# An Unconstrained Approach to Generating Equity Income

The economic and capital market volatility in recent years has reduced the attractiveness of equities to many investors, and it has led to unprecedented flows into fixed income. However, the yields available in fixed-income markets were already low by historical standards, and additional capital flows have further reduced those yields. Conversely, dividends have been rising as corporate earnings continue to recover and investors increasingly demand dividends from a wider variety of companies. In our view, equities can be a means of securing a high yield, and a global portfolio of equities can be an effective method of achieving that yield. Even more, an unconstrained portfolio that looks beyond large, mature, defensive businesses can access the most attractive high-yielding stocks globally, thus potentially maximizing both income and capital appreciation.

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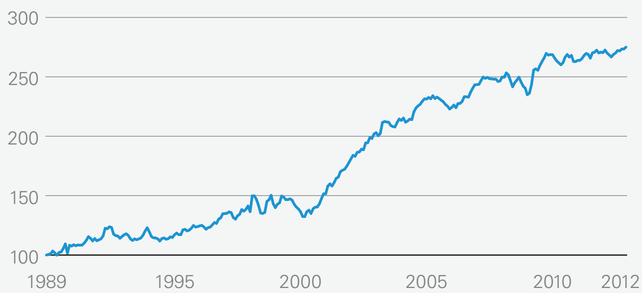
Many investors believe that in order to materially increase the income generation of an equity portfolio one has to sacrifice capital appreciation. However, Exhibit 1 illustrates that high-yielding stocks have actually outperformed the broad global market by 4.7%, annualized since 1990. This is attributable in part to the higher level of dividend yield compounding over time. But the other primary driver of this outperformance is mean reversion, as a simple focus on yield leads to cash-generative yet out-of-favor companies that, in many instances, recently underperformed. In several cases these stocks are poised to rebound, and rigorous fundamental analysis can help differentiate between those positioned to outperform and those in secular decline. In addition, we believe an unconstrained portfolio which seeks high-yielding opportunities in a wide variety of stocks, including more cyclical companies, can capture mean reversion well. In contrast, by focusing solely on less-volatile stocks one will likely forgo some element of outperformance.

Exhibit 1
**High-Yielding Stocks Outperform Globally**
Relative Return of Global High-Yielding Stocks vs. the Broad Market (1989 = 100)




As of 31 December 2012

The above returns do not represent the performance of any product or strategy managed by Lazard and are provided for illustrative purposes only. The performance presented represents historical performance of an unmanaged index. Returns would have been lower if they were subject to management fees and other trading expenses.

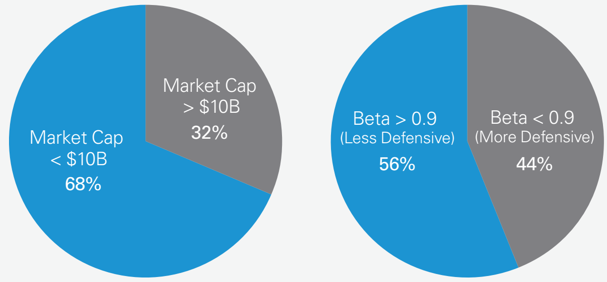
Past performance is not a reliable indicator of future results. The broad market is the FTSE All World Index and global high yielding stocks are based on the highest quartile of stocks screened on dividend yield on an equal-weighted basis. Portfolios have been rebalanced quarterly and are in USD. The index is unmanaged and has no fees. One cannot invest directly in an index.

