TD Global Investment Solutions

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Shareholder Yield in Uncertain Times

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How long can the market shrug off what seems like a jarring dose of uncertainty that could weigh on economic growth? For years, a combination of significant monetary and fiscal stimulus allowed equity markets to flourish, even in the face of a global pandemic that shut down economies overnight, and a rapid increase in interest rates to fight inflation. Market corrections and subsequent rebounds in recent years have been extreme as investors dissected central bank speak and were able to find solace in the resilience of the consumer and, therefore, the global economy. Following a decade plus of ultra-accommodative policy, it is our belief that investors should be mindful of the range of unpredictable events that threaten to pressure economic growth moving forward – central banks remain embattled by inflation, the world is deglobalizing, there is a war in Europe, tensions between China and the U.S. have been revived, and the possibility of a mild recession still lingers.

While the global economy has proven far more resilient this year than was expected on the heels of monetary and fiscal spending in recent years, there is reason to believe that markets will remain volatile in the face of uncertainty. We believe investors are well positioned to focus on high quality companies with a demonstrated track record of consistent cash flow growth and sound capital allocation policies. Growing levels of free cash flow, strength of balance sheets, and disciplined capital allocation form the pillars upon which strong businesses are built and shareholder value is created. The Shareholder Yield strategies are constructed with these principals in mind, and the belief that firms possessing these traits will demonstrate a consistent tendency to return capital to shareholders in the form of dividends, share repurchases, and debt reduction.

Free Cash Flow and Capital Allocation

Free cash flow can be defined as the cash generated by a company that is left over after all planned capital investments and taxes. Understanding the possible uses of free cash flow is how we arrive at our definition of "shareholder yield" and, in our view, there are only five possible ways to deploy this cash: dividends, stock repurchases, debt reduction, acquisitions, and reinvestment in company capital projects. We view the first three (dividends, share repurchases, and debt reduction) as equal methods of returning capital to shareholders, and so refer to them collectively as "shareholder yield," a term coined in 2005 by TD Epoch founder, Bill Priest.

Before diving into the components of shareholder yield, lets first address the other two uses of cash. Inorganic growth via acquisitions or investment in expansionary capital projects will only create incremental value for the business (and its owners) if the proposed investment can earn a return that exceeds the firm's cost of capital (ROIC-WACC). There are, however, at any given time a finite number of profitable opportunities for investment, and once these are exhausted the best use of free cash flow is returning it to shareholders.

So how do the other three uses of cash create value for shareholders? The value of cash dividends is fairly obvious, requiring no explanation. Share repurchases implemented using free cash flow will provide equal value. Because there is no sale of assets to fund the repurchase of shares, the enterprise value of the firm will remain the same while the number of outstanding shares declines, increasing the remaining shareholders claim on the firm's future cash flows. Debt reduction is perhaps the least obvious means of value creation; however, we can point to a famous paper written by Franco Modigliani and Merton Miller titled "The Cost of Capital, Corporation Finance and the Theory of Investment (from The American Economic Review, June 1958) to explain. The paper authored by these two Nobel laureates postulated that a firm's value is independent of how it is financed, provided we ignore the tax effect of debt interest. If we assume they are correct, then using free cash flow to repay debt results in a direct transfer of value from debtors to shareholders. And so, whether via cash dividends, share repurchases, or debt reduction, we can see that the value provided to shareholders is equivalent when the funding for the distribution is sourced from free cash flow.

Capital allocation practices will dictate how effectively free cash flow is used, and it is the fiduciary responsibility of management to utilize company cash in the most value additive manor for shareholders. Management teams made up of shrewd capital allocators will demonstrate discipline when deploying cash among the five possible uses, investing in growing the business organically or through acquisition when it is profitable and otherwise returning cash to shareholders in the form of dividends, share buybacks and debt reduction.

What Drives Equity Markets?

