Investment Focus

Global Equities
as a Source of Income

The economic and capital markets volatility of recent years has reduced the attractiveness of equities to many investors and has led to unprecedented inflows into fixed-income mutual funds. However, the yields available in fixed-income markets were already low by historical standards, and the recent flows of money have further reduced those yields. Conversely, dividend yields have begun to rise, as corporate earnings continue to recover. 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 can access the most attractive high-yielding stocks globally, thus potentially maximizing income and capital growth.

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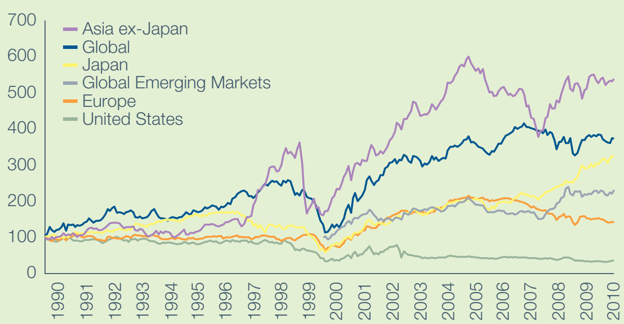
Global versus Domestic

Looking at the regional performance of high-yielding stocks, dividend-paying companies have outperformed the broad indices over the long term. The United States is the only market where high-yielding stocks have underperformed, as U.S. companies have traditionally not paid high dividends—generally, in the United States dividends are paid in defensive sectors, primarily utilities.

Europe may have underperformed over the past few years, but there have been some pockets of outperformance. The most important point to take away from Exhibit 1 is the relative position of global stocks—near the top, just below Asia ex-Japan—when we would expect them to be in the middle. Far from simply delivering average returns, the reason for the outperformance of global high-yielding stocks appears to be their ability to chase relative yield by moving capital between regions.

Exhibit 1
Regional Performance of High Yield



As of June 2010

The above returns do not represent the performance of any product managed by Lazard Asset Management. 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. Performance indices based on highest/lowest quartile of stocks screened on dividend yield on an equal-weighted basis. Portfolios have been rebalanced quarterly. The benchmark universe is the 500 largest stocks in the FTSE World Index.

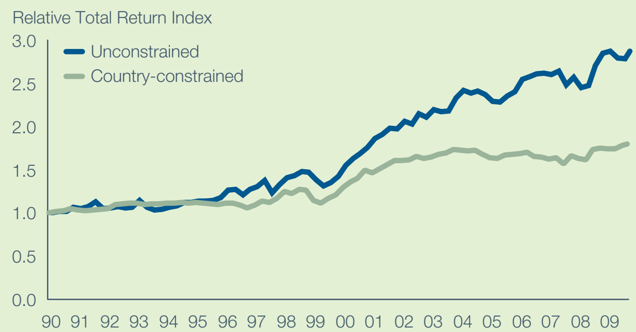
Source: Nomura

It is also worth highlighting that country-constrained strategies have historically led to a loss of alpha, as illustrated in Exhibit 2.

The U.S. market offers approximately 17% of the global opportunity set; not a meager level of diversity for a single country, but it is missing a great number of opportunities, in our view. If we look again at Exhibit 1, all the best high-yielding stocks in Asia, Japan, and, importantly, the emerging markets are missing. As Exhibit 3 illustrates, high-yielding stocks have 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 to be found in the developing world; this simply is not the case. Adding emerging markets slightly raises the yield versus a developed-only opportunity set and increases the potential for alpha. Dividends have been growing at a much higher rate in the emerging markets than in the developed world due to the faster GDP growth driving higher earnings, as well as an increased orientation toward rewarding shareholders through dividends.

Exhibit 2
Global versus Single Country Strategies



As of 31 August 2010

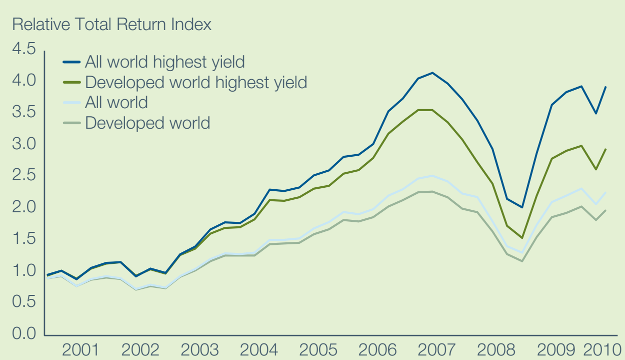
Source: Société Générale

Based on Société Générale's proprietary universe.

Capturing Outperformance in High-yielding Stocks

High-yielding stocks have posted relatively lackluster performance in recent years, with the MSCI World High Dividend Yield Index marginally lagging the standard MSCI World Index on an annualized basis since the end of 2006.[1] However, the relative returns of high-yielding stocks have improved recently, and they have outperformed since the market bottom in March 2009. As a result, we believe that the cycle of relative performance may favor these stocks.

