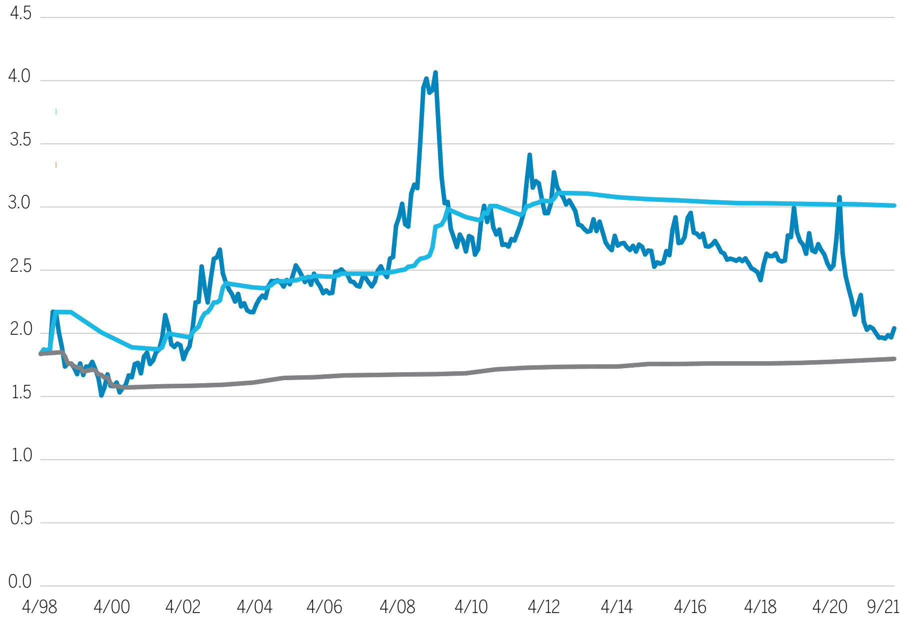
Is It Time To Be All in on Equity Income?

Broader fundamentals for high-yielding stocks present opportunity for equity-income investors.

Across global-equity markets, dividend levels have been driven to lows not seen since the late 1990s (**FIGURE 1**). What does this mean for income-oriented equity strategies going forward? Wellington considers the answer through their team's factor lens.

FIGURE 1
Dwindling Dividends
MSCI ACWI Index dividend yields (%)



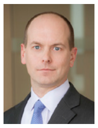
Past performance does not guarantee future results. Indices are unmanaged and not available for direct investment. The universe is MSCI ACWI Index. **MSCI ACWI Index** is a free float-adjusted market capitalization index that measures equity market performance in the global developed and emerging markets, consisting of developed and emerging market country indices. MSCI index performance is shown net of dividend withholding tax. Sources: Wellington, MSCI, FactSet, as of 9/30/21.

What Went Wrong With High-Yield Stocks?

Our contrarian instinct led us to examine the highest-yielding stocks in the US, Europe, and Japan. In 2020, these stocks saw their worst performance since the inception of our Fundamental Factor team's "factor library" (2002), during a synchronized developed-market drawdown for the dividend-yield factor (**FIGURE 2**). We think this poor performance was driven by a combination of several, simultaneous effects. First, the regulatory scrutiny on dividend payers in parts of the market caused extreme negative sentiment (e.g., for European banks). Second, during the pandemic, there were "going concern"[1] questions about many dividend payers and whether dividends would have to be suspended to preserve cash flow for operations. Third, there was a clear style and sector impact as higher payers tend to be later-stage companies with lower growth, more leverage, and

