Allspring

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PM Perspectives: Global Equity Enhanced Income

Solving the income tug-of-war

Over the past three years, the world has experienced a global pandemic, spiraling inflation, and one of the fastest rate-hiking cycles ever recorded. Despite these challenges, Allspring's Global Equity Enhanced Income (GEEI) strategy delivered attractive yield and robust capital growth. Eddie Cheng, Vince Fioramonti, and Megan Miller each manage components of the strategy. Here they share lessons learned in managing the strategy throughout this challenging market environment along with opportunities over the longer term.

For income investors feeling whipsawed from rapid shifts across the income spectrum, GEEI may offer a better solution because it combines an actively managed high-yielding equity portfolio with an enhanced systematic options overlay, seeking to deliver a more consistent income stream in addition to long-term capital growth.

Q: WITH YIELDS ON FIXED INCOME AND EVEN CASH LOOKING ATTRACTIVE, WHY SHOULD INVESTORS CONSIDER EQUITY INCOME STRATEGIES?

Eddie: It's true, compared with three years ago, investors have many more choices when it comes to income-generating assets. That said, we believe income investors need more than just income in an environment of heightened inflation—they need a strategy that can offer an attractive level of income and help protect real purchasing power over the long term.

Certain equity income strategies may be an attractive solution to meet these needs. However, balancing income and total return can be somewhat of a trade-off. We like to think of it as the equity income tug-of-war. Our approach seeks to overcome this challenge by combining a well-balanced high-yielding equity portfolio and an actively managed options component to deliver high, consistent income streams along with long-term capital growth. This diversified and balanced approach helps overcome some common pitfalls of equity income investing.

Q: WHAT BENEFITS DOES A SYSTEMATIC APPROACH OFFER TO AN EQUITY INCOME PORTFOLIO?

Eddie: A systematic approach seeks to provide a disciplined, consistent way of implementing the investment philosophy and constructing portfolios, which can help mitigate certain behavioral biases that arise in more discretionary approaches. We believe it is key to recognize the limitation of financial models as well as the irreplaceable wisdom of human judgment. While our approaches are systematic, they are researched, designed, and actively managed by experienced portfolio managers, providing an additional lens to keep systematic tools and models in check.

Our systematic approach also has some commonalities with fundamental techniques. For example, we look at various metrics of a security to help determine its attractiveness. The power of this approach lies in the ability to process vast amounts of data efficiently and analyze thousands of securities across a wide variety of metrics daily. This provides a highly effective way of identifying companies with the potential to deliver sustainable income and outperform their peers in our equity portfolio—before we review these companies qualitatively. We have a similar approach in our options component, using proprietary models to assess hundreds of options to help identify the most suitable ones for our strategy.

The cornerstone of systematic investing is research. Our team has decades of experience in researching new signals and methodologies to enhance portfolios for clients. The latest evolution of our equity income strategy involves the use of natural language processing to gauge sentiment around dividend policy. This machine-learning technique provides our portfolio managers with an additional lens to assess reliability of a company's dividend.

Q: VALUE STOCKS, COMMONLY FOUND IN INCOME PORTFOLIOS, HAVE FLUCTUATED DRAMATICALLY SINCE MID-2022. HOW HAVE YOU NAVIGATED THESE HUGE STYLE SWINGS?

Vince: Across the market cycle, we manage portfolios with the goal of avoiding extreme style exposures and focusing on bottom-up stock selection by using our tools to measure company cash flows, and the price markets are willing to bear for these cash flows.

While many investors rely on market timing, we concentrate on discovering mispriced stocks according to their expected future cash flows to generate excess returns and on maintaining a beta of one. For example, in 2022, many investors were selling technology stocks expecting an impending recession—which markets are still awaiting—only to become buyers of tech stocks months later in the name of artificial intelligence (AI) and generative AI.

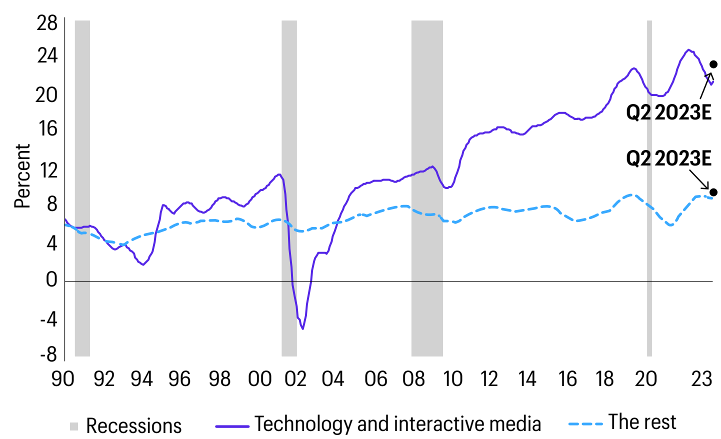
We seek to understand the context of why asset prices are selling at a specific level and analyze company fundamentals daily using proprietary technology. Case in point, as homebuilder stocks in the U.S. and the U.K. sold off when interest rates rose, we maintained our investment in many securities, including U.K.-based Barratt Developments, based on the stock's price and 6% yield. Barratt rallied 36% (versus the MSCI All Country World Index benchmark of 30%) from January through July this year, providing an outperformance for a high-yielding stock in an upward-trending, growth-oriented market. It appears homebuyers have not been as interest rate sensitive as market timers expected.

