May 11, 2020

EPOCH

Q&A - The Death of Dividends: Greatly Exaggerated

On April 30, Epoch held a webinar ([webinar link]) dedicated to discussing the current outlook for dividends. Our speakers wanted to address questions from the audience using a Q&A format in written form. The questions below are the ones we thought would be the most interesting to discuss with our larger audience.

Q1. *Please discuss at-risk dividend rates in your portfolio?*

The team remains highly focused on evaluating each portfolio holding's cash flow, balance sheet strength and capital allocation policies to ensure that they are able and willing to continue to return cash to shareholders. While we do expect there to be some capital allocation changes within certain sectors, we believe that the majority of the companies we hold will be able to sustain their dividends and that many will be able to increase them over the course of this year. We are actively managing our Global Equity Shareholder Yield portfolio and have made some changes to it over the past few months in those instances where we have reduced confidence in cash flow and dividend sustainability. For example, we exited Cinemark, Darden Restaurants, and Simon Property Group, all companies facing significant challenges as a result of stay-at-home orders and the closure of non-essential businesses. On the other hand, we continue to find new opportunities for the portfolio. For example, over this same time period we have initiated positions in high quality companies in the healthcare (Novo Nordisk) and financials (CME Group) sectors. These are companies that generate strong cash flow, possess strong balance sheets and are focused on returning cash to shareholders. Overall, we remain highly confident that we can continue to deliver attractive dividend income from a diversified portfolio of high-quality equities.

Q2. *How much did buybacks contribute to stock appreciation in the last couple of years?*

We look at share buybacks in the context of appropriate capital allocation. That is, the Shareholder Yield strategy focuses on companies that are good capital allocators who invest when they can generate a return above their cost of capital and otherwise return that excess cash flow and capital to the owners of the business through dividends, share buybacks or debt reduction. We view share buybacks as "dividends by another name," (as discussed in a white paper by that name which you can find on our website), and we believe this approach will help us achieve the strategy's long-term targeted return objective. Since there are many variables that influence a company's share price evolution over time, it is virtually impossible at the portfolio level to isolate and calculate the amount of return that buybacks contribute to stock appreciation in a specified time period.

For the market as a whole, we can provide some estimates. For 2018 and 2019 buybacks accounted for 1.6 ppts of the 12.1% annualized return of the S&P 500. However, there was a great deal of variability across sectors, with buybacks having the greatest impact on tech and financials, followed by discretionary, industrials and staples.

For the last decade, buybacks accounted for a similar 1.4 ppts of the 13.6% annualized return.

Buybacks contribution to S&P 500 returns (%, annualized): 2010 to 2019

Revenue	Margin	Earnings	Buybacks	EPS	P/E	Price return	Dividends	Total return
3.9	3.4	7.4	1.4	8.9	2.2	11.2	2.1	13.6

Buybacks contribution to S&P 500 returns (%, annualized): 2018 and 2019

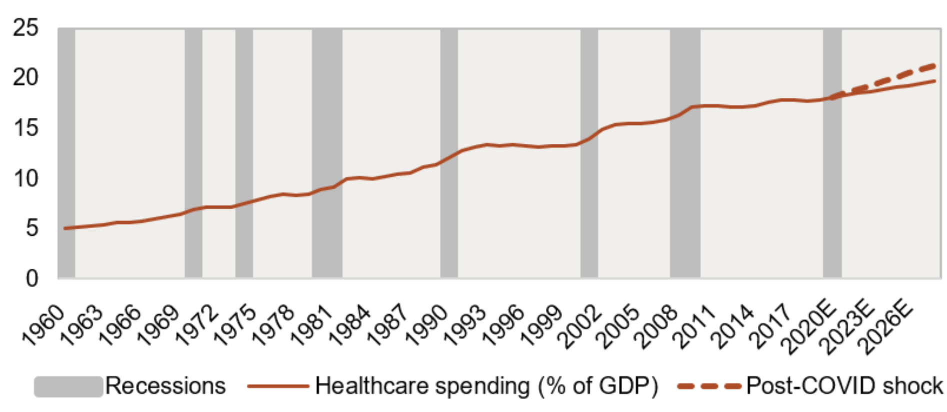
Revenue	Margin	Earnings	Buybacks	EPS	P/E	Price return	Dividends	Total return
6.0	3.3	9.5	1.6	11.3	-1.2	9.9	2.0	12.1

