Welcome to the third episode of Conversations and the first for 2022. The series will focus on investment concepts and outcomes of interest to you and your clients. As with our earlier podcasts, this episode will focus on income, and in this third instalment, we're going to discuss income from global equities. For many people, global equities are not the first asset class that come to mind when investing for income. However, to ignore it is to disregard a very real opportunity to get that all important income for your clients.

Today's podcast features GSFM's CEO Damien McIntyre and Epoch Investment Partners, managing director and Portfolio Manager, John Tobin. John's been managing the Epoch Global Equity shareholder yield fund for a number of years, and you may have seen him present at one of our road shows or in more recent times, via webinar. Today, Damien and John will discuss how global companies return cash to shareholders and consider the outlook for dividends in the current investment environment and compare long and short duration stocks. That's right, bond terminology being used in the equity market.

Before I hand over, I need to read this important notice: The information contained in this podcast is general and does not consider your objectives financial situations or needs. The information and views contained in this update reflect as at the date of recording the current opinions of the participants and the subject to change without notice. Before making an investment decision in relation to a fund, investors should consider the appropriateness of this information, having regard to their own objectives, financial situation and needs and read and consider both the product disclosure statement and the additional information. GSFM responsible entity services has to target market determination in relation to all the GSFM funds, the TMD sets out the class of persons who comprise the target market for the various funds which can be downloaded from our website. This podcast was recorded on Wednesday the 2nd of February 2022.

The floor is all yours, gents.

Damien McIntyre

Thank you very much, Tracey. And on behalf of GSFM, I reiterate our welcome to you and we sincerely hope you enjoyed our episodes last year, which included Steve Miller, speaking about fixed income and Max Cappetta from Redpoint, talking about dividends from Australian equities. Today, as Tracey pointed out, we're joined by John Tobin. John is a long-time friend of GSFM and been with Epoch approaching 10 years.

By way of background, John started his career in the bond market, managing high yield and investment grade bond portfolios, took a spell from that and then, I believe, went to Fordham University, John, where you lectured in economics before making a return to the equity market about 10 years ago with Epoch to work specifically on this portfolio. So John brings bond market experience, economic experience and of course, a long background in the equity market to bear on this portfolio.

So I'm really looking forward to an interesting conversation with you, John. The purpose of these podcasts is to talk about where we find income, because the lust for yield and the demand for income bearing assets really is insatiable given the demographic of the ageing population. And it really is a case of buyer beware, because I think the greatest truism in financial markets is that 'all the glitters is not gold'. And there are times when income bearing assets look great and times when they don't. And for some reason, traditional dividend paying stocks during this Nasdaq rally of the last four or five years, seemingly lost their appeal to investors, which was quite interesting because we find ourselves in a period of time now where interest rates are rising because of inflation and bonds become problematic in investments for clients because bonds can't keep up with inflation.

Inflation is actually their enemy, whereas equities or companies in many ways can pass on the inflationary aspects of their finances to customers in higher prices or they can seek other ways compensate earning. So equities for a long time have been a great place to find yield. So with that, just before Christmas, you, you hosted a webinar, John, titled Reflation, Duration and Salvation. Do you think investors can look forward to an improved income scenario from global equities in the coming year or so?

John Tobin

I think the short answer Damo is, yes. You know, you touched on a lot of important facts that have just defined the environment in recent years. For the most part for the past decade have dealt with very low interest rates as a result of monetary policy. And we've made the argument over the years that investors had seek income should take a look at what a diversified portfolio of high quality equities can deliver in the way of income. And that was true when interest rates were low and anchored at zero around most of the world, it's still true today, even as interest rates move higher. And as you've pointed out, we are seeing rates move higher. It's in response to inflation, it's in response to a favourable economic backdrop, as the world begins to recover from the pandemic and the pace of economic growth around the world is, I guess an economist would describe it as above trend. Even as it slows and decelerates, we're still anticipating above trend growth around the world this year and even into next year.

