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Global equities

To serve and protect: income and dividend strategies

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Income and high-dividend strategies had a strong 2022 while many hedging strategies failed their mandate in a difficult market. This was no coincidence. Income strategies are among the most resilient strategies in the equity space, delivering not only strong but also very stable returns. The combination of defensiveness and value creates a style which is quite unique and tends to work well during the late stages of a cycle. As rates are likely to stay high and the economy is set to weaken further, their tactical outlook remains favourable. But there are also good reasons to be invested in the long term.

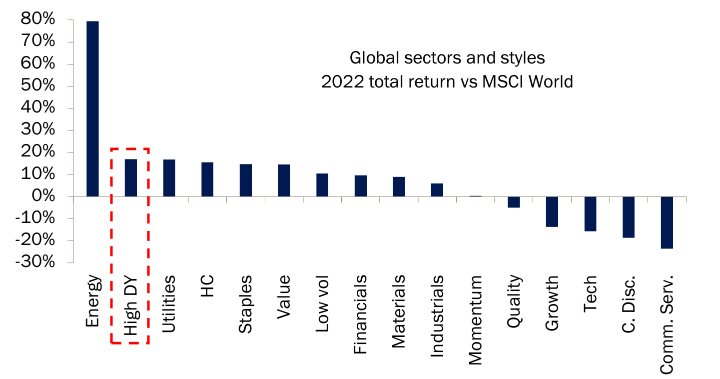
Income strategies had a strong 2022

Income strategies staged a big comeback in 2022. While typical hedging strategies failed to fulfil their mandate, income and dividend strategies held up as one of the few shelters against the rates-driven storm which ripped through markets. The global MSCI high dividend yield index outperformed the MSCI World by more than 17% between January and December 2022. Doing so, it clearly stood out among sectors and styles, with energy being the only sector which provided a higher return (Exhibit 1).

Dividend yield is not the only criteria. Other quality criteria are applied as well

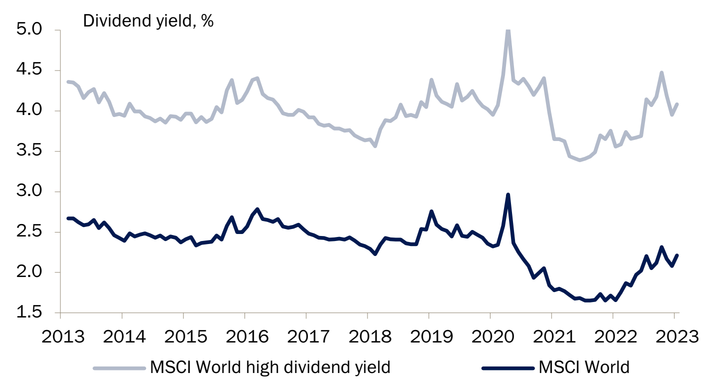
What's behind this remarkable performance? The composition of the index surely is one reason. As the name suggests, a company's dividend yield is the key criteria to be included. This results in a dividend yield for the index which has been more than 1.5%-points above the MSCI World's dividend yield over the past 10 years (Exhibit 2). Yet it's not only the level of the dividend yield which is taken into account in the selection process, but also dividend growth, its stability and the persistence of dividend payments. Companies with falling dividends over the past five years for example are excluded, as are companies with unsustainably high pay-out ratios. Additionally, several other quality criteria apply, such as leverage limits, profitability floors and earnings volatility thresholds. All these measures are supposed to further ensure the stability of future dividend payments.

Exhibit 1: MSCI high-dividend yield among the best performers in 2022



Source: Refinitiv, Bank J. Safra Sarasin, 20.02.2023

Exhibit 2: An average 1.5% dividend premium over the past 10 years



Source: Refinitiv, Bank J. Safra Sarasin, 20.02.2023

This creates a defensive style with a strong value and quality exposure

That leaves us with a style which is second to none. It is dominated by defensive sectors, such as health care and staples, but has a fairly strong value tilt (Exhibit 3). Some of the traditional high-dividend paying sectors, such as energy, have a relatively low weighting. They often don't meet the quality criteria, given the high cyclicality of their earnings and the corresponding risk that dividends may have to be cut at some point in the future.