Exhibit 3
Fully-global versus Developed-only Strategies



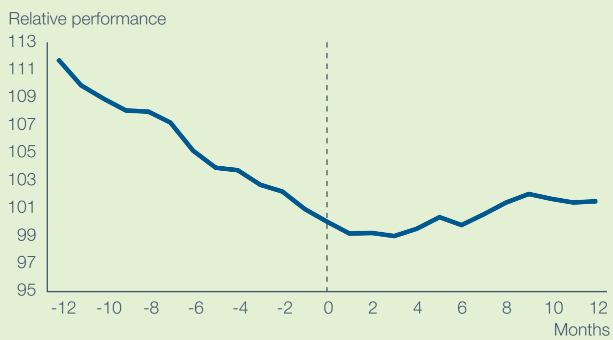
As of 31 August 2010

Source: Société Générale

Based on Société Générale's proprietary universe.

As Exhibit 4 demonstrates, on a bottom-up basis it has been possible to select winners out of the recent slump. We believe that quality, high-yielding companies will rebound, as the performance of these stocks is driven by the fact that dividend yield is a good valuation screen to identify undervalued, out-of-favor, and cash generative companies.

Exhibit 4
Performance of Dividend Yield Factor



As of 31 December 2008

Source: Nomura Equity Strategy

The chart shows the average of stocks in the high-yield basket relative to the market x months before and after portfolio formation. All years 1994-2008.

Based on Nomura's universe including the 500 largest stocks in the FTSE World Index.

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.[2]

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 must begin to ask themselves whether equities, traditionally viewed as a source of capital gains, may currently be more attractive as a source of income.

As we can see from Exhibit 5, bond yields are currently relatively low; fixed-income yields in the United Kingdom and the United States are far below their 10-year average. This is certainly not the case with equities, where yields are marginally ahead of their 10-year average.

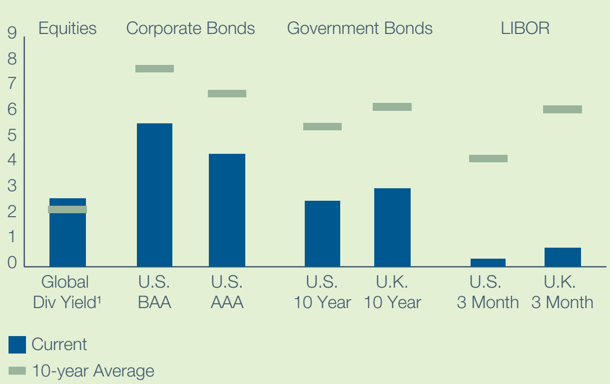
Even focusing on a single market—the United Kingdom—we can see from Exhibit 6 that the yield advantage of fixed-income securities has begun to unravel.

Are Equity Yields Sustainable?

It could be argued that equity yields are not sustainable. With earnings under pressure, increasing sovereign debt risks, and the global economy appearing fragile, many believe that companies will be unable to generate the earnings and cash flow to maintain these dividends going forward. Others simply would not consider investing in equities following the volatility of recent years. This is, in part, due to the severity of dividend reductions during the recession, as Exhibit 7 illustrates.

While dividends have historically been far more resilient than earnings—management teams often endeavor to maintain dividend

Exhibit 5
Current Yields versus 10-year Average of Equities and Fixed Interest

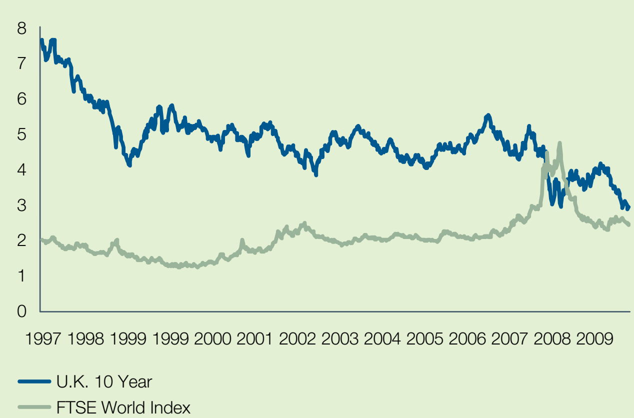


As of 30 June 2010

1 MSCI World Index

Source: UBS

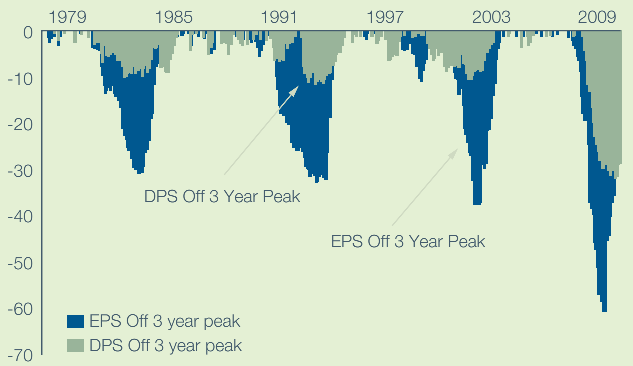
Exhibit 6
The Yield Advantage of Fixed Income Securities Has Eroded



