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The Value of Income Diversification

Mellon's Equity Income Team

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For the past 30 years, investors have bid up an investment theme each decade, typically resulting in the overvaluation of that particular market segment. Due to excitement surrounding the popular theme of the moment, the S&P 500® Index typically becomes overweight the dominant theme of the prior ten years. In each occasion, the previous dominant theme stumbled during the subsequent decade as the dominant theme did not perform as well as investors expected. This phenomenon informs our belief that the future can be very difficult to predict. We believe that a strategy that purchases discounted stocks can be a great diversifier unlike maintaining sole exposure to an S&P 500 Index portfolio.

This view is also held by one of the most prominent investors in modern history, Warren Buffett, who described how indexes can be driven to unsustainable levels. His comments from a 1999 interview with Fortune ring particularly true today.[1] During this interview he made three vital points. First, interest rates drive stock prices. Second, profits can't hold above 6% of GDP or political problems can occur. Third, investors have a habit of looking in the rear-view mirror instead of through the windshield. All of these points are particularly concerning today as rates hit 5,000-year lows, profits as a percentage of GDP are 9% and large cap technology stocks continue to boom.

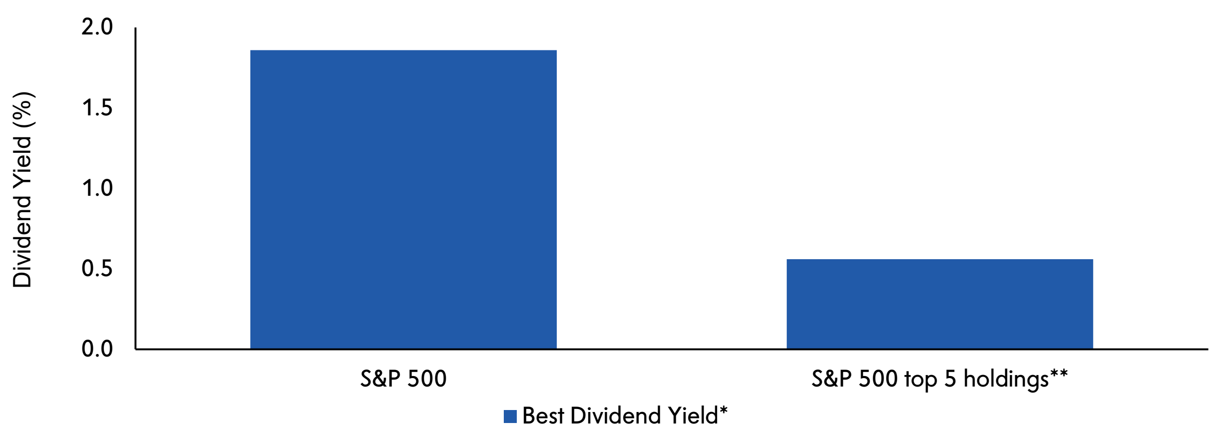
In this note we highlight key turning points in market leadership over the past three plus decades. Additionally, we outline how allocating to a value and income-oriented strategy can provide robust diversification elements and lead to better returns relative to an S&P 500 Index allocation alone.

Value-Oriented Income as a Diversifier

We have developed a platform of income-generating portfolios with a decades-long history of seeking to deliver robust yielding strategies with low income volatility. We believe these types of income-generating equities are particularly attractive as a diversifier versus the S&P 500 in today's market. Our proprietary framework seeks to deliver income as an outcome and generate sustainable and consistent income with low volatility.

In fact, the income characteristics of Mellon's equity income suite of strategies compares quite favorably to the S&P 500, and even more so to the highly concentrated top 5 holdings of the S&P 500. Mellon's Income Stock and Large Cap Core Equity Income strategies seek to maintain a minimum 50% dividend yield premium, while Mellon's Global Infrastructure Dividend Focus strategy seeks to deliver 6% equity yield profile throughout the market cycle.

Best Dividend Yield*



Source: Bloomberg and Mellon as of September 30, 2020. *Best Dividend Yield is Bloomberg's forecasted 12-month dividend yield. **Weighted average top 5 S&P 500 holdings Best Dividend Yield.

1990s: Internet Boom[2]

The 1990s present a compelling example of a theme performing very well—in this case, the tech-fueled internet bubble. At the end of 1999, technology stocks traded at 47.8x earnings and made up 28% of the S&P 500®, making the overall index appear expensive. Importantly, this over valuation was not caused by small internet stocks; it was mainly large cap stocks with earnings. Therefore, the risk of owning the S&P 500 was largely due to the high valuation multiples of these mega cap stocks, which were not sustainable. For example, the biggest weight in the S&P 500 at the end of 1999 was Microsoft, which traded at a 65.7x price-to-earnings (P/E) multiple. After three years and a 56% decline, Microsoft was one of the biggest catalysts of the 38% decline in the S&P 500 index.

Technology wasn't the only expensive theme at the time. In 1999, the top five companies in the S&P 500 traded at an incredible 56.0x earnings. Three years later, those top five companies traded at 21.0x earnings. It is very difficult for the largest companies in the market to sustain the growth rates necessary to support these very high multiples.

On the other hand, sectors such as Financials got left behind as investors showed little interest in slower growing companies. Financials traded at only 14.5x earnings and made up 13% of the S&P 500. The internet boom resulted in the technology, media and telecom (TMT) bust of 2000, triggering a 3-year bear market. Since investors were not paying much for Financials at the peak of the bubble, these stocks outperformed the broader market over the next three years with a decline of only 2%. Along with Financials, the cheapest quintile of the market by P/E also protected on the downside, increasing by 6% in the three years after the technology bubble, and beating the overall market by an impressive 44%.

2000s: Energy and China's Economic Rise[2]

Energy was the star of the first decade in the 2000s. At the start of the decade, the market was not focused on the sector, though it rose 147% versus the S&P 500, which decreased 10%. In contrast, the sector that previously benefited from the explosion of the internet declined 50% as the P/E multiples contracted in the Technology sector.

Additionally, China's extraordinary economic expansion led to a prolonged bull market in commodities and the emerging markets asset class, an outcome that was decidedly not on the radar of investors in the late 1990s.

2010s: Cloud Expansion[2]

In the 2010s, Technology made a big comeback after delivering the worst S&P 500 sector performance of the prior decade. After ten years of underperformance, the Technology sector traded at a modest premium to the market by the end of 2009. The sector was out of favor, providing investors the opportunity to purchase technology stocks at a market multiple despite offering over 40% higher growth prospects versus the overall market. Conversely, the Energy sector traded at peak cyclical earnings as the market continued to forecast strong growth in China.

Ultimately, oil and commodities corrected due to a prolonged period of sub-trend global growth. This correction impaired higher-cost assets that had developed after investors assumed a continuation of the commodity super-cycle. Excess supply weighed on the supply/demand picture, resulting in a challenging period of rationalization.

2020s: Opportunities[2]

After a decade of multiple expansion and relative outperformance of growth-oriented technology stocks, we believe this segment is overrepresented in the S&P 500®. As of October 2020, technology is back to peak-1999 levels at 27.5% of the overall market. However, this number actually underrepresents the true level of exposure. There is an approximate 7% of technology stocks in the Communication Services sector and nearly 5% in the Consumer Discretionary sector. Therefore, almost 40% of the S&P 500 is made up of technology. On the other side of the spectrum, the cyclical sectors of Materials and Energy comprise only 5% of the index.

To further exacerbate this concentration problem, the top five stocks in the S&P 500 comprise 22.9% of the index versus 16.7% in 1999.

Top Five Stock Weightings in the S&P 500

As of 10/31/20	Weight (%)	As of 12/31/99	Weight (%)
Apple	6.5	Microsoft	4.9
Microsoft	5.7	General Electric	4.1
Amazon	4.8	Cisco Systems	2.9
Alphabet	3.6	Walmart	2.5
Facebook	2.3	Exxon Mobil	2.3
	22.9		**16.7**

Source: Bloomberg, as of October 31, 2020.

Would any risk advisor suggest it is prudent to have almost 25% of your portfolio in five stocks and a 40% sector concentration?

Our current view is that the S&P 500 is positioned to do well if the next ten years appear similar to the last ten years. However, as noted earlier, we are at 5,000-year lows in interest rates, at peak corporate profit margins and have been through a pandemic that caused a cyclical acceleration in technology spending reminiscent of Y2K in the late 1990s.

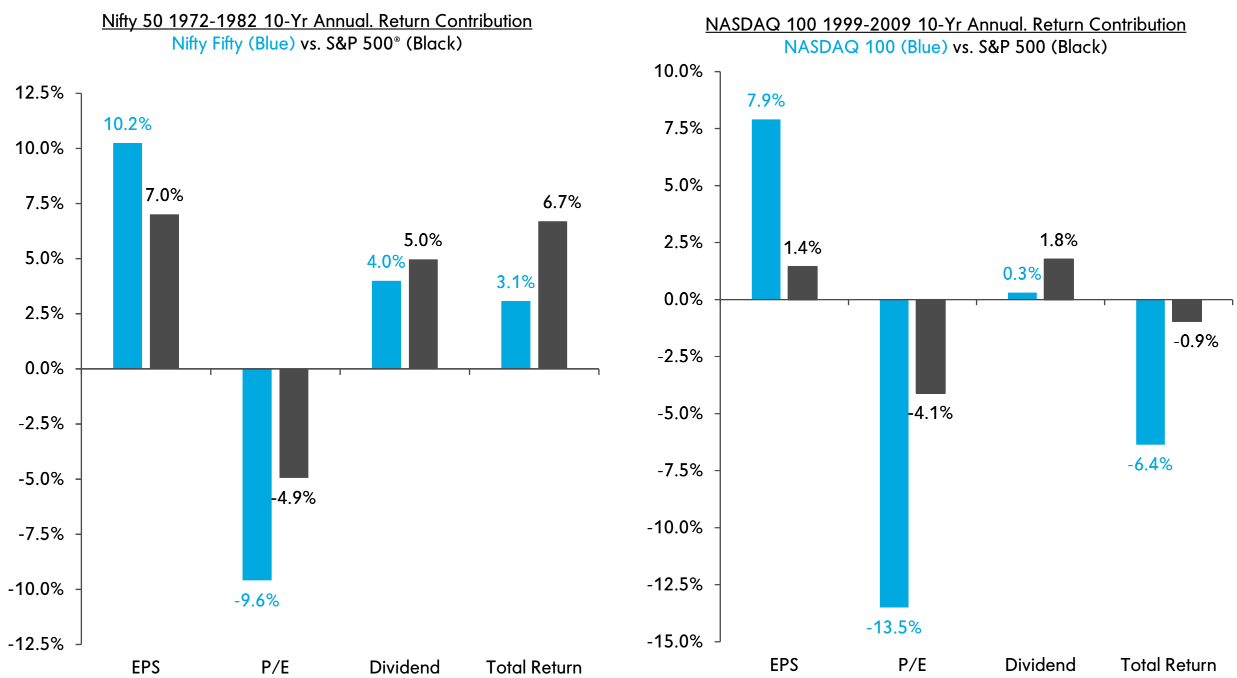
As Warren Buffett noted, investors tend to look in the rear view mirror. In the second quarter of 2020, Technology was only one of two sectors that reported positive sales and earnings growth. What about 2021? Based on bottom-up, 2021 S&P 500 earnings expectations from Bloomberg (as of November 18, 2020), the Technology sector will continue to grow earnings at 14.9%. However, this is expected to be below the overall market. By comparison, the Financials sector is expected to grow earnings 15.5%, while the Industrials sector is forecasted to grow 29.6%.

Is it different this time?

We are often asked whether widespread disruption and secular tailwinds supporting the digitization of all facets of the economy renders the argument for rotation away from the dominant theme moot. In essence, is it different this time? There is a persuasive argument that today's dominant growth technology companies will grow earnings faster than the broader market, let alone value-oriented, income-generating opportunities. In fact, the good news is we can concede or acknowledge this may occur over the next ten years, but still be accurate in the assumption that market leadership changes.

