials. They've consistently delivered superior returns. They have strong risk management that has enabled them to avoid significant stress during previous crises. From a valuation standpoint, they do warrant a premium, but we do see them currently as being fairly attractively valued. And having CEO Jamie Dimon running the ship has all sorts of positives.

IBD: Any other financials you're bullish on?

Morey: BlackRock (BLK) is very intriguing. It is an absolute leader within the asset management space. It continues to gain market share and assets to manage. And we feel this trend is going to continue. And with the consistency of dividend growth that we're likely going to see out of them for years to come, we find BlackRock very, very suitable for this portfolio.

IBD: AbbVie (ABBV), a health care stock, remains a top holding. Do you see risks as its top-selling arthritis drug Humira now faces competition from copycat drugs, or biosimilars?

Morey: The reason why AbbVie is so high in the portfolio is they just check a lot of the boxes. It has a greater than 4% dividend yield. They have over 50 years of consecutive dividend increases. And very attractive valuations.

Even considering the headwinds facing it with Humira knockoff competition, they have two new key products, Skyrizi (treats arthritis, psoriasis, and Crohn's disease) and Rinvoq (a drug for arthritis, eczema, and ulcerative colitis), that are projected to exceed Humira's peak revenue by 2027. Revenue from those two drugs alone is projected to be $17.5 billion by 2025 and north of $21 billion by 2027.

And even with the Humira headwinds, the company is adapting by diversifying its pipeline of new drugs. Another good thing that the company has done is the 2020 acquisition of Allergan. That also significantly diversified AbbVie's product pipeline.

IBD: What other health care stocks do you like?

Morey: Merck **(MRK)**. It's in a very similar position as AbbVie was about five years ago when the issue of Humira eventually losing its exclusivity started to affect AbbVie's share price. But just as AbbVie, through diversification, improving its drug pipeline and making acquisitions, mitigated that risk, I think Merck is in the same position right now with Keytruda, its leading cancer treatment drug. Keytruda has a patent expiration in 2028. It's five years from now.

But Merck is much more diversified currently than what AbbVie was five years ago. And from a valuation standpoint, it looks very compelling. The company is an absolute oncology leader. And they're going to leverage that. They're also advancing their drug pipeline, whether it's through M&A or internally. They're delivering incredible growth. Keytruda's patent (is good until 2028), so that does allow them significant runway to continue to expand on their oncology leadership. And we think any stock pullback that we see from concerns over (future) Keytruda competition would be quarantined.

IBD: Tech isn't known for dividends. But you have a big slice of non-sexy tech. Explain.

Morey: We are highly focused on profitable tech. When we do make investments in technology, they're going to be highly profitable companies with strong free cash flow profiles and steady growth. (When it comes to valuation), it must be something realistic. One thing with free cash flow, accessing capital isn't nearly as critical.

IBD: Name some tech stocks you like.

Morey: Our number one holding is Broadcom **(AVGO)**. The chipmaker has gone from being a growth company into more of a hybrid company. It possesses exceptional longer-term growth characteristics. Still, it offers a 3%-plus dividend yield. And has a 12-year track record of raising its dividend.

They are (known as) a semiconductor company, but they're becoming much more diverse. They've made a lot of acquisitions over the past decade. The chip component is becoming a less important part of their business, which reduces the cyclicality of its revenue, which we like. But we also like stability. Their software division is really what is going to be the anchor to their bottom line on a going forward basis. And, ultimately, that's going to be an anchor for the dividends. So, if all things go well with the VMware acquisition (which European regulators are scrutinizing), that's going to take Broadcom's software division to around 50% of total revenues. And that is basically recurring software sales. You know, very, very sticky sales.

IBD: The staple of dividend funds is still consumer staples stocks, right?

Morey: Yeah, we like the space. And it's naturally going to be a larger position in a portfolio like ours. Consumer products that everybody uses on a daily basis (sold by fund holdings like) Procter & Gamble **(PG)**, Kimberly-Clark **(KMB)**, PepsiCo **(PEP)**, and Coca-Cola **(KO)** are in demand regardless of what the economy throws at us. Even if we go into recession, you're still going to need to buy food, soda, and toilet paper. They're the anchor of our portfolio.

And from a performance standpoint, it's undeniable how well these established consumer companies can do through the full cycle. Both Coke and Pepsi are great examples of companies that have long track records of raising their dividends every year. Look at the performance of both companies through the Great Recession. Their earnings per share saw a minor hit, followed by a very strong recovery. Their ability to pay you an above average dividend yield is unfazed regardless of GDP.

IBD: Energy was hot last year. Does the sector still have gas in the tank?

Morey: Since New Year's, everybody's asking the same question. (Energy still has some things working in its favor.) There's just not a lot of ownership in energy, even though the sector outperformed the market drastically last year. In the fourth quarter, the energy sector contributed more than 10% to S&P 500 earnings, yet it's weighting in the index is closer to 5%. And that's why I don't think there's a lot of asset flows out of energy.

IBD: Exxon Mobil's 80% return last year helped the fund. Are you still a believer?

Morey: Exxon Mobil **(XOM)** is coming off an absolute blockbuster year. One thing that the company did right is when things got bad a few years back, they continued their capital spending programs in key assets, including the Permian Basin in Texas. And that allowed them to capitalize in the current market environment. That capital expenditure is flowing into massive free cash flow. So, there's a lot of positivity there.

There are also two independent oil exploration and production companies that we like: Pioneer Natural Resources **(PXD)** and Diamondback Energy **(FANG)**. They are both focused on the Permian Basin, which we continue to believe is a premium drilling area.

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The performance data represents past performance, which does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. To obtain performance data current to the most recent month-end, an investor may call toll free 800-276-1262 or visit www.integrityvikingfunds.com.

Because the Fund can only distribute what it earns, the distributions to shareholders could decline when dividend income from stocks in the portfolio decline. The Fund's emphasis on dividend-paying stocks involves the risk that such stocks may fall out of favor with investors and underperform the market. Also, a company may reduce or eliminate its dividend, which could affect the Fund's ability to generate income.

Preferred stocks are subject to the risks associated with other types of equity securities, such as potential volatility, as well as additional risks, such as risks related to deferral and omission of distributions; credit and subordination risk; interest rate risk; call, reinvestment and income risk; liquidity risk; risks related to limited voting rights; and risks related to special redemption rights.

The Fund may invest in securities of non-U.S. issuers, which have special risks. These risks include international economic and political developments, foreign government actions including restrictions on payments to non-domestic persons such as the Fund, less regulation, less information, currency fluctuations, and interruptions in currency flow. Investments in foreign securities also entail higher costs.

IDHIX returns & yields are for the period ended 12/31/22: YTD 3.18%, 1-year 3.18%, 3-years 8.37%, 5-years 8.28%, SI 8.98%; Due to inception date of 8/1/2016, 10-year returns are unavailable. Total Annual Fund Operating Expenses After Fee Waivers and Expense Reimbursements are 1.19%; Total Annual Fund Operating Expenses Gross of Fee Waivers and Expense Reimbursements is 0.70%; 30-Day SEC Yield is 2.095% subsidized, 1.633% unsubsidized.

IDHIX Top 10 Holdings represented 35.95% of the Fund as of 12/31/2022: AbbVie 6.69%, Broadcom 6.62%, JPMorgan Chase 3.49%, Verizon 3.48%, Exxon Mobil 2.69%, Kimberly-Clark 2.67%, Merck & Co 2.67%, Pfizer 2.63%, American Electric Power Co 2.60%, PepsiCo 2.41%.

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