Source: Nomura

With investors seeking alternatives to low-yielding bonds, it's not surprising that they initially sought equities that looked the most like bonds; mega-cap, defensive, developed-market stocks. Many associate income with large, diversified, mature businesses as they generally offer stability and high levels of free cash flow since their modest growth outlooks lead to low levels of reinvestment. However, restricting a search to such stocks leads to the introduction of significant concentrations in defensive sectors such as utilities and telecom services, and the low level of reinvestment in these typically mature businesses limits the potential for growth in earnings and dividends. By increasing the search to a broader range of high-yielding stocks, including less-defensive and smaller-cap companies, one can achieve much greater diversification, as the opportunity set increases significantly, as displayed in Exhibit 2. For example, one can gain more exposure to sectors such as technology and materials where there are limited yield options among larger developed-market companies. In addition, high-yielding stocks from more cyclical sectors typically generate generous yields while paying out a fairly modest portion of their cash flow, with a greater portion reinvested in the business to drive growth.

Exhibit 2
**Small-Cap and Less-Defensive Companies Increase the High-Yield Universe**

Companies with Dividend Yield > 3%




As of 31 December 2012

Data based on the MSCI ACWI. The data presented above do not represent any product or strategy managed by Lazard and are provided for illustrative purposes only.

Source: Lazard, MSCI

## Global versus Domestic

Looking at the performance of high-yielding stocks by region, one observes that they have generally outperformed both on a broad market and regional basis. It is worth noting that the United States is the only market where high-yielding stocks generally underperform, as portrayed in Exhibit 3. Roughly 25%[2] of the US market pays no dividend at all, as compared to only 10%[2] outside the United States, and a focus on yield generally leads investors to concentrate holdings in a few defensive industries like utilities. The US market offers approximately 17%[2] of the global opportunity set (which we define as stocks yielding more than 3%). The number of stocks is not meager for a single country, but by not investing globally, one is missing the chance to further diversify and add value through bottom-up stock selection in an expanded opportunity set.

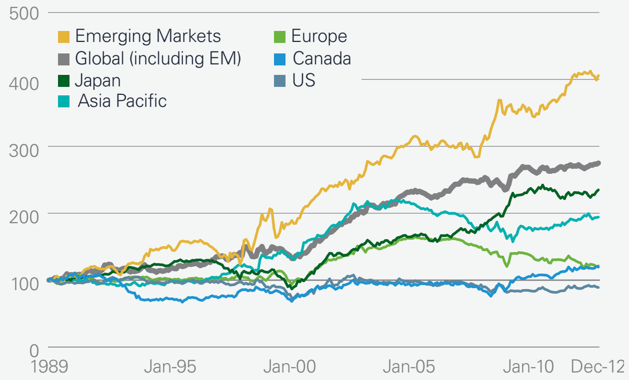
Exhibit 3 depicts the relative performance of high yielding stocks vs. applicable benchmarks by region. As noted in the chart, US high yielders have underperformed. In every other region of the world other than the United States, high-yielding stocks outperform the broad market although the relative performance of high yielders has deteriorated in Europe amid the sovereign debt crisis. The relative performance of high-yielding stocks has been particularly impressive in the emerging markets, a region where simple valuation tools have generated strong results.

The most important point to take away from Exhibit 3 is the relative position of global stocks—near the top, just below Emerging Markets—when we would expect them to be toward the middle since Global is a composite of the regions, and nearly half of the stocks are from the United States (where high yielders tend to underperform). Far from simply delivering average returns, the reason for the outperformance of global high-yielding stocks appears

Exhibit 3

**Performance of High Yield Varies by Region**

Relative Returns of High-Yielding Stocks by Region (1989 = 100)




As of 31 December 2012

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Past performance is not a reliable indicator of future results. Global (including EM) represented by FTSE All World Index, Europe by FTSE World Europe Top 300, Asia Pacific by the FTSE World Asia ex Japan, US by the FTSE World US, Japan by the FTSE World Japan Top 200, the Emerging Markets by the FTSE World EM Top 300, and Canada by the FTSE World Canada Index. Portfolios have been rebalanced quarterly and are in USD. The index is unmanaged and has no fees. One cannot invest directly in an index.

