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Aegon Asset Management

A time for dividends to shine

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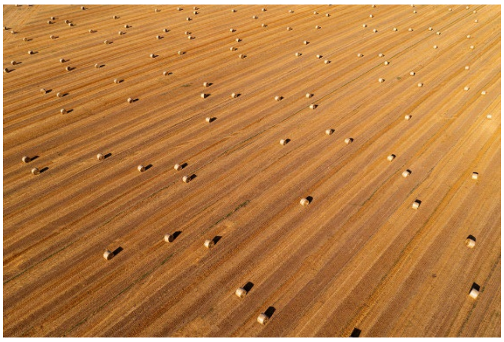
The past decade has been an exceptionally profitable period to be invested in global equity markets, with the MSCI AC World Index averaging 10.6% per annum in the 10 years to 31 March 2022*. Solid GDP growth, low interest rates and the emergence of hugely disruptive and profitable technology companies combined to create a favourable environment for global companies. Can it last?



There are reasons to be optimistic: robust corporate and individual balance sheets, fiscal stimulus, and many stocks trading on attractive valuations. But there are reasons to be cautious: the continuing impact of Covid19, high government debt levels, the war in Ukraine, slowing GDP expectations, and concerns about rising inflation.

This more cautious case is gathering momentum. Inflation is now 8.5% year-on-year in the US, while GDP expectations are being revised downward, with global growth now expected to be in the region of 3%, down from 4% just a few months ago. Most cycles of tightening by the US Federal Reserve end in recession and this may be no different.

Equity investing can seem easy when you have a strong view on the direction of the market. Bulls can buy the market, go fully invested and seek exposure to high beta. Bears can stay on the side-lines. What if you anticipate a more uncertain outcome, where you think there is likely to be upside, but want some protection if you are wrong? This requires a more nuanced approach, one that lets you participate in the market upside during the good times, while offering defensive qualities and steady income payments during the bad times.

We believe dividend-focused equity investing is a solution worth considering and specifically the Aegon Global Equity Income Fund, which has its tenth anniversary in 2022. The Fund has a distinctive 'quality income' approach and a strong record of meeting its objectives.

* Source: Aegon AM. USD, 10 years to 31 March 2022.

Capturing the upside, defending the downside

Traditional equity income funds tend to do as the name suggests – focus on income. They typically concentrate on higher-yielding sectors, such as pharmaceuticals and telecommunications, even when these are struggling to keep up with rising equity markets.

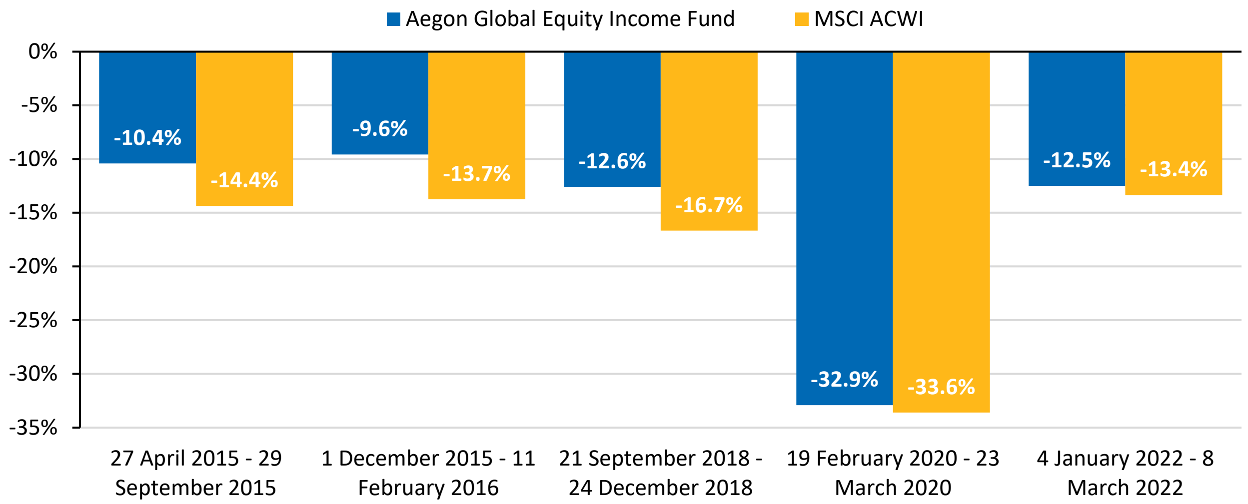
The Aegon Global Equity Income Fund is different. Our portfolio is currently underweight in telecommunications and only marginally overweight in pharmaceuticals. Instead, we have modest overweight positions in utilities, real estate and consumer staples, while our largest overweight positions are in financials and technology. Atypically for an income-themed strategy, stocks such as Tokyo Electron, Microsoft, Broadcom, Samsung Electronics and Taiwan Semiconductor Manufacturing Company are core holdings.

We have achieved top quartile returns relative to peers over three and five years, and since launch**. One reason for our success has been our effectiveness at preserving capital during periods of falling markets. Because we focus on high-quality income-generating stocks our approach has been relatively resilient during such downturns.

** Source: Aegon AM. Source: Lipper as at 31 March 2022. NAV to NAV, noon prices, income reinvested, net of ongoing charges, excluding entry or exit charges. Sector median source: Lipper. Median is Lipper Global Equity Global Income. Inception 28 September 2012. Primary share class is Aegon Global Equity Income Fund C (Inc) USD shares. Fund rankings are compiled using Lipper Primary share classes, which are generally the highest charging share classes available and are usually the 'A' retail share classes for Aegon funds.

One way of thinking about downside protection is how much the fund falls when the market has a meaningful correction. In chart 1 we show what happened to the Fund and the benchmark in the instances where the market corrected by more than 10%. In each case the Aegon Global Equity Income Fund outperformed the MSCI AC World Index net of fees.

Chart 1: Equity downturns of more than 10%



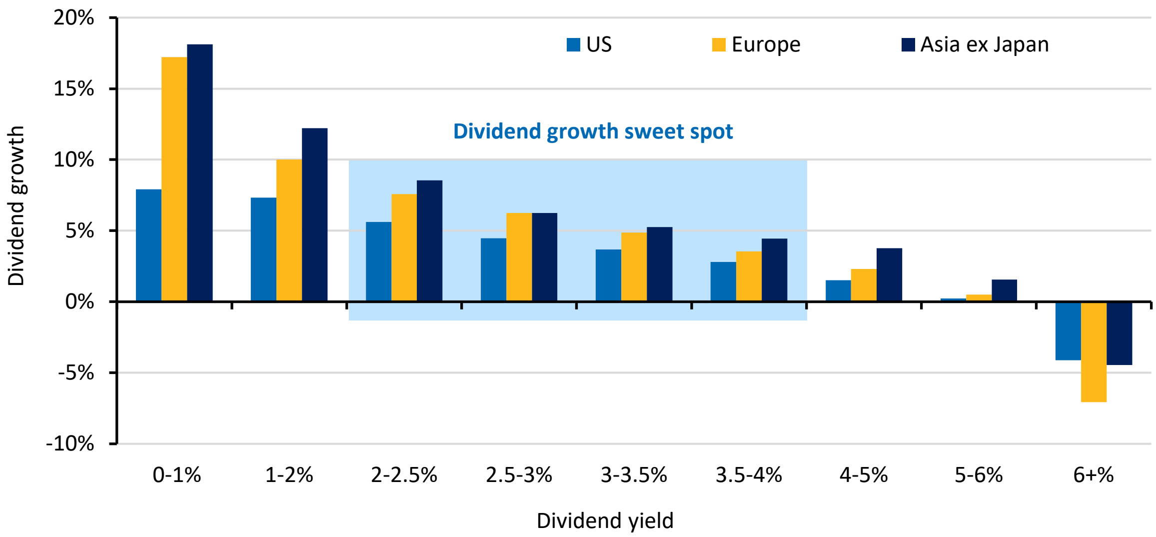
Source: Aegon Asset Management. Aegon Global Equity Income C USD. Chart shows Fund performance (net of ongoing charges and noon-priced), during periods where global equities sold off by more than 10% since inception on 28 September 2012. Index is MSCI AC World Index USD.

The dividend sweet spot

The Aegon Global Equity Income Fund targets a 30% income premium to the wider global equity market as defined by the MSCI All Country World Index. This 30% premium is what we call the income 'sweet spot'. Any less and the income may not offer protection, any more and the income becomes vulnerable to dividend cuts.

