ClearBridge Investments

Low Downside Capture from Dividends Adds Up

Key Takeaways

- As the bull market enters its 10th year, investors are weighing several risks that might lead to a recession.
- The ClearBridge Dividend Strategy takes a conservative approach that has historically achieved a low downside capture, i.e., outperforming during most market drawdowns, especially when those drawdowns were severe.
- We believe a successful conservative strategy should target companies that are market leaders with strong balance sheets, ample free cash flow generation and an attractive dividend growth profile.

With equities off to a great start in 2019, it is easy to forget the fourth quarter of 2018, when the market came within a hair of technically being a bear market (defined as a market down 20% from the peak) before bouncing significantly in the final few days of the year. The December drawdown serves as a useful reminder of the value of a conservative investment portfolio.

Many of the concerns that made for a rocky fourth quarter are still looming in the market. Investors are worried about slowing growth: in the U.S. GDP growth hit a remarkable 4.2% in the second quarter of 2018, due in part to 2017's Tax Cuts and Jobs Act, but it has slowed since. Growth in Europe has followed a similar trend, peaking in late 2017 and then gradually declining. China, meanwhile, is lowering its growth target as economic activity continues to wind down. A trade deal between the U.S. and China remains uncertain, and, if not reached, threatens to further slow global demand. The 2-year/10-year Treasury spread narrowed to only 11 basis points in early December, the tightest level since 2008, and is still narrow. The 3-month/10-year yield curve inverted briefly in March; an inverted yield curve has historically proved to be a reasonably good predictor of recessions. The current bull market rally is also now 10 years old, the longest on record since World War II.

In light of these concerns, having a strategy that offers good downside protection while retaining the potential for upside participation can be valuable. A conservative, defensive-oriented investment approach such as one that targets companies offering consistent and growing dividends may be a prudent choice for today's uncertain environment. A detailed examination of downside capture over turbulent periods helps explain the value of a conservative, dividend-focused approach.

Exhibit 1: Dividends Contribute to Excess Returns During Market Drawdowns

Drawdown Rank	Drawdown Period	ClearBridge Dividend Strategy	S&P 500	Excess Return (%)
#1	Nov. 2007-Feb. 2009	-37.02	-50.95	13.93
#2	Oct.-Dec. 2018	-8.77	-13.52	4.75
#3	Aug.-Sept. 2015	-6.71	-8.36	1.65
#4	April-May 2012	-2.92	-6.60	3.68
#5	Feb.-March 2018	-6.27	-6.13	-0.14
#6	June-July 2007	-4.06	-4.71	0.65
#7	Jan. 2014	-3.14	-3.46	0.32
#8	July 2004	-2.02	-3.31	1.29
#9	Dec. 2014-Jan. 2015	-3.52	-3.25	-0.27
#10	March-April 2004	-0.42	-3.05	2.63
#11	Aug. 2013	-2.72	-2.90	0.18
#12	May 2006	-1.48	-2.88	1.40
#13	Jan. 2005	-0.50	-2.44	1.94
#14	Feb. 2007	-1.79	-1.96	0.17
#15	June 2015	-2.91	-1.94	-0.97
#16	Oct. 2012	-0.94	-1.85	0.91
#17	Oct. 2016	-2.29	-1.82	-0.47
#18	Aug.-Oct. 2005	-1.64	-1.78	0.14
#19	March 2015	-2.23	-1.58	-0.65
#20	Sept. 2014	-1.37	-1.40	0.03
#21	July 2014	-1.66	-1.38	-0.28
#22	June 2013	-0.10	-1.34	1.24
#23	Sept. 2003	0.21	-1.06	1.27

As of March 31, 2019. Source: ClearBridge Investments, Standard & Poors. Measures ClearBridge Dividend Strategy SMA Portfolios, incepted June 1, 2003, against S&P 500 benchmark. Periods shown in descending order of market drawdown severity.

