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JOHCM Funds

Global Value and Income Dispatch

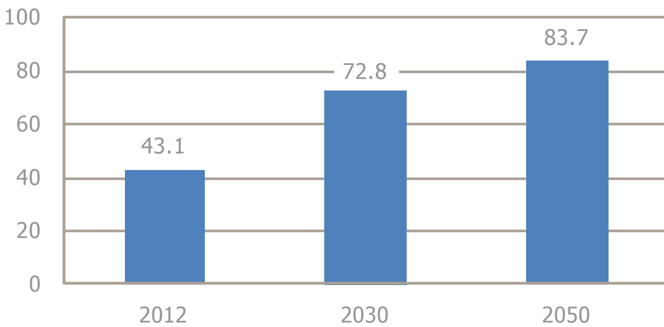
Looking for income? Three reasons to go global

By adopting a U.S.-centric approach to income, investors may unwittingly heighten their exposure to certain key risk factors and limit their diversification.

The income problem may last for decades

To some, the evolution of demographics is like watching paint dry. To fiscal planners, the image that may come to mind is more of a slow moving train wreck. Irrespective of one's perspective, the aggregate statistics are largely indisputable. In the U.S., the next couple of decades will see substantial increases in the number of retirees, with the total almost doubling from 2012 to 2050.

U.S. population 65 and over (millions)



Source: U.S. Census Bureau; An Aging Nation (2014).

This phenomenon is not unique to the United States, as dependency ratios are set to rise throughout much of Europe and Asia as well.

With many millions of households worldwide shifting from the **accumulation phase** of the investment lifecycle to the **distribution phase**, there is likely to be continued strong demand for income-generative assets.

With this strong and rising underlying demand, income generative assets may continue to display premium valuations for decades and income investors may be vulnerable to new product issuance that seeks to exploit the global income need. One example of this in the United States was the Master-Limited Partnership (MLP) bubble of 2014, where volatile energy businesses were able to raise capital at high valuations by portraying themselves as stable income sources.

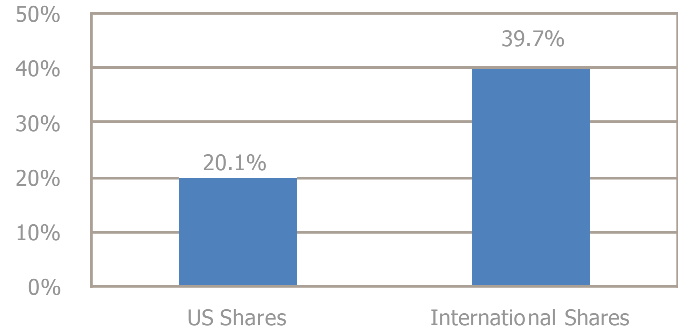
The importance of looking beyond the U.S.

While the United States offers very deep and rich capital markets, U.S. equities are deficient in many respects as a hunting ground for income investors. As a result, income seekers can suffer some unintended and potentially adverse consequences by focusing too narrowly on the U.S. We would like to highlight three key contrasts between the U.S. and the rest of the world.

#1 – A numbers game

Simply put, the proportion of business that pay high dividends is much higher outside the U.S. As illustrated below, almost 40% of the non-U.S. MSCI World stocks pay 3% dividends or more, compared with barely 20% in the United States.

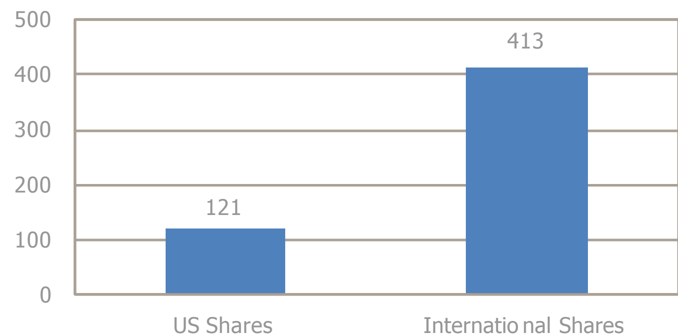
% of MSCI World paying 3% dividends or more



Source: Bloomberg. Data as of August 13, 2018.

When viewed in absolute numerical terms, the contrast is even more striking. There are simply many more opportunities to find attractively valued income streams outside the United States.

MSCI World companies paying 3% or more



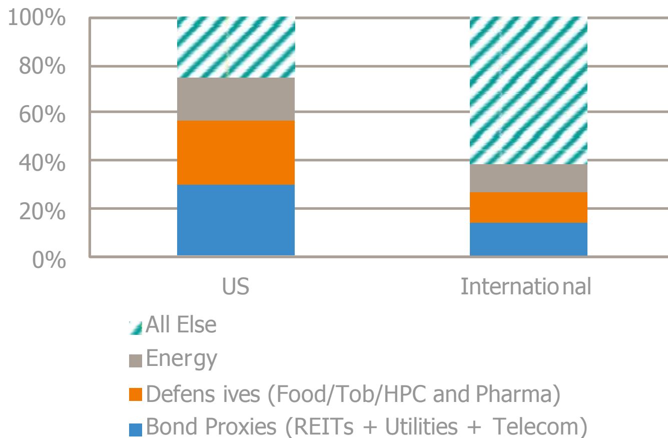
Source: Bloomberg. Data as of August 13, 2018.

The reasons for this discrepancy are debatable, but one explanation could be the historical tax advantage that capital gains enjoyed in the U.S. over dividends. Although the introduction of qualified dividends in 2003 addressed this disparity, buybacks continue to be used as a prominent way to return capital in the U.S.

#2—Geographic diversification is industry diversification

In addition to the numerical disparity, the composition of dividend payers varies considerably by geographic area. In particular, many of the **U.S. high dividend payers tend to be clustered in "bond proxy" sectors where investors may be exposed to significant interest rate risk.**

MSCI World companies with 3%+ yields by sector



Source: Bloomberg. Data as of July 2018.

Traditional bond proxy sectors (such as REITS, Utilities and Telecommunications shares) along with defensives (such as food and tobacco firms) make up more than **half** of the U.S. high dividend payers, versus only one quarter of the dividend payers outside the U.S.

When one adds in the energy sector (which includes the pipeline stocks and MLPs mentioned above), the total grows to **over three quarters of the U.S. dividend universe.**

The picture is the almost mirror image outside the U.S., where there are many more cyclical, industrial and commercial businesses offering attractive yields.

To summarize, for income investors, geographic diversification is industry diversification.

#3 – Cultural conservatism

Another possible reason for the disparity in income payers is the preponderance of family-controlled public companies outside the U.S. Controlling family shareholders often rely on dividend distributions to meet their liquidity needs, creating alignment with income investors. These businesses often tend to be conservatively managed and eschew financial leverage.

Conversely, in the U.S., public markets have been shaped by the corporate raiders of the 1980s and the activists of today who favor debt-funded buybacks as a way to crystalize returns quickly. If timed well, these measures can indeed create value. However, **the levered capital structures they leave behind, may not be suitable for income investors with more subdued risk appetites.**

A value filter is key

Income investors may continue to face an environment where yield is in high demand and the financial industry is eager to sell it. A value approach focused on a margin of safety can help identify when to say no to income and differentiate between attractive cash flow and "yield traps."

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