Source: Nomura

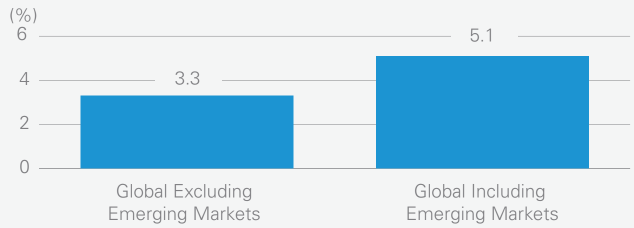
to be the ability to shift capital among regions based on shifts in relative yield, which can enable one to fully capture the alpha generation of a high-yield approach.

In addition, high-yielding stocks have an even greater potential for outperformance when the emerging markets are included in the opportunity set. There is a misconception among some investors that only growth stocks are found in the developing world; this simply is not the case. There is a strong culture of dividends in many emerging markets countries, such as Brazil, where companies are required to pay out at least 25% of their net income, and Taiwan, where many technology companies are cash rich, and yet buybacks have historically been a challenge. In China, the government has encouraged dividend payments in order to stabilize the market and to develop a longer-term time horizon among its investors. Most importantly, many companies in the emerging markets have reached the stage where their need to invest in factory construction or telecom systems is declining, leading to a dramatic increase in free cash flow to fund dividends. As shown in Exhibit 4, adding emerging markets to a developed-only opportunity set has historically increased the outperformance. Dividends have been growing at a much higher rate in the emerging markets than in the developed world due to the faster GDP growth, which drives earnings, as well as an increased orientation toward rewarding shareholders through dividends.

Exhibit 4

**Why Include Emerging Markets?**

Outperformance of Top Yielders*




Data indexed from 29 December 2000 to 31 December 2012

* Relative performance of top quartile by trailing dividend yield

Based on Société Générale's proprietary universe. The performance quoted represents past performance. Past performance is not a reliable indicator of future results. The above returns do not represent the performance of any product or strategy managed by Lazard and are provided for illustrative purposes only.

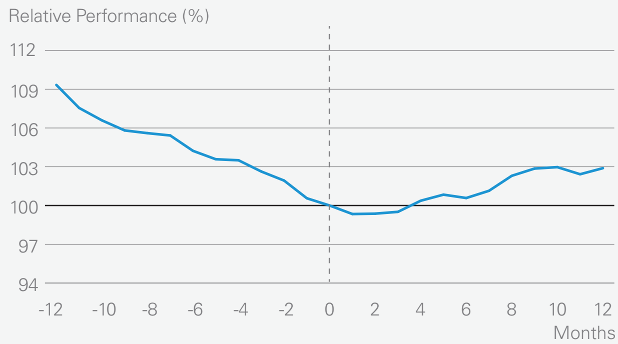
Source: Société Générale

## Capturing Outperformance in High-Yielding Stocks

While the extended period of very low interest rates has triggered heightened interest in dividend-focused investing, the high-yielding portion of the market on a global basis has not dramatically outperformed. As a result, high-yielding stocks have not been driven to unappealing valuations.

Exhibit 5

**Performance of Dividend Yield Factor**




As of 31 December 2012

The chart shows the relative performance of the high-yield quartile relative to the benchmark "x months" before and after portfolio formation. This includes the years from 1994–2012. The underlying universe is the top 500 stocks in the FTSE World Index. The above returns do not represent the performance of any product or strategy managed by Lazard and are provided for illustrative purposes only.

Source: Nomura Quantitative Research

Exhibit 5 demonstrates that much of the outperformance of high-yielding stocks is driven by mean reversion as cash-generative, yet out-of-favor, companies rebound. We believe one needs a valuation-driven process and an unconstrained opportunity set (including emerging-market and smaller-cap stocks) to fully capture mean reversion opportunities which are less prevalent among less volatile, larger defensives. Forward-looking fundamental analysis is also necessary to help differentiate between sound companies poised to rebound and structurally challenged value traps.