Source: Credit Suisse, Epoch Investment Partners

Q3. *The healthcare sector includes hospitals, but they are suffering badly financially at this time. Ultimately this will impact their supply chain. They depend on corporate paid healthcare but millions are now unemployed.*

Healthcare is now the second-largest sector (after tech), representing 15.6% of the SPX. The top-down view on the sector is very constructive. Healthcare already represents 18% of U.S. GDP, but is likely to become ever more important in our daily lives. This partially reflects demographics and technological advances (many of which, at least initially, are quite expensive). But we also expect approaches to healthcare monitoring and maintenance to increase. Testing, for example, will become more widespread. There will also be more overlap with technology in areas such as data analytics, robotics, AI and advanced healthcare equipment. According to 13D, "Investing massive sums in public health will be the biggest reallocation of capital resources in generations." This suggests **Figure 1** may significantly underestimate the coming acceleration in healthcare spending. Of course, there remains the question of who will pay.

Figure 1: U.S. Healthcare spending (% GDP)



Source: Department of Health and Human Services, BEA, NBER, Epoch Investment Partners

Hospitals directly account for a very small fraction of the healthcare sector. As you would expect for such a large sector, Healthcare is quite diverse consisting of two main sub-sectors. The first is pharmaceuticals (8.7% of SPX), which also includes biotechnology and life sciences. The second is healthcare equipment and services

(6.9% of SPX), which includes healthcare equipment (3.8%) and healthcare providers (3.0%). The majority of the latter consists of managed healthcare (1.9% of SPX), which includes companies like UnitedHealth Group. However, healthcare providers also includes healthcare facilities (comprising only 0.15% of the SPX), which consists of two companies. Neither pays a dividend and both have underperformed the SPX by over 20% YTD (in spite of the healthcare sectors 10% outperformance).

Q4. *What has financed buybacks: (1)debt issuance which caused bond ratings to decline and actually undermined capital access for a company when cash the most, or (2) excess cash flow in excess of value creating internal investment?*

It is true that some companies have issued debt to fund share buybacks. Our view is that there are good buybacks and bad buybacks. Companies with sound capital allocation policies finance share buybacks using excess cash flow. If a company elects to borrow capital to fund a share buyback, this does not generate any shareholder yield and is essentially a form of a balance sheet recapitalization. We want to invest in companies that are good capital allocators and use excess free cash flow – not debt – to fund share buybacks. Furthermore, in our view a company that forgoes attractive, return-generating investment in favor of share buybacks is not following good capital allocation practices.

Q5. *Weren't there a tremendous amount of buy-backs because of the tax cuts?*

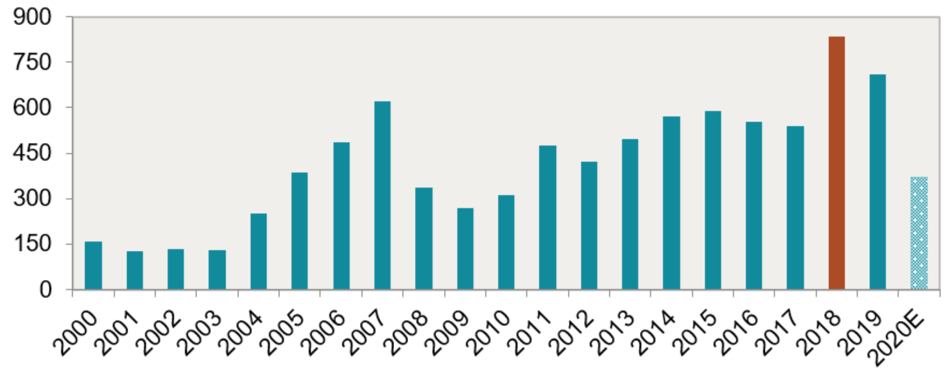
The corporate tax cuts as a result of the Tax Cuts and Jobs Act of 2017 did cause an increase in stock buybacks as many companies repatriated cash from overseas. However, the longer-term increases that we have observed in stock buybacks can be explained by fundamentals across various companies and sectors including an increase in aggregate corporate income, higher cash holdings and a decline in capital expenditures.