So above trend growth and inflationary pressures and a changing stance from central banks around the world who are all now talking about reducing accommodation and normalising policy, it's leading to an environment of rising interest rates. And it's still an environment where income investors face challenges. Yes, fixed income interest rates are starting to move up but they're moving up in the context of rates going higher in response to inflation. And that's a really challenging investment for a fixed income investor, as you alluded to earlier. The early days of my career were in the bond market in the high yield bond market and bond investors know when interest rates go up, there's really no place to hide. But what they also know is that best strategy in a rising interest rate environment for a fixed income investor is to shorten duration. And that's a concept that we're starting to see a lot of people talking about in the context of equities.

Damien McIntyre

Just on shortening duration, really the most effective way for a financial advisor to shorten the duration of their interest rate exposure if you like is to hold a term – or time – deposit. And in Australia, even with this sort of latest volatility and interest rates, it's still a pittance, it's still 30 basis points for a one year time deposit. So again, it just makes the task of finding fixed income investments with duration taken out of the equation so difficult.

John Tobin

You know, the other thing that we've all observed in recent years is that income investors are looking at more and more exotic ways to generate income, either more risk, move down the risk spectrum go into junk bonds, go into exotic structured vehicles that are designed to create income. And it's complicated and it's challenging. And frankly, it's just a whole lot easier to understand what you own and what you're investing in. If your portfolio is a portfolio of equities, of blue chip companies, large companies, high quality companies that have a history of paying dividends, growing dividends supported by growing cash flow. It's almost so simple. It's obvious.

Damien McIntyre

This is probably the most appropriate time to remind investors the purpose of equity and the purpose of equity is really, they're not a casino. They're not intended to be a mechanism for people to get famously rich. What they really are is their income generating asset that over long periods of time, appreciate in value and beat inflation. And really that's their key purpose in a portfolio. Tell me about reflation and how you see this impacting equity markets.

John Tobin

The way we're starting to frame this in our shop is we see the world emerging from the pandemic. 2020 was a spectacular collapse. If you will, a once in a century pandemic, very abrupt and sharp economic collapse but the world is recovering and largely thanks to the incredibly rapid development of effective vaccines and the pace at which the world is recovering is frankly, I think it's surprising fast. I think if you go back to the middle of 2020, when people started to talk about how we might recover from the pandemic, there was a lot of discussion about what the shape of the recovery might look like. And it was a pretty strong consensus view. I think that we certainly weren't going to see a V-shape recovery. Maybe it looks a little bit like a Nike swoosh, it sort of takes off and gradually over time we climb back out of this hole.

Well, in fact, it has been a V-shape recovery. We've had setbacks. We had Delta, we have Omicron, who knows what might come next. Nevertheless, I think the evidence is that the global economies are recovering. So this is the reflation part of this thesis that we have. The global economies are recovering, we'll have above trend economic growth for the next couple of years. It's a very favourable environment for businesses in terms of revenues, earnings, cash flows, demand, you see consumer demand, recovering, you see employment recovering. And so that sets this stage for a favourable economic backdrop for businesses for the next couple of years, so that's the inflation part of our thesis.

Damien McIntyre

It's been fascinating to observe. I mean, I think we all expected economic growth to fall off a cliff once the pandemic gripped the world through the first quarter and second quarter of 2020. But I think what's been fascinating to observe is that we've spoken about technology and the power of technology for 20 years. But we really saw its most tangible evidence in that so many service industries worked from home productivity was maintained if not improved, it's really been a fascinating time. I think the thing that is of concern to all of us, are these lags in supply chains around the world for various reasons, which is at the heart of the inflationary pressure isn't it?

John Tobin

I think that's right. I think it shut everything down suddenly and you tell everybody to stop working unless you're an essential worker go home. When you start that machine, it takes a little while for the supply chain, for the inventory channels to be refilled. It's not something that can happen in the span of two or three or six months. It's kind of interesting sometimes to take a step back and think about what we were saying, not that long ago. And it that the message that we were hearing consistently from the Federal Reserve was, well, inflation is going to be transitory. This isn't going to last, it's supply chains and they'll all get refilled, and everything will be back to normal soon. Well, clearly it's taking longer than we thought. And supply chain issues continue to be problematic for businesses. There are signs that things are getting better, but it is taking time for that to be relieved.

Now, the other aspect of this is playing out is labour shortages, and labour availability, and labour costs. So there are some components of this inflation experience that will likely dissipate as supply chains, get me filled and inventory channels get me filled. But I think that there's probably some lingering inflation in the system and that's not a bad thing. It's something that for a number of years, central banks around the world were hoping to get inflation up to around 2% and were frustrated that it couldn't seem to get inflation at all. So now it looks like we might be in an environment. Whereas as the inflation numbers come down in coming months and quarters, we drift down to something and end up with an inflation rate in, I don't know, two and a half, 3%. Maybe it gets down to 2%.

That's not a bad outcome. That's the outcome we were hoping for. So now we're going to have some inflation in the system. And when you think about businesses and how they operate a little bit of inflation is not a bad thing. It gives businesses pricing flexibility. It allows them to have some mechanism to respond, to cost pressures, whether it's raw materials or labour. The ability to raise prices and pass some of those cost increases along to customers. So we are going to be left with some residual inflation here and the inflation sort of steady state inflation. Once the dust has settled after the pandemic, is going to be higher than it was before. But again, not a bad thing. That's what we've been hoping to achieve from a policy standpoint for a while. So I think that's favourable. So above trend growth, moderate inflation, moderately higher interest rates. These are signs of a healthy environment and positive macroeconomic backdrop businesses to operate in. Good for revenues, earnings, cash flows, good for the ability of businesses to make distributions to shareholders in a form of dividends and share buyback.

Damien McIntyre

How do you see that playing out this time? Do you, you think that companies have lost the fear to put prices up?

John Tobin

I think that every good businessperson wants to maximise profitability and of ways to maximise profitability is to raise prices when you can take market share when you can be as competitive as possible. So the desire to use price as a tool or as a lever, I don't think it ever went away. I think maybe it was frustrating for businesses to operate in an environment where it was just really impossible to raise prices. And now that for flexibility seems to be returning. And it's just in a normal course of operations.

Businesses are in a position to say new season, new price list. And you might have noticed that my prices have gone up and that's just the environment we're operating in. And I'm finding that I'm not getting resistance from my customers if I institute a moderate price increase. So I think this is an environment where, as I said earlier, if there's a broad, general inflation, modest inflation in the economy, then those are the types of events that can take place without attracting a whole lot of attention or competitive pushback or customer pushback. We're all operating in a different environment. We're all experiencing higher costs. I get it. You're raising your prices. I'm raising my price. It works all the way down the chain.

Damien McIntyre

And the virtuous circle actually does end up with the wage earner; without inflation and without the ability for a company to pass on the impacts of inflation at a profitable level to consumers, there's really no hope of wages growth. If companies are earning less and less through the cycle, by not letting inflationary impact their margin, the average worker can't get a pay ride. So all this is necessary, isn't it?

John Tobin

It is and the wage at the risk of saying something that's kind of a truism, it's always supply and demand. And the same is true with workers. And again, if you're a businessperson and you have a business and you need to hire somebody, you might find that yeah, I used to pay people X for this job and have been advertising the job with that salary or that wage. And I'm just not getting applicants. There's a supply and demand phenomenon in labour markets that can cause wages to go up independently of what's going on in terms of job inflation. It doesn't have to be... now, the workers are able to get wage increases. It may simply be the labour market's tight. That's why we get wage increases. And that's part of the inflationary pressure story. Businesses are raising prices to cover costs, including the higher costs that they're paying to get workers to fill positions.

Damien McIntyre

Well, we're experiencing that down here in Australia here because borders were closed for two years, and immigrants didn't receive any social security protection from the governments during the various lockdowns. So many of those foreign workers left the country to go back to Europe and wherever they came from, where they could get some sort of help from government. So we've got a massive labour shortage here in Australia as well. And wages are significantly sparking as a result of that.

John Tobin

Anecdotally, we did a little project on a vacation home. It took considerably longer than we thought but that was one of the issues. It wasn't just that building supplies were hard to get – and they were – and lead times were longer than they would normally be. But the contractor that we were working with explained, 'I can't get workers. The people that were working for me that I sent home when everything was shut down during the pandemic, they're not working in construction anymore. They've moved on'.

This is another example of a supply chain bottleneck that new workers to replace these missing workers that can take time to find people that have the right skill and come to a job site and perform those tasks. It doesn't happen overnight. It takes months and months and months for that population to be refilled.

