Allspring

Spicing Up Your Portfolio? Equity Income's On the Menu

In Allspring's 2024 Investment Outlook[1], our Systematic Edge team noted that the low interest rate era following the Global Financial Crisis challenged many individual and institutional investors who were seeking specific rates of return without taking on inappropriate levels of risk—but today, the opportunity set has changed for the better. The team's analysis found that now, most investors can pursue moderate (7–8%) return targets with conservative portfolios relying more heavily on fixed income and less on equities.

Investors who adopt this approach and adjust their portfolios to a majority fixed income allocation also have a second important decision to make: How should the *equity* portion of their portfolio be invested? We believe equity strategies focused on companies that have consistently paid out dividends (income) to shareholders warrant strong consideration—especially if those companies are dividend growers: quality companies with the ability to consistently raise their dividends over time.

WHY CONSIDER AN ALLOCATION TO INCOME-PAYING EQUITIES IN A PRIMARILY FIXED INCOME PORTFOLIO? WE SEE TWO MAIN REASONS:

Dividend-paying quality companies that habitually increase their dividend rates help portfolios maintain their "real return"— their return after accounting for inflation's impact.

Income from companies that consistently pay dividends adds stability to a portfolio. This is especially helpful in periods of volatility due to fluctuating inflation, interest rates, and/or markets. These companies tend to be well managed and focused on delivering long-term value.

Rising-dividend equities could enable primarily fixed income portfolios to maintain their real return.

While inflation has slowed substantially since hitting 9% in the summer of 2022, it's likely to remain higher than the Federal Reserve's 2% target for some time. With inflation elevated and its future movements uncertain, many fixed income investors could be wondering—since fixed income securities held to maturity have (as their name implies) dollar returns that are "fixed"—how to maintain the real, post-inflation returns they expect from their portfolios.

BENJAMIN ADAMS, CFA

+ Senior Portfolio Specialist, Head of U.S. Product, Systematic Edge

JAMES ARGABRIGHT, CAIA

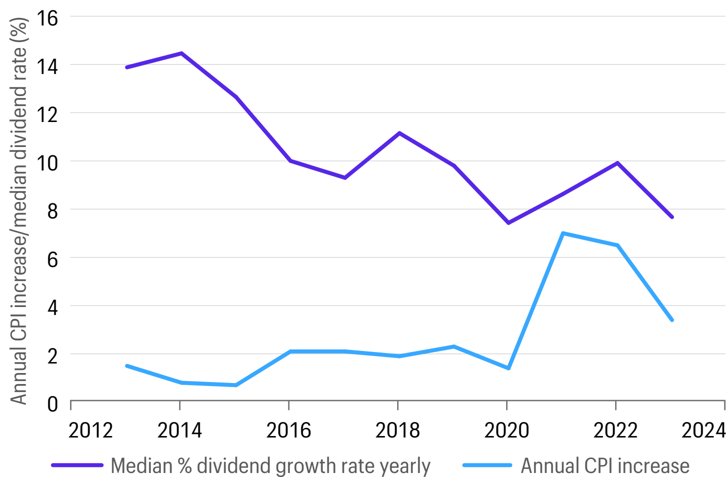
+ Senior Portfolio Specialist

1. "Are Higher Fixed Income Allocations Warranted Today?" Allspring Systematic Edge team, Allspring 2024 Investment Outlook, December 2023.

The thing is, fixed income securities are priced to compensate investors for *expected* inflation. In uncertain times, however, inflation's movements can be *un*expected. To help address this uncertainty, investors could add an equity income layer to their portfolio as a hedge against unexpected inflation.

Income from equity dividends is NOT fixed—it can grow along with the earnings of the company, benefiting from the company's ability to raise prices along with inflation. As the chart shows, dividend payments from dividend growers have increased at a faster rate than inflation (represented by the Consumer Price Index, or CPI) over time.

ANNUAL CPI INCREASE VS. MEDIAN DIVIDEND % PAID BY COMPANIES THAT INCREASED DIVIDENDS THAT YEAR



Source: Allspring

For each year, the median-level dividend percentage was calculated using the group of S&P 500 companies that increased their dividend payouts during that year. The dividend payout percentage in this chart for each year is the equally weighted average median dividend payout for the entire group of S&P 500 companies that increased their dividend payouts for that year.

Past performance does not guarantee future results.

It takes stable, high-quality companies to consistently increase dividend payments over the long haul.

As a group, companies capable of consistently increasing dividend payouts, year after year, generally have resilient business models, exceptional management, financial strength, and proven track records of prudent capital allocation. The regular, rising dividends they provide can help smooth the effects of short-term volatility within a portfolio.

In addition to their pattern of consistent dividend increases, many dividend growers have appreciated in value over time. These well-managed companies focus on careful capital allocation and setting dividend payout levels that create a healthy balance between growing dividends and growing the business. As a result, investors in dividend growth equities could benefit financially from the companies' capital appreciation as well as from their rising dividends.

For diversification, we suggest investors also look beyond their home country for high-quality companies that consistently increase their dividends. There are many world-class, multinational companies in developed markets outside of the U.S. that have historically offered both competitive returns and notable incremental yield. These companies provide geographic diversity along with the opportunity for rising dividend streams.

An income-producing equity option overlay can add to the toolkit.

Equity market derivatives are flexible tools that can be used to potentially benefit income-focused portfolios in a number of ways, including steadying portfolio values and increasing income from investments. Overlays for generating income are designed to add value during times of market stress and reduce the drag caused by portfolio volatility over the long run.

A SYSTEMATIC EQUITY OPTION OVERLAY CAN GENERATE CONSISTENT INCOME WHILE MITIGATING RISK, ADDING VALUE TO A PORTFOLIO:

How is income generated? Consistent cash flow from the overlay offers a diversified source of income and can potentially add value to a portfolio's equity exposure.

How is risk mitigated? By helping smooth the ups and downs from equity volatility, the impact of large portfolio losses due to volatility fluctuations can be reduced—securing larger portfolio balances that enable the portfolio to grow at a higher compounded return over time.

Why is this important? The lasting impact of portfolio losses is not symmetric: As the percentage of loss grows, the percentage of gain required to break even grows even faster. By helping smooth volatility, the overlay could enable a portfolio to grow at a higher compounded return over time.

For further information

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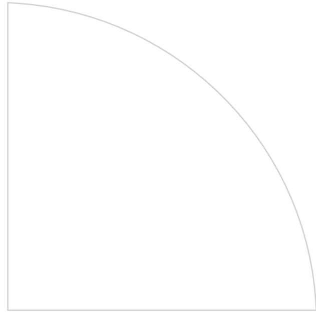

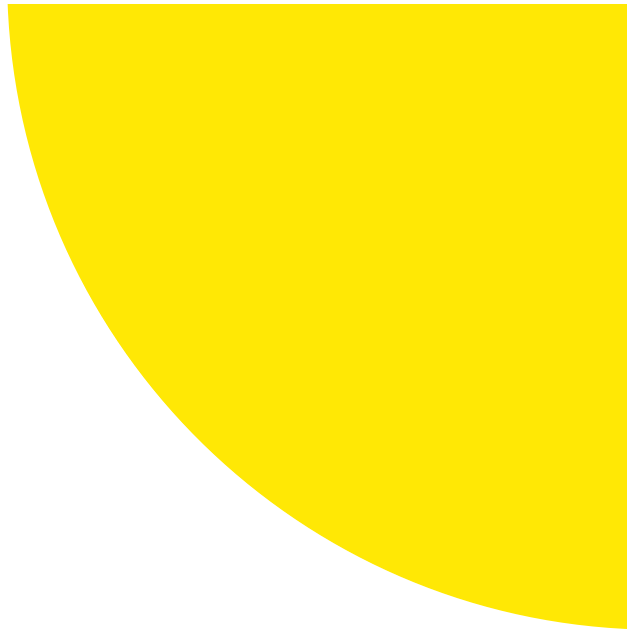

Contact details

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- For retail clients, contact your financial advisor.
- To reach our intermediary sales professionals, contact your dedicated regional director, or call us at **+1-866-701-2575**.
- To reach our institutional investment professionals, contact your existing client relations director, or email us at **AllspringInstitutional@allspringglobal.com**.
- To reach our retirement professionals, contact your dedicated defined contribution investment only specialist, or call us at **+1-800-368-1370**.

FOR EMEA AND APAC INVESTORS ONLY

- To reach our EMEA- and APAC-based investment professionals, contact us at **AllspringInternational@allspringglobal.com**.

FOR SUSTAINABLE INVESTING

- To discuss sustainable investing solutions, contact **Henrietta Pacquement**, head of Sustainability, and **Jamie Newton**, deputy head of Sustainability, at **henrietta.pacquement@allspringglobal.com** and **jamie.newton@allspringglobal.com**.

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Derivatives involve risk and are not suitable for all investors.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. You cannot invest directly in an index.

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock's weight in the index proportionate to its market value. You cannot invest directly in an index.

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