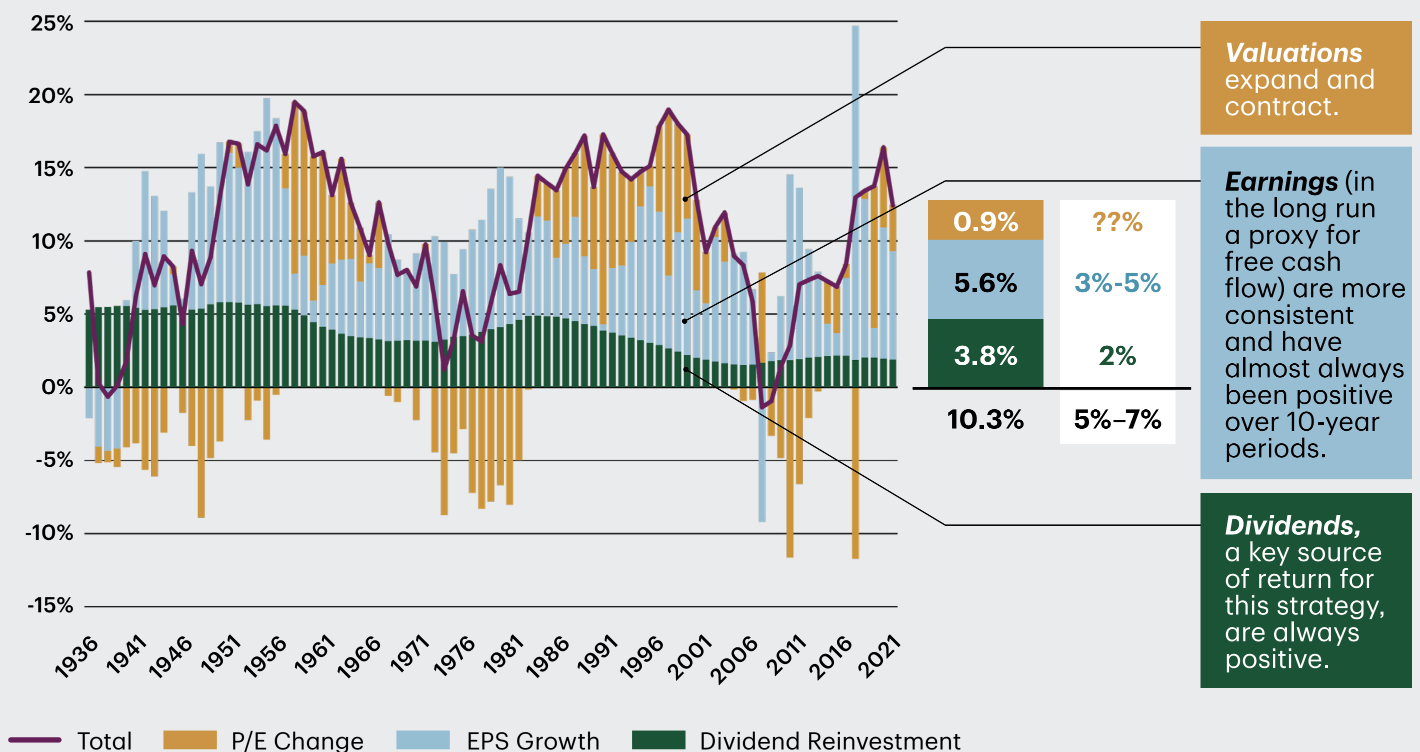
As investors, it is essential to understand the drivers of future equity market returns if we are to build a successful equity portfolio. Our analysis looks to the past for insights into the future, and as evidenced in **Figure 1**, demonstrates that equity returns are really determined by just three components: dividends, earnings growth (which, over the long run, serve as a proxy for free cash flow) and changes in valuations reflected by price-to-earnings multiples.

Notably, dividends have always provided a positive return and earnings have almost always been positive for every 10-year period. Valuations, on the other hand, can be positive or negative; they expand and contract. Over time they have contributed very little to the market's overall return.

As evidenced in this chart, attempting to time the expansion and contraction of price multiples is a fickle pursuit. Rather than chasing volatile valuations, we believe a portfolio built to capture the most stable and consistently positive contributors to market returns will be best positioned to offer attractive investment returns over the long term, and with that in mind the Global Equity Shareholder Yield strategy was created, followed by the U.S. Equity Shareholder Yield and Non-U.S. Shareholder Yield strategies in subsequent years.

Figure 1 – Earnings, Dividends and Valuation: Return Contributions for Rolling 10-Year Periods

(S&P 500 Index 1936 – 2022)



In more recent decades it can be seen that the contribution from dividends has declined, however this can largely be attributed to the rise of share buybacks as the preferred method of shareholder distribution for U.S. firms. As buybacks reduce the outstanding share count, they increase earnings per share, and so some of what previously showed up in this analysis as contributions from dividends is now embedded in the earnings component.

Sources: TD Epoch; Standard & Poor's.

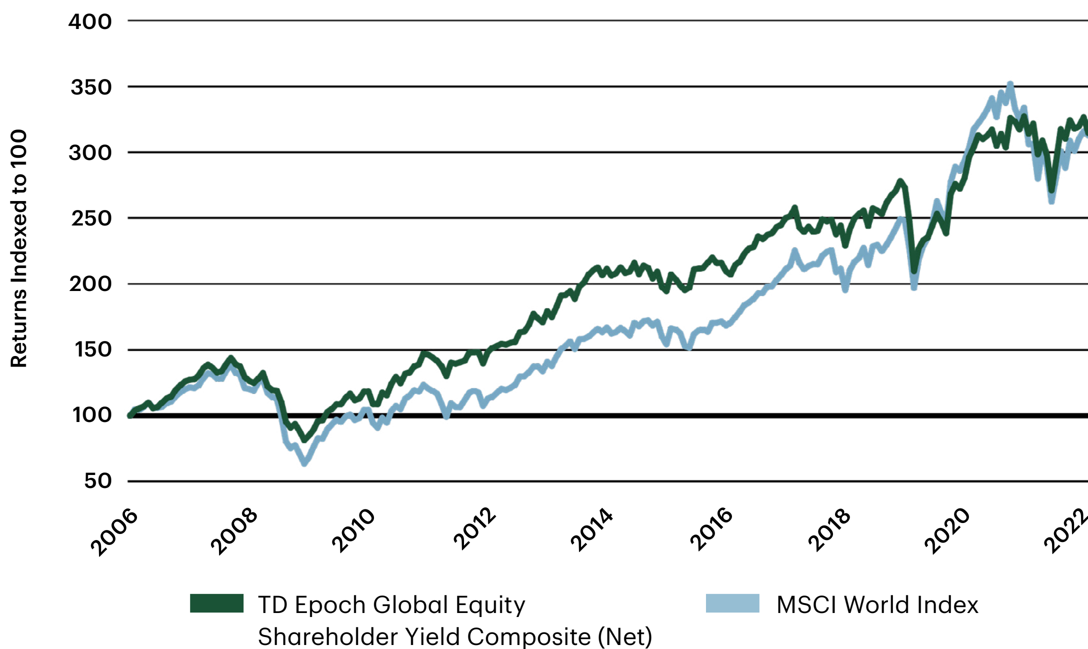
Note: We use U.S. historical data as a proxy for global markets because similarly detailed data is not available for non-U.S. markets.

Global Equity Shareholder Yield

The Global Equity Shareholder Yield strategy is a globally diversified, long-only portfolio that is built on the foundational belief that free cash flow and efficient capital allocation are the building blocks for successful equity investing. As evidenced earlier in this paper, companies who are generating high levels of free cash flow and being steered by skilled capital allocators will naturally be returning cash to shareholders on a consistent basis. Thus, the portfolio is focused on owning steadily growing companies that are perennial distributors of cash back to shareholders via shareholder yield. Our broader inclusion of share repurchases, and debt reduction as effective returns of capital expands our opportunity set beyond companies that just pay cash dividends and further diversifies our sources of return. We seek to achieve the majority of portfolio return from these distributions, but growth is also a vital piece of the puzzle for the strategy. A focus on growing cash flows ensures we are investing in dynamic and growing businesses, avoiding the pitfalls of high-yielding firms that are in fundamental or structural decline. The strategy has historically provided market-like performance or better with lower volatility, demonstrating strong long-term returns driven by resilience in down markets and sustained through strong participation in up markets. A focus on consistently capturing the most historically stable components of equity market returns makes it an ideal all-weather core equity allocation within a portfolio, around which tactical asset allocation decisions can be implemented.

Figure 2 – Cumulative Returns: Since Inception

As of June 30, 2023



	One Year	Three Year	Five Year	Ten Year	Since Inception
TD Epoch Global Equity Shareholder Yield (Gross)	11.11	12.39	6.97	7.23	7.53
TD Epoch Global Equity Shareholder Yield (Net)	10.70	11.95	6.55	6.81	7.06
MSCI World Index (Net)	18.51	12.18	9.07	9.50	7.09

Source: FactSet Research Systems. Performance shown for the TD Epoch Global Equity Shareholder Yield Composite and is shown net of management fees. Performance for the most recent quarter is preliminary and subject to change. Past performance is no guarantee of future results.

Strategy Attributes

Abundant Income

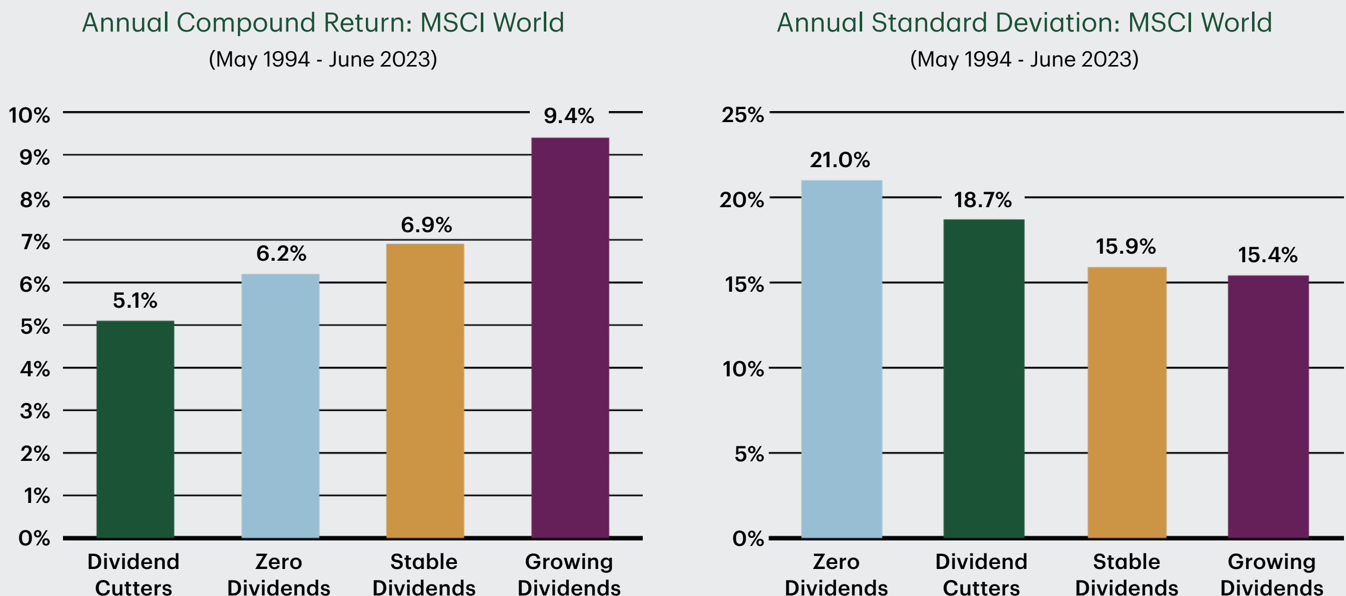
The strategy has historically provided a high level of income compared to stocks in general or to equity income strategies specifically. It has also provided a yield that has been more stable, and often more favorable to, investment-grade bonds. That's because in addition to looking for companies with attractive yields and a history of paying dividends, we also expect those dividends to grow. The strategy's yield has averaged 4.4% since its inception, ranging from 3.5% to 6.3% as of June 30, 2023.

Steadily growing dividends are a sign of good health and dividend policies matter. In the paper, Surprise! Higher Dividends = Higher Earnings Growth, Robert D. Arnott and Clifford Asness demonstrate that companies with stated dividend policies are associated with faster earnings growth than firms without stated dividend policies.

Dividend yield provides a positive cushion for total returns. As shown in **Figure 3**, over the long term, companies that pay and grow dividends have provided better total returns than companies that do not pay dividends or have cut them, according to data from Ned Davis Research that goes back to 1994 for global stocks and 1972 for U.S. stocks. And they have done so with less volatility.

It's important to emphasize that the strategy's objective is not to function solely as an income vehicle or "bond proxy," but as a core equity holding incorporating dividend yield as an important component of total return. We value the income provided by stable and growing dividends, but we're also focused on what they often signal about a company: abundant and growing free cash flow generation and effective capital allocation. We believe companies demonstrating these traits can deliver favorable returns with lower volatility, driving long-term wealth creation and preservation.

Figure 3 – Dividend Policies Matter



Reporting Currency: USD

Source: Ned Davis Research. Start period based on earliest available data.

Note: Based on equally weighted compound total returns of dividend and non-dividend paying MSCI World stocks. Each of the four portfolios were reconstituted at the beginning of each year based on the actual dividends paid over the previous year.

Downside Protection

The strategy has a lifetime beta of 0.79 and has historically been significantly less volatile than the market, with an annualized standard deviation of 13.5% over its life versus the MSCI World Index's 16% over the same period as of June 30, 2023. This has been especially true during market downturns, where the fund has typically fallen less than the broader market. The strategy is not explicitly managed to target lower volatility, but rather it is the organic outcome of owning the high-quality companies selected through our active fundamental research, portfolio construction and risk management processes.

When markets were negative, the strategy's net-of-fees return beat the MSCI World Index 69% of the time by an average of 3.9% on a net-of-fees basis. When markets were down by at least 5%, the portfolio outperformed 82% of the time by an average of 4.3% on a net-of-fees basis. (These numbers are based on rolling three-month periods since the strategy's inception at the start of 2006 as of June 30, 2023.)

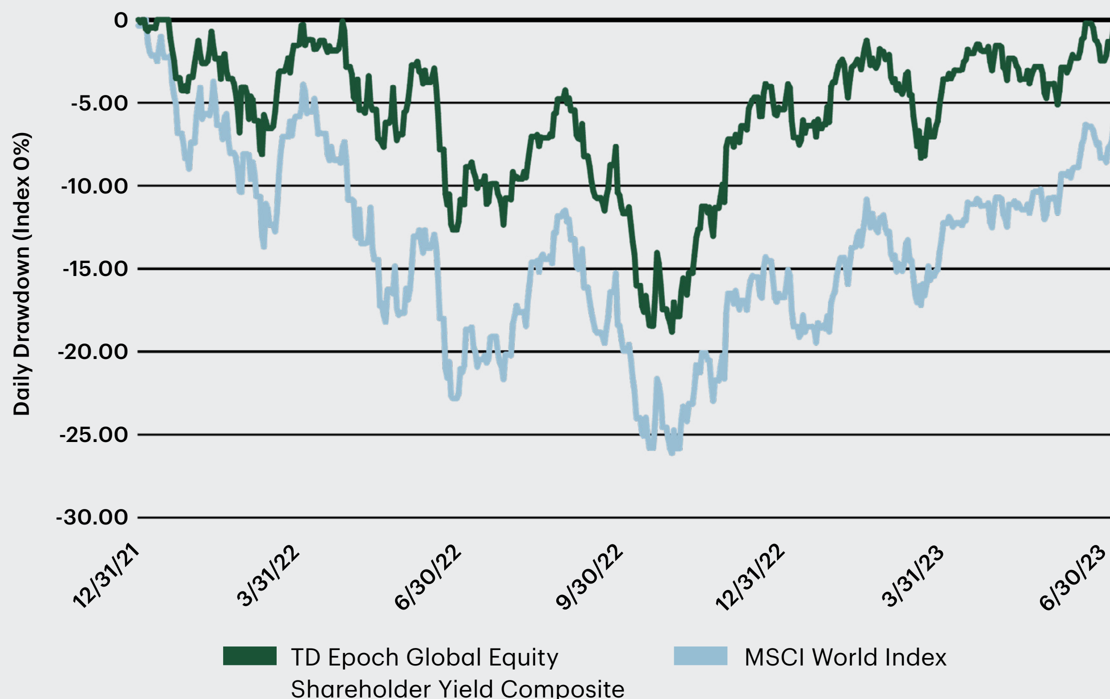
The strategy has traditionally had shallower drawdowns than the market. This is illustrated in **Figure 4** which looks at the strategy in a challenging macroeconomic backdrop.

Consistent Investment Style and Factor Exposure

The strategy has high exposure to the yield factor without sacrificing quality. While it is not a value strategy per se, it has a value tilt. These characteristics have been remarkably consistent over its lifetime. Suited to the role of a portfolio diversifier, the strategy tends to have low correlations with traditional equity styles due to our focus on growing dividends and our research that emphasizes financial metrics (i.e., cash flow) over accounting metrics (i.e., earnings).

Figure 4 – Daily Drawdown (Index 0%)

As of June 30, 2023



Source: FactSet Research Systems. Performance shown for the TD Epoch Global Equity Shareholder Yield Composite and is shown net of management fees. Performance for the most recent quarter is preliminary and subject to change. Past performance is no guarantee of future results.

The Case for Shareholder Yield Going Forward

The global macroeconomic and market environment remains challenging in a dynamic world of ongoing uncertainty. The fight with inflation that central banks began in 2022 continues, and despite the steady pace of disinflation achieved through significant monetary tightening, there is still much ground to cover for a return to target inflation levels. While forecasts for a near term recession have tempered in comparison to 6 months ago, the risk of economic contraction still looms as policy makers retain their hawkish stances and it's likely that interest rates will remain "higher-for-longer." The historically lagged effects of tightening along with eroding supports that have served to dampen policy effects (i.e., excess savings and strong profit margins) imply there may be more pressure forthcoming. Geopolitical risk is high as well with the war in Ukraine dragging on and creating uncertainty for trade flows and commodity prices. Additionally, growth in China is faltering, and a critical election in the U.S. is looming for 2024, the outcome of which could lead to a significant shift in policy priorities.

Recently rising broad market indexes have largely overshadowed much of the persisting uncertainty in the global macro environment, but we believe equity performance year to date is causing many investors to miss the forest for the trees. Closer examination of the rally we've seen thus far in 2023 shows that it has been largely confined to a short list of mega-cap tech stocks, fueled by speculation on future growth tailwinds from AI. This narrow segment of the market perceived to be best poised to benefit from AI has already seen multiples blow out, pricing in extraordinary growth expectations and dragging benchmark returns upwards. Zooming out and viewing the corporate landscape in aggregate, revenues, margins, and earnings remain pressured, and the outlook going forward is murky at best.

Near term, distilling the current backdrop into one word, we would say it is *uncertain*, and in the marketplace, uncertainty breeds volatility. The environment argues for a defensive and cautious approach to investing. In such periods, the defensive characteristics of GESY should serve investors well: a highly diversified portfolio of quality companies with growing cash flow, paying attractive dividends, with lower-than-market volatility, and protection during drawdowns.

Looking beyond headwinds presently facing markets and economies, when the world assumedly enters a period of more stability, we believe we'll see a return to a more historically normal macroeconomic environment, one that looks quite different than the years between the global financial crisis (GFC) and COVID. Barring another crisis (which we can, of course, never predict), there is little reason for central banks to return to the standard of hyper-stimulative near-zero interest rates and quantitative easing characteristic of that era, and consequently we don't anticipate seeing the same aggressive multiple expansion that took place either. Going forward, we believe shareholder distributions will likely be the most reliable component of equity returns, as they've been throughout history.

The Global Equity Shareholder Yield strategy is focused on owning companies with a track record of maintaining and growing cash flow through economic cycles, with strong market positions, pricing power, and disciplined capital allocation practices. A strategy built on these principles complements other equity styles as a portfolio ballast, providing durable stability and consistency; poised to weather the storm when volatility rises and to dependably capture the most stable components of equity returns over the long term.

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