Damien McIntyre

Now, during your webinar, you spoke about duration and duration is a concept that's usually associated with bonds. So in the context of equities, what is a source or a long duration stock and how does that impact their ability to provide income in the duration of the business?

John Tobin

You know, it is true it is a concept that is familiar to fixed income investors and maybe a bit foreign for equity investors. But I also think that it's very straightforward. And as soon as you sort of lay out what you mean by duration and why you think it's important, I think you very quickly have people nodding their heads saying, oh, I makes perfect sense. I get it. The idea that well, money has time value. And it matters whether the dollar you're going to receive is a dollar that you're going to receive this year or next year or 10 years from now. And so what's a long duration equity, a long duration equity is the stock of a company where the revenue, earnings and cash flows are expected to occur years into the future. And the current generation of revenues, earnings and cash flows might be really, really small.

I've used this as an example, and I think it actually is a nice way to illustrate what we mean by these concepts. If you think of two different companies, Tesla on one hand and Toyota Motor Corporation, on the other hand. Toyota's been around for a very long time. They are the world's largest automobile manufacturer in terms of the number of cars that they make. They generate a tremendous amount of revenues, earnings and cash flows right now. They're paying a dividend today. They engage in share purchases today.

Just put that to one side and then contrast that with Tesla. This is a company that is perhaps at the forefront legitimately at the forefront of an emerging trend and shift towards electric vehicles. But when you think about how many cars do they make compared to the number of cars made by Toyota, what's the revenue generation at Tesla relative to Toyota. What's the cash flow generation at Tesla relative to Toyota. You begin to see, this is what we're talking about. Tesla as a company, the valuation of that stock today is built on an expectation of significant revenues, earnings and cash flows years out in the future. And even though in terms of the number of cars manufactured, Toyota is multiples larger than Tesla. Toyota has a market capitalisation of about 300 billion dollars. Tesla has a market capitalisation close to a trillion dollars.

I don't mean this in any way to suggest I'm criticising Tesla or predicting the downfall or collapse of Tesla. I'm just saying, when you look at those two companies and what their cash flow streams look like and what their equity valuation looks like, you begin to get an understanding of, oh, short duration versus long duration. Now I'm kind of understanding it. Another example that I recently was utilizing in a conversation with one of my co-workers was well, even within the tech space, there's a tendency perhaps to think, ah, so tech, tech is long duration.

I think that's a little bit too simplistic. I think that there's variation in duration across sectors as well as within sectors. And so I was saying, well, I'll give you three different tech stocks. One is Cisco Systems. One is Broadcom and one is Nvidia. And again, if you look at those companies in terms of free cash flow generation, dividends that they're paying today and then the market valuation, again, I think you can really pretty quickly wrap your head around this idea that Nvidia may be really well positioned for some significant trends in the goal global economy, whether it's gaming, data centres, artificial intelligence, autonomous vehicles, they're really well positioned as a business to benefit from those trends. But when you look at the stock and the valuation of the stock and the timing and the profile of the cash flows that that business generates. Again, I think you start to have that kind of, oh, I get it long duration versus short duration.

Well, so what does it mean if interest rates are going up, the math is pretty straightforward. It's a present value calculation. And so you've got projected cash flows in enumerator and a discount factor in the denominator. And as the discount factor goes up, the present value goes down. And again, the math is pretty straightforward. It has a bigger impact. A given interest rate increase has a bigger impact on a distant future cash flow that it does on a near term cash flow. This is the intellectual foundation of this argument that we've been making along with many others by the way, that durations a concept that applies to equities as well as fixed income securities and in a rising interest rate environment.

This is something that equity investors should probably be thinking about. Do I have long duration equities in my portfolio? Do I have long duration equities that have experienced significant price appreciation and multiple expansion in my portfolio? And would I expect them to face valuation headwinds in an environment of rising interest rates? And the argument that we tried to present in the webinar is that shorter duration equities should be more resilient in that environment. And shorter duration. Equities are the kinds of equities by definition that we're investing in, in the shareholder yield strategy companies generating cash flow today, paying dividends today, as opposed to companies that we hope someday will generate significant cash flows and maybe someday actually pay a dividend.

