DuPont Capital

EQUITY STRATEGY REVIEW
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International Equity

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With investor sentiment and risk appetites swooning since the turn of the year, the markets are focusing squarely once again on relative valuations and financial flexibility as potential shock absorbers against looming headwinds to earnings momentum. Recent surveys indicate that a plurality of investors are now categorizing inflation impulses as stubbornly permanent rather than transitory in nature, but more noteworthy is the fact that the vast majority of institutional managers (a net diffusion of 60% of respondents) consider the economy to be "late cycle" in nature. As such, the prospect of a global recession has now edged ahead of inflationary fears on aggregate risk radars, with the hybrid "worst of both worlds" outcome of stagflation being increasingly cited as a plausible scenario.

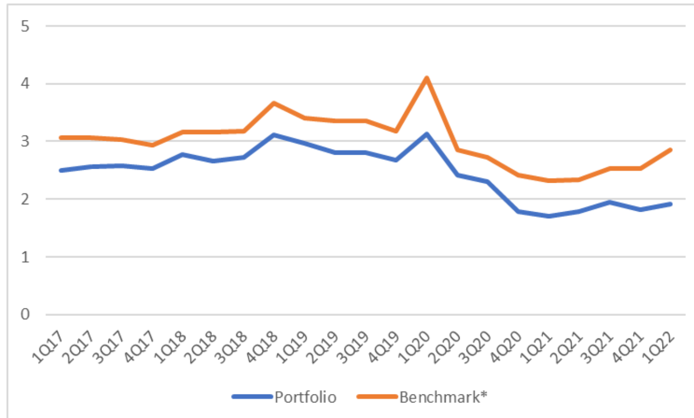
In previous quarters we have touched upon some sources and examples of that company-specific pricing power that can provide margin and earnings resilience within an environment of more pronounced inflation. Typically, characteristics such as persistent innovation, proven productivity paybacks and brand power fare relatively well when stress-tested by economic headwinds. Our recent observations on the increasing prevalence—and performance—of share buybacks in some corners of international markets also reflect the importance that a dynamic approach to shareholder-friendly total return can play as conditions evolve.

Earnings in many cyclical sectors—not just those most directly vulnerable or geographically proximate to fallout from Russian warmongering—have come under sequential pressure and seen anticipatory de-ratings of their valuation multiples. Anticipated movements in interest rates and monetary policies, coupled with lingering bottlenecks across supply chains suggest that even if "late cycle" Europe avoids an economic recession, the scope for upside surprises to either valuations or earnings momentum into 2023 has become narrower.

Is it therefore worth considering how important a role absolute dividend yields could play in a potentially more rangebound market environment?

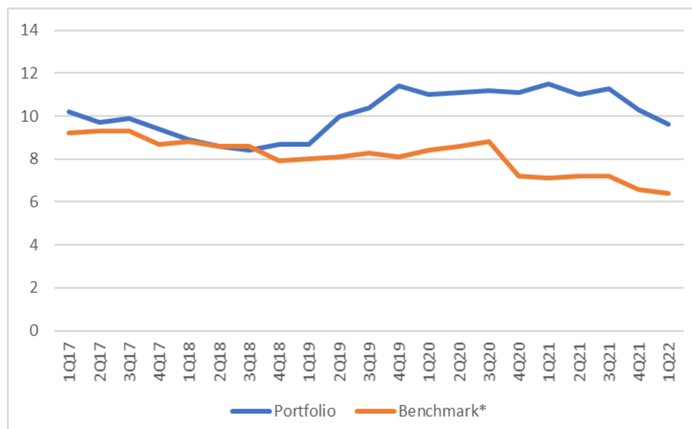
From a qualitative perspective we, as stock pickers, tend to attach as much significance to the direction (growth) of individual dividend yields as their absolute level. A progressive payout, in line with underlying earnings growth and financial headroom is often a healthier profile than a higher but less sustainable yield. Empirical evidence appears to bear this out, with research showing that a basket of European firms that bear reasonable—but, crucially, well covered and earnings-driven—yields of >2% outperform the market on a through-cycle basis. This awareness of dividend vitality can also help in sidestepping value traps; examples of such pitfalls in the telecoms sector have seen management teams at Vodafone and Telefonica beholden to maintaining payouts in vain and to the detriment of capex.

EXHIBIT 1: DIVIDEND YIELD (%)



Source: MSCI, Bloomberg, DuPont Capital

EXHIBIT 2: 5-YEAR DIVIDEND GROWTH (%)



Source: FactSet, Morgan Stanley Research

Over its history, our portfolio has featured a modest but consistent headline dividend yield differential versus its benchmark. Over time this spread has averaged just over 0.5%. However, in keeping with the compounding and cash-generative hallmarks of many of our holdings, the underlying growth rate of dividends—viewed over a five-year CAGR—has maintained a fairly steady cadence in the 9-12% range. In contrast, the longer-term compound growth rate of the index has—even allowing for the enforced dividend "holidays" among banks and cash conservation measures implemented in 2020—is more stagnant.

This balance of progressive and well-covered dividend payouts across our holdings ensures an adequate degree of financial rigor on behalf of company managements without constraining their broader opportunity set of capital allocation options. The balance sheet strength of our portfolio (a structurally lower net debt/EBITDA ratio than the benchmark) coupled with healthy and recurring returns on capital offers ample financial firepower for self-funded capital investments. Several of our longest-tenured holdings, including Pernod Ricard and Atlas Copco, have demonstrated prowess in successfully acquiring businesses and adjacent brands that expand their addressable markets. Such value-enhancing M&A skillsets are admittedly rare—markets are littered with plenty of counter-examples—which is why sound capital stewardship is a key criterion in our qualitative scoring of companies in any sector. Quality compounders do not need to adopt a "rob Peter to pay Paul" funding approach to shareholder returns versus business needs. It can also be a relative differentiate between viable investment candidates and value traps in capital-intensive or deeply cyclical industries.

Dividend yield dynamics are also a reliable platform for our own valuation discipline when evaluating individual companies or budgeting active risk positions at the portfolio level. They serve as an anchor for reconciling cash flow metrics and capital efficiency at the firm level. Simultaneously, they ensure that our portfolio holdings remain well-diversified in terms of time horizons and catalysts.

As Warren Buffett shrewdly observed, "when the tide goes out you discover who's been swimming naked." We maintain a measured approach to balancing future earnings power against current cash flow generation. As the tide of market returns potentially ebbs over the coming quarters, you will not find our portfolio paddling among the dividend yield skinny-dippers.

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: