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Global Equity Shareholder Yield: Performance in a Quarantined World

Global equity markets (represented by both the MSCI World and the MSCI World High Dividend Yield Indexes) fell by about one-third from their peak in February through March 23: the fastest arriving bear market ever. The Global Equity Shareholder Yield strategy's focus on collecting shareholder yield (primarily dividends, but also share buybacks and debt paydowns) has historically led to substantially less volatility than the market. That has not been the case so far this year.

To get straight to the point, the strategy did not provide the downside protection that we expected and that it has demonstrated so strongly in past market downturns. Why? Certain portfolio exposures played a role, and we will focus on that later in this letter. More importantly, we are struck by the market's blanket disregard for dividend-paying stocks, which we view as indiscriminate.

It is an unprecedented period in which governments are deliberately shutting down the global economy. With the disruption in revenues and cash flows, investors have rightly questioned whether companies that have pledged to return capital to shareholders will have the financial wherewithal to keep those commitments. Even if they can, the political environment in the U.S. has turned against buybacks and shareholder distributions will certainly be curtailed by any company benefiting from a government bailout.

Having said that, a core tenet of the strategy is to seek out companies that are well established and have a history of being able to withstand downturns. The strong often emerge stronger. Every stock in the portfolio has been vetted by our analysts for financial strength as well as its commitment to returning capital to shareholders. We therefore believe that, while some temporary interruptions in buybacks are likely, they will resume, and the holdings in the portfolio will continue paying and growing their dividends. Once the market gets more comfort around that, we would expect more differentiated pricing among dividend paying stocks, which should benefit the portfolio.

In times like this we search for similar episodes in history to guide our expectations for the future. We seek characteristics that are analogous to this period, but it is almost impossible to find a reasonable match. As we searched some characteristics we can focus upon, we examined periods of uncertainty where expectations for a significant decline in global activity was present. The global financial crisis (GFC) comes to mind, but for Epoch and this strategy, we anticipated the building crisis in financials[1] and, therefore, we had almost no exposure to financials in the strategy when that crisis hit the markets. The strategy performed quite well during the GFC, with many portfolio companies maintaining dividends and, indeed, many companies raising dividends. (In 2008, 62 portfolio holdings raised dividends. In 2009, 69 portfolio holdings raised dividends.)

Another similar period which had the additional characteristics of being a complete surprise and put America and the world on war footing was the September 11, 2001 attacks. During September of 2001 the global equity markets[2] were down -9.5% and the backtest for the Global Equity Shareholder Yield

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[1] See our papers on the coming financial crises, beginning with "Financial Services Stocks: The Wheels are Coming Off," August 15, 2005.

[2] S&P/Citigroup BMI World Index

strategy[3] was down -11.9%. In the subsequent 6 months and 12 months the GESY strategy outperformed the benchmark by 14.7% and 21.5% respectively.

As we now face the challenges of COVID-19, we cannot predict either its length or the human toll it might take, but we are confident that as economies and markets calibrate to absorb the effects of the virus, rationality will return to markets. During this period, we would expect some of the sectors that did not provide their typical historical defensive characteristics will perform well. For example, although utilities may be affected by slowing demand due to slower economic activity, we believe the extreme repricing of that sector may have been an overreaction to perceived high debt levels as all companies were treated similarly by the market.

We believe this sector wide shift in value in utilities was inappropriate and that stock selection matters. GESY owns highly regulated utilities that operate in favorable regulatory regimes. Many of these firms are replacing or repairing an aging infrastructure. These projects are not going to stop, and the companies are receiving a return on their rate bases. Furthermore, there is a reasonable expectation that there will be a large fiscal stimulus focusing on infrastructure occurring around the globe. The companies we own should benefit from this spending.

Although not considered a defensive sector, the performance of the energy sector has had an outsized impact on the performance of the portfolio in the most recent period. We had been concerned about the prospects of slowing global activity due to the impact of the COVID-19 virus and were trimming some positions going into the end of the February. What we could not have predicted was the failure of OPEC and Russia to agree to production cuts and Saudi Arabia's subsequent decision to dump more oil into the market forcing oil prices down to $30 a barrel.

We have always invested in energy companies that have strong balance sheets and the capacity to protect the dividend through a commodity price cycle. That said, there were some energy stocks that we owned where we concluded that at the current level of oil prices, they might have to cut their dividends because of their relatively weak balance sheets. We elected to sell these companies.

We recognize dividends are not covered by cash flows at these oil prices. Our focus has been on leverage metrics and how long companies can protect the dividend based on their balance sheet capacity. No company can sustain a dividend if oil prices remain depressed for a few years. We continue to monitor the supply and demand dynamics within the oil markets. As a firm, we believe the economy will rebound in the second half of the year and that $30 oil is not sustainable in the long run. Today, we have confidence in the ability of the remaining portfolio of energy companies to survive a temporary period of low oil prices.

We, too, have been surprised by the swift and unprecedented moves in the capital markets. Volatility measures of the equity market reached three and four times their historical average. While we are disappointed in the less defensive nature of the strategy demonstrated during this extraordinary time period, there are good reasons to believe that some of the unusual sector pricing volatility experienced will return to normal.

We believe the strategy's investment architecture and our investment process retain their conceptual and execution integrity. The companies in which we invest have strong balance sheets, generate significant cash flow, and we believe will deliver and grow their dividends.

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[3] Epoch's Original simulated results run gross of fees in the Fall of 2005.

Furthermore, we are convinced that dividend-paying stocks and strategies that invest in them will take on an increasingly important role. In an environment of collapsed bond yields, the world is starved for income. Cash flows at pension plans are increasingly turning negative, particularly in the U.S. and U.K., as the workforce ages and younger members are directed toward defined contribution plans. On the defined contribution side of the equation, a typical retirement portfolio associated with a target-date strategy has an estimated income return of just around 2% per year according to Wilshire Funds Management.

Dividend-paying equities are a natural fit to help address the shortfall. Average equity dividend yields are higher than sovereign bond yields in developed markets. If we narrow the equity universe to companies that specifically emphasize dividends, the dividend yield of this group compares favorably to other income sources as well, such as corporate debt and property. And as companies strive to replace capital and labor with technology, an increasingly asset-light structure will enable them to increase their payout ratios. And, of course, dividends have the ability to grow along with the profits of the underlying companies.

APPENDIX

Global Equity Shareholder Yield

Principles, Philosophy and Process – Needed Now More Than Ever

In 2006, we wrote a book, *Free Cash Flow and Shareholder Yield, New Priorities for the Global Investor*. With significant help from my partner and Co-CIO, Mike Welhoelter, we created a strategy that became the largest portfolio in our firm. In this note, Mike and I revisit our original premise and conclude that this strategy is more relevant today than it was 14 years ago. Indeed, in our opinion, it is a "must have" sleeve in any portfolio where income is a need.

Income is a need today and the need will be an even greater in the future. Let's begin with a few facts about the U.S. national retirement system (Social Security); the nation's demographic structure; and the likelihood that for any couple where both parties are age 65 or older, one individual will live to 90.

The Social Security system's average annual payment in 2019 was $17,463 and over 48 million people received payments. The total amount paid out was $843 billion, according to the Social Security administration. This is just slightly above the U.S. Department of Health and Human Services 2020 guideline for poverty of $17,240[4]. It will be impossible for an average retiree to sustain a decent lifestyle if that is his or her only source of income. Thus, it will be necessary to find additional sources of income, a significant portion of which will need to be furnished by equity income strategies. Fixed income strategies are inadequate at current yields and contain no exposure to economic growth.

In our view, Global Equity Shareholder Yield (GESY) is the most efficient "dividend" collection machine in the world. Let us explain, and some of our long-time investors will note that these arguments appeared in our book written many years ago.

We set out in 2006 to create a strategy that would provide an equity market-like return over time, where a large proportion of the return would be derived from "dividend" payments. From a finance perspective, whether operating cash flow is used to pay dividends, buy back stock, or pay down debt they are equivalent. All three uses are effectively a form of capital returned to the shareholder rather

[4] U.S. Federal Poverty Guidelines Used to Determine Financial Eligibility for Certain Federal Programs; https://aspe.hhs.gov/2020-poverty-guidelines

than reinvested in internal capital projects or consumed for acquisition purposes. We deemed these three uses to be “Shareholder Yield”.

After extensive analysis, we concluded there were many companies in economic sectors that were regulated or located in mature industries that simply did not have sufficient internal reinvestment or acquisition opportunities that would allow them to utilize the operating cash flow generated by the enterprise. We defined free cash flow as the cash available for distribution to shareholders after all planned capital expenditures and all cash taxes. Unless a company can reinvest its free cash flow at the same level as its cost of capital, or higher, any investment is value destructive.

How might we build this portfolio? Almost all investment strategies fall into one of two categories; maximizing return per unit of risk taken or minimizing risk per unit of return sought. We desired to construct a portfolio that would minimize risk (think volatility) per unit of return sought. What portfolio construction process would most likely accomplish that end? Could we build a highly diversified portfolio with a large proportion of that expected return derived from the components of shareholder yield and yet still generate a return equal to the long-term return of the stock market – nine percent, the historical rate of return for the S&P 500 from 1929 – 2005?

We concluded this objective could be accomplished with a portfolio possessing a current yield of 4.5%, another 150 basis points of return from buybacks and/or debt paydowns, and an expected growth rate of cash flows of at least 3%. The sum of these three variables added up to a 9% aspirational return. With half of the total return expectation received up front in terms of the cash dividend yield, this portfolio promised to have a lower volatility level than that of the overall market.

How did our selection and construction process work? We created a multi-factor screening process for sorting through 12,000 names every week. The result of the screen generated 150 to 250 potential investment candidates. We have averaged about 100 names in the portfolio, never less than 90, and occasionally almost 120. The inception to date result through 2019 is an average annual return of 9.3% and lower-than-market volatility[5].

The analyst’s role for this strategy is twofold – a “knock out” function and a “verification” function. After the initial screen, the analyst begins with a bias – if it passed the screen, it must be a buy. Further analysis on his or her part permits the analyst to find reasons to exclude the name, and there are a surprising number of reasons why candidates get “knocked out”. Price, however, is not one of those reasons. Unlike traditional active portfolios where the analyst role plays a “knock in” function, the objective here is to include any name that contributes to the overall shareholder yield aspirational return of nine percent per annum. If minimizing risk per unit of return sought is the objective, then price is not a relevant factor for those strategies. What matters most is diversification. The more diversified the portfolio around the sources of expected return, the more likely you are to realize the goal sought.

The analyst’s second role is equally important. It is verification rather than discovery. Does the capital allocation policy of the company under scrutiny provide the combination of ingredients that would allow it to be included in the portfolio selection process given our aspirational goal of a 9% return? Is it likely to continue and be as successful as it has been in the past?

Over a long period of time, we have learned many things about the strategy. Dividend cuts are rare but do occur. More often than not, however, a dividend cut reflects an exogenous event such as the GFC or an unforeseeable major industry disruption. But, we have also made occasional errors when we missed an endogenous element that, with hindsight, further analysis might have prevented. We are pleased to

[5] The market is defined as the MSCI World Index.

say that in 16 years of history in the strategy, we have made fewer than 30 errors of this type. Our analytical process and our analysts have excelled in carrying out their responsibilities.

What is different today? The yield and valuation levels present today are very different than those measures in 2006. At that time, Treasury bonds were yielding about 4% and stocks were yielding about 2.3%. Dividend growth rates for the portfolio in aggregate over the last 15 years have actually exceeded our three percent expectation. Share buybacks are trickier to measure today because firms have expanded their issuance of equity as compensation in the form of stock options and RSUs over the past 15 years and one must net those numbers with the with proper buybacks in order not to overstate buybacks. It is important to remember that, buybacks financed by the issuance of debt are not dividends; they are a form of a balance sheet recap.

Monetary policy changed dramatically from the practices pursued prior to the GFC. Quantitative easing (QE), significantly affected the financial world. Perhaps its most important impact affected the discount rate applied to cash streams in any net present value model. It was lowered significantly as QE policies reduced the entire yield curve. Longer duration holdings, whether bonds or equities, benefited greatly from this systematic effect. Short duration bonds and equities also benefitted, but not as much. "Growth" benefitted more than "value" as a result. One might have thought this type of portfolio would have suffered relatively, but, cumulatively over the period, it performed quite well and met its aspirational goals.

The long term returns of the strategy both pre and post the GFC appear below including risk measures.

TABLE 1

Year	GESY (gross of fees)	GESY (net of fees)	MSCI World
2006	27.0	26.0	20.1
2007	9.9	9.0	9.0
2008	-31.5	-31.8	-40.7
2009	25.2	24.7	30.0
2010	13.2	12.8	11.8
2011	7.1	6.7	-5.5
2012	11.5	11.1	15.8
2013	25.2	24.7	26.7
2014	7.5	7.1	4.9
2015	-4.1	-4.5	-0.9
2016	8.2	7.7	7.5
2017	17.8	17.3	22.4
2018	-8.6	-8.9	-8.7
2019	21.9	21.5	27.7
Average	9.3	8.8	8.6
Standard Deviation	15.8		18.7

Source: Factset Research Systems. Data shown for Global Equity Shareholder Yield is of the composite account.

We stress this is actual data, not some hypothetical back-test. This is real data in real time.

The world today is indeed meaningfully different than it was 15 years ago. As a result of QE and the emerging popularity of Modern Monetary Theory, it appears that rates will remain low for a significant

period of time. Ten-year bond rates are just above 1% today, not 4%. Is this some kind of new paradigm for investing? We believe it is just too soon to tell.

Today, the GESY portfolio yields nearly 5% with an underlying growth rate of that dividend yield of three to five percent. In addition, one can add back share buybacks—real ones, not recap buybacks, which add another 100 basis points or so in our view.

How might we recharacterize our aspirational return? The end number, our aspirational long-term return expectation, remains 9% but its composition is more like 4% yield with a 4% growth rate of the underlying dividend yield topped up by buybacks averaging 1%.

Most important, unless the world falls apart because of COVID-19, we expect the world economy to grow once again. Perhaps not as fast, but global real GDP can still grow within a range of 2% to 3%; one could add an inflation rate of 1 to 2% and that arithmetic suggests global nominal GDP growth will approach 3 to 5%. In the very long run, earnings growth tends to equal the growth rate of nominal GDP if one holds profit margins constant. Add a 2% equity market yield to the 3% to 5% growth rate and we have a market expectation of 5% to 7%. With a 5% cash yield today, an underlying rising trend in payout ratios reflecting the impact of technological improvements on profit margins and the volume of physical assets (bricks and mortar) required to run a business, makes GESY more attractive now than ever. Of even greater importance, without incorporating an equity yield strategy as part of the solution required to address the upcoming income needs of tens of millions of retirees, the outlook for a successful income replacement strategy for retirees is bleak.

Sources: FactSet Research Systems Inc.; MSCI Investors cannot directly invest in an index.

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