Spotlight — *What Is Quality Yield?*

A conversation with Kera Van Valen, CFA — Managing Director, Portfolio Manager and Senior Research Analyst

QUESTION. *What is quality yield?*

ANSWER. Shareholder distributions that are sustainable and have the potential to grow is how we would define "quality yield." When considering shareholder distributions, we take a holistic view of dividends, which includes share repurchases and debt pay downs, as they both provide the shareholder with a larger claim on future cash flows. While looking for companies with attractive yields, it is important to not simply buy stocks with the highest dividend yields, because not all yields are created equal. A high yield could be the product of a one-time windfall or a collapsing stock price and may not be sustainable.

We believe that using detailed fundamental research to identify quality yield — dividends that are sustainable and growing — as we do in our Shareholder Yield strategies is crucial. 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 the company has a capital allocation policy that is disciplined, transparent and shareholder friendly.

QUESTION. *Why is quality yield relevant in the current environment?*

ANSWER. We are in an unprecedented period in which governments are deliberately shutting down the global economy with little clarity on when economies will reopen. The disruption in revenues and cash flows has led investors to question whether companies that have pledged to return capital to shareholders will have the financial wherewithal to keep those commitments. That is where quality and, more specifically, sustainability come into play. Not all businesses will face the same degree of stress from the government restrictions on social interaction, and some will continue to generate material cash flows. Others entered this period with ample liquidity to withstand a temporary demand hit. In our quest to find quality yield, we look for companies that generate more cash than their expected distributions, have strong balance sheets or the capacity to weather market cycles, and have clearly articulated capital allocation policies that emphasize a disciplined approach to returning excess cash to shareholders in the form of dividends, share repurchases or debt reduction. We believe that, for the most part, the companies that were offering a quality yield before the crisis will be some of the ones that can withstand the current environment and continue returning capital to shareholders. These are generally companies that are well established and have a history of being able to withstand downturns. Of course, this may not be the case for every company, but we believe the companies that remain in the portfolio will continue paying and growing their dividends. We expect more differentiated pricing among dividend-paying stocks once the market gets more comfortable distinguishing which companies have sustainable dividends with the potential to grow.

QUESTION. *What factors are associated with quality yield?*

ANSWER. Companies that offer a quality yield often rank well in certain factors in addition to dividend yield and shareholder yield. These include earnings yield, cash flow yield and EBITDA-to-EV metrics. That makes intuitive sense for companies that we believe are sustainable and can grow their yield over time. While these companies are often growing, they are not what some investors might consider "growth" companies, and they are often less volatile. That is because the companies that can reliably support and grow shareholder yield tend to be more mature companies. There are limits to how much they can invest profitably, and if they are disciplined about capital allocation they will instead elect to return excess cash to shareholders.

QUESTION. *What is the outlook for quality-yield-producing stocks?*

ANSWER. As mentioned, we are in unprecedented times and the short-term outlook for some yield-producing stocks may be uncertain. 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 recently emerged in this unique environment is heightened political pressure on companies to reduce or restrict distributions temporarily. To date, concerns about cutting the dividend as a result of public pressure appears to be limited to select countries and industries and will not have a material impact on our ability to deliver quality yield. In addition, we do not anticipate that a meaningful number of companies within the portfolio will seek direct relief aid, which would limit cash distributions back to shareholders as a result. While we remain confident in our ability to continue to deliver an attractive level of income based on our focus on quality yield, the same cannot be said of the broader market where dividend expectations are facing downward pressure.

Over the longer term many investors—individuals and institutions alike—require income, and that has become increasingly hard to find. Bond yields, which were already near historic lows, have now fallen even further and are even negative in some instances. That is why we expect dividends to remain especially relevant to investors. This has also prompted investors to place a greater emphasis on equities that provide "quality yield" for a core component of their portfolios. This term, as noted earlier, means a dividend that is expected to grow over time in a sustainable way, specifically because it is based on the growing cash flow of the business.

One other factor to consider is that, despite the deterioration of the short-term market environment, the ability of many companies to pay dividends has actually improved over recent years. Most firms are pursuing "capital light" business models. They are substituting technology for both labor and physical assets at a pace never seen before. With the deployment of technology, less labor and less investment in physical assets is required to generate the same level of revenues. Since the universe of profitable opportunities in which to invest that capital is not likely to expand at a rate greater than the savings generated from the effects of technology substitutes, companies with thoughtful capital allocation policies will return more capital to their shareholders. We do not expect sound capital allocation policies to disappear as a result of the global coronavirus pandemic.

In conclusion, we know these are challenging times for businesses, consumers and investors. Uncertainty is high—about the global trajectory of COVID-19, the ability to quickly devise medical treatments and vaccines, the length of government-imposed social distancing restrictions and about the pace of economic activity when restrictions are lifted and things begin to return to "normal." And while we cannot make high-conviction predictions about these matters, we can say with high conviction that we believe there will be many businesses that successfully navigate through this challenging episode, and that our focus on using rigorous fundamental analysis to find companies with sustainable cash flow that grows over time and supports shareholder distributions—quality yield—will remain relevant and valuable for investors.

Kera is a portfolio manager for Epoch's Equity Shareholder Yield strategies. Prior to joining the Shareholder Yield team, Kera was an analyst within Epoch's Quantitative Research and Risk Management team. Before joining Epoch in 2005, she was a portfolio manager of Structured Equities and Quantitative Research at Columbia Management Group where she was responsible for the day-to-day management of two index funds. She also worked at Credit Suisse Asset Management. Kera received her BA in Mathematics at Colgate University and her MBA at Columbia University, Graduate School of Business.