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BlackRock®

Income, evolved

A systematic approach to diversifying income sources

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Raffaele Savi
Head of Systematic Investing and Co-Head and Co-CIO of BlackRock Systematic Active Equity

Robert Fisher, CFA
Senior Portfolio Manager
BlackRock Systematic

Adam Riley
Head of International Wealth Platform Strategy for BlackRock Systematic

Summary

- A succession of central bank rate hikes ushered in a new regime in markets from 2022 onwards — one of higher interest rates and greater macro volatility. While sentiment in some of the world's leading central banks has now turned dovish, leaving investors expecting rate cuts going into the end of 2024, markets continue to operate in a new regime of heightened macro volatility.[1]

- Elevated fixed income yields have persisted in 2024, but the role of bonds as a diversifier in traditional 60/40 portfolios has come under question as markets saw a positive correlation between the returns of stocks and bonds in 2022 and 2023.[2]

- While traditional dividend-focused investment strategies historically have offered investors the opportunity to benefit from both equity exposure and income,[3] this has frequently come at the cost of increased style bias.

- A systematic approach to targeting a yield and risk level may help investors meet income targets, serve to dampen equity market volatility, and provide upside potential — while simultaneously reducing style bias and boosting diversification.

- In this paper, we investigate the breadth of the systematic toolkit and offer an evolved approach to income investing within equities, that may help investors better navigate the challenges presented by the current market environment.

1 Reuters, "Why Fed rate cuts matter to world markets," September 17, 2024. **2** BlackRock, "Rebuilding resilience in 60/40 portfolios," June 2023. **3** BlackRock, "Deep dive into dividend investing guide," April 2024.

Systematic income in the current market regime

Income yielding assets went through a reboot in 2022, as global central banks stepped back from bond purchases and wound down long running policies supporting quantitative easing. The traditional 60/40 portfolio endured one of the worst calendar year performances on record in 2022, while the traditional role of fixed income (as a diversifier against equity market declines) came under scrutiny.[4] Today, whilst sentiment in some of the world's leading central banks has become more dovish, the proportion of global fixed income assets yielding greater than 4% has persisted at the elevated levels reached in 2023 (as shown in Figure 1). Higher yields mean income-oriented investors have more choice to generate income. However, higher correlations between bonds and equities, increased macro volatility, and questions around the overall strength of global economies has given investors a lot to consider when evaluating how to seek to generate consistent income for their portfolio.

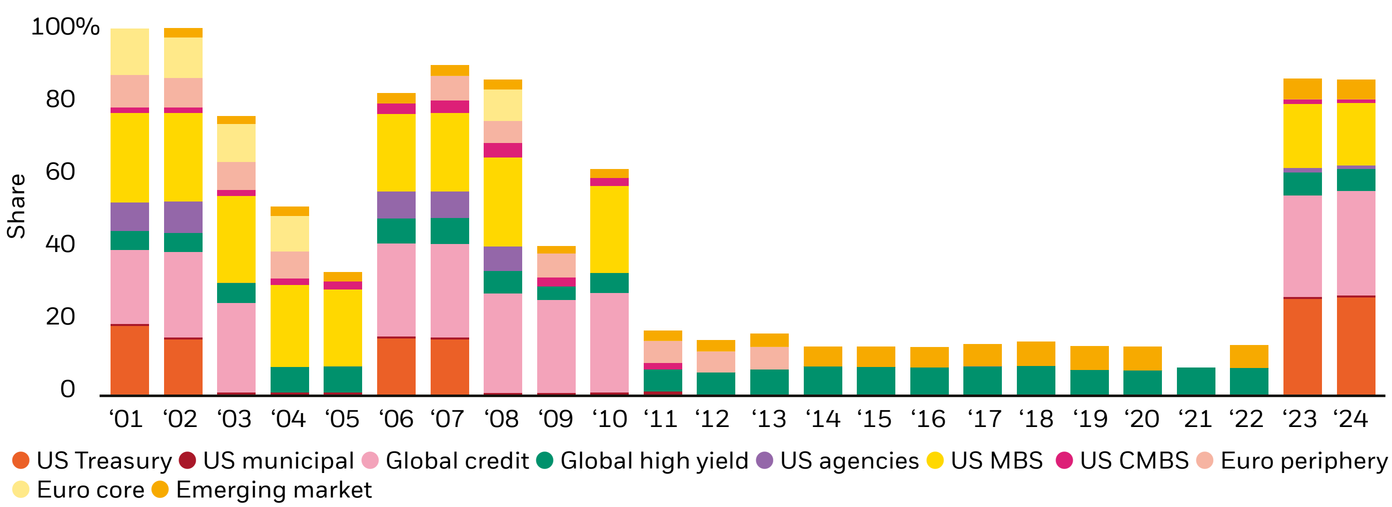
Irrespective of the interest rate environment or market dynamics, not all income strategies are created equal. Headline market drivers in early 2024 were reminiscent of those in 2023. Resilient macro and micro data drove continued strength across global stocks, despite stubbornly sticky inflation data contributing to rates markets unwinding expectations for policy easing. Mega-cap technology stocks and AI leaders continued to drive gains, while interest rate-sensitive sectors lagged. As a result, investors who chose to hold their assets in cash or interest rate-sensitive securities missed out on substantial equity market returns.