In our view, another driver of outperformance, in both good and bad times, is the capital discipline a regular dividend encourages. Since companies that share a significant part of their cash flow with shareholders have fewer funds for reinvestment, management teams are forced to prioritize, so that only the best projects are funded while weaker opportunities are not pursued. This prioritization often leads to better subsequent return on these investments; studies have shown that, paradoxically, high-dividend-payout companies tend to generate higher earnings growth.[1]

## High-Yielding Equities versus Fixed Income

Currently, both corporate and government bonds have little or no yield advantage over equities. This is in sharp contrast to the past 20 years, when fixed-income yields were a multiple of what was available in equities. As a result, we believe that investors have begun to ask themselves whether equities, traditionally viewed as a source of capital gains, may currently be more attractive as a source of income.

As Exhibit 6 demonstrates, bond yields are currently relatively low; fixed-income yields in the United Kingdom, the United States, and Canada are also far below their 10-year average. This is certainly not the case with equities, where yields are marginally ahead of their 10-year average.

Exhibit 6 shows that equities are the only part of the capital markets where current yields are near or below their long-term averages, while those from various types of bonds are all well below. As a result, the yields available from equities are much more competitive than those from bonds, which has not been the case historically. The current 2.2% yield of the broad equity market is above the 10-year government bond yield in many countries, and when one specifically focuses on high-yielding equities (approximated using stocks within the highest-quartile of yield), the opportunity is truly compelling in comparison to bonds, particularly considering that equity dividends offer the potential for growth as well.

## Are Equity Yields Sustainable?

Some may argue that equity yields are not sustainable. With earnings under pressure, sovereign debt risks, and the fragility of the global economy, many believe that companies may be unable to generate the earnings and cash flow to maintain these dividends going forward. Others simply will not consider investing in equities following the volatility of recent years.

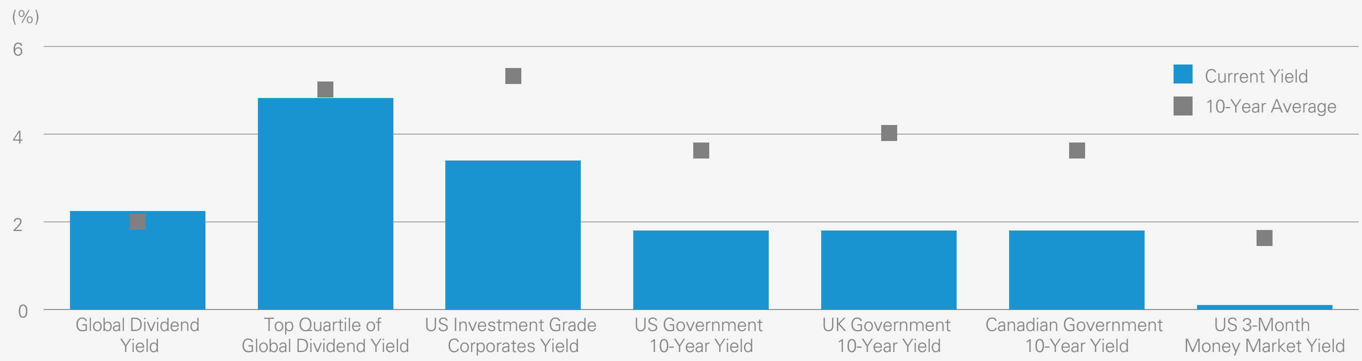
In our view, the weak links have already been broken in this cycle, and companies that felt their dividends might be unsustainable in a weak economic environment have already cut or eliminated their dividends. There was no stigma to such measures in 2008 and 2009, as many companies were in a similar situation. With the vulnerable dividends already reset to lower levels, we feel that dividends in aggregate are more sustainable than usual. Earnings have rebounded strongly after the financial crisis and free cash flow, which is what ultimately pays dividends, has been even more resilient, as companies have aggressively reduced capital expenditures amid the economic uncertainty. Globally, corporations are currently flush with cash.