Crucially, our fund is premium yielding rather than high yielding. Our income is stable and growing rather than high, which helps to protect the downside. History shows that once stocks have a dividend yield over 4% then the dividend growth slows materially. Above 5% and the growth becomes negligible, while above 6% and the dividends typically decline. We illustrate this on chart 2, which shows our dividend yield 'sweet spot' of between 2% and 4%.

Chart 2: Finding the dividend growth sweet spot



Source: SG Cross Asset Research/Equity Quant, June 2021.

Aristocrats, Kings and Diamonds

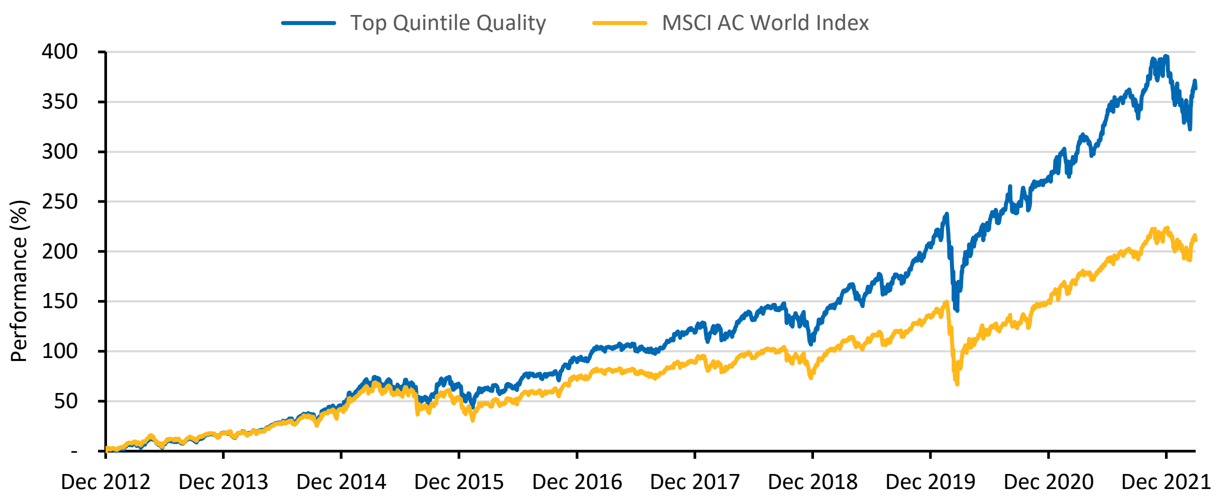
'Dividend Aristocrats' are companies which have increased their dividend every year for more than 25 years. We own several in the Fund, including Automatic Data Processing, NextEra, Albemarle and Air Products.

A 'Dividend King' is a company with at least 50 years of dividend increases. Pepsico is due to join that elite band next year, while Johnson & Johnson and Cincinnati Financial have raised their dividends for over 60 consecutive years, making them 'Dividend Diamonds'.

Only high-quality businesses can sustain growing dividends over such long periods. We define 'quality' as profitability, measured by return on equity, and balance sheet strength. It is our focus on quality which allows us to target a 30% income premium to the market, while also benefitting from capital appreciation in rising markets and offering downside protection during challenging times.

In short, we believe that across a market cycle, quality is likely to outperform. Intuitively this sounds sensible, but it has also been borne out by analysis. Comparing the return of the MSCI AC World Index to the highest quality quintile within that index is instructive. As chart 3 illustrates, in the period from 31 December 2012 to 31 March 2022 the MSCI AC World Index rose by 211%, but the highest quality quintile within that index (as measured by return-on-equity and net debt/EBITDA) rose by 368%*.

Chart 3: Quality vs the broader global equity market



*Source: Aegon Asset Management. From 31 December 2012 to 31 March 2022, Euro.

A reliable strategy in uncertain times

Equities have proven to be an excellent long-term asset class and are an important part of any asset allocation. With an interest rate tightening cycle just one of several economic headwinds, unbridled enthusiasm for equities is being replaced by cautious optimism. We believe this strengthens the case for a strategy which focuses on quality income and can enjoy the upside of rising markets, while offering some protection should markets falter.

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