The Value of Limiting Drawdowns

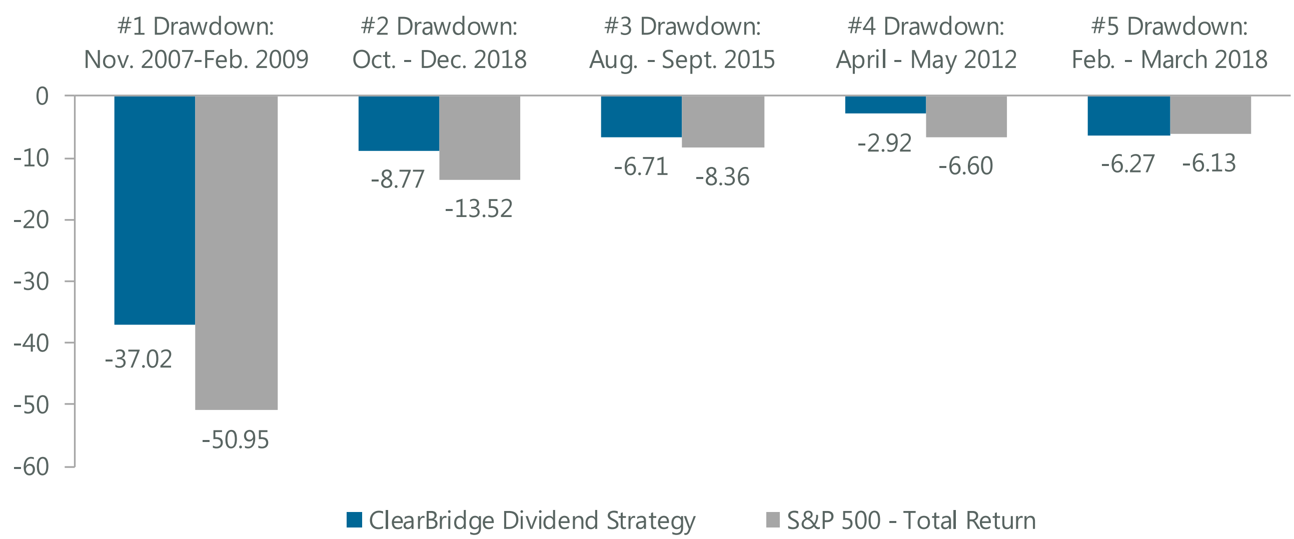
To help appreciate the different dimensions of downside capture, we used the performance of the ClearBridge Dividend Strategy and identified 23 distinct periods since the Strategy's inception (June 2003), measured on a monthly basis, where the market experienced a drawdown. We found Dividend Strategy outperformed the S&P 500 Index in roughly three quarters of them (Exhibit 1) with an overall downside capture of 72%. Further, we found that when the Strategy outperformed the index, it did so meaningfully, by 2.13% on average. Conversely, when the Strategy underperformed the index, the difference was comparatively minor: it did so by -0.46% on average.

We find a similar pattern when we take a closer look at the periods in which the market drawdown was the most severe. Of the 23 periods, five featured market drawdowns of greater than 5% (Exhibit 2). In these we note both that Dividend Strategy outperformed in four out of five periods, and that the downside capture tends to be even better the more severe the drawdown. There was only one situation when it underperformed, and it did so by only 14 basis points. This is consistent with the trends we identified over the complete set of periods since inception.

This downside capture occurred under a variety of market types:

- In 2007–2008 (Drawdown 1) markets were reeling as the housing market bubble burst and financial institutions went under in the Great Recession;
- In 2012 (Drawdown 4) higher sovereign funding costs due to worsening economies in Greece, Spain and Italy, as well as the ongoing banking crises, created headwinds that slowed growth throughout Europe, and called into question the future structure of the European Union.
- Later, in 2015 (Drawdown 3), China took currency action to loosen the yuan's peg to the U.S. dollar and investors feared a Chinese "hard landing" and a repeat of the 1998 Asian crisis.

Exhibit 2: Downside Capture Consistent in Most Severe Drawdowns



As of March 31, 2019. Source: ClearBridge Investments. Most severe drawdowns since 2003: greater than 5%.

- In early 2018 (Drawdown 5) investors worried the U.S. economy was running too hot as higher interest rates and fears of increasing inflation led to a large selloff.
- Most recently, in the fourth quarter of 2018 (Drawdown 2), slowing global growth, exacerbated by escalating trade tensions with China, and rising short-term interest rates raised concerns about the sustainability of the U.S.'s robust domestic economy.

These five severe down markets had diverse catalysts — the bursting of excessive speculation, sovereign debt crises, fears growth was slowing (in China) or running too hot (in the U.S.), and international trade tensions. As exemplified by the ClearBridge Dividend Strategy, a portfolio focused on quality companies with long histories of dividend growth are well positioned to outperform through a variety of volatile market conditions.

Key Factors in a Conservative Portfolio

We believe there are several qualities of a conservative portfolio that lend themselves to achieving a low downside capture. We focus on quality companies that are leaders in their respective sector with management teams in place and with strong track records of creating shareholder value.

We also have a bias toward owning companies with strong balance sheets, generating strong free cash flow and having an attractive dividend profile.

Further, in significant market downturns, holding too much debt can become problematic. Many of the companies we favor have modest debt levels and strong cash positions, providing a buffer against downturns. Financial strength and staying power also provide these companies with ample dry powder, which can be used during downturns, for example, to make accretive acquisitions, typically at more attractive prices.

Our emphasis on companies that generate high amounts of free cash flow sets the stage for continued dividend increases. Many of our holdings have rich histories of increasing their dividends for many years, if not decades. These dividend compounders tend to see their share prices rise over time as well, leading to a trifecta of income, income growth and capital appreciation. The dividends generated by these portfolio holdings provide a return regardless of underlying price action.

Diversification within a conservative portfolio can also lower risk and help in a market drawdown; we strive to diversify our portfolio by investing across many sectors. This is key because not all drawdown periods are the same. Just as drawdowns have different catalysts and reflect different market environments, a resilient conservative portfolio such as the ClearBridge Dividend Strategy has qualities that will help under a variety of conditions.

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