The analysis below lays out two historical periods that have similarities to the current environment. The first reviews performance trends after the Nifty Fifty phenomenon in the late 1960s and early 1070s. The other focuses on the NASDAQ 100 bubble in the late 1990s. In both subsequent ten-year periods following their respective market dominance, valuation multiple contraction overwhelmed the picture and led to material underperformance, despite posting better earnings growth than the broad market.

Performance Trends of the Nifty Fifty and NASDAQ Bubbles

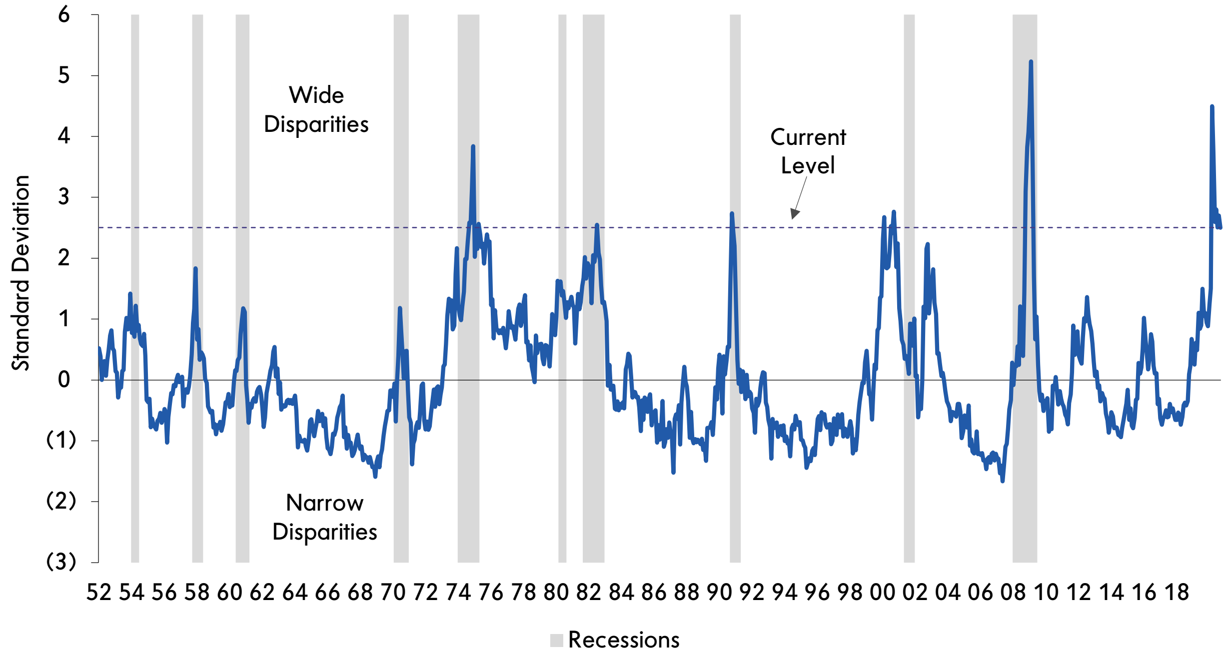


Source: Stifel, SRC Chart Books (various issues), Standard and Poor's, Univ. of Alabama Bruno Library historical financial report database. Nifty Fifty list (an informal designation for fifty popular large cap stocks on the New York Stock Exchange in the 1960s and 1970s that were widely regarded as solid buy and hold growth stocks. The Nifty Fifty 10-Yr Annualized Return Contributions are from the median stocks returns.

Much of this result comes down to inflated valuations and earnings expectations coupled with wide valuation spreads.

The chart on the next page illustrates how wide valuation spreads are for value stocks compared to broad market averages. Even after the market rallied from depressed levels in late March 2020, value securities remain two and a half standard deviations less expensive versus the market. Historically speaking, value securities outperform meaningfully after reaching just two standard deviations over the subsequent 12-month period.

