Optimising equity allocations

Equity income strategies can be useful for captive insurers protecting their portfolio. Eric Hovey and Frank Lee of Payden & Rygel explain

With equities globally producing another year of strong returns, investors in many markets have enjoyed one of the longest equity bull markets in history. As just one example, the S&P 500 has rallied more than 250 percent over the past nine years.

Although the fundamentals of global equity markets continue to be supportive of valuations, the duration and magnitude of the market rally is driving captive insurance companies to look at introducing strategies that reduce equity beta while allowing for continued upside participation. Our favoured strategy is an equity income allocation that checks these boxes and provides the added benefit of higher income.

Lower volatility

One byproduct of higher dividend yielding stocks is lower volatility. You might question the need for lower volatility in an equity portfolio given the extremely low levels of volatility exhibited in the markets over the past year, but like a rubber band, the calm can be snapped back at any moment.

While the US equity volatility index dropped to new record lows (Chart 1), there are ample examples of potential sources of instability. Even though the rubber band survived frequent tests from countless negative global political headlines and multiple terrorist attacks in 2017, any one event this year might still trigger a break, leading to a market correction. In our opinion, the risks are not evenly weighted between maintaining historically low volatility and experiencing a technical correction.

This begs the question: how do high dividend stocks perform in down markets? Over the past 50 years, high dividend stocks have captured just 34 percent of the down market, while maintaining 100 percent of the up-market (Chart 2). If the S&P 500 was down 10 percent, high dividend stocks would have only been down 3.4 percent in the same period, significantly protecting gains realised over the bull market. The positively-weighted risk/reward profile is attractive for managing asset volatility on a captive's balance sheet, while participating in positive equity momentum.

If a captive wants to reduce equity beta, why not just sell equities and move into cash or fixed income? The primary argument against this move is the downfall of attempting to time the market over short-term periods. Staying true to your long-term asset allocation, while optimising the risk/reward of each sector, is a more prudent approach. In addition, global growth is strong and corporate earnings are expected to see double digit growth for 2018. This expectation combines with other positive factors to give a favourable fundamental equity outlook and we continue to believe an equity allocation is beneficial over the medium-term for captives that can take the risk. Moving into high dividend paying stocks allows an investor to participate in a market rally, while prudently protecting the portfolio to the downside. Again, historically high dividend stocks have captured 100 percent of the up move in the S&P 500, while limiting the downside.

More income

Over the past decade insurance companies have taken on more risk in the search for higher investment income by moving down the credit quality spectrum, extending longer in duration, or expanding more internationally.

However, dividend paying stocks are often overlooked as sources of income despite providing yields comparable to most fixed income securities. To begin 2018, there are several high-quality dividend-paying companies that offer yields above 4 percent, such as AT&T with a dividend yield of 5.3 percent in the US or Atlantia paying 4.1 percent in Europe.

Granted, companies subject to letters of credit, risk-based capital constraints, or other restrictions may find their haircut- or capital-adjusted yields to prefer fixed income markets, but another attractive characteristic of dividend paying stocks is dividend growth. Unlike longer duration bonds, increasing dividends can serve as a hedge against higher interest rates and inflation, providing a growing income stream for investors. That is a feature found only in the floating rate coupon realms of fixed income.

How Payden & Rygel approach equity income strategies

The Payden equity income strategy is managed with the goal of continuing to deliver high levels of income and superior risk-adjusted returns. Unlike many dividend stock strategies, Payden combines common stocks with real estate investment trusts, preferred stocks, and master limited partnerships to optimise the return profile with increased diversification.

Additionally, we take a bond investor's approach to analysing company cash flows for stability and growth potential. We leverage our 34 years of fixed income expertise to make stock investment

Chart 1: US Equity Volatility Index (VIX)

VIX Index
55
50
45
40
35
30
25
20
15
10
5
2010 2011 2012 2013 2014 2015 2016 2017

decisions, searching for high levels of consistent income from high-quality companies. Our global industry analysts conduct proprietary research up and down the entire capital structure, seeking companies with the ability and willingness to continue covering their dividend payments, and preferably grow them over time. Over 80 percent of the issuers held in the equity strategy are also held in fixed income portfolios within the firm. The strategy seeks to be well-diversified across common stock sectors and security types, not concentrating on the historical dividend plays of utilities and telecommunications. Many strategies are also focused solely on the US markets, however, expanding the large cap dividend universe to include global markets increases the opportunity set by 150

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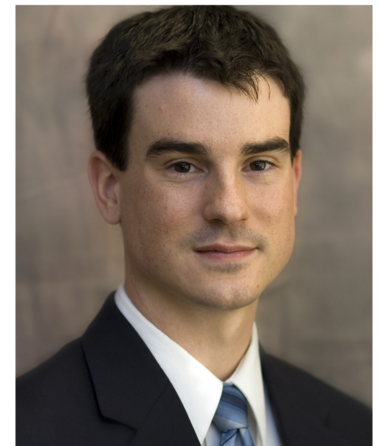

Eric Hovey, SVP senior portfolio manager insurance accounts, Payden & Rygel

Chart 2: High Dividend Stocks – Strong Upside Capture, Low Downside Capture

50 Year Total Return (1967-2016)

	High Dividend Stocks	S&P 500	Difference
Total Return (Annualised)	12.01%	9.04%	2.97%

Up Markets: 102% Market Capture (40 positive return years)

	High Dividend Stocks	S&P 500
Total Return (Annualised)	16.89%	16.56%
Calendar Year "Wins"	22 Years	18 Years
Market Capture (%)	102%	

Down Markets: 34% Market Capture (10 negative return years)

	High Dividend Stocks	S&P 500
Total Return (Annualised)	-5.57%	-16.50%
Calendar Year "Wins"	7 Years	3 Years
Market Capture (%)	34%	

Source: Kenneth French

percent. Payden currently offers the strategy through separately-managed accounts and commingled vehicles.

Equity income strategies present a great opportunity for captive insurers looking to protect gains in their portfolio, while maintaining participation in the broad equity market. It is also important to note that not all equity income strategies are the same. We believe a diversified portfolio of income producing sectors and security types delivers the upside participation, lower volatility, and higher income that meets the needs of a captive insurance company. **CIT**

"Unlike longer duration bonds, increasing dividends can serve as a hedge against higher interest rates and inflation, providing a growing income stream for investors"

Frank Lee, SVP, senior equity strategist, Payden & Rygel