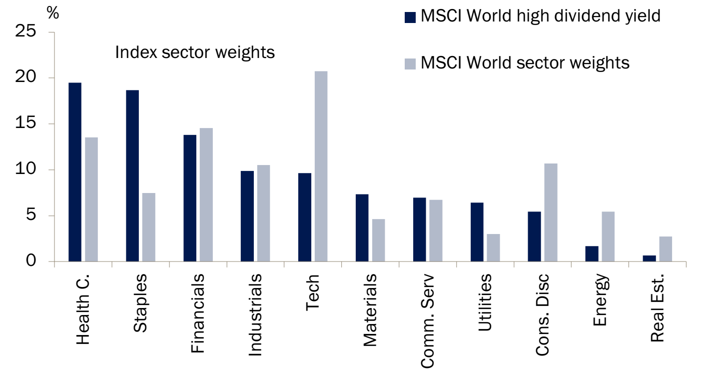
The quality filter also is instrumental when it comes to the value footprint of the index. Companies which pass the filter are typically very stable and well-established businesses.

They have strong earnings and a solid free cash flow. While their growth outlook is positive, they are quite mature and thus unlikely to see the highest earnings growth rates in the market. As such, a larger share of their earnings stream lies in the nearer future, lowering the duration of their income and making their valuations less vulnerable to rising rates.

The short duration of high dividend earners makes the style less vulnerable to rising rates

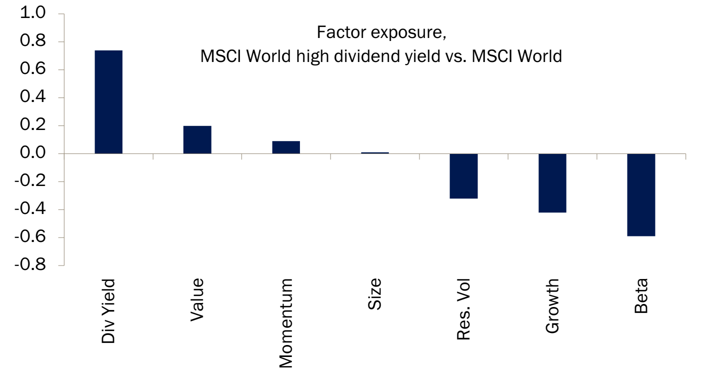
A factor exposure analysis confirms this assumption. While the dividend yield factor clearly and unsurprisingly dominates the high-dividend yield index and the low weighting of the beta factor underlines its defensive character, value is the second most dominant factor, relative to the MSCI World (Exhibit 4).

Exhibit 3: Health care and staples dominate the high-dividend index



Source: Refinitiv, Bank J. Safra Sarasin, 26.02.2023

Exhibit 4: Strong value exposure of the high-dividend index



Source: Bloomberg global MAC3 model, Bank J. Safra Sarasin, 26.02.2023

The rise in rates did not hurt as much

That's one reason why income and high-dividend strategies did very well last year, when rates moved sharply higher. The correlation of the high-dividend index to rates has been positive over recent years, only trailing the high correlations of pure value plays and corresponding sectors, such as financials or energy (Exhibit 5).

Positive correlation to yields, low beta and low correlation to the cycle

The second feature which stands out is the relative defensiveness of high-dividend strategies, reflected by their correlation with the cycle and with the benchmark (Exhibit 6). The beta of the MSCI World high-dividend yield to the MSCI World is 0.8, only slightly above the three most defensive sectors in the market. That's another reason why high-dividend income strategies have been less affected by the sharp market sell-off in 2022.

Lastly, the low sensitivity to the cycle is reflected by the correlation coefficient to the US manufacturing ISM, which is one of the best proxies for US growth (Exhibit 7). The sharp drop of the ISM last year weighed heavily on some of the more cyclical sectors, but had a much more moderate impact on dividend and income strategies.

Exhibit 5: Positive correlation to yields

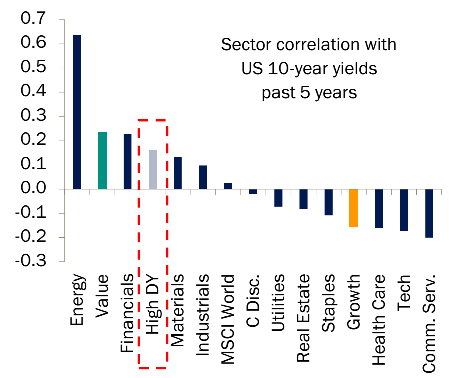


Exhibit 6: Low beta

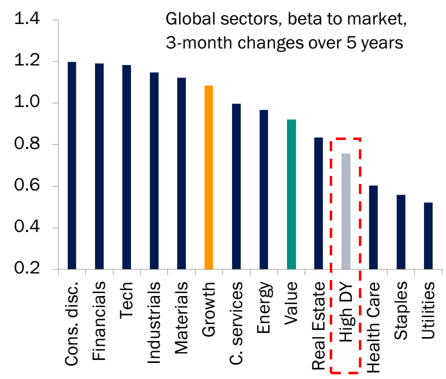
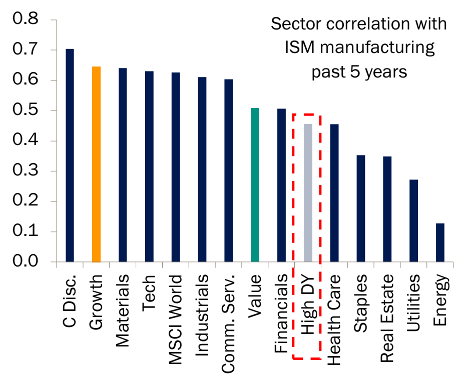


Exhibit 7: Low correlation with ISM



Source: Refinitiv, Bank J. Safra Sarasin, 27.02.2023

Considering the features above, it becomes clear why last year proved to be great for income and dividend strategies. The economy slowed while interest rates surged, providing a perfect backdrop for their relative performance.

There are good reasons for income and dividend strategies to do well

A full replay of 2022 is unlikely, yet we think a strong case for dividend and income styles remains in place, for several reasons:

The macro backdrop

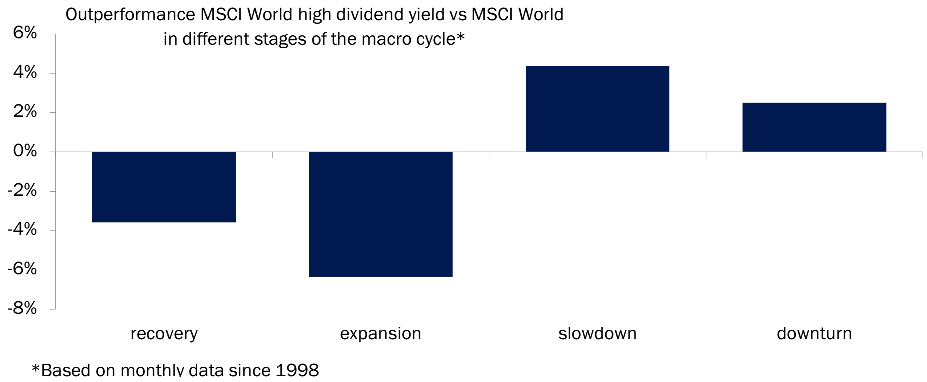
1) The macro and markets backdrop should remain supportive for dividend strategies

   A quick return to a pre-COVID world with muted inflation rates, solid GDP growth and low interest rates seems unlikely. Inflation has proven to be much stickier and more pro-cyclical than expected, implying further central bank tightening and persistent macro headwinds in the months and quarters ahead. This means that a trough in the macroeconomic cycle is likely still ahead of us.

   Uncertainties around the trajectory of the economy also appear more elevated than in the past. The current geo-political backdrop seems more fragile than just a few years ago, while the re-emergence of inflation broadens the range of potential macro scenarios in the years to come. Dividend and income strategies should thus continue to benefit from their defensive character and their partial immunity to inflation and high interest rates. They have typically performed well during these later stages of the cycle, which we have yet not left behind (Exhibit 8)

   Clearly, once the cycle has troughed and starts to accelerate again, a shift to more cyclical strategies would be advised in order to benefit from the macro expansion.

Exhibit 8: The high-dividend yield index tends to outperform during late cycle stages



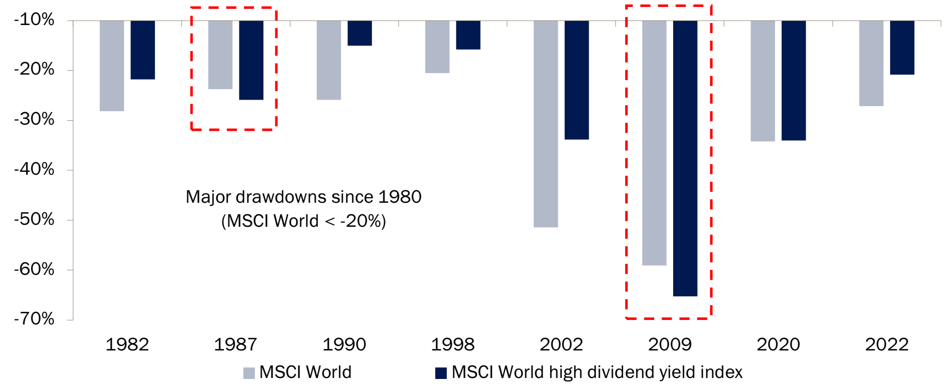
Source: Refinitiv, Bank J. Safra Sarasin, 28.02.2023

Their resilience has been proven

2) Dividend strategies are highly resilient, with limited drawdown risks

   Given the uncertainty around the macro cycle and generally elevated equity valuations, it seems feasible that the market may have to adjust to a lower growth trajectory at some point in the coming year or two, likely resulting in a more pronounced market downturn. Dividend strategies have proven to be very resilient against market drawdowns in the past 40 years. In only two out of the eight major market corrections since 1982 has the MSCI high-dividend yield seen a larger pullback than the benchmark MSCI World. In all other instances has the MSCI high-dividend been more resilient than the wider market, providing decent protection against the pullback (Exhibit 9).

Exhibit 9: High-dividend strategies show resilience during market turmoil



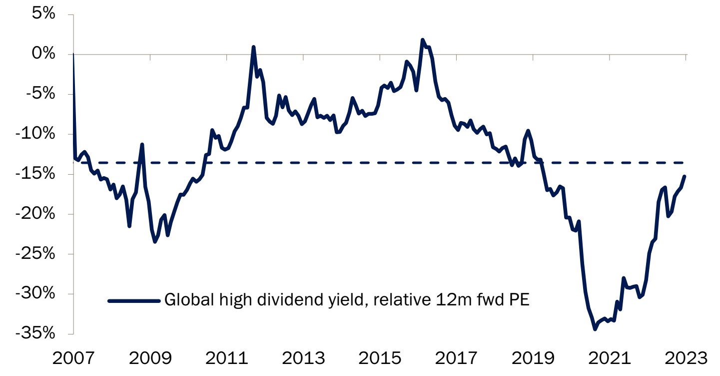
Source: Refinitiv, Bank J. Safra Sarasin, 27.02.2023

Their valuations are still attractive

3) Valuations of high-dividend indices are no longer cheap but not expensive either

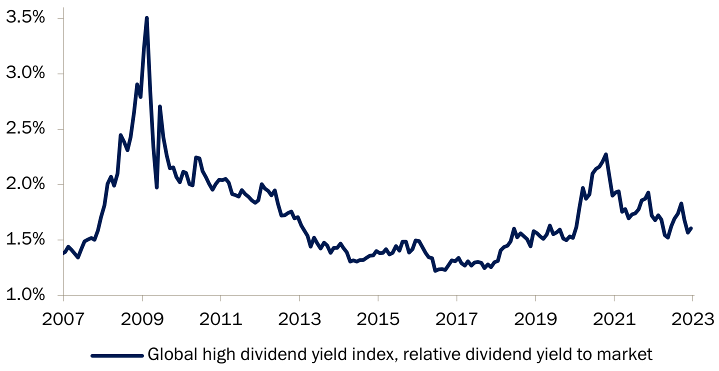
Valuations of high-dividend yield styles proved resilient against higher rates in the past two years and even managed to rise relative to the market. Not yet expensive, the relative price-to-earnings ratio is now back at its long-term averages (Exhibit 10). More importantly, the dividend yield has come back down somewhat on a relative basis over the past two years (Exhibit 11) but remains above its long-term average premium of 1.5% vs the market.