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act (TCJA), which was the largest gross tax cut in American history (cutting more than $5.5 trillion in taxes over 10 years); the act took effect on January 1, 2018.

The TCJA has two key elements: (i) a reduction in the corporate income tax rate from 35 percent to 21 percent, and (ii) a one-time tax holiday that cuts the tax on cash repatriation from foreign subsidiaries from 35 percent to 15.5 percent. Furthermore, in connection with (ii), the U.S. corporate tax system also moved from a worldwide tax system to a hybrid territorial system in which taxes on foreign profits are unrelated to the repatriation of these profits. Thus, the TCJA reduced the tax incentive for U.S. corporations to hold cash overseas by reducing tax-related frictions in the operation of their global internal capital markets.

The underlying logic for the TCJA was that allowing companies to keep a greater share of profits, would stimulate investments in long term growth. So far the evidence suggests that hasn't really occurred. However, it is clear that the TCJA did have a direct and immediate impact by turbo-charging stock buybacks. This means that, when assessing the underlying trend in buybacks, it is best to average out the years 2017 to 2019.

Figure 2: Executed Buybacks (USD bn)



Source: Goldman Sachs

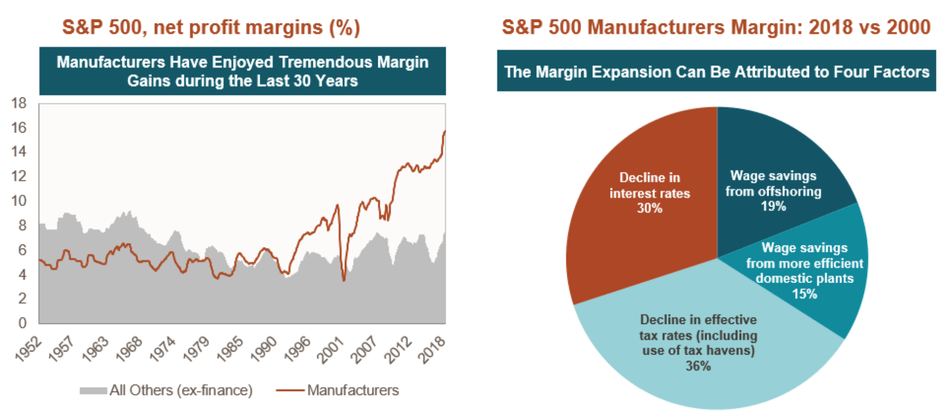
Q6. *If, in the next cycle, corporate America spends more on wages, the environment, and so on, will this lead to lower margins, reduced shareholder yield and tepid equity returns?*

Employee earnings have averaged only 2.5% growth over the last fifteen years, barely keeping ahead of inflation (mean of 1.7%). Moreover, unit labor costs averaged a tepid 0.9% growth over this period. This suggests wages have boosted margins rather than hurt them. While this dynamic could clearly change over the medium term we doubt it will. The key factor is the digitization of the economy, or the shift from "atoms" to "bits," which we believe is more likely to accelerate than slow down.

The environment, and ESG more broadly, is gaining a great deal more attention. We believe this is largely a good thing and will improve the sustainability of cash flows for many sectors. There are some heavy industries though where margins could be negatively impacted.

One factor that could reduce margins and equity returns is de-globalization. This trend began around 2008 and appears to be speeding up. This is worrisome as globalization was a key factor driving the improvement in profit margins since 1990.

Figure 3



Source: Empirical Research Partners
Note (chart on left): Net profit margins for S&P 500 companies, trailing 4 quarters, smoothed.

Q7. *How do you adjust the required yields for the increasing risk of public companies as their risk has increased due to associated increase in leverage and default risk?*