Insight from sub-adviser Wellington Management

Kat Price, CAIA
Investment Director



Gregg Thomas, CFA
Director of Investment Strategy

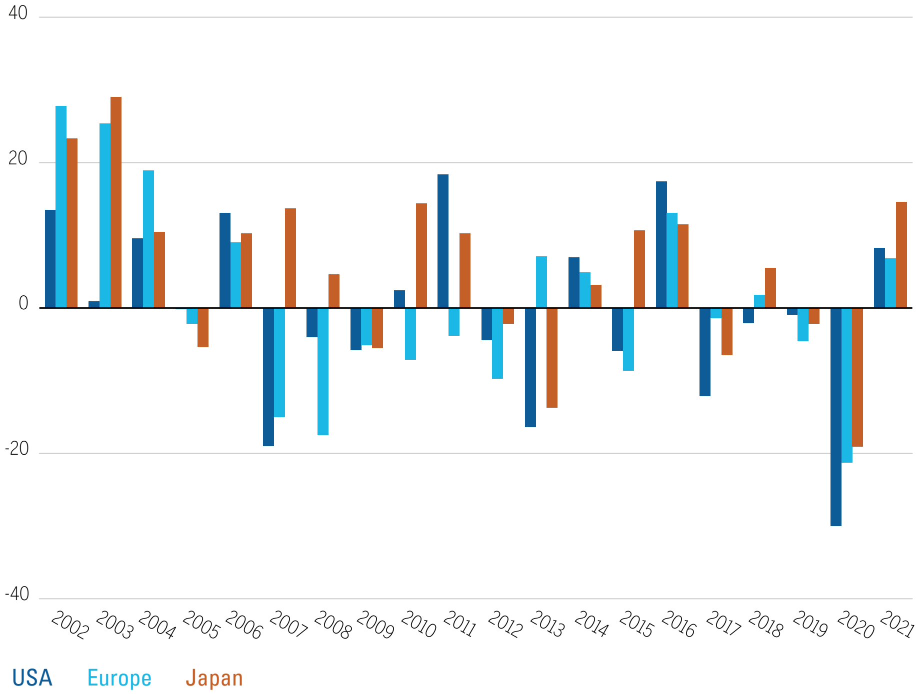
Key Points

- In 2020, high-yielding stocks saw their worst performance. We think this poor performance was driven by a combination of several, simultaneous effects.
- While dividend payouts haven't returned to previous levels, many companies are flush with cash and have improving earnings—unlike what we've seen after prior downturns.
- We maintain our conviction in the opportunity for equity-income investing, albeit with some nuances and caveats.

higher capital expenditure intensity. In the end, most investors weren't looking to buy companies in highly regulated industries with cash-flow commitments to a high payout and with sector/style characteristics that were in the crosshairs of COVID-related economic and policy developments.

> The struggles of high-yielding stocks in 2020 were driven by unique macro circumstances, suggesting that performance has dislocated.

FIGURE 2
A Closer Look At the Highest-Yielding Stocks
Dividend-yield factor, excess return (%)



Past performance does not guarantee future results. Indices are unmanaged and not available for direct investment. Dividend yield is a proprietary factor representing the top decile of names, with respect to dividend yield, in the MSCI USA, Europe, and Japan Indices. Bars indicate excess returns for the factor relative to its respective benchmark. See page 3 for representative index definitions. Sources: Wellington, MSCI, FactSet, 2021 data is through 9/30/21.

In short, the struggles of high-yielding stocks in 2020 were driven by unique macro circumstances, suggesting that performance has dislocated and should mean-revert.[2] In fact, we've already started to see this trend reverse as the percentage of non-payers and dividend cutters comes back down—but not yet to pre-pandemic levels, suggesting that there may be more runway for this opportunity.

We think the broader fundamentals for these stocks look attractive in a historical context as well. While dividend payouts haven't returned to previous levels, many companies are flush with cash and have improving earnings. This is unlike what we've seen after prior downturns, when companies, having depleted their cash and taken on leverage to sustain themselves through a recession, have taken a while to recover. This time, the recession was short, and the recovery was quick, suggesting that we may be poised for an acceleration in dividend payments.

How We Think About Income as a Factor

Our work with fundamental portfolio managers at Wellington has led us to believe that some pitfalls of passive equity-income investing (e.g., exposure to high-dividend payers with solvency risk) can potentially be mitigated by considering not only the dividend yield, but also the ability of companies to maintain their dividends. Fundamental managers typically do this through deep dives into company balance sheets. Based on our collaboration with fundamental managers, we've constructed a proprietary sustainable-income factor that incorporates the highest-yielding names that also have a historical track record of maintaining dividend commitments, the ability to pay based on cash flow, and a lower expected likelihood that leverage may present a risk to the business and its future dividend payments. We find these criteria have historically tended to point to more profitable sectors such as consumer staples and healthcare (vs. less profitable sectors such as energy and materials) and to more established, larger-cap stocks.

Using our sustainable-income factor, we considered the attractiveness of the opportunity across different regions, considering capital distribution in relative and absolute terms, quality and profitability, revenue growth, and valuation (current and relative to history). Based on the results, we maintain our conviction in the opportunity for equity-income investing, albeit with some nuances and caveats. To highlight a few of our findings:

- **Europe** may be most attractive if an investor's focus is on the absolute level of income. It's had the highest level of yield overall, supported by strong valuations.
- **Japan** may be more of a value play, with the lowest dividend yield and low profitability (i.e., cash-flow returns barely above the cost of capital), but also strong valuations and a high market-implied discount, suggesting there may be runway for improvement.
- **The US** may be more attractive than Europe for investors willing to sacrifice some yield in exchange for strong fundamentals (e.g., strong cash-flow returns).

Talk to your financial professional to learn more about equity-income investing.

[1] Going concern is an accounting term for a company that has the resources needed to continue operating indefinitely until it provides evidence to the contrary.

[2] Mean reversion, or reversion to the mean, is a theory used in finance that suggests that asset price volatility and historical returns eventually will revert to the long-run mean or average level of the entire dataset.

MSCI USA Index is a free float-adjusted market cap Indices are unmanaged and not available for direct investment.italization index that is designed to measure the performance of the large and mid cap segments of the US market.

MSCI Europe Index is a free-float adjusted market-capitalization-weighted index designed to measure the equity market performance of the developed markets in Europe.

MSCI Japan Index is a free-float adjusted market-capitalization index designed to measure large- and mid-cap Japanese equity market performance.

Important Risks: Investing involves risk, including the possible loss of principal. • Foreign investments may be more volatile and less liquid than US investments and are subject to the risk of currency fluctuations and adverse political, economic, and regulatory developments. • These risks may be greater, and include additional risks, for investments in emerging markets or if a fund focuses in a particular geographic region or country.

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