As at 30 September 2010

Source: Bloomberg, FTSE

Exhibit 7
Earnings and Dividend Reduction in Economic Downturns



As at 31 August 2010
Source: UBS
Based on the UBS global universe.

payouts even when earnings are depressed—dividends are clearly impacted by the economic cycle. The recent economic crisis has seen high-profile dividend reductions and omissions. In past downturns, dividends have been reduced by about a third of the fall in earnings; in 2008 and 2009, when all companies were cutting dividends, earnings fell on average 60% and dividends 30%.

The weak links have been broken with a greater severity than previous cycles, 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 all 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.

Exhibit 7 also illustrates the sharp rebound in earnings in the current cycle, which contrasts with earlier cycles when earnings languished at the trough. 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.

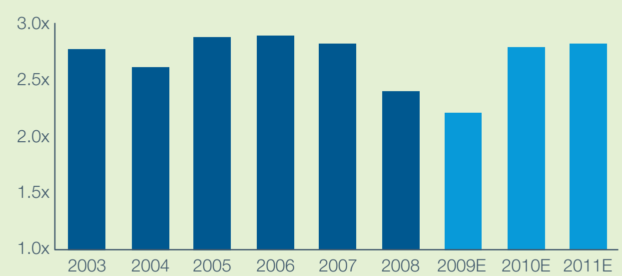
In our view, dividends will continue to climb not just because of the severity of their fall during the downturn, but also because of the current conditions and growth rates of companies. In fact, costs were cut aggressively in 2008 and 2009, and cash as a percentage of assets is now at an all-time high 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.

Exhibit 8 illustrates how the dividend coverage ratio (earnings divided by dividends) troughed in 2009 but has since rebounded back to historical norms, improving confidence in dividend sustainability. Dividend coverage is expected to further improve modestly in 2011, although a return to recession could call those earnings estimates into question. Looking at analysts' estimates of individual company dividends, these have been rising in aggregate since September of 2009. With earnings rebounding, free cash flow resilient, liquidity high, and dividend coverage expected to further improve, we feel companies are in a good position to maintain and possibly even increase dividends.

What about Inflation?

One of the notable elements of the current economic environment is that economists can make a reasonable case for either an extended period of deflation or an inflationary spiral. This is because the financial crisis is inherently deflationary, as it depresses aggregate demand; however, aggressive government stimulus efforts, particularly in the United States, have the potential to ultimately trigger inflation.

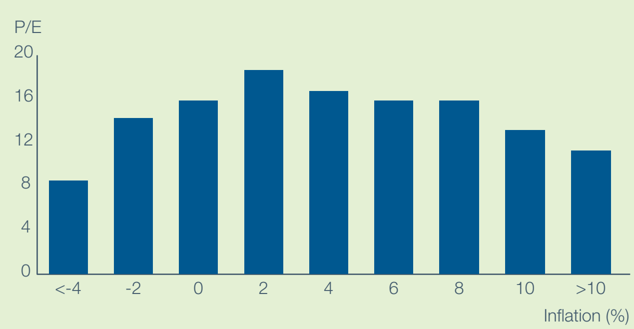
Exhibit 8
Dividend Coverage is Expected to Improve



As at 31 August 2010
Source: UBS
Based on the UBS global universe.
Estimated data does not represent a promise or a guarantee of future results and is subject to change.

Exhibit 9 shows the price-to-earnings ratio (P/E) U.S. equities have traded at in different inflation environments over the past hundred years; it is significant that equities have retained reasonable valuations in a wide variety of environments, only falling to single-

Exhibit 9
Equity Valuations in Different Inflation Environments



As of 31 December 2009
U.S. P/E and U.S. CPI Inflation data 1909 – present
Source: UBS

digit P/Es during the 1930s' deflation on the far left of the chart. The resilience of equities in inflationary environments is not too surprising, as inflation translates into corporate pricing power, which impacts earnings and ultimately dividends. On the other end, 10-year Treasury yielding below 3% are clearly vulnerable to an increase in inflation, as are corporate bonds. In particular, in a mildly deflationary environment, corporate bonds may not perform well, as depressed earnings may not be sufficient to service the debt. With such a wide range of possible outcomes, we feel high-yielding equities offer an attractive risk/reward profile due to their resilience in a range of inflation environments and yields that are currently more competitive with 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.

Notes

1 Source: Bloomberg, MSCI

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

Important Information

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