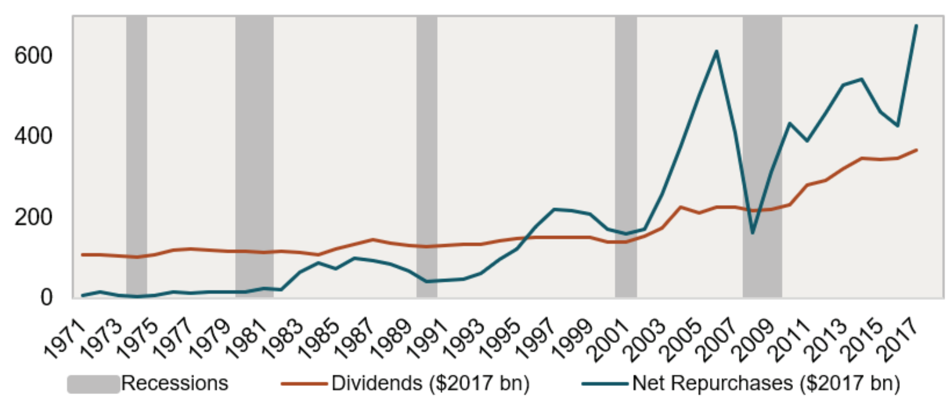
We are focused on investing in companies that have strong balance sheets with manageable leverage. The companies we own generate strong free cash flow, have ample liquidity and the balance sheet capacity to sustain shareholder distributions during the current environment. Recall that the Shareholder Yield investment approach is about investing in companies that return excess cash to shareholders through dividends, share buybacks and debt reduction. Debt reduction is an important component of shareholder yield. Looking at investment opportunities through a "shareholder yield" lens, therefore, naturally steers us away from investing in companies with excessive leverage or those at risk of a default. In addition, we have said many times that we are looking for companies that fund share repurchases with excess cash flow and avoid companies using debt to fund share buybacks.

Q8. *What is it that, over the last 30 years, companies have increased buybacks instead of dividends?*

While it is true that companies have increased share buybacks over the past 30 years after the SEC provided a safe harbor from liability for stock manipulation, it is important to note that dividends have also increased over time and have tracked with earnings growth. It has really not been a case of buybacks instead of dividends, but rather buybacks in addition to dividends. See slides 4 and 17 of the webinar presentation where this is discussed. Share buybacks provide greater flexibility for the company and its investors and act as a "shock absorber," as referenced on slide 12. Because a company is under no obligation to complete a stated repurchase program in a specified time frame, it has the option to slow down the pace of buybacks to conserve cash if necessary. Although dividend payments are discretionary for a dividend-paying company, reducing or eliminating dividends is not viewed favorably by investors and management teams are loath to do it under most circumstances.

Additionally, buybacks really took off from 1990, coinciding with the accelerated digitization of the economy and the rise to dominance of the tech sector. That sector accounted for 27% of buybacks over the last decade.

Figure 4: Since 1990, buybacks have outpaced dividends



Source: Kahle and Stulz, "Are Corporate Payouts Abnormally High?" 2020
Note: Public U.S. firms, ex-FIN & UTIL

Moving across the Atlantic, in the UK share repurchases have been legal since the Companies Act of 1981. Initially the shares repurchased had to be canceled, but in 2003 the law was changed so that they could be kept as treasury stock. In Germany share repurchases were mainly illegal before May 1, 1998, as they were perceived to be a prohibited repayment of capital. Similarly, in France share repurchases became legal on July 2, 1998. Prior to that year buybacks were rare on the continent. Since then the legislation on share repurchases has become relatively standardized across the EU countries.

Turning to Japan, stock repurchases were forbidden by the Company Law of 1899. Only in 1994 were Japanese firms permitted to repurchase their shares, albeit with tight restrictions. In 2001 an amendment to the company law for the first time allowed firms to repurchase shares with relatively few restrictions.

Q9. *Does a dividend cut trigger a sale of the position?*

Not necessarily. We analyze dividend cuts "holistically," exploring and analyzing the circumstances that have led a portfolio company to take this step. Traditionally, companies that cut or eliminate cash distributions are often considered poorly managed or facing structural decline. While some companies will continue to cut dividends for those reasons, one factor that has emerged in this unique market environment is the heightened political pressure on companies to reduce or restrict distributions temporarily. We believe it is prudent to take into consideration the fact that not all dividend cuts are the same when making portfolio decisions. There may be instances where, based on our research and conviction that the businesses remain fundamentally sound and that the suspension of or a reduction in distributions is temporary and likely to be short-lived, we decide not to sell the position simply because of a dividend cut or suspension. The decision to maintain these positions will be informed by the factor that led to the dividend cut – public pressure versus a need for financing or a change in the commitment to cash dividends going forward.