The Great Income Reversal Begins...

December 2020

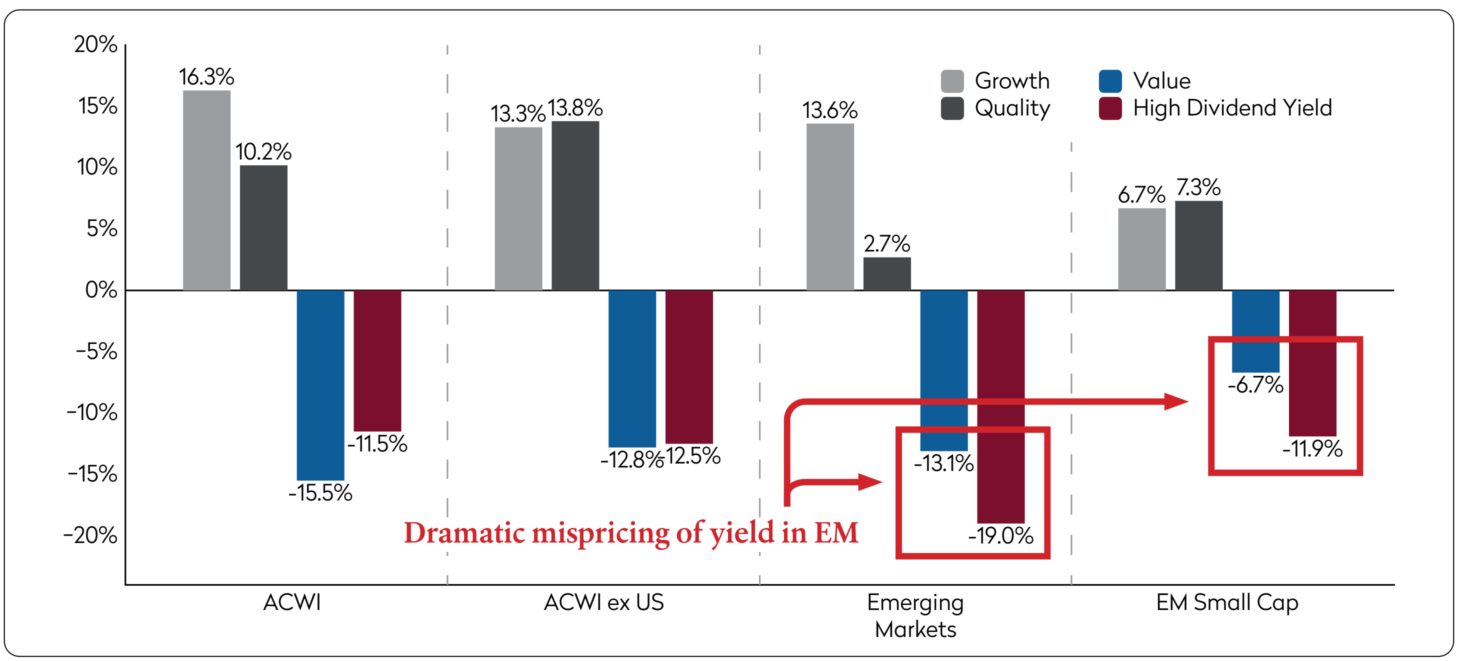
Global Value stocks have been sold off in this crisis, but Income-oriented Value stocks have been thrown out, especially in Emerging Markets. We estimate that around 200 of these global stocks maintain good fundamentals and strong US$ dividends. The Great Reversal may have begun, and allocators are overexposed to Growth like never before. This piece focuses on the income opportunity available to those that kept the faith.

In this piece:

1. **Yields of 5%+[1] available** – Income stocks have underperformed the market by more than -10% so far this year[2], particularly in Emerging Markets (EM), and are pricing in a dividend apocalypse that has not happened (and, we believe, will not happen).
2. **High intrinsic value in Income-oriented stocks** – Around 200 Income-oriented Value stocks with solid fundamentals have maintained or increased dividends since March and have seen a median price fall of -20%[2].
3. **A dividend apocalypse has not happened** – Bond yields are at all-time lows[3] while the dividend picture, in reality, is not that bleak. The Rothko Dividend Monitor (RDM) now tracks the growth in dividends available, in real-time. Click here to explore.

We first show the extent to which Income-oriented Value has been sold off during the COVID-19 crisis. Secondly we consider the material mispricing of stocks and the significant intrinsic value in a broad and diverse basket of Income-oriented Value names that have been punished by the market. Finally, we introduce the Rothko Dividend Monitor (RDM) which allows you to explore and track the changing dividend payments across global equities markets in real-time. **With the announcement of high-efficacy Coronavirus vaccines the Growth/Value reversal has potentially begun.**

Exhibit 1: Relative performance of factors versus relevant market index (YTD to 30 Sept 2020)



Source: MSCI, Rothko Investment Strategies
*constructed proxy index using top quintile dividend yielding stocks as MSCI index variant does not exist

[1] Rothko EMAC dividend yield is 5.4% (31 October 2020). Current yield is not a reliable indicator of future results.
[2] Year-to-date to 30 September 2020
[3] Barclays Global Aggregate Bond Index, Yield to Maturity of 0.8% (20 November 2020)

Fundamentally solid stocks with dividend yields of 3% or more are out there.

Bond yields at less than 1% represent an existential crisis for many institutional investors, which makes it all the more bizarre that sustainable income stocks have been sold down to the greatest extent of the past 20 years. Huge market interventions from central banks around the world in response to the COVID-19 pandemic have dragged down corporate borrowing costs and bond yields have tumbled. However, if you have the tools to look in the right places, we believe, one can find fundamentally solid stocks with dividend yields of 3% or more.

This piece examines the opportunity in Income-oriented stocks in a global context. We drill into 2020's upside down markets across the emerging and developed world, where companies have been punished for sustainably maintaining or increasing dividends, and others rewarded for cutting them. Why is this the case? We find the answer is stylistic and not substantive. As a result we believe significant alpha opportunities exist for the discerning stock selector focused on future income potential. With the announcement of high-efficacy vaccines, the reversal has potentially begun.

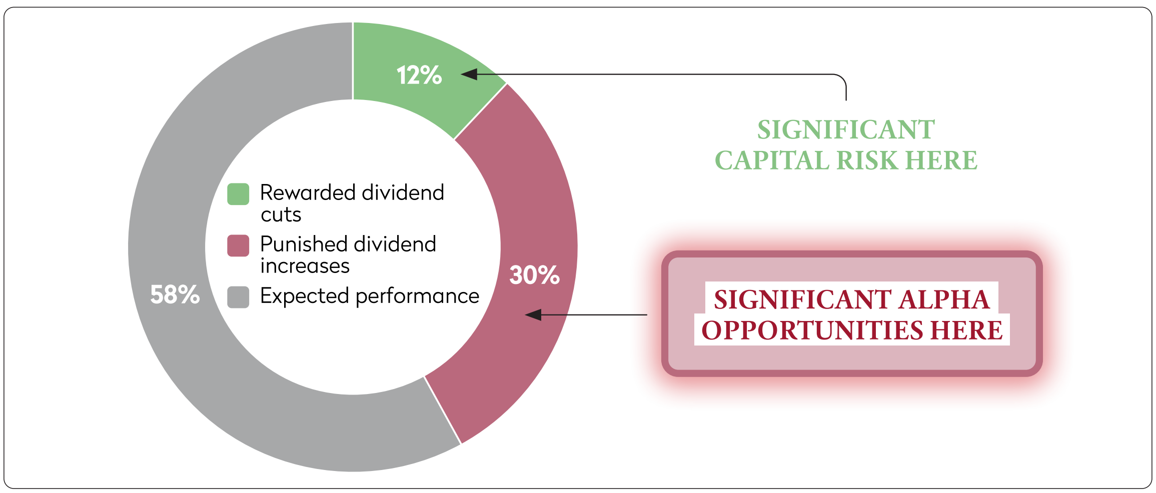
1. High yields are available

Naïve Value, as defined by MSCI, has struggled as a style, relative to the broader market this year and some of that struggle is justified, with the Value sectors of Energy, Banking and Utilities arguably getting their dues. However, the broad and diverse basket of Income-oriented Value stocks is a very different matter. The market has dumped over 700 stocks globally that have been able to maintain or increase (yes increase) their dividend this year, since March. Income-oriented Value has underperformed the market by over -10% so far in 2020[2] (see Exhibit 1, which shows the weakness of high dividend yielding stocks, especially in EM), representing an incredibly attractive entry point, especially for those needing more than the 0.8% yield offered by bonds[3].

Income-oriented Value is the most severe dislocation of this crisis and, in our view, will continue to reverse sharply.

2. High intrinsic value in Income-oriented stocks

Exhibit 2: 42% of Global Equity Names Materially Mispriced



707 Stable Dividend Payers have been dumped.

58% of (or 1,379) dividend payers in the MSCI All Countries World Index (ACWI) saw their prices change in line with the changes in dividends (Exhibit 2). If a company increased dividends it was rewarded by the market and punished if dividends were reduced. However, 42% saw price changes against expectations and within this there is evidence of considerable mispricing: 12% (or 288) of dividend payers were rewarded by the market for cutting dividends. 30% (or 707) of dividend payers were punished by the market for maintaining or increasing dividends. We believe there are significant alpha opportunities here.

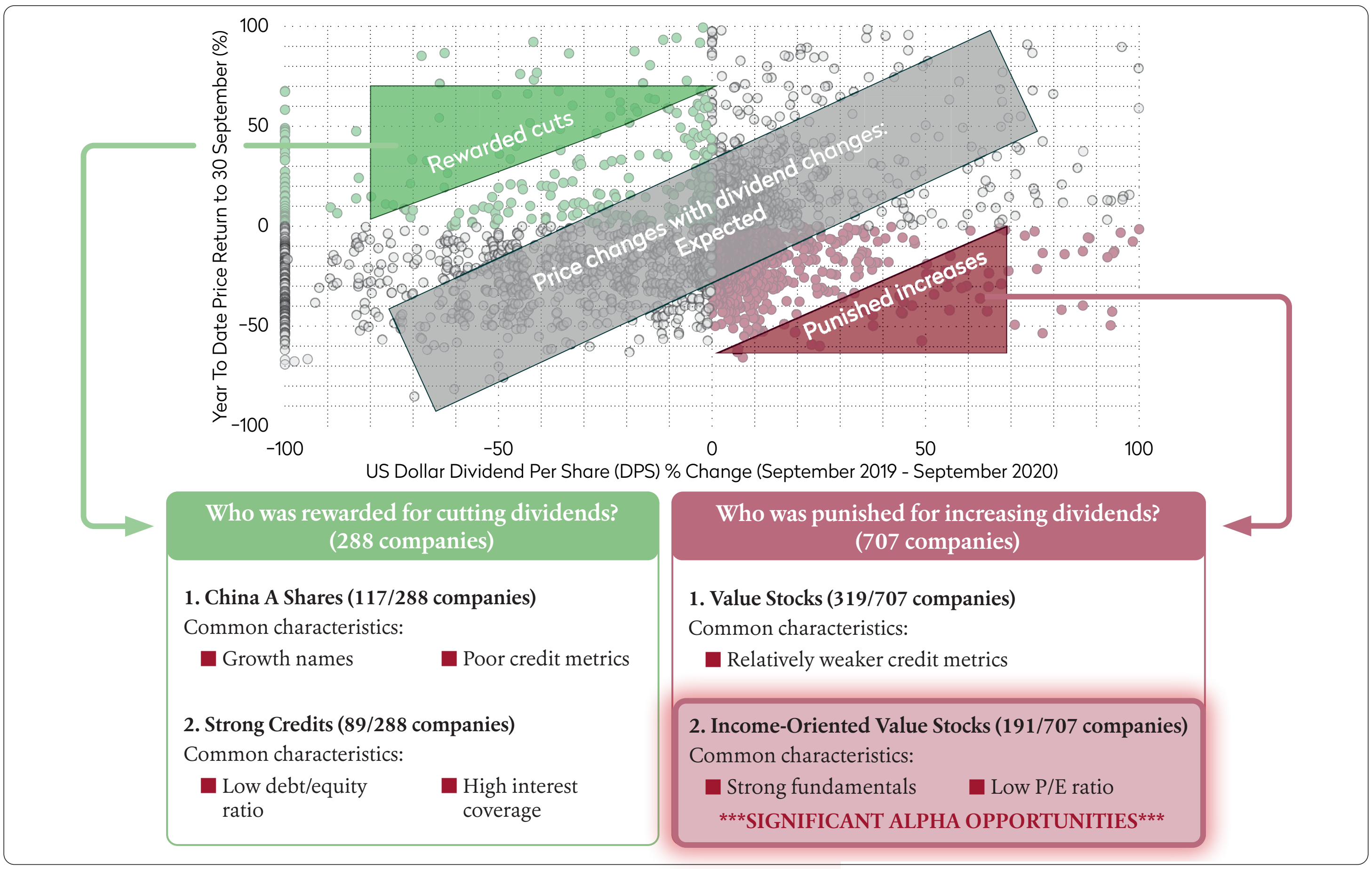
Exhibit 3 (top panel) shows each company's dividend change plotted against the year-to-date price change. You would normally expect prices to broadly change with dividend changes (diagonal area in the top panel), but not this year. The top left quadrant are 'Rewarded Cuts' shown in green. The bottom right quadrant are 'Punished Increases' shown in red. 191 of the 707 stocks that have been dumped while maintaining or increasing their dividends have strong fundamentals as well, and we believe represent a clear opportunity.

Rewarded Cuts, come with capital risks

- **China A shares** – 41% (or 117 names) of rewarded dividend cuts were China A shares. These were characterised by very high price-to-earnings (P/E) ratios but with relatively poor fundamentals. There is a good reason Chinese names have defied gravity - market intervention (see our recent research note on the National Team). We believe **a measured, cautious approach to investing in China is warranted now more than ever.**

- **Strong Credit metrics** – a further 31% (or 89 names) had strong credit metrics. Resilience and survivability has clearly been prioritised above income by markets.

Exhibit 3: Rewarded dividend cuts and punished dividend increases



Source: Rothko Investment Strategies, Factset. The percentage change in USD dividends per share (DPS) represents changes in dividend policy such as regular payments missed, changes in normal dividends, includes currency valuations and changes in outstanding shares in issuance. We are showing only those companies that have seen a change in regular, announced or stated dividends. Those that have not paid nor altered payments since 31 March 2020 are not included in this analysis.

Significant Alpha Opportunities:

- 191 Income-oriented Value stocks have maintained or increased US$ dividends and have been sold off. These stocks are characterised by strong fundamentals, attractive P/E ratios and diverse sectors.

We examine companies with rewarded cuts and punished increases further in Exhibit 4.

Exhibit 4: A deeper look at select fundamentals for rewarded cuts and punished increases

Rewarded dividend cuts (288 companies)

China A Shares (117/288 companies)

Rest of World Shares (171/288 companies)

Strong Credits (89/288 companies)

Other companies (82/288)

"Low interest coverage, high short-term debt to cash, low free cash flow to sales and poor profitability"

"Displaying resilience and survivability based on very strong credit metrics"

China A Shares (117/288 companies)

Median values	P/E	Debt/ equity (%)	Interest coverage	Short-term debt/cash	Net income margin	Free cash flow to sales (%)
Rewarded cuts: China A	44	86	2.6	1.5	5.1	4
Punished cuts	16	93	4.0	0.6	5.9	9

Examples of companies:

- Everbright Securities Company Limited Class A
- CSC Financial Co. Ltd. Class A
- Will Semiconductor Ltd. Class A

Strong Credits (89/288 companies)

Median values	P/E	Debt/ equity (%)	Interest coverage	Short-term debt/cash	Net income margin	Free cash flow to sales (%)
Rewarded cuts: Strong credits	23	27	29.9	0.3	10.0	10
Punished cuts	16	93	4.0	0.6	5.9	9

Examples of companies:

- Toyota Industries Corp. (Moody's A2)
- Kering SA (S&P A-)
- Estée Lauder Companies Inc. (S&P A+)

Punished dividend increases (707 companies)

Lower Price to Earnings stocks (510/707 companies)

Higher Price to Earnings stocks (197/707 companies)

Value stocks (319/707 companies)

Income-oriented Value stocks (191/707 companies)

"Strong fundamentals, high intrinsic value, high income"

Value stocks (319/707 companies)

Median values	P/E	Debt/ equity (%)	Interest coverage	Short-term debt/cash	Net income margin	Free cash flow to sales (%)
Punished increases: Value	14	97	4.1	0.7	10.8	10
Rewarded increases	26	52	13.2	0.4	12.0	11

Examples of companies:

- Vale SA
- Iron Mountain Inc.
- Hewlett Packard

Income-oriented Value stocks (191/707 companies)

SIGNIFICANT ALPHA OPPORTUNITIES

Median values	P/E	Debt/ equity (%)	Interest coverage	Short-term debt/cash	Net income margin	Free cash flow to sales (%)
Punished increases: Income-oriented Value	13	70	7.0	0.6	11.7	12
Rewarded increases	26	52	13.2	0.4	12.0	11

Examples of companies:

- Rio Tinto
- Bajaj Auto Limited
- Sekisui House Limited

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3. A dividend apocalypse has not happened

The Rothko Dividend Monitor (RDM) tracks the shifting economic landscape, using changing dividend payments across global equities markets in real-time. The RDM (Exhibit 5) clearly shows that many global companies have continued increasing dividends, but we find that most of these companies have actually been sold down by the market. As we have seen, this has created the largest dislocation of this crisis.

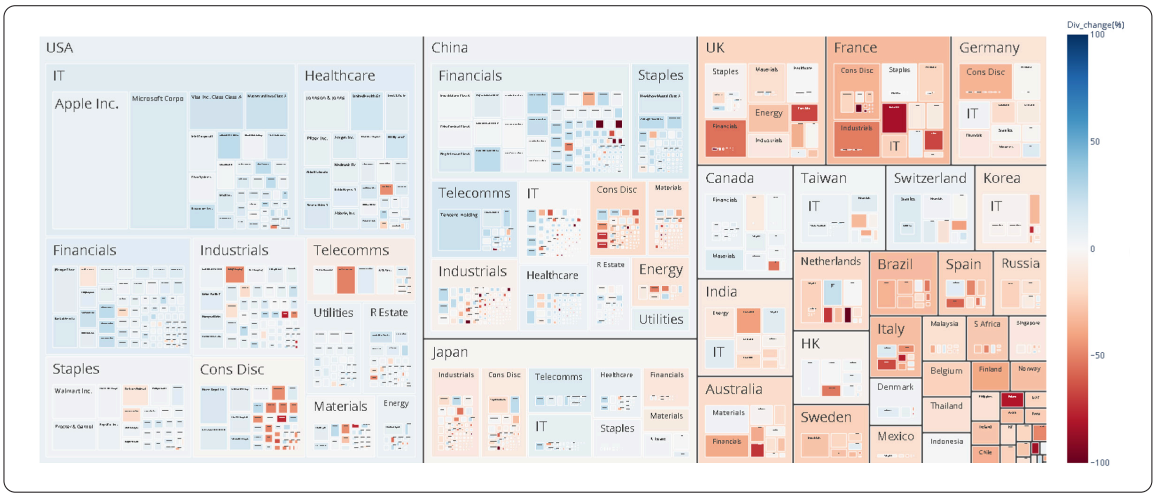
Many global companies continue to increase dividends

We observe that the dividends picture is, in reality, not that bleak.

- USA and China are relatively unscathed but reporting season is underway.
- European markets have been particularly affected by dividend cuts but some companies are starting to restore suspended payouts.
- Cyclical sectors have been fairly predictably affected such as consumer discretionary

Ultimately, are dividend changes being reflected appropriately in the markets? No. As discussed in this piece, Rothko's AI-based fundamental analysis strongly suggests that there are considerable pricing anomalies.

Exhibit 5: The Rothko Dividend Monitor (RDM)



RDM is powered by a proprietary AI engine that picks up subtle and forward-looking changes in dividend policies across thousands of companies. Blue gradients illustrate dividend increases while red gradients identify dividend cuts. The RDM is systematically updated as the dividend picture evolves. Click on the picture or head over here to drill deeper into companies by clicking your mouse on any country name or sector name you wish to explore, and the image will expand into that area.

The Great Income Reversal Begins...

Income-oriented Value equities remain the most significant dislocation of the COVID-19 crisis and, in our view, will continue to reverse sharply. Our AI engine has identified a subset of Income-oriented names with strong fundamentals and high intrinsic value.

All of Rothko's defensive, income-oriented strategies, running a dividend yield of 5%+[1], are poised to extract the benefits: Emerging Markets All Cap, Emerging Markets Small Cap, and All Countries World-Ex US.

With bond yields at all time lows and Growth stocks deep into bubble territory, asset allocators are well advised to ensure they are positioned for the overdue Great Income Reversal.

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Disclosure

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