Q: HAS THE STRATEGY'S PERFORMANCE SUFFERED THROUGH THE RISE OF THE "MAGNIFICENT SEVEN" MEGA-CAP STOCKS, INCLUDING NVIDIA, APPLE, AND OTHER GROWTH STOCKS?

Vince: We are pleased with the strategy's performance during this period of narrow market breadth and significant outperformance of growth stocks. In 2023 through July, MSCI ACWI Growth has outpaced MSCI ACWI Value by 20%, so having exposure to six of the Magnificent Seven stocks at about equal weight has helped the strategy's performance. We do not own Meta because of the company's poor environmental, social, and governance scores.

Our blended style approach is part of our risk management framework, and we believe this differentiates us from other income managers. While growth stocks typically have low or no dividend yield—the MSCI ACWI Growth dividend yield is 0.93% versus the MSCI ACWI Value dividend yield of 3.38%—we invest in certain growth stocks for their ability to compound returns given their high margins.

NET PROFIT MARGINS FOR THE S&P 500 TECHNOLOGY AND INTERACTIVE MEDIA VERSUS THE REST (1/1990 TO 6/2023)[1]



Sources: National Bureau of Economic Research, Corporate Reports, Empirical Research Partners Analysis, as of 1-Aug-2023

We can argue about the effects of regulatory issues on this high-margin group, but technology and interactive media sectors currently exhibit a 23% net profit margin versus 9% for the rest of the large-cap market (see the chart above). Technology and interactive media stocks are cash-flow-generating machines—this group usually trades at a premium relative to the rest of the market, but this is where growth has been residing. Their profitably is unprecedented, and they may be beneficiaries of the AI movement because these companies have the cash to fund research and build products. A blended style portfolio is our remedy for consistent returns relative to the benchmark.

1. Measured as aggregates and data smoothed on a trailing six-month basis. Excludes financials and real estate investment trusts.

We seek to understand context and invest in stocks that are attractively priced given market conditions, and we do not attempt to time markets. We continuously focus on risk management and measure fundamentals, so we can invest in one mispriced stock at a time.

Q: HAS THE USE OF OPTIONS HELPED ENHANCE THE STRATEGY OVER THE PAST THREE YEARS?

Megan: The option component has helped the strategy deliver on its annual distribution target and meet its broad-based global equity return objective by adding value in three ways. The primary objective is to bolster income to help meet the strategy's distribution target. Second, the collected option premium is expected to add a diversifying source of distributions in most market environments. In down, flat, and moderately rising environments, the option premium is expected to add to the distributable income; in sharply rising markets, when options are expected to detract value, strong equity gains help support the distribution.

This natural offset between the equity and option strategies leads to a more stable distribution source and less volatile strategy overall. So as a result, the consistency and volatility reduction from the option component has allowed the strategy return to compound at a higher rate over time. Lastly, the option component has added alpha to the strategy through the volatility risk premium, which is an alternative risk premium, and through active option security selection.

Q: HOW DO YOU NAVIGATE CHALLENGING ENVIRONMENTS FOR OPTIONS?

Megan: A challenging environment for call options is typically a good environment for equities and one in which equity markets are sharply rising and the strategy is generating considerable wealth for its investors. In these challenging environments, the option contribution to income distribution is often reduced, but the large equity gains can help support the distribution. This typically occurs roughly 15% of the time over a full market cycle. The other 85% of the time, we expect the option component to add positive value to the strategy and bolster the distribution to meet the strategy's income target, notably in times when equities are challenged. This negatively correlated relationship between the equity and option portfolios reduces the overall volatility of the strategy over time, creating more consistent and stable distribution sources.

In navigating various market environments, we take an active and dynamic approach to managing the option component. First, we target deep out-of-the-money calls to maximize possible upside participation from equity market gains. In this case, the price of the underlying stock is trading well below the strike price of the call option. We then adjust the strikes based on the amount of premium we need to collect. For example, if dividend yields are high, we will dial back the option component, aiming to collect just enough premium to meet our target. Finally, we enhance this process with our relative-value framework to select attractive options we expect to outperform. Since inception, active option selection has added approximately 0.4% on average annually in alpha compared to a naïve implementation of the option component without active selection.[2]

2. In the naïve implementation, a 10-delta global covered call overlay is based on a 60% S&P 500 Index, 30% MSCI EAFE Index, and 10% MSCI EM Index split, monthly options rolled monthly.

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