

Diversified Stock Income Plan

2017 Concept Review

The Diversified Stock Income Plan (DSIP List) focuses on companies that the Advisory Services Group believes will provide consistent annual dividend growth over a long-term investment horizon. Our objective is to provide a broad list of high quality, industry leading companies from which an investor can assemble a well-diversified portfolio. Through consistent dividend growth, our goal is to help investors stay ahead of the wealth eroding effects of inflation.

Primary DSIP objectives:

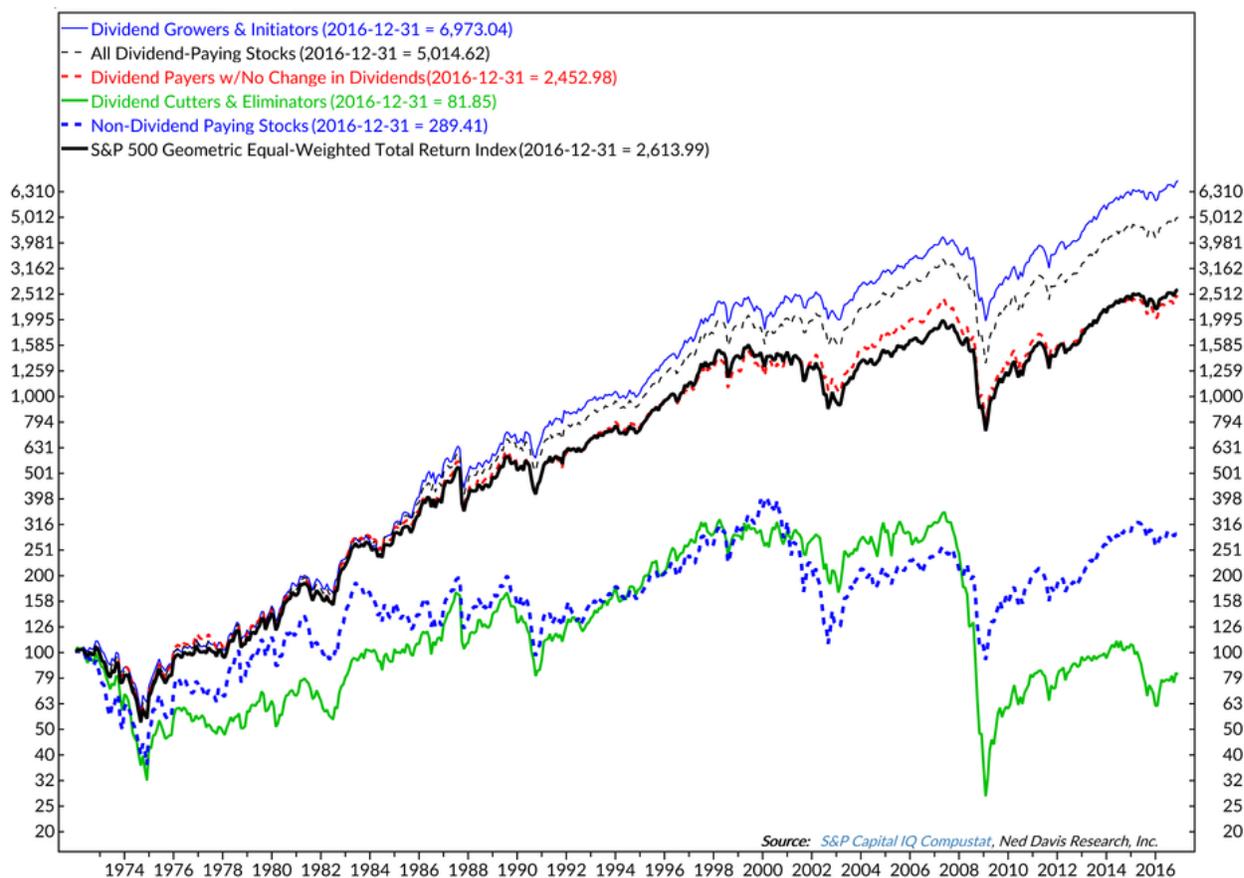
- **Potentially provide a higher stream of income over time.** With a diversified package of stocks that we believe have the potential to raise their dividends with regularity, conservative income and growth-oriented equity investors should have the potential to keep up with the rising cost of living. To help achieve this goal of a growing income stream, we recommend that investors plan to hold these stocks for an extended period, typically a minimum of five years.
- **Modify risk through diversification.** A well-constructed portfolio typically contains stocks from several different market sectors. Studies have shown that stocks in as few as six sectors with different investment characteristics can help reduce a portfolio's volatility to roughly that of the marketplace in which the stocks are traded.
- **Keep you informed about these stocks through your financial advisor.** We notify our financial advisors whenever a stock on the DSIP List announces a dividend change, if we add a stock to or delete a stock from the list, or if any other significant events occur. We also publish quarterly updates summarizing activity in the Diversified Stock Income Plan as well as other reports on topics of interest.

No one has control over what stock prices do. But if we can invest in companies for which we have reasonable confidence that their products and services will remain in demand in both difficult and favorable economic times, thereby having the potential to consistently increase earnings and dividends, over time the stock prices of those companies should increase also. In addition, rising dividends have historically tended to cushion the fall of stock prices in challenging markets. It's important to realize, however, that there are no assurances that stock prices will rise or that dividend income will increase.

History has shown that investing in stocks of high-quality dividend-growing companies over long periods of time has been a successful strategy to help investors build wealth, although there is no guarantee that this will be the case going forward. Receiving cash dividends up to four times a year with the prospect of dividend increases at least once a year from a properly diversified portfolio should help investors get in and stay in the market to participate in the wealth building potential of the stock market, even in uncertain or volatile times. The following chart from Ned Davis Research shows the returns of S&P 500 stocks categorized by dividend policy and highlights the significance of dividends, and dividend growth in particular, with regard to long-term returns. The DSIP strategy emphasizes owning pieces of what we feel are great businesses, many of which sell products or services that most readers know and use, and that have the potential to pay growing dividends while waiting for stock prices to reflect the upward trend of dividends (and earnings) over the long term.

Please see page 7 of this report for Disclaimers

Investment and Insurance Products: ►NOT FDIC Insured ►NO Bank Guarantee ►MAY Lose Value

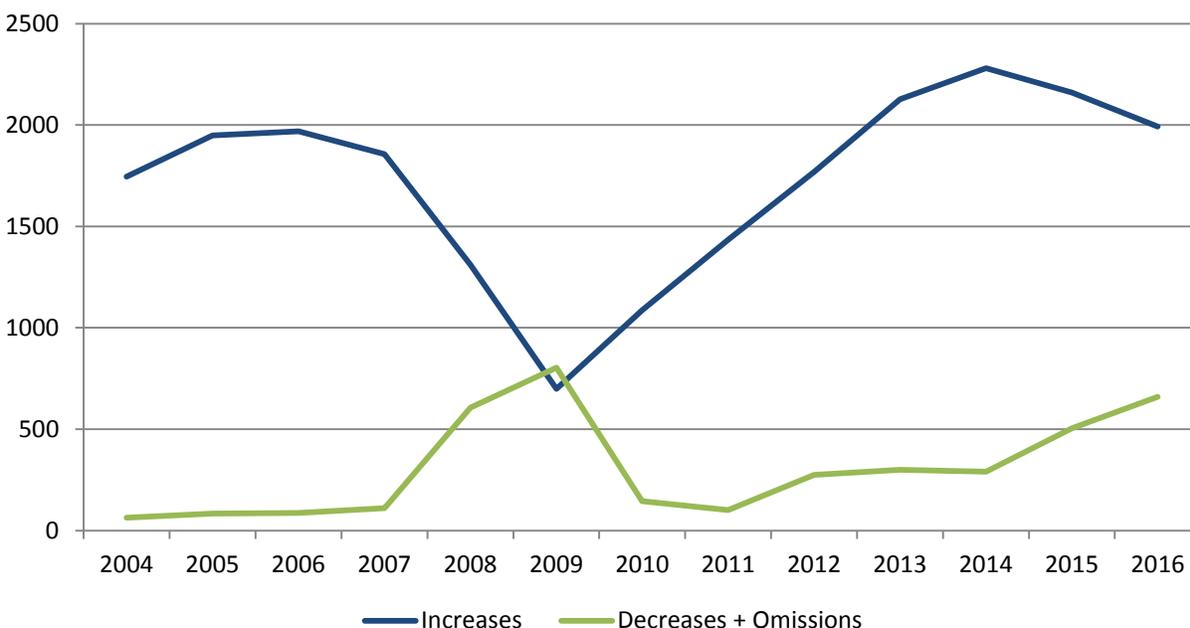
Figure 1– Returns of S&P 500 Stocks by Dividend Policy

Monthly Data 1/31/1972 – 12/31/2016 (Log Scale). Returns based on monthly equal-weighted geometric average of total returns of S&P 500 component stocks, with components reconstituted monthly. **Past performance is no guarantee of future results.** An index is unmanaged and not available for direct investment. Dividends are not guaranteed and subject to change or elimination. Copyright 2017 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved. See NDR Disclaimer at www.ndr.com/copyright.html. For data vendor disclaimers refer to www.ndr.com/vendorinfo/.

Source: Ned Davis Research

We have scrutinized the dividend stability and long-term growth potential for every company on the list, including only the stocks of those companies for which we believe the likelihood for regular dividend increases is high, and which we consider appropriate for conservative income and growth-oriented investors with a multi-year investment horizon.

Some investors can be cavalier about dividend growth; but in fact, it is no small feat for a company to be able to increase its dividend with regularity. As shown in Figure 2, the number of dividend increases from a broad universe of publicly traded companies decreased substantially from a peak in 2006 to a trough in 2009. Over that period, the number of dividend increases declined from 1,969 to 699, a reduction of 64%. Over that same time period, the number of dividend cuts and omissions rose dramatically from 87 to 804, an increase of over 800%! Dividend increases have rebounded nicely since the low point in 2009, with 2014 marking a new annual high of 2,280 increases. Notably, dividend cuts and omissions trended up in 2015 and 2016 with 2016 surpassing 2008's total.

Figure 2– Dividend Changes from a Broad Universe of Stocks

Sources: Standard & Poor's, Wells Fargo Advisors

Looking a bit more narrowly at just dividend payers in the S&P 500, in 1980 469 of the 500 companies (94%) paid some kind of dividend. The percentage of dividend payers dropped steadily until 2001-2002, when this metric hit a low with just 351 of the S&P 500 members (70%) paying a dividend; coincident with the peak in the market's "tech bubble." The percentage of dividend payers steadily rebounded from the 2002 lows to 78% in 2007 (390 of 500), before declining again in the 2007-2009 recession. In the current low interest rate environment where dividend income has become increasingly sought after by investors, the number of dividend payers has grown to 418 (83%), and now exceeds the 2007 level. But, in our opinion, it will likely take some time (if ever) to return to the 90% level.

DSIP criteria

We utilize a disciplined philosophy and methodology that focuses upon finding companies that:

- appear fundamentally sound (in solid financial condition with investment grade debt, if they have debt),
- have historically paid dividends well-covered by free cash flow,
- operate generally mature, defensive businesses (providing products or services that customers tend to patronize in all kinds of economic environments), and
- most importantly, offer the potential to consistently raise their annual dividends.

We prefer companies that pay cash dividends out of after-tax earnings. Rarely are we attracted to companies that maintain or increase their dividends using money generated from activities outside the company's primary business of producing goods or services (for example, by selling assets or increasing borrowings). We look for companies that, in addition to increasing their earnings year after year, also generate growth in "free" cash flow, basically more cash than is required by the company to pay its bills and employees, invest in its business, and maintain facilities and equipment. This is because dividends are paid (and increased) out of free cash flow.

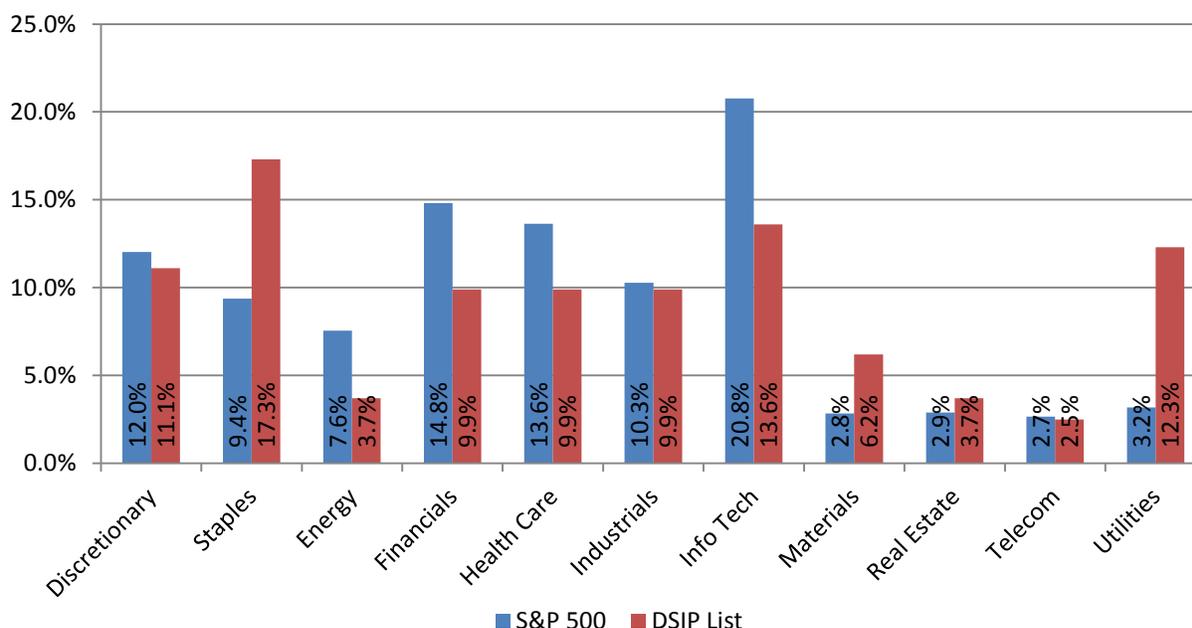
We intend to add only what we believe are the highest quality companies with the potential for consistent annual dividend growth; and then to patiently hold them for an extended period of time, throughout economic and market cycles, selling only if the fundamental characteristics of the company have changed materially and presumably permanently for the worse. Consequently, we are not likely to include every stock within a particular market sector that meets the basic criteria for inclusion on the DSIP List. We aim to include only those companies that are clear industry leaders, and those with the strongest financial condition and outlook for sustainable dividend growth.

Proper diversification is extremely important

A properly diversified DSIP portfolio should contain companies from a number of different sectors, and different business types within those sectors. Diversification does not guarantee a profit or protect against loss; it can, however, help reduce the volatility of a portfolio as measured by its standard deviation (a higher standard deviation means there has been greater volatility). The sector weightings of the DSIP List and the S&P 500 at the end of 2015 are presented in Figure 3. We recommend an investor assemble a portfolio consisting of 20-30 stocks from at least six to eight sectors with different investment characteristics. We would not recommend holding more than roughly 20% of a portfolio in any one sector or more than 10% in any one stock.

Investors looking for current income may find better yields than DSIP has to offer in fixed income securities or other investment types but to capture the potential for growing income, it is typically necessary to consider dividend-paying equities as part of an overall asset allocation strategy. For DSIP purposes, we consider a stock that offers a good dividend yield but has no potential for dividend growth to be a relatively unattractive investment. A high quality bond with a similar yield may offer a better return with less risk.

Figure 3– Year-end 2016 DSIP List and S&P 500 Sector Diversification



Sources: FactSet, Wells Fargo Advisors

Some investors are comfortable owning only one kind of stock, perhaps a company or industry they know well or a group which, in the past, has been fairly stable and predictable in its results, such as utility stocks. Utilities, after all, typically enjoy a dependable cash flow stream because customers view the service the utility provides as essential, paying their utility bills regularly each month. Regulatory changes, however, and other competitive factors have affected the monopoly status of local utilities, further emphasizing the need for selectivity in investment choices, and the wisdom of diversifying beyond utility stocks.

Similarly, we advise against confining a portfolio to only the highest yielding investments. Remember that a dividend yield significantly greater than the overall market or a company's peers frequently signals a higher degree of risk, including the risk that the income stream may not be sustainable.

Removing stocks from the DSIP List

Most successful stock investors set emotions aside and seek to patiently build wealth over time. Our hope is that through a disciplined process for adding stocks to the DSIP List, we rarely have to consider their removal. However, companies evolve and markets are dynamic. The main reason we remove a stock is because we are no longer comfortable with the company's prospects for consistent annual dividend growth. This typically happens when the criteria we look at to add a stock begin to deteriorate, or are expected to do so. Examples would include an unsustainably high payout ratio (dividends per share as a percentage of earnings per share), prolonged weakness in earnings or free cash flow growth, and deteriorating balance sheet strength. We rarely remove a stock solely for valuation reasons; although we encourage clients to realize capital gains in particular stocks if and when it makes sense in individual portfolios, reinvesting the proceeds in other, more attractively valued DSIP List companies.

DSIP is suitable for many investors

The Diversified Stock Income Plan is considered appropriate for conservative investors seeking some income and growth from their equity portfolios. It may also be appropriate for more aggressive investors who prefer to keep a portion of their portfolios in more conservative equity securities. Young investors can potentially benefit from decades of dividend growth and reinvestment in a diversified portfolio of DSIP stocks. Investors looking to build or rebuild their retirement accounts may find the DSIP strategy appropriate. Retired individuals may benefit from the possibility of receiving annual dividend increases. The decision as to whether a particular security is suitable for an individual portfolio should be made by investors and their financial advisors, with full consideration given to existing portfolio holdings as well as investment objectives, time horizon and risk tolerance.

Consider dividend reinvestment

One way to potentially enhance the total return potential of a DSIP portfolio is to reinvest cash dividends to buy more shares of stock. A dividend reinvestment program allows for automatic reinvestment of dividends into additional shares of the stock. If the dividends are reinvested on a day when the share price is lower, more shares are purchased; and if the stock price is higher, then fewer shares are purchased. A systematic investment plan does not guarantee a profit or protect against loss in a declining market, and investors should consider their ability to continue investing through periods of low price levels. We believe investors who reinvest dividends, as well as investors who want to initiate or add to stock positions, should welcome market pullbacks. Ask your financial advisor about dividend reinvestment, a service that allows you to more fully take advantage of the growth potential of your dividend income.

We realize that you might choose to take delivery of cash dividends. Please understand, however, that you will not have the opportunity to take advantage of the compounding effect of dividend reinvestment, which may affect your total return.

Investment risks

As with any investment strategy, there are risks associated with investing in DSIP stocks. There will be times when dividend-paying stocks are out of favor relative to other investment themes. For example, coming out of a recession, stocks that are more cyclically tied to a rebound in economic growth may outperform the generally defensive names on the DSIP List. As DSIP stocks are predominantly large-cap in nature, there will be times when small company stocks outperform those on the DSIP List. Our methodology for choosing DSIP List stocks focuses on high quality dividend growers. For various reasons, some market sectors will have more companies that meet the DSIP criteria for inclusion than others (Consumer Staples and Utilities, for example). Consequently, there will be times when the market favors sectors not as heavily represented on the list as others. In general, the defensive nature of the DSIP List tends toward underperformance in rapidly rising markets, and relative outperformance in down markets, given the downside cushion potentially provided by rising dividends.

How can you participate?

If you would like to read more about the concept of investing in stocks with the potential for rising dividends to enhance total return, ask your financial advisor for our report titled Why Invest in Stocks?

There is more than one way to participate in the DSIP strategy. Your Wells Fargo Advisors financial advisor can help you choose the way that best suits your individual financial goals and risk tolerance.

Please contact your financial advisor if you would like a copy of the DSIP List performance report.

Disclosures

Equity investments are subject to market risk which means their value may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. There is no guarantee that dividend-paying stocks will return more than the overall stock market. Dividends are not guaranteed and are subject to change or elimination.

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