In our view, dividends will continue to climb because of the current highly liquid conditions and the organic growth of companies. In fact, cash as a percentage of assets is now at an all-time high in the United States; if we consider this in conjunction with the rebound in earnings, higher dividend payments are likely, and stable balance sheets bode well for the sustainability of those payments.

## What about Inflation?

Central banks around the world are engaged in unconventional monetary policy on a massive scale. The end result of this is unclear, and it is possible that central banks will be unable to remove stimulus quickly enough after the economy gains traction, which could trigger an inflationary spiral. While no financial assets benefit from inflation, equities are better placed than fixed income, particularly as most bonds currently offer little or no real yield above inflation.

Exhibit 6
"Safe" Assets Currently Have Lower Yields

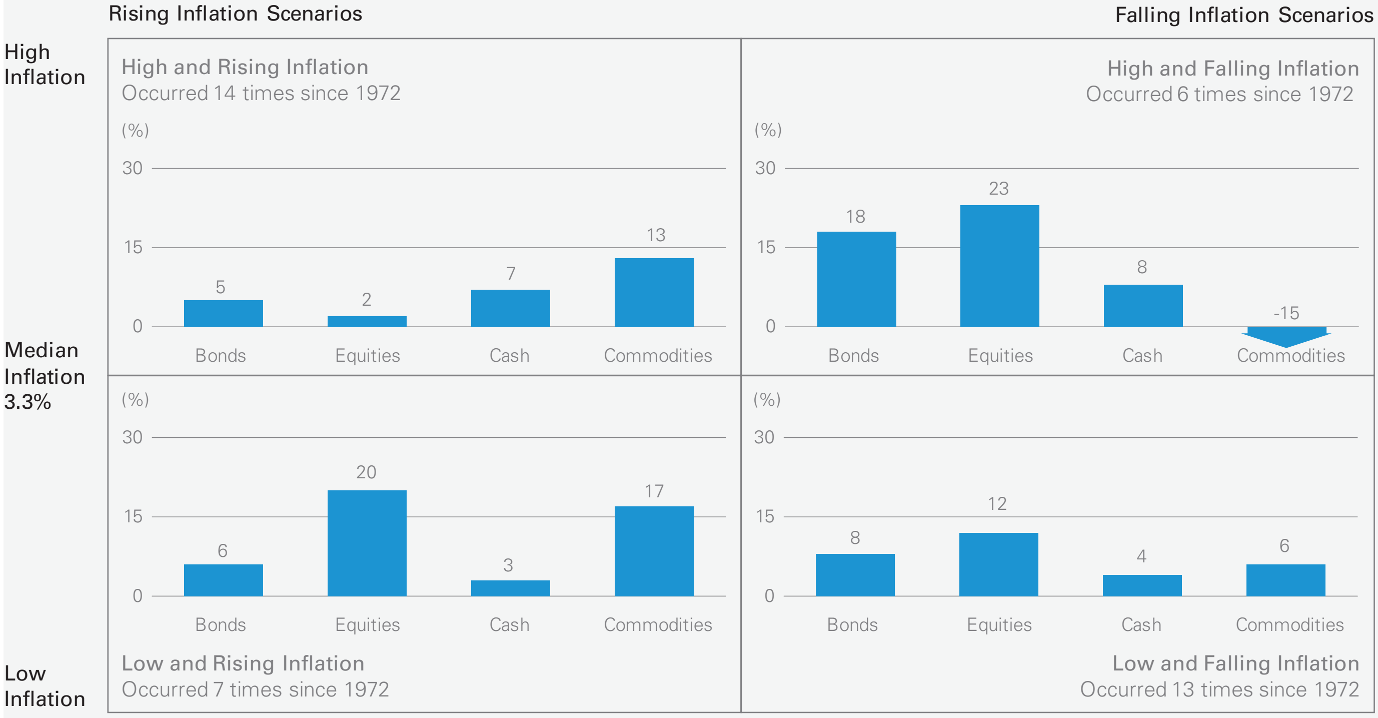



31 December 2012

Global dividend yield data are based on the MSCI ACWI; US investment grade corporates are based on the FINRA-Bloomberg Active Investment Grade US Corporate Bond Average Yield to Maturity; and US 3-month money market yields are based on the Nomura US Money Market Yield. The data presented above do not represent any product or strategy managed by Lazard and are provided for illustrative purposes only. Past performance is not a reliable indicator of future returns.

Source: Nomura, Lazard, Bloomberg

Exhibit 7
Returns in Different Inflation Environments, 1972–2012




As of 31 December 2012

High or low inflation distinction is relative to median CPI-U inflation for the period 1972 to 2012. Rising or falling inflation distinction is relative to the previous year CPI-U inflation rate. Bond returns are based on the Barclays US Aggregate Index since its inception in 1976 and a composite bond index prior to that. Equity returns are based on the S&P 500 Index price return and annual dividend yield. Cash returns are based on the Barclays 1-3 Month T-Bill Index since its inception in 1992 and 3-month T-Bill rates prior to that. Commodities returns are based on GSCI.

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Past performance is not a reliable indicator of future returns.

Source: BLS, Barclays Capital, Robert Shiller, Federal Reserve, Strategas/Ibbotson, Standard & Poor's, FactSet, J.P. Morgan Asset Management

In a yield-starved environment, equities can offer investors a robust total return, and in a period of rising inflation they can offer protection. While bonds and equities are both vulnerable to the ills of inflation, research shows that equities are generally resilient versus other asset classes, as displayed in Exhibit 7. This outperformance is not too surprising as inflation is essentially corporate pricing power, which impacts earnings and ultimately dividends, providing some level of insulation. In addition, as dividends tend to grow more quickly during periods of rising inflation, we would expect high-yielding equities to be more resilient than bonds should inflation accelerate.

In contrast, 10-year Treasury bonds yielding below 3% are clearly vulnerable to increasing inflation. This is true for corporate bonds as well, particularly during a mildly deflationary environment, as depressed earnings may not be sufficient to service debt.

We feel high-yielding equities offer an attractive risk-reward profile due to their resilience in a range of inflationary environments and yields that are currently more competitive relative to fixed-income alternatives than usual.

## Conclusion

In our view, the merits of investing in high-yielding stocks remain intact: historical outperformance driven by the efficacy of a dividend yield screen to identify undervalued companies, and the capital discipline that a regular dividend payment encourages. In addition, we currently see an opportunity to take advantage of the one area of the global capital markets—equities—where yields are above their historical average. As we see it, dividend coverage is relatively strong and is expected to further improve, and the dividends that were vulnerable in a weak economic environment have already been reduced to more sustainable levels. We believe that the combination of regular income and the potential for capital growth, should the economic recovery persist, are attractive in these uncertain times.

We feel an unconstrained opportunity set offers a range of opportunities for income, from mega-cap bond proxy type stocks that currently appear relatively expensive, to less efficient markets which offer greater potential to benefit from fundamental analysis. While sentiment on equities seems to be improving, the environment remains uncertain. As such, we feel that a broadly diversified equity income approach is a compelling option, as it offers an attractive income stream while seeking to capture the upside in future rallies.

## Notes

1 Source: Ping Zhou, CFA and William Ruland, "Dividend Payout and Future Earnings Growth," Financial Analysts Journal, (May/June 2006)

2 Source: MSCI, Data based on MSCI ACWI as of 31 December 2012

## Important Information

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Investments in emerging markets carry an above-average degree of risk due to the undeveloped nature of securities markets in the emerging countries. Investors should consider whether or not investment in such a strategy is either suitable or should constitute a substantial part of their portfolio.

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