US Large-Capitalization Stocks Valuation Spreads: The Top Quintile Compared to the Average



Source: National Bureau of Economic Research, Empirical Research Partners Analysis as of September 30, 2020. September 2020 = most recent data available.

Creating Value

We believe investors seeking technology and growth exposure should maintain an allocation to the S&P 500®. However, as demonstrated in the early 2000s, an investment in the cheapest quintile of the market added alpha and downside protection when market conditions changed. While it is anyone's guess which sector will produce the highest returns in the 2020s, we believe the case for diversifying an S&P 500 allocation is extremely compelling at this juncture. Income-oriented equities have been at the eye of the COVID-19 storm due to their higher levels of cyclicality. Recent positive vaccine news is a clear catalyst for a more fulsome economic normalization and recovery, which may prove to be a turning point for a recovery in value securities. There are plenty of attractive valuations in today's market. Therefore, an allocation to a time-tested income-oriented strategy would provide great diversification to an S&P 500 index portfolio.

John Bailer, CFA

Executive Vice President, Senior Portfolio Manager

John is the lead portfolio manager for the dividend-focused Large Cap Value strategies. In this role, he was responsible for creating our Income Stock strategy to meet demand from clients seeking attractively valued higher dividend income while not sacrificing dividend growth. He has managed the team's dividend strategies since 2005 and is the lead portfolio manager for the Equity Income strategy which emphasizes dividend growth stocks. He is also a senior research analyst on the Dynamic Large Cap Value strategy, responsible for the Consumer, Technology and Communication Services sectors. John also is the chair of the Mellon Proxy Voting Committee. Previously, John was a senior research analyst on the Large Cap Value team and joined the firm in 1992.

John received a BS in accounting and information management systems, with distinction, from Babson College and an MS in finance from Boston College. John holds the CFA® designation and is a member of the CFA Institute and the CFA Society Boston.

James Lydotes, CFA

Managing Director, Senior Portfolio Manager

Jim is a senior portfolio manager for the Global Infrastructure Dividend Focus Equity, International Equity, International Small Cap Equity and Global Healthcare REIT strategies. Jim has been the lead portfolio manager on the Global Infrastructure Dividend Focus Equity and Global Healthcare REITs strategies since their inceptions in 2011 and 2015, respectively. He engineered these thematic, outcome-oriented income strategies to provide exposure to distinct themes in a risk-aware framework in partnership with clients. Previously, Jim was a senior research analyst on the Global Equity team, and joined the firm in 1998.

In addition to his role as lead portfolio manager, he assists in the development and enhancement of the team's quantitative stock selection models and processes. Jim also manages the firm's research associate program, a group that combines fundamental research with advanced technical skills.

Prior to joining the firm, Jim served as a fixed income business analyst at Wellington Management Company. He has been in the investment industry since 1998.

Jim earned a BA in economics from Syracuse University. He holds the CFA® designation and is a member of the CFA Institute, the CFA Society of Boston and the Boston Committee on Foreign Relations.

William Adams
Managing Director, Global Investment Strategist

Bill is a global investment strategist for the firm's equity, Small Cap Value, Non-US and Emerging Markets investment disciplines, responsible for communicating the teams' strategies to clients, prospective clients and consultants. He is a critical interface between client-facing staff and investment teams and guides the messaging and positioning of these investment strategies.

Before joining the firm, Bill was an associate at Deutsche Bank, where he was responsible for European equity research sales. Previously, he was a senior account officer at Putnam Investments, where he managed 401(k) relationships, and a senior account administrator at State Street Research and Management Co. Bill has been in the investment industry since 1995.

Bill earned a BA in political science from Boston College and an MBA in finance from the University of Maryland.

Endnotes

[1] Fortune Magazine, Mr. Buffett on the Stock Market, November 22, 1999. https://www.berkshirehathaway.com/1999ar/FortuneMagazine.pdf

[2] Figures from this section are based on Bloomberg data.

Disclosure

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