Damien McIntyre

Ironically, this is exactly what we were saying since the beginning of the last quarter of '21, isn't? It's a simplistic way to describe it is a value rotation. But effectively the world saw rising interest rates coming and became concerned about inflation. So rather than switching their emphasis on short duration stocks, they really did begin to switch in number to those companies earning money now that they can see in real time and benefit from any cash distribution along the way.

John Tobin

Exactly. I mean, we've seen it. It's played out for us as we don't always have perfect timing, but we actually have complimented ourselves saying, boy, that December webinar, I'm glad we didn't put that off and say, oh, it's the holidays. It's hard to get people focused. Let's just do that in the first quarter of 2022. We went ahead, we did it in December. And I think it was good that we got that message out there. Because as you've said, since the end of December and into January, we've seen this play out in the market in the way that some of these, if you call it growthier stocks, long duration equities in the behaviour of those stocks over the past five or six weeks.

Damien McIntyre

This is the great conundrum, that investors in dividend paying companies was confronted with in the last two or three years, as I said in my opening remark for decades, and I'm talking about 80, 90 years of history, showed that companies that paid dividends to their shareholders, outperformed companies that didn't pay dividends to their shareholders, and companies that paid increasing dividends to shareholders outperformed even more.

And this is what gave everyone this feeling of comfort in security, in those types of companies. And then we got to a two or three year period where it was turned on its head where those companies, those long duration companies now on the main spectacularly outperformed short duration companies. And the traditional dividend investor was left scratching his head trying to work out what happened, which I think is a pretty fair description of what happened. So now we're starting to see that reverse. But how do you think that'll be... History will reflect on this in one quarter is one quarter, what do you think history will say in a couple of years' time?

John Tobin

Well, I guess my hope is my expectation is that as you've just described, there's a long term history for decades that established a pattern that made sense in terms of which stocks you could rely on to do reasonably well. And there were companies that were generating earnings and generating cash flows and paying dividends and growing dividends. It all kind of makes sense. That's what economic theory business theory would all suggest that those are successful companies and those should be successful equities. And I think if there is a normal and what we've experienced over the past two years is an anomaly as we go forward in time, maybe the look back will be, it was an anomaly. Well, how do we explain that anomaly? Probably had something to do with interest rates being held by central banks around the world at zero or below zero for an extended period of time. That is an anomaly.

It was a policy response to a crisis if you will. So I'm not going to say it was the wrong policy response, but it was a policy. And one of the consequences, maybe one of the unintended consequences of that is when the cost of debt is zero, it allows for a market environment where very, very long duration stories can become very attractive because the discount rate... If the discount rate is zero, it doesn't matter whether you're going to get a dollar today or 10 years from now. And suddenly, when interest rates start to normalize, then you start to think about things maybe in a more critical way and you start to realize there is time value to money.

And a world of nominal interest rates at zero or negative, a world of negative real interest rates, there's something anomalous about that. That's not the long run, steady state economic environment that we should expect that long term interest rates should be negative. That's weird.

Damien McIntyre

You also look at the implications for the bond market. Just on that for a sec, is that while interest rates are zero or near zero, lenders aren't being compensated for the risks they take. And at the end of the day, that risk is really transferred to the shareholders, as it always is anyway but that risk is magnified when risk has little or no price.

John Tobin

So it all sort of fits together the pieces of the puzzle here. One of the sectors that has done well in this environment with rates starting to move up is financials, because this is finally an environment where the arithmetic of how a financial institution makes money, it starts to work again.

Damien McIntyre

So the last leg in your thesis is salvation. So what is it? And what do income investors look forward to during this period of salvation, John?

John Tobin

And I have to say, so that was a title that we came up with and when it was first suggested, it was put forward as, I don't know, that's a little bit dramatic. That's not really like us. And then we kind of gravitated around and it said, "Yeah, it's a little dramatic but let's go with it." The salvation we've kind of been talking about at this return to a more normal environment, a return to an environment where the kinds of strategies like global equity shareholder yield that used to be very successful and then for a period of time were left behind, the wheel turns and they can be successful again.

And you can look at a business and say, "This should be a good stock." Why? Because it's a good company. It's generating earnings, it's generating cash flows. The cash flows are growing, pays an attractive dividend. The dividend is supported by the growth and earnings and cash flows. Not only do I expect the business to do well, I expect it to pay a dividend and grow a dividend and even have excess cash to return to shareholders through shareholder distributions, like share buybacks. That's a good business. That should be a good stock.

When we talk about salvation, it's the salvation for those of us who've kept the faith continue to try to invest in a certain way, even when it wasn't the popular way to invest.

Damien McIntyre

So, John, this has been a fascinating conversation. Thanks very much for your time. I think if we were to summarise how you invest, can you just very quickly summarise the base thesis of shareholder yield and what it's looking to achieve for investors?

John Tobin

Sure. I mean, it's a diversified portfolio. We own typically about a hundred stocks. We're looking for companies that, as I've said a couple times already, they're generating cash flow, they have a track record of generating, growing cash flow over time, a track record of paying an attractive growing dividend over time. And on the basis of our analysis, as we manage the portfolio and vet ideas for the portfolio, we have an expectation that going forward, these businesses will continue to grow, continue to prosper, continue to generate growing cash flow and continue to reward the shareholders of the business with attractive growing dividends over time.

It's a strategy that I sometimes say, what's the value proposition with shareholder yield. It should give you call it market like returns. And as you alluded to earlier, it's not a portfolio of lottery tickets that is going to promise a possibility that you might get rich overnight but it's a strategy that should deliver a market like returns with lower volatility than the market with consistent and steady income, dividends are always positive.

And that's an important component of your total return stream dividends that you collect quarter after quarter after quarter, good upside participation. When the market goes up 25%, we're not going to beat the market, but we should be able to keep up with the market.

And 2021 is a good example; the market was up over 20% and we were up about 19%. So we were a couple of hundred basis points behind in US dollar terms. That's the kind of upside participation we should be able to deliver with good downside protection. And that's critically important because we're investing with the hope of generating wealth, protecting and preserving wealth. And so you need to also be able to protect on the downside. And this is something that this strategy has demonstrated over its 15 plus year history, that it dampens the effect of the downdrafts, which makes sense because you're investing, as I said, in a diversified portfolio of companies that have been generating cashflow and paying dividends.

These are resilient businesses to begin with and we put them together into a diversified portfolio. And so there's resilience and durability in that portfolio effect. It's a good core strategy, it's a good income strategy, it's a good defensive strategy. And we think it should be a good strategy in an environment where rates are rising. And that's what we see unfolding over the next couple of years.

Damien McIntyre

And we agree with you, John. I think that you touched on diversification in your remarks about describing the portfolio you invest in. And of course every investor diversification is their best friend. So for those investors seeking income, of course, they should own some fixed income interests, they should own some time deposits or term deposits, but they should also own equities because equities compensate for what bonds can't do as equities have the ability to pass on the impacts of inflation through price rises to their customers and thus protect their earnings.

So equities really are a great inflation edge and that's why you should own some of them in your income generating asset pool. And for a long period of time, we lost sight of that because all the interest, pardon the pump, was focused on these short duration stocks and the explosive returns they generate. But the tides turned now.

I think this is a great opportunity for everyone, I should say, to refocus on benefits of the types of equities that you and your colleagues at Epoch invest in. So it's a great time to have another look at this portfolio. So John, thank you very much for your time this afternoon. We really appreciate your insights. Hopefully, in the not too distant future, our borders will reopen to you and your colleagues. And we'd like to take you back to see how investors here in Australia again.

John Tobin

Well, thanks, Damien. I've really enjoyed the conversation. Thank you so much for inviting me and I do look forward to visiting you again. It's been nice to look out in the snow in my backyard and imagine you sitting in warm, sunny Australia. It's a nice picture in my mind.

Damien McIntyre

Well, we did use to get you out in the first quarter every year. So it was always a good distraction from the snow. Wasn't it?

John Tobin

It was. It was a good break.

Damien McIntyre

Maybe we would do that again soon.

John Tobin

Look forward to it.

Damien McIntyre

Thanks, John. We'll see you soon.

John Tobin

Okay, thanks Damien.