Exhibit 10: Relative PE has moved back to its long-term average



Source: Refinitiv, Bank J. Safra Sarasin, 27.02.2023

Exhibit 11: Relative dividend yield is at a 1.6% premium to the market



Source: Refinitiv, Bank J. Safra Sarasin, 27.02.2023

They should continue to deliver strong and stable long-term returns

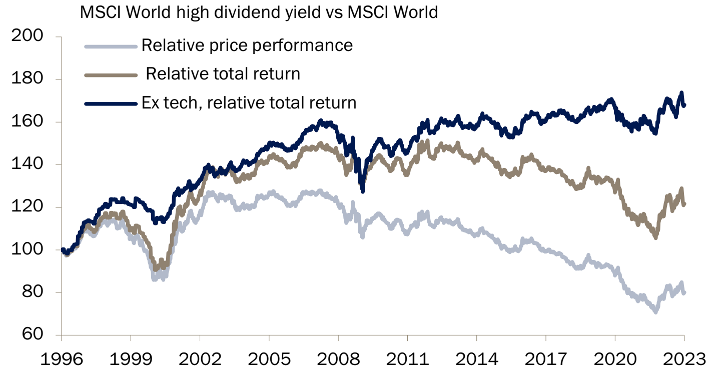
4) Long-term returns of dividend strategies have been strong and should remain strong

The long-term attractiveness of dividend and income strategies cannot be dismissed. Not only performance itself, but also the risk-return profile makes dividend strategies a strong and stable contributor to long-term returns.

While the simple price return vs the MSCI World looks dismal over the past 30 years, the total return looks much more favourable. Dividends have added around 50% of return to the MSCI World high-dividend yield over the MSCI World since 1995, turning a 20% underperformance in prices into more than a 20% outperformance in total returns. Removing the tech sector from the benchmark, the dividend index even outperformed the MSCI World by a remarkable 68% since 1996 (Exhibit 12). This also shows one of the main weaknesses of the style. Tech is clearly underrepresented. As a result, pure dividend investors failed to participate in the growth and tech boom over the past decade. A balanced approach with both, tech and dividend building blocks in a portfolio is certainly advisable, with weights being a function of the macro cycle.

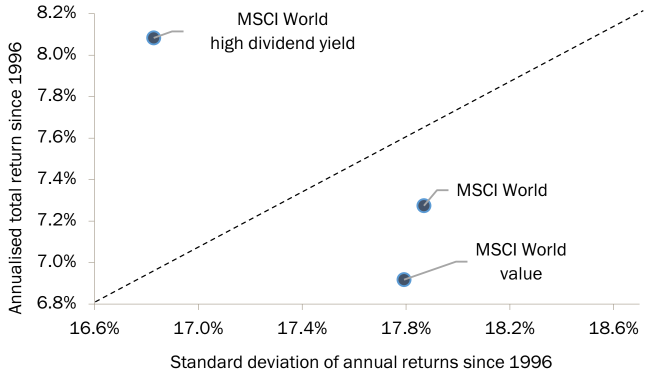
The cost of the performance of dividend strategies has been fairly low. The risk-return profile of the MSCI World high-dividend yield index does not only look much more appealing than the profile of the benchmark index, but also more attractive than the profile of an equivalent value index. It has delivered an annualised return of 8.1% since 1996, with a lower volatility than both the MSCI World and the MSCI World value index, which generated less than a 7.5% total return p.a. (Exhibit 13).

Exhibit 12: Total return has been solid over past 20+ years



Source: Refinitiv, Bank J. Safra Sarasin, 24.02.2023

Exhibit 13: Attractive risk-return profile



Source: Refinitiv, Bank J. Safra Sarasin, 24.02.2023

Breaking down the past 26 years of performance in five year periods (and one seven-year period), the MSCI World high-dividend yield index outperformed global equities in three out of five, underlining the stability of returns. It also delivered positive returns in 20 out of the last 26 years, which is not unmet but came with substantially higher returns than value and growth styles managed to generate (Exhibit 14).

Exhibit 14: High-dividend strategies delivered strong and stable performance in past decades

Total return, annualised		MSCI World Index	MSCI World High dividend yield	MSCI World Value	MSCI World Growth
1995-1999		20%	22%	15%	21%
2000-2004		0%	4%	3%	-4%
2005-2009		-3%	-3%	-3%	-3%
2010-2014		18%	19%	17%	18%
2015-2022		11%	8%	8%	13%
1996 - 2022	Total return	630%	748%	533%	687%
	Years of positive return	19 (out of 26)	20	19	20

Source: Refinitiv, Bank J. Safra Sarasin, 24.02.2023

Income and dividend strategies should be a cornerstone of each and every long-term portfolio

While the past performance is no guarantee of future performance, we think high-dividend and income styles have shown their long-term appeal. Different than certain sectors which tend to benefit from temporary trends, the risk-return structure of high-dividend and income strategies is first and foremost a result of the selection process. This guarantees that certain quality criteria are met and should thus deliver attractive and stable returns in the coming years as well.

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