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BlackRock®

Income, evolved

A systematic approach to diversifying income sources

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Summary

- A succession of central bank rate hikes has ushered in a new regime in markets — one of higher interest rates and greater macro volatility — to combat stickier inflation than many had originally anticipated.

- Fixed income yields have risen appreciably, but the role of bonds as a diversifier in portfolios has come under question as correlations with equities provided little downside mitigation to 60/40 portfolios in 2022.[1]

- While traditional dividend-focused investment strategies historically have offered investors the opportunity to benefit from both equity exposure and income,[2] 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 this new market regime.

1 BlackRock, "Rebuilding resilience in 60/40 portfolios," June 2023. **2** BlackRock, "Deep dive into dividend investing guide," November 2022.

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Systematic income in a new regime

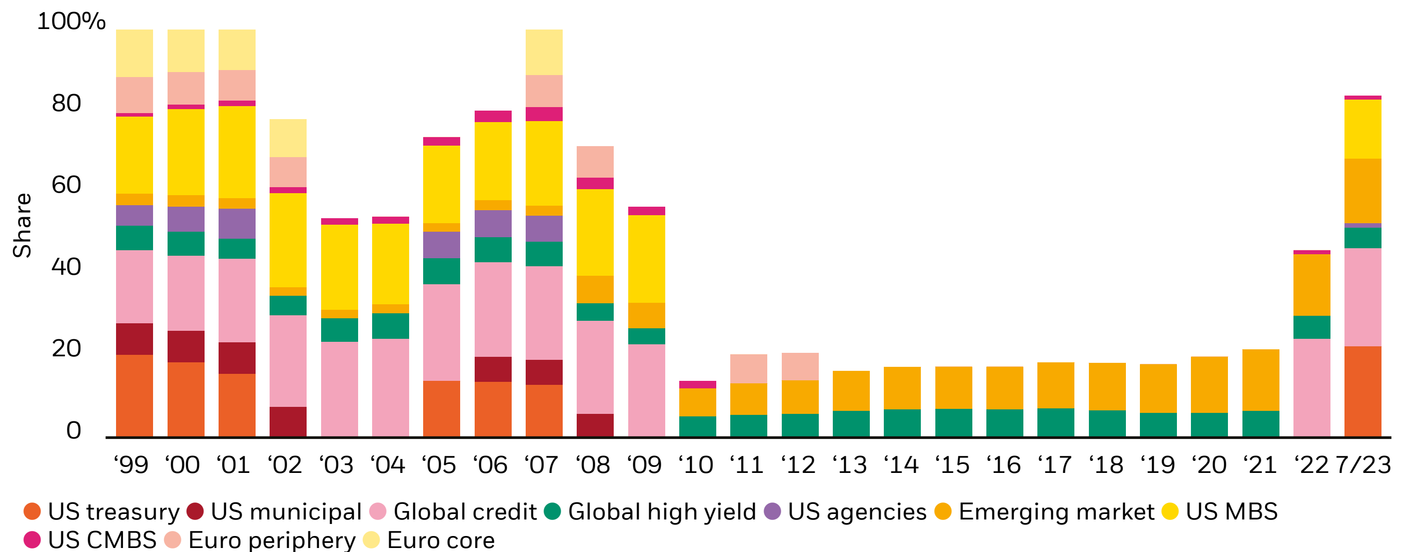
Income yielding assets went through a reboot in 2022, as global central banks stepped back from bond purchases and wound down long running policies supporting quantitative easing. The traditional 60/40 portfolio endured one of the worst calendar year performances on record in 2022, while the traditional role of fixed income (as a diversifier against equity market declines) came under scrutiny.[3] Today, higher yields mean income-oriented investors have more choice to generate income (as shown below in Figure 1). 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. The first half of 2023 has revealed some stark differences. The year started risk on. China re-opened and equity markets rallied. Investors who moved their assets to cash missed out on early year returns. Then in February and March, January gains were erased as fears around rate increases reemerged only to be trumped by the collapse of select US banks and ensuing bank stock volatility. More recently, a tech-led rally fueled by earnings for generative AI leaders has driven the best first half year returns for the NASDAQ Index since 1983 and advanced most equity indexes by double digits.[4] Simultaneously, many investors parked in cash and invested in fixed income missed out on the equity rally.

What's become apparent is this new regime likely holds greater uncertainty, more volatility, and stickier inflation than many predicted.[5] Despite a more favorable yield environment, increased market volatility has helped raise awareness that cash returns alone won't deliver the yield necessary to counter the bite of persistently higher inflation. In our view, today's environment calls for a more innovative approach, and strategies that leverage a systematic lens may provide an investment edge.

Figure 1: Yield is back

Fixed income indexes yielding over 4%, 1999-2023



Sources: BlackRock Investment Institute, with data from Refinitiv Eikon, August 2023. 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.**

3 In 2022, a globally diversified 60/40 portfolio returned -16%. **4** Bloomberg, as of June 30, 2023. **5** Curran, E. and A. Saraiva, Bloomberg, "Inflation Is Sticky, But Economists Can't Agree on Why," April 27, 2023.

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.

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

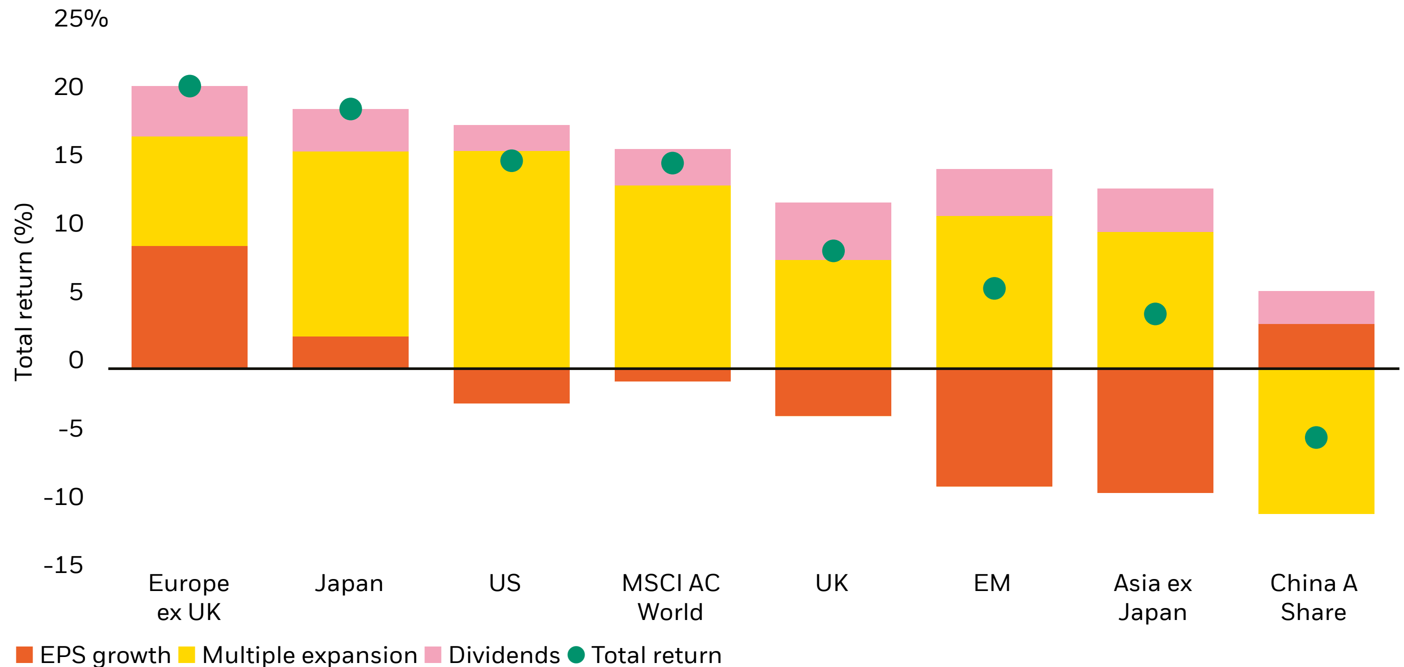
As the quality of earnings comes into greater focus for investors, analyzing companies based on dividend per share, dividend growth and the sustainability of dividend payout can unearth telling evidence about a company's financial health. Investors focused on companies characterized by lower debt and higher profitability tend to be investing in mature, higher quality companies. 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: Refinitiv Datastream, MSCI and BlackRock Investment Institute, Jul 26, 2023.
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 year-to-date change in 12-month forward Institutional Brokers' Estimate System ("I/B/E/S") earnings estimates. World is defined as the MSCI All Country World Index ($ USD). Returns are based on the MSCI indexes.

6 BlackRock, "Why dividend stocks are back in fashion," February 8, 2023. **7** Ned Davis Research, Inc. and Refinitiv, Jan 1973-Dec 2022.

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Dividends help return purchasing power to investors

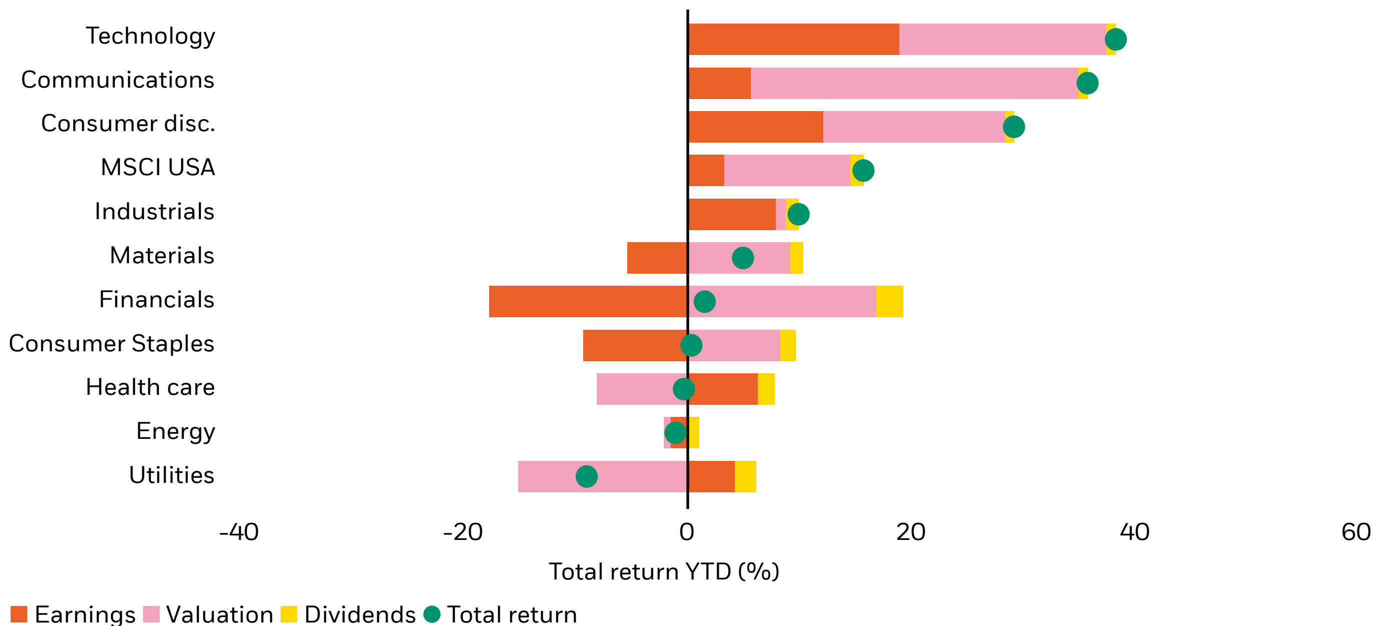
Inflation has impacted nearly every area of the economy, but its impact of purchasing power on investor capital is often overlooked. As an example, an investment in the MSCI UK Index appreciated 6.8% on a one-year basis through July 31, 2023.[8] Meanwhile, inflation ran at 6.4% during this same year-over-year period, eating the majority of investors' total return.[9] But without a 3.8% dividend yield contribution, the results against the bite of inflation would have been far worse for investors.

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 contributes 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 1.5% as of June 30, 2023 (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



Source: Refinitiv Datastream, MSCI and BlackRock Investment Institute. Jul 26, 2023.
Notes: The bars show the breakdown of each sector's year-to-date return into dividends, earnings growth and valuation (multiple) for the MSCI USA Index. 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. **The figures shown relate to past performance. 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.

8 MSCI United Kingdom Index (GBP) gross return, July 31, 2022 to July 31, 2023, https://www.msci.com/documents/10199/3b75b636-55c0-4ce8-a8aa-6bb70e12b99d.
9 UK annual inflation rate, https://www.ons.gov.uk/economy/inflationandpriceindices. **10** Bloomberg, as of August 2023.

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.

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

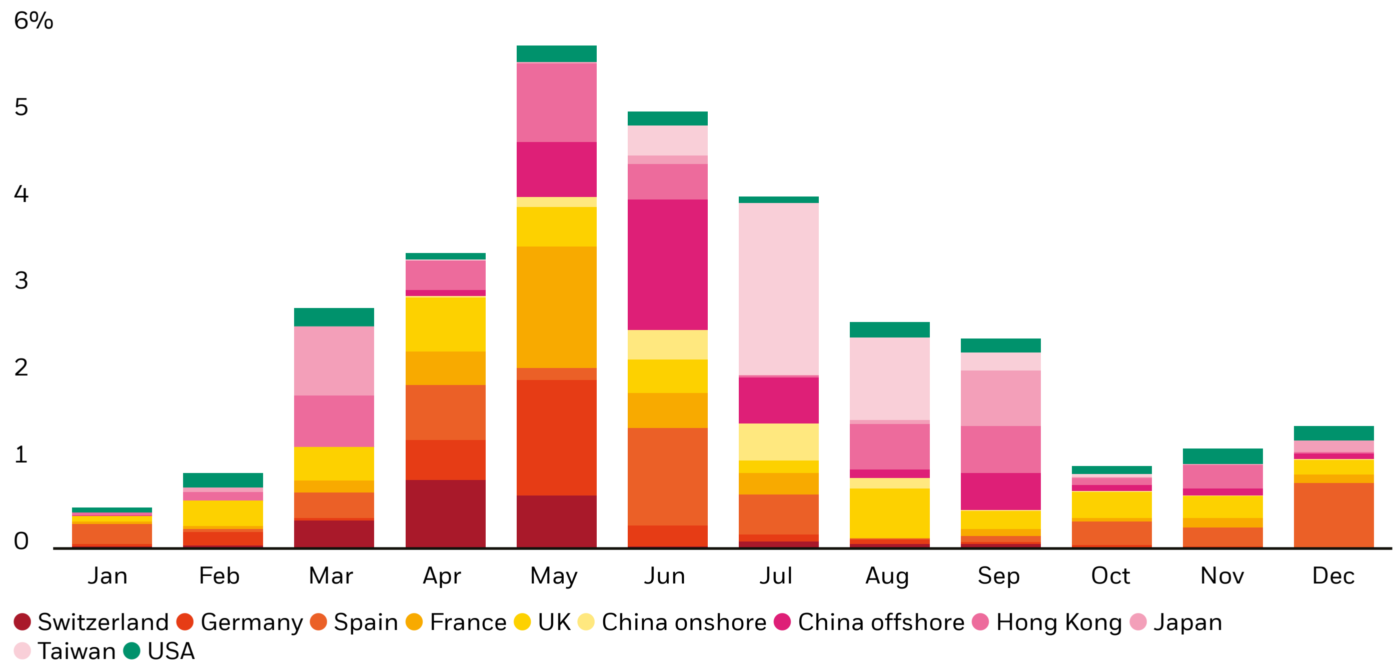
There can be no guarantee that the investment strategy can be successful and the value of investments may go down as well as up.

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. Income-focused investors armed with this knowledge could target exposure to Nestlé each April just prior to each annual payment. A systematic approach offers the opportunity to screen thousands of securities based on dividend growth, profitability, and other metrics to help investors time 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 the typical dividend fund during 2020, when "stay at home" growth stocks 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 2018-2022. Data as of December 31, 2022.

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.

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

While dividend strategies held up better than broad equity markets in 2022, the degree of outperformance has varied widely depending on the specific approach.[13] Strategies seeking dividend-paying companies that combine healthy balance sheets with solid yields generally helped 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 to be able 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.

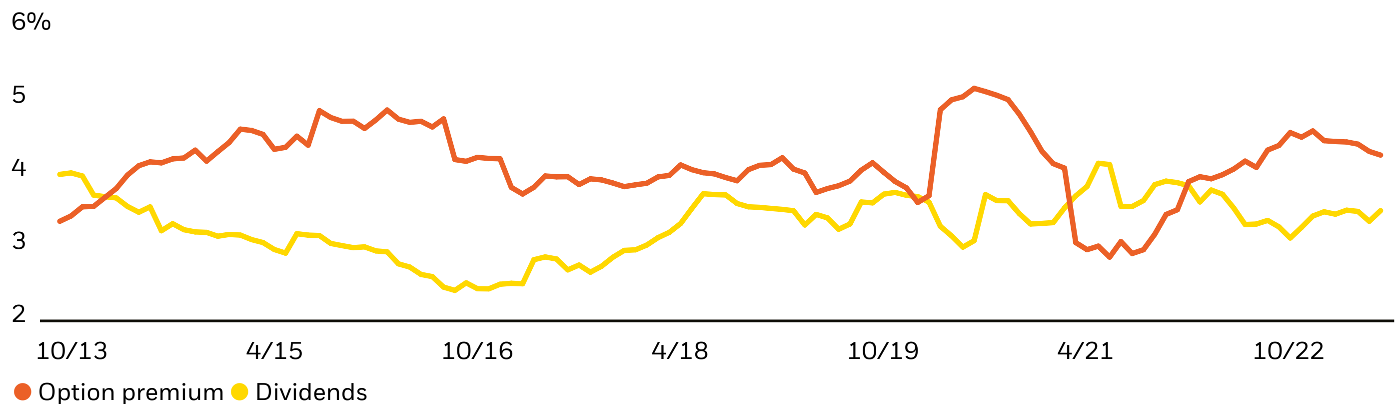
Income optionality

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 October 2012



There is no guarantee that a positive investment outcome will be achieved. For illustrative purposes only. Source: BlackRock, as of March 31, 2023.

13 Morningstar Direct, Morningstar Indexes. Data as of December 31, 2022.

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.[14]

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

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