EQUITY STRATEGY REVIEW
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International Equity

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A great deal of attention has been devoted over the past couple of years to ESG investment trends, not least the migration from European to US markets. This phenomenon is laudable and, as outlined in our November Insight piece, there is growing empirical evidence to suggest that ESG metrics are both correlated with longer-term corporate financial performance and complementary in assessing fundamental risks more comprehensively.

However, in the spirit of our "growth contrarianism" and attempts to identify opportunities that are underappreciated by the broader market, we consider an equity market feature that is steadily being exported from the US for consumption in both Europe and Japan; namely, corporate share repurchases, or "buybacks".

Recent research by Redburn reports that since 2010, aggregate earnings growth for S&P 500 constituents has compounded at an annualized rate of 7.7%. This compares with the equivalent European index (Stoxx 600) figure of 3.1% earnings CAGR over the same timeframe. By their estimate, almost half of that annualized differential, or around two percentage points per year, can be attributed to more prolific buybacks among US large caps. Federal corporate tax cuts in 2017 likely acted as an accelerant for the S&P500, but the discrepancy remains noteworthy.

There are some structural and cultural elements that help to sustain the primacy of dividends, and relative disdain toward buybacks, in Europe. In the UK, which is compositionally skewed toward higher yield Financial and Natural Resources sectors, there is a large dividend appetite from popular equity income funds. In other parts of the continent, stock options are less prevalent and share price performance tends to be a smaller component of overall executive compensation. In addition, tax treatment of dividends versus buybacks is not always conducive to the latter.

Despite Europe being a transatlantic laggard in terms of repurchases, Morgan Stanley data show that their deployment within the region has aligned favorably with well-performing stocks. Since the onset of the pandemic there has been a marked divergence between the market-relative performances of MSCI's Buyback and High Dividend Yield indices (Exhibit 1). Enforced dividend curtailments (e.g. by bank regulators) have had an impact, but the divergence has persisted even as those constraints have eased. Furthermore, looking at risk-adjusted returns on a five-year basis, Net Buyback Yield has one of the highest Sharpe Ratios across all factors. High absolute dividend yields are, on average, an inherently riskier standalone characteristic (Exhibit 2).

In Japan, the issue of deeply conservative, cash-rich (aka financially inefficient) balance sheets has been a long-entrenched and widespread anomaly. In many instances the picture is complicated further by extensive cross holdings between companies or the conglomerate keiretsu networks of affiliated companies.

EXHIBIT 1: PERFORMANCE OF BUYBACK INDEX VS. DIVIDEND YIELD INDEX

Source: MSCI, Bloomberg, DuPont Capital

EXHIBIT 2: 5-YEAR SHARPE RATIOS FOR VARIOUS FACTORS

Source: FactSet, Morgan Stanley Research

Nevertheless, corporate governance reforms and more forthright dialogue with institutional investors have helped to accelerate return enhancing and shareholder-friendly initiatives in several of the more multinational industries. High profile examples in our portfolio include Sony, which has been repurchasing billions of dollars of stock as part of its broader strategic streamlining measures, and Hoya, a diligent advocate of financial fitness. The latter's share count has declined by 10% over the past five years.

Of course, the persistent deflationary, or at least non-inflationary, environment that has beset Japan for a generation has not been punitive on cash-hoarding by domestic corporates. Should that change, and the current wave of global impulses drive Japanese price indices to even modestly positive territory on a sustainable basis, then negative real interest rates could catalyze payouts and buybacks.

We do not explicitly consider a company's proven ability to conduct share repurchases as a prerequisite for investment. All things considered, the sector context, specific liquidity requirements and even sovereign tax regimes can influence optimal capital structures. However, we believe that any management team that is unwilling to include buybacks in their capital allocation calculations and hierarchy is not painting with a full financial palette. Typically, companies that have such inculcated top-down mindsets or cultures are more vulnerable to other strategic inertias or operational blind spots.

Among the most recent additions to the portfolio in the past quarter, three of the four demonstrate a proactive approach toward buybacks. Mid-cap Australian testing and inspection firm ALS Ltd has repurchased more than 4% of its equity since 2017 and Japanese bicycle manufacturer Shimano recently announced it's first meaningful program in fifteen years. Pharmaceutical giant Roche has just undertaken a significant (>$20bn) buyback and cancelation of Novartis' passive financial stake. In the fourth instance, biotech and life science specialist Lonza, which has abundant growth avenues and trades at higher valuation multiples, the prevailing capital priorities are organic investment and acquisitions.

Overall, we are encouraged that some of the unvindicated stigma associated with share buybacks in international markets is eroding. Dividend yields remain an important component of total return in this asset class. However, payouts should not be rigidly determined, to the exclusion of other return mechanisms, as circumstances and valuations change .

About our firm:

DuPont Capital Management is an SEC registered investment advisor based in Wilmington, Delaware. Since the firm's establishment in 1993, we've had a long history of developing global investment opportunities in both traditional and alternative strategies across equity, fixed income and alternative investments. Our investment team structure gives us the ability to be flexible and adapt to changing market conditions. DuPont Capital's focus is delivering consistent investment management results for our clients. Our history of institutional asset management is rooted back to 1942 when our former parent company, DuPont, established a pension plan for its employees. Corteva Inc. succeeded DuPont as sponsor of the DuPont Pension Plan in 2019. DuPont Capital is a wholly owned subsidiary of Corteva and continues to manage the legacy DuPont Pension Plan.

DuPont Capital's President and CEO, Valerie Sill believes in education and diversity of experience as represented in our investment teams which are comprised of PhDs, engineers, medical doctors, and scientists. We believe their global expertise creates a portfolio implementation edge that benefits our clients.

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Important Disclosures: