September 2019

Dividend-Paying Equities as a Consistent Source of Income for Pension Plans

Summary

With the maturation of defined benefit pension plans, many have reached an inflection point where cash flows are turning from positive to negative. This is causing a greater emphasis to be placed on income in asset allocation decisions. Income from bonds, however, has withered while alternative sources of income come with tradeoffs. Some have high transaction costs, poor diversification and a lack of liquidity. Others may have weak investor protections or are simply further out on the risk spectrum.

One way to help address the income shortfall is by adding dividend-paying equities. Average dividend yields remain higher than sovereign bond yields in a number of 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, infrastructure and property. Additionally, dividends have the ability to grow along with the profits of the underlying companies.

Of course, a high dividend yield can reflect a non-recurring windfall or be a sign of distress. Dividend-paying companies must be actively vetted for growing free cash flow (to sustain and potentially grow dividends) and for managements that prioritize shareholder distributions as part of a disciplined capital allocation policy. A portfolio of stocks with these characteristics can go a long way in helping pension plans generate a higher level of cash flow to meet near-term liabilities.

Epoch's Shareholder Yield strategies invest in diversified portfolios of high-quality companies, which have growing cash flows and a track record of paying dividends, buying back stock and reducing debt. The strategies have historically provided income well above that of most sovereign bonds and comparable to many alternative investments. They have done so with less volatility than the broader equity market. We believe Epoch's Shareholder Yield strategies can play a key role within an income solution. This paper includes information on the Global Equity Shareholder Yield strategy. U.S. and Non-U.S. versions are also available.

Pension Funds: negative cash flows are increasingly common

Defined benefit pension plans, particularly in North America and in the U.K., are maturing as the workforce ages and younger members are directed toward defined contribution plans. As a result, cash flows at these pension plans are increasingly turning negative. In 2016, a Goldman Sachs study found that 57% of UK FTSE 350 funds had negative cash flow, with that number rising to 82% for S&P 500 companies.

This scenario has become a growing influence on asset allocation decisions, with a greater emphasis being placed on income. But as all investors know, income from traditional sources has been increasingly difficult to come by. Some plan sponsors are turning to asset sales to fund near-term pension payments as they struggle to generate the cash they need from traditional income-generating asset classes. Selling assets, of course, can be problematic for future asset levels, particularly if sales have the unfortunate timing of taking place in a bear market.

It's a low yield world after all

Paltry yields from fixed-income investments have become the norm, making income generation an arduous task. Sovereign bond yields are negative for short- and intermediate-term maturities in much of the developed world, with the U.S. and U.K. being notable exceptions. Real yields are negative for an even broader set of maturities and countries.

Ten-year sovereign yields in Germany, Japan, Denmark and the Netherlands are negative, and over $17 trillion of debt globally have yields below zero, according to Bloomberg.

There are many reasons bond yields could rise. Central banks in North America and Europe would eventually like to normalize monetary policy and step away from the quantitative easing that was designed to hold rates down, but that appears like a distant hope in the current environment. In the U.S., wider budget deficits and an expanding supply of bonds from both the public and private sectors could eventually provide upward pressure.

Over the long haul, however, interest rates are a reflection of economic growth and inflation. Economic growth in developed countries is challenged by an aging population and stubbornly low productivity growth (at least as it is traditionally measured). So while the global economy is growing, it is showing signs of a slowdown and its growth rate will remain hostage to these powerful secular forces. Furthermore, the next recession could push nominal rates below zero for a large swath of the yield curve even in the U.S. and U.K.

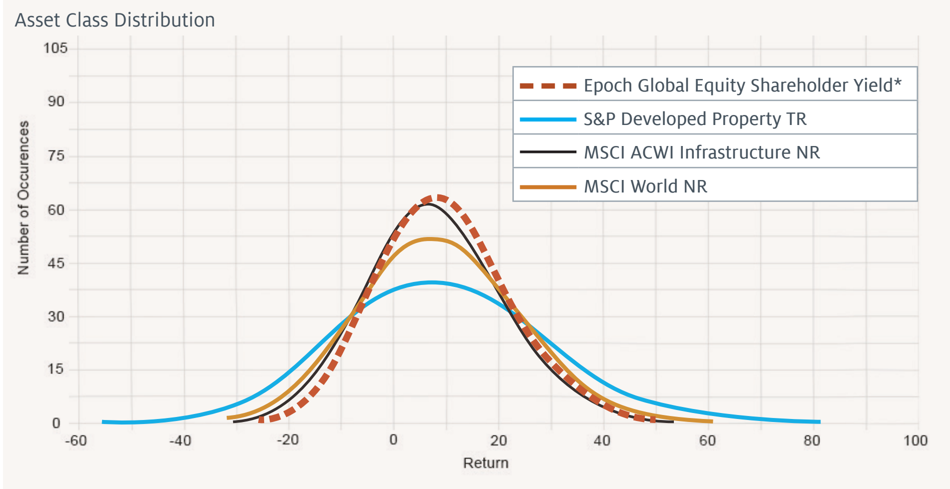
It is no surprise then that pension plans have sought out alternative sources of income. But with $100 trillion in global institutional assets (according to the World Bank) pursuing a limited number of investment opportunities, rising valuations across a wide range of asset classes from bonds to Bordeaux have further diminished yields.

Dividends from public equities: attractive compared to bonds and alternative investments

Fixed Income

Fixed income, for a host of reasons, will remain a portfolio cornerstone as plan sponsors consider their liability profiles and the implications of their funded status. The role of a core fixed-income allocation as a reliable source of income, however, has seemed quaint for more than a decade. Buying longer-dated securities or lower-rated credits comes with additional risks, and yields in these areas have also compressed. High-yield bonds in particular saw spreads over sovereign bonds narrow to post-2008 lows in 2018 and are not too far from that mark currently. Meanwhile, covenant quality has deteriorated to record lows, reflecting a seller's market and, perhaps, late-cycle behavior. "Bondholders are not being compensated for covenant risk," according to Evan Friedman, Senior Vice President at Moody's in a report from June of 2018. "Spreads remain narrow and covenant quality sits at the weakest level, reflecting issuers' continued negotiating strength in a crowded high-yield market." Since that report the Moody's Covenant Quality Indicator for high-yield bonds in North America posted its weakest-ever reading in July of this year.

Long tails: many alternative asset classes have a wide range of possible outcomes



Source: Morningstar Direct, December 31, 2018
**Represents an Epoch-managed mutual fund.*

Alternative Investments

For many, property and infrastructure have become new or larger allocations. They can provide consistent income and low correlations with public markets. Only the largest pension funds, however, have the expertise and heft to invest directly and capture their full income streams. While income can be higher, the tradeoffs are high transaction costs, a lack of liquidity and minimal diversification; returns are often dependent on a few large projects, making outcomes less predictable.

Unlisted funds are another way to invest, but they also lack liquidity. According to the Chartered Alternative Investment Analyst Association, lockup periods can be as much as seven to ten years. During this time, investors can receive some of their investment back in the form of distributions, but are restricted from receiving the remaining principal except at a discount or via the secondary market. Investors using these asset classes for income generation must be confident that the income will come through; trying to raise cash by selling these asset classes may not always be possible given the prevailing market environment. Investing in listed stocks that represent real estate or infrastructure holdings is the easiest and most liquid approach, although they have return profiles that are often closer to stocks than to their underlying assets.

Another issue with private vehicles is that realizing return objectives has become harder. After a long bull market, it has become difficult to acquire profitable investments. While it may be reassuring to see private asset managers show discipline in the prices being paid, the upshot is that a substantial amount of cash is not being deployed. Closed-end real estate vehicles launched as far back as 2013 still had substantial "dry powder" according to industry tracker Prequin. Real estate funds are sitting on record amounts of cash, on which they are charging active management fees.

	Yield on June 30	Avg. Annual Total Return (Since 1/1/06)	Volatility/ Standard Deviation
Global Bonds ICE BofAML Gbl Brd Mkt	1.45	3.70	5.33
Global Corporates BBgBarc Global Aggregate Corp	2.31	4.89	5.54
Global Stocks MSCI World	2.47	6.31	15.13
Global High Dividend Stocks MSCI World High Dividend	4.03	5.38	15.65
Global Property S&P Developed Property	3.89	5.86	19.45
Global Infrastructure S&P Global Infrastructure	4.08	6.11	15.22
Global High Yield ICE BofAML Gbl HY	5.70	7.44	10.43
Global Equity Shareholder Yield	4.14*	7.73 (gross) 7.25 (net)	12.25

Source: Morningstar, FactSet and Bloomberg. Figures are in USD and as of June 30, 2019. The period begins on January 1, 2006, the inception date of the Global Equity Shareholder Yield strategy.

** Dividend Yield is the asset-weighted average of the dividend yields of all the stocks in the portfolio as of the report date. The dividend yield shown for Global Equity Shareholder Yield is of a representative account and is calculated by dividing the sum of the regular gross dividends declared over the twelve months ended as of the report date by the closing price of the security as of the report date. All other yields are from Bloomberg. The performance data shown for Global Equity Shareholder Yield reflects the composite and such data may vary for each client in the strategy due to market conditions, client guidelines and diversity of portfolio holdings.*

Reconsidering dividend-paying public equities

With the shift toward alternative asset classes, the potential for dividend-paying stocks to help meet income goals has gone underappreciated. Yet these equities hold up surprisingly well in terms of yield, return and risk among these options, as shown in the table above.

In scenarios where dividend-paying equities could be a part of an income solution, we recommend considering our Global Equity Shareholder Yield strategy. (U.S. and Non-U.S. versions are also available.) It has provided a relatively high and very stable yield throughout its nearly 13-year history in an environment of collapsing bond yields. This is illustrated in the chart on the following page. It has done so with equity-like total returns, but with significantly less volatility than the broader equity market.

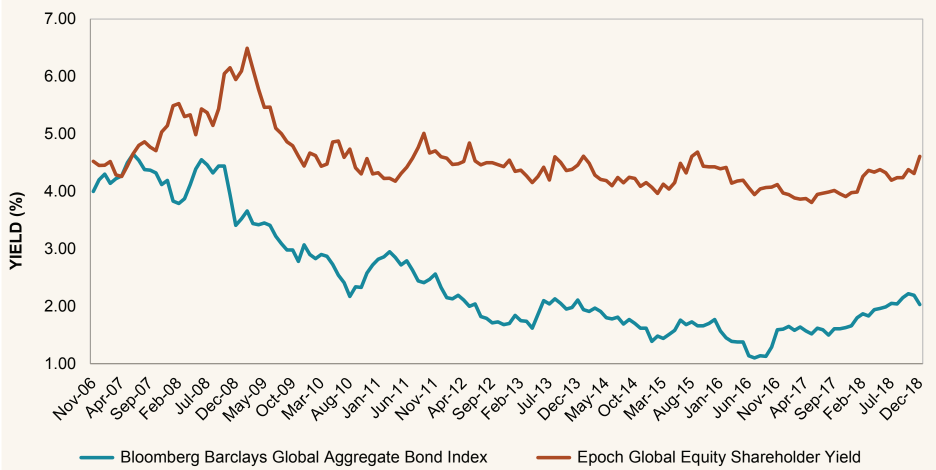
Global Equity Shareholder Yield as a consistent source of relatively high income

The Global Equity Shareholder Yield strategy has an approach to income generation that prioritizes consistency. Active management is critical in this process. While we look for stocks with attractive yields, we do not simply buy stocks with the highest yields. The companies with the highest dividend yield in the market often end up cutting that dividend. For example, many dividend-oriented strategies were heavily weighted in financials for their relatively high dividend yields leading up to the Global Financial Crisis. But of course, those dividends were unsustainable in the aftermath of the crisis, and most banks were forced to slash or even eliminate their dividends. Similarly, many energy stocks appeared to sport very high dividend yields in 2015, because the sharp drop in the price of oil had driven their stock prices

What is "Shareholder Yield"?

In addition to collecting cash dividends, the Global Equity Shareholder Yield strategy also looks to harvest share buybacks and debt pay downs. Cash dividends are the most obvious means of returning cash to shareholders. But buying back shares and paying down debt are also legitimate ways to return cash, as both provide shareholders with a larger claim on future cash flows. Collectively, dividends, share buybacks and debt pay-downs are known as "shareholder yield."

A history of abundant, steady income



Sources: Bloomberg, FactSet.
The data shown for Global Equity Shareholder Yield is of a representative account and such data may vary for each client in the strategy due to market conditions, client guidelines and diversity of portfolio holdings.

lower. But they, too, were forced to eventually cut their dividends, because the low price of oil meant they did not have the operating cash flow to sustain the previous level of those dividends.

We invest in stocks where we believe—based on detailed fundamental research—dividends are sustainable and can grow. This differentiates our approach from other dividend-oriented strategies. Our research is focused on understanding what drives free cash flow at individual companies and we look for companies that can grow their operating cash flow by at least 3% annually. Equally important is determining whether company management has a capital allocation policy that is disciplined, transparent and shareholder friendly.

The below-market volatility of the strategy is rooted in several factors. First, the investment process is focused on collecting dividends, along with share buybacks and debt pay downs. Once a dividend is paid, regardless of how a stock's price fluctuates from there, you are starting out with the cushion of a positive return. Second, companies that pay and grow dividends tend to be mature and well established, with the ability to withstand downturns and steadily grow their business throughout business cycles. Indeed, the average debt rating for the companies in the portfolio is investment grade (between A and Baa).

Third, lower volatility and consistency of income are aided by a rigorous approach to portfolio construction and risk management. The strategy is diversified in terms of cash flow growth and sources of shareholder yield. For example, if a security has a very high level of yield, rather than making it among the largest holdings in the portfolio, it is limited in size so that it does not represent too large a percentage of the portfolio's overall yield. That may seem counterintuitive, but diversifying in this fashion ensures that the shareholder yield being collected in the portfolio is not dependent on one or two high-yielding stocks. In other words, if one company does fail to pay its dividend, the overall income of the portfolio is not put in jeopardy.

Worth a look

In short, cash flows are turning from positive to negative as pension plans mature. This is causing a greater emphasis to be placed on income in asset allocation decisions. Traditional sources of income have been diminished, while newer sources come with their own complexities, drawbacks and risks. In this context, we believe Global Equity Shareholder Yield can play an important role. It may provide substantial income that has historically held up well relative to alternatives since its inception in 2006. It has the convenience, diversification and liquidity of a listed equity portfolio, but has displayed lower volatility than equities, with a history of shallower declines in down markets. And unlike bond coupons, dividends from the portfolio have the potential to grow.

The strategy invests in high-quality companies that not only generate growing cash flows, but have a long history of making payments to shareholders a priority. We believe collecting these payments up front, with the intention of making them compose the bulk of an investment return, increases the reliability of returns and reduces volatility. It also provides a strong income stream that can be used to fund near-term benefit payments.