Global stocks gained 11.30% in the first half of 2024 amid higher levels of macroeconomic volatility.[5] US inflation data spiked bond yields, which later eased as economic activity cooled. In Europe, volatility rose due to a snap election in France. Additionally, a surprise hawkish move by the Bank of Japan in August caused global equity market turbulence as the Yen carry trade unwound.

What's become apparent is that the current market regime likely holds more volatility, greater interest rate uncertainty, and pockets of sticky inflation. Despite the continuation of an elevated yield environment in 2024, ongoing market volatility highlights that innovative alpha capture will help add resilience in portfolios.

Figure 1: Yield is back

Fixed income indexes yielding over 4%, 1999-2024



Sources: BlackRock Investment Institute, with data from Refinitiv Eikon, July 2024. Note: The bars show market capitalization weights of assets with an average annual yield over 4% in a select universe that represents about 70% of the Bloomberg Mulitiverse Bond Index. Euro Core is based on French and German government bonds indexes. Euro periphery is based on an average of government debt indexes for Italy, Spain and Ireland. Emerging markets combine external and local currency debt. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.**

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4 In 2022, a globally diversified 60/40 portfolio returned -16%. Sparks, Andy. "The 60/40 Portfolio Is Sick. Can It Recover?" MSCI, 21 September 2022, www.msci.com/www/quick-take/the-60-40-portfolio-is-sick-can/03397595154. **5** MSCI All Country World Index's (ACWI) as of June 30, 2024.

A diversifying source of income

Dividends have played a significant role in boosting investors' total return over time, making dividend-paying stocks an attractive option to deliver income in portfolios.[6] During select decades (particularly when equity returns were under 10%), dividends have contributed over 50% of the total return of major indices.[6] Figure 2 illustrates the contribution dividends have made over the last 12 months by region.

In addition to dividends providing a diversifying source of income and contributing to total return over longer time horizons, equity investing for income has three key benefits in our view:

Dividends reflect earnings power

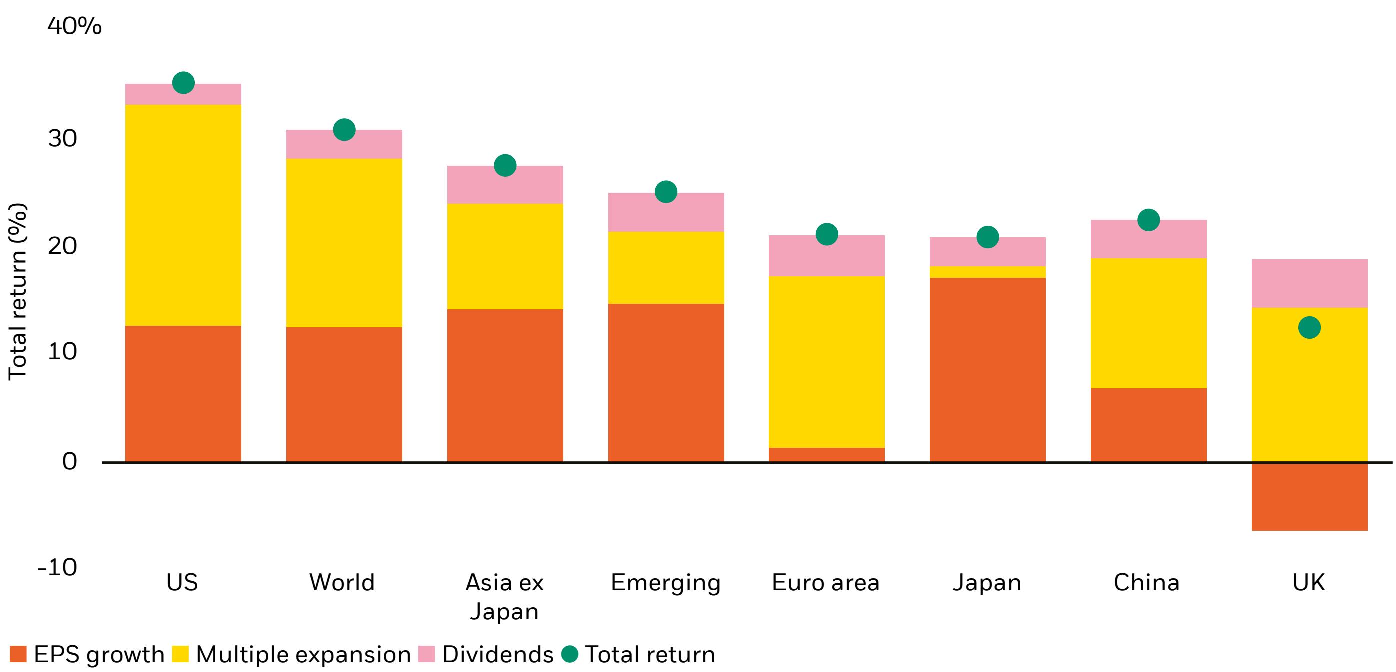
As the quality of earnings comes into greater focus for investors, analyzing companies based on dividend per share, dividend growth and the sustainability of dividend payout can unearth telling evidence about a company's financial health. Investors focused on companies characterized by lower debt and higher profitability tend to be investing in more mature, higher quality companies with greater financial flexibility. These higher quality companies generally offer greater resilience during market selloffs and tend to maintain their earnings growth throughout market cycles.

Dividends help mitigate potential losses from declines in equities

Historically, stocks that grew or maintained their dividend have outperformed non-dividend-paying stocks, or stocks that cut dividend payments.[7] During equity market declines, dividend paying stocks can offer a cushion to help offset the short-term unpredictability of share prices. Management teams of dividend-paying corporations tend to avoid making dividend cuts unless absolutely necessary.

Figure 2: Dividends contributed significantly to total return

Sources of total return – last 12 months by region



Source: LSEG Datastream, MSCI and BlackRock Investment Institute. October 15, 2024.
Notes: The bars show the breakdown of each market's 12-month return into dividends, earnings growth and valuation (multiple). The dots show each market's total 12-month local-currency returns. Earnings growth is based on the 12-month change in 12-month forward I/B/E/S earnings estimates. World is defined as the MSCI All Country World Index ($). Returns are based on MSCI indexes.

Past performance is not a reliable indicator of current or future results. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

6 The Economist, "The dividend is back. Are investors right to be pleased?" February 8, 2024. **7** Ned Davis Research, Inc. and Refinitiv, Jan 1973-Dec 2023.

Dividends help return purchasing power to investors

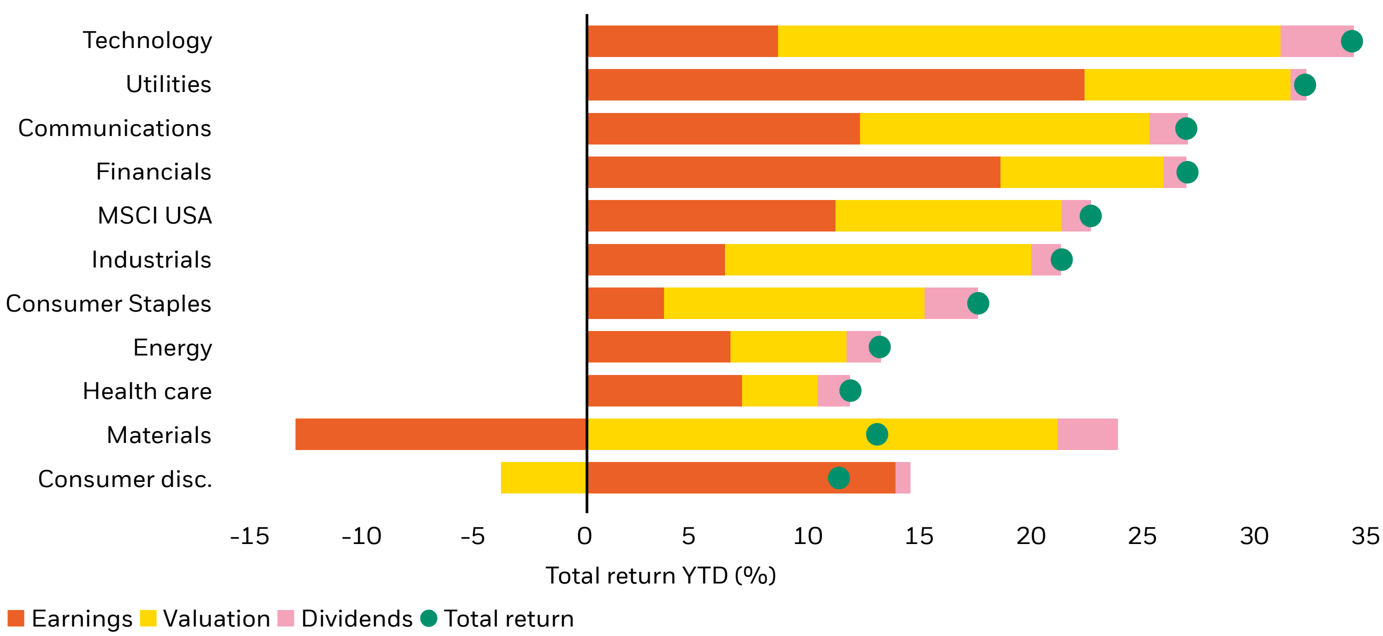
Inflation has impacted nearly every area of the economy, but the impact of purchasing power on investor capital is often overlooked. As an example, the MSCI UK index appreciated 17.6% on a one-year basis through August 30, 2024.[8] Meanwhile the annual inflation in the UK was 3.1% through July 31, 2024.[9] Therefore the 3.6% dividend yield contribution comes into its own, when you consider that it more than offsets the negative impact of inflation that the investor experiences.

While we believe dividend-paying stocks can be riskier than bonds, a focus on high quality dividend yielding stocks can help dampen equity market volatility, offer investors a way to maintain equity exposure to capture potential price appreciation, and help contribute reoccurring income. Despite these attractive qualities, pursuing high-yielding stocks alone can generate portfolios with higher exposure to certain sectors and style factors, including value (as shown in Figure 3).

Banking, consumer staples, and utilities stocks are typically well represented in equity dividend strategies, but also tend to be established companies that offer lower growth potential. Consequently, traditional equity dividend portfolios typically exhibit an inherent value bias. In addition, dividend yields for major indices like the S&P 500 Index have fallen considerably to 1.3%, as of August 30, 2024 (relative to over 6% at peaks in the early 1980s), which may be lower than the income levels required by some investors.[10] These dynamics have been a headwind for equity income strategies. As a result, traditional dividend yield strategies largely fell out of favor with investors, until recently. Our response, as systematic investors, was to thoughtfully design a different equity dividend solution that could be diversifying to client portfolios and more appealing to clients. A solution that targets a higher yield and lower risk, *without* the value footprint of a traditional equity income strategy.

Figure 3: Sector variance in dividend contribution to return

US sector sources of return – year to date



There can be no guarantee that the investment strategy can be successful and the value of investments may go down as well as up.
Source: LSEG Datastream, MSCI and BlackRock Investment Institute. October 15, 2024.
Notes: The bars show the breakdown of each sector's year-to-date return into dividends, earnings growth and valuation (multiple). The dots show each sector's total year-to-date returns. Earnings growth is based on the year-to-date change in 12-month forward I/B/E/S earnings estimates.

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8 MSCI United Kingdom Index (GBP) gross return, August 30, 2023 to August 30, 2024, https://www.msci.com/documents/10199/3b75b636-55c0-4ce8-a8aa-6bb70e12b99d. **9** July 2024, latest printed figure. UK annual inflation rate, https://www.ons.gov.uk/economy/inflationandpriceindices. **10** Bloomberg, as of August 2024.

Systematic tools help reduce style bias

As the Covid-19 pandemic hit in 2020, many companies across the world postponed, canceled or reduced their dividends. In the MSCI ACWI Index, 279 stocks cancelled their dividend all together.[11] Plummeting yields, growth stock dominance, and dividend companies suspending or reducing payments left equity focused income investors confronted with a triple threat in their portfolios. Traditional financial information pulled from financial statements, such as details on net assets on a balance sheet, financial leverage position, cash flows, and dividend history, gave little guidance to assess future payout ratios, debt levels and dividend growth in a pandemic driven market. But what if investors employed a "real time" modernized approach to navigating the challenges faced by investors?

As systematic investors, we believe in the power of incorporating alternative data into our investment approach. This can help spur more informed decisions at greater scale. We augment traditional data, such as dividend announcements and confirmed dividend payments, with alternative data and machine learning tools. These tools can help us better assess the health of a company and the future likelihood of it paying, and growing, its dividend. Using machine-learned large language models to extract differentiated insights from job postings, management sentiment, and central bank speeches can help us efficiently form an *alternative* view of a company's future return potential relative to other companies across the entire market. To put that scale into context, our investment models can help us forecast the dividends for over 3,000 companies in the market — which is practically only possible through a scalable, systematic investment approach.

Through this systematic lens, we believe we can devise better ways to anticipate, and efficiently capture — or harvest — dividends. We believe we can also use these dimensions to build a portfolio that is more diversified and has less of a style tilt to value companies than the typical equity dividend strategy. We do this through a "dividend rotation" strategy that forecasts payment dates to more efficiently allocate capital to firms with variable dividends when more yield is available. Our overall philosophy for managing a portfolio of stocks with a higher-than-average dividend yield is based on the hypothesis that if three stocks each have a 1% yield, and pay their dividend at different times of the year, we can theoretically source 3% income annually at the portfolio level. This strategy offers a greater range of flexibility in its composition and is not constrained to a "buy and hold" approach to dividend yielding companies.

There can be no guarantee that the investment strategy can be successful and the value of investments may go down as well as up.

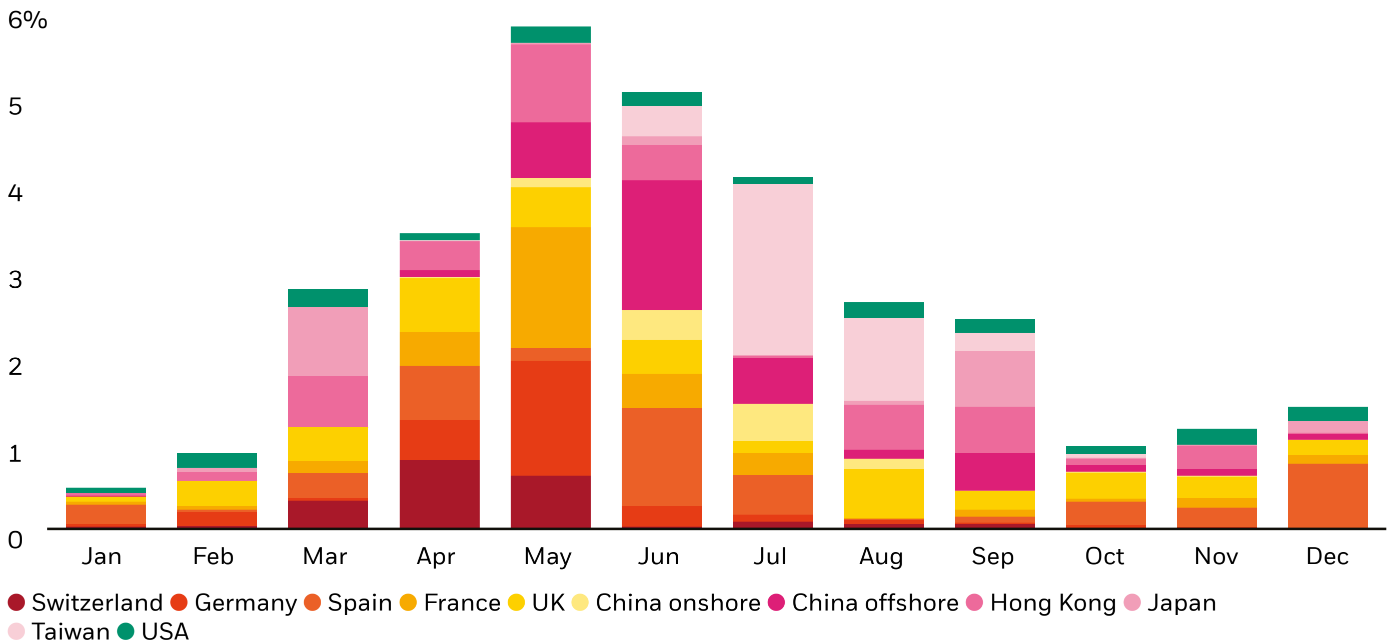
11 MSCI, "Robust Selection Paid Dividends," May 2020, https://www.msci.com/www/blog-posts/robust-selection-paid-dividends/01837227103.

Dividend payment dates range widely across countries. In Canada, Ireland, or the US, it's more common to have quarterly dividend payments, while countries such as Australia, Japan, Korea, or the UK tend to have semi-annual dividend payments. In continental Europe, many countries issue annual dividend payments, making a traditional buy-and-hold strategy less effective than one that could dynamically overweight positions prior to payout. For example, the largest company in the Swiss stock exchange is Nestlé, the world's largest food and beverage company.[12] Nestlé usually pays its annual dividend each April, following shareholder approval at its Annual General Meeting. A systematic approach offers the opportunity to screen thousands of securities based on dividend growth, profitability, and other metrics to help investors time their exposure to these payments to deliver income and potential alpha. Figure 4 shows in practice how this rotation strategy can be scaled to take advantage of the seasonality of dividend payments across countries, with European companies tending to focus payments in March-May, Taiwanese companies in July and August, and Japanese companies making two payments in March and September.

Harvesting dividends and rotating into other stock specific opportunities could have helped income investors generate positive total returns during 2019's growth market. Simultaneously, a rotation strategy would likely have outperformed a traditional dividend strategy during 2020, when "stay at home" growth stocks (like Apple, Netflix, and Google that benefited from accelerated use of their services during this period) surged, and traditional funds were forced to buy and hold dividend stocks that lagged the market. Conversely, this approach may trail the performance of a typical dividend strategy characterized by a value or quality tilt when those styles are in favor, for example in 2022. We believe a systematic approach to income investing makes it possible to achieve greater diversification across income sources, while also reducing risk and increasing yield at the portfolio level.

Figure 4: Seasonality of dividend payments across countries

Monthly dividend yield breakdown by country



Source: BlackRock. Average yield paid each calendar month by companies in selected countries and industries 2018-2023. Data as of December 31, 2023.

Diversification and asset allocation may not fully protect you from market risk. While the investment approach described herein seeks to control risk, risk cannot be eliminated.

12 Reference to the company name mentioned in this communication is merely for explaining the investment strategy, and should not be construed as investment advice or investment recommendation of those companies. Nestlé is the largest company based on market cap as of September 30, 2024.

Two sources of income can help combat sticky inflation and interest rate uncertainty

Strategies seeking dividend-paying companies, that combine healthy balance sheets with solid yields, generally help bolster whole portfolio resilience. But as uncertainty lingers around interest rates staying higher for longer and market volatility remains elevated, there is a continued need to evolve income strategies in order to seek to deliver positive inflation-adjusted returns, irrespective of market environment.

To meet this need, systematic investors consider all the tools in the toolkit to meet tailored investment outcomes. Incorporating the use of derivatives, such as call overwriting, can be strategic within an income equity solution in times of higher market volatility. Using call overwriting in combination with delta hedging can help reduce directional risk, help generate additional income, and assist with the management of overall portfolio risk.

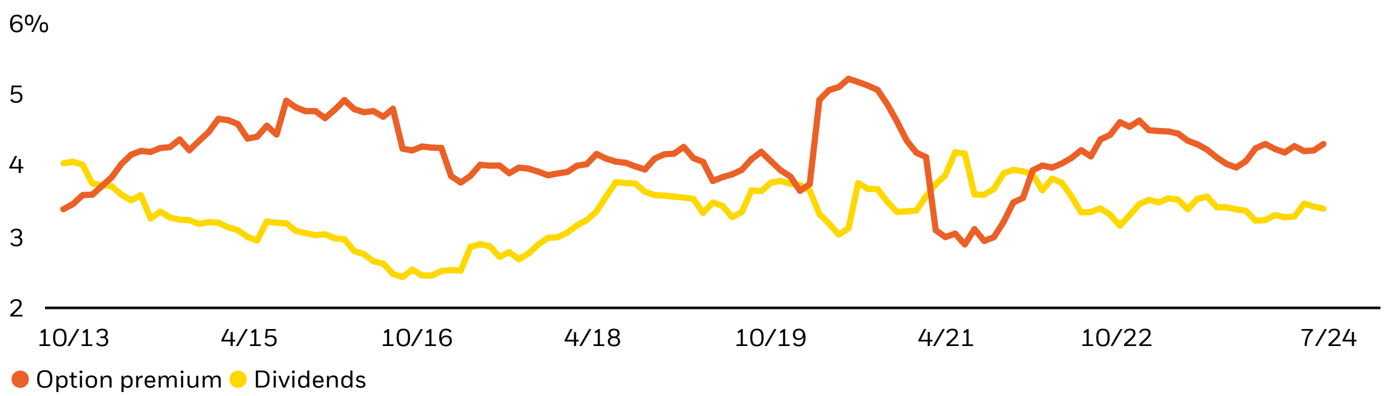
Income optionality

A call option is one of the most basic forms of options contracts, and gives the buyer the right, but not the obligation, to buy shares of a stock at a specified price, up to a defined expiration date. A call option buyer profits when the underlying asset price increases (beyond the total of the specified price and cost of the option) and the buyer exercises the option to buy as markets go up. A call option can also be implemented using exchange traded (listed) index options to mitigate counterparty risk, help generate additional income, and help reduce stock specific idiosyncratic volatility. In essence, call options can provide a tool that may help investors incrementally enhance yield.

To offset this risk of potential upside getting "called away," investors can purchase index futures contracts to "delta hedge," or reduce the directional risk associated with the overwriting strategy (selling covered call options on a long equity position). The delta hedge ensures an overwriting strategy doesn't sell away too much upside (as buyers exercise the option if markets go up). Exchange traded futures contracts seek to allow investors to hedge the market risk associated with the potential direction of a security or financial instrument. As an illustrative example, Figure 5 shows how these two return sources can be used in tandem. A strategy employing these tools in a diversified portfolio with hundreds of companies could typically have a handful of covered call options contracts and four futures contracts that are continually priced and exchange traded. In this way, an enhanced income strategy can boost income using two sources of income and target specific amounts to precisely hit a desired income level per year.

Figure 5: Two sources of income may be better than one

12-month rolling income generation by strategy since September 2013



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Delivering income systematically

A desirable outcome for most income-focused investors is the ability to generate higher levels of income, at lower levels of risk, with enhanced diversification characteristics. As systematic investors, we believe there is a fourth piece to this puzzle: the ability to deliver these targeted levels of income more consistently over time. Traditionally equity income strategies rely on buy-and-hold approaches that target higher-yielding equities to generate income. We believe today's market dynamics require an approach that is more agile. We leverage cutting edge technology to identify shifts in dividend payment frequencies across both industries and countries. In addition, we have found new ways to incorporate the use of an options premium, written on indices rather than single stocks, to complement our positioning in high income opportunities. Using this model, we exchange potential market upside for a secured premium, and help preserve high conviction stock selection views. This evolved approach to income investing seeks to provide investors with a systematic approach to target diversifying income sources more consistently.[13]

13 Diversification and asset allocation may not fully protect you from market risk.

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