EPOCH

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Inflation, Bond Yields and Shareholder Yield

(Or, Don't Fear the Inflation Reaper)

We view the Shareholder Yield approach as a core strategy. We take a long-term view and manage the portfolio with an absolute return orientation. Nevertheless, asset allocators need to think about timing versus other investment options. With equity markets having rallied and valuation in some areas appearing rich, many are considering shifting assets to a more conservative approach. A Shareholder Yield strategy is a viable option for many; it offers the potential of upside participation as economies continue to open while historically having provided a measure of downside protection, with a larger portion of return coming from a consistent stream of growing dividends.

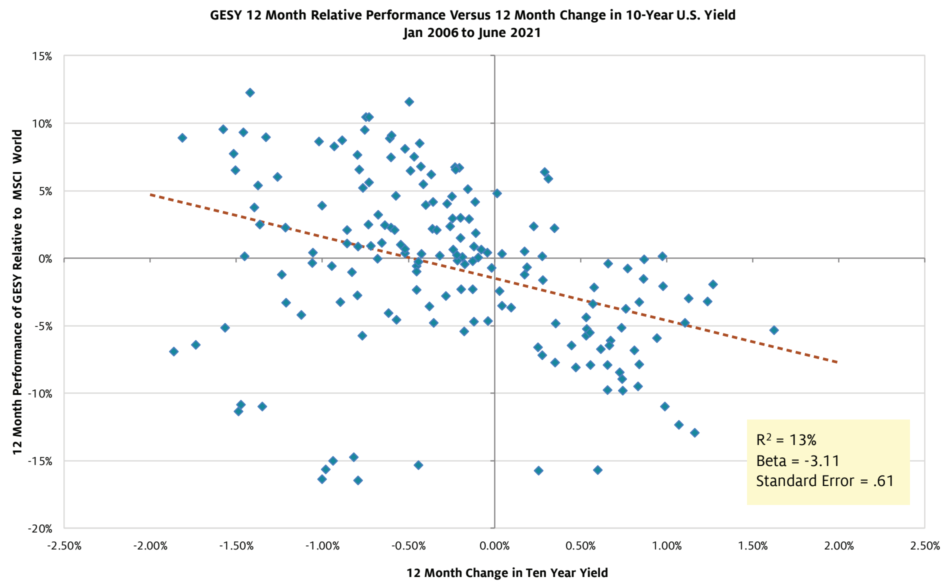
This year's inflation headlines, however, have put these shifts on hold. Investors have voiced concern that an allocation to dividend-paying stocks could underperform with an upturn in inflation. We believe these fears are unwarranted. So, let's begin by examining the relationship between dividend-paying stocks and long-term bond rates and inflation.

The influence of long-term bond yields and inflation

History shows, perhaps surprisingly, there is little evidence dividend investors will be hurt relative to the broader equity market should we see an upturn in long-term bond yields or inflation. The following chart shows the full history of the Global Equity Shareholder Yield strategy vis-à-vis 10-year Treasury yields. Note the R squared* is very low, meaning there is almost no connection between these two variables. Therefore, investors should not jump to the conclusion that rising interest rates would lead to the relative underperformance of dividend stocks.

> **R squared measures the degree of interrelation and dependence between two variables. In other words, it determines how much a variable's behavior can explain the behavior of another variable.*

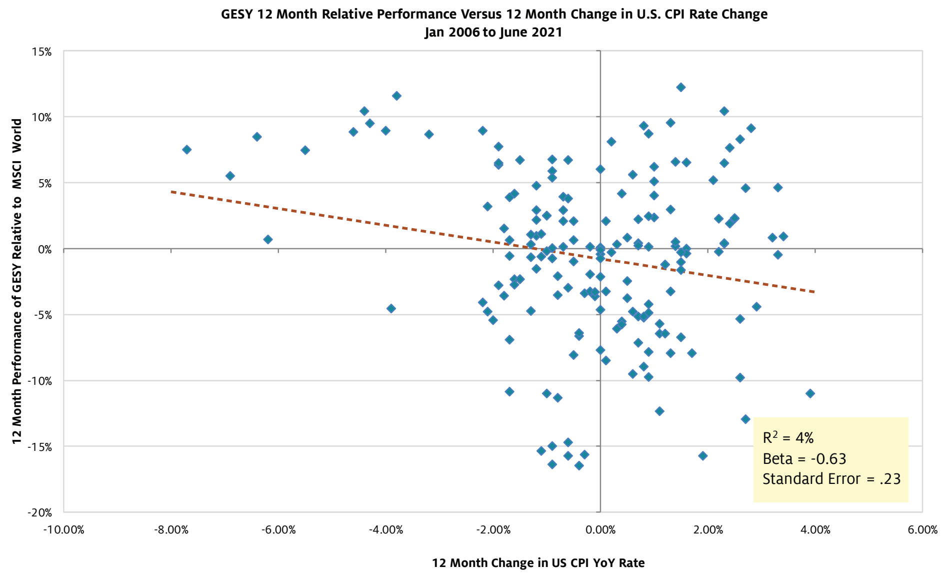
Figure 1: GESY Relative Performance vs 10 Yr Yield Change



Source: Bloomberg

Of course, inflation is one of several influences on bond yields. In the following chart, we look at relative returns for Global Equity Shareholder Yield with changes in inflation.

Figure 2: GESY Relative Performance vs CPI YoY Growth Rate Change



Source: Bloomberg

In this instance the R squared is almost zero, suggesting there is no causal relationship between relative returns and inflation.

In summary

Should dividend-oriented investors fear a pick-up in inflation and moderately higher bond yields? In our view, if the output gaps in our economy eventually close and inflation become more than "transitory" there is no evidence to suggest dividend-paying stocks would be at a disadvantage.

Short- and long-term bond yields have bounced back from the extremely low levels of last year, but they are still quite low historically speaking. That is part of the attraction of dividend yields from equities, which remain substantially higher than yields available from government securities.

Not all income-generating stocks are the same, however. If a company is not growing, and its dividend is not growing (i.e. the income is "fixed"), then a rise in interest rates could diminish its attractiveness. But a company that can grow its cash flows and its dividend is nothing like a fixed coupon bond at all. In fact, a growing dividend should provide a hedge against inflation.