MARKETING COMMUNICATION

Allspring

# Equity Income and Climate Risk: Have Your Cake and Eat It?

## What do you see investors looking for these days?

SOPHIE CAREFORD, CFA

+ Product Specialist
+ Systematic Edge Team

Generating income from investments has been a perennial request from investors. In the past few years when fixed income yields have been persistently low, we've seen investors looking beyond the relative safety of fixed income securities and moving toward riskier assets, such as equities, in their search for a stable source of income and perhaps a bit of upside potential as well. Whether that has been to benefit from income and growth while accumulating savings or to boost a person's retirement income, we believe the desire for a consistent, stable source of income is here to stay.

That said, income is no longer a solitary request. **Investors are looking for income accompanied by capital growth, and increasingly we see a desire for investments to be contributing to a more sustainable planet.** The numbers provide the evidence: At the end of the fourth quarter of 2021, there was $2.74 trillion in global sustainable fund assets, including $142.5 billion that flowed in during that quarter alone—representing increases of 9% and 12%, respectively, versus the third-quarter data.[1] While assets continue to flow in this direction, delivering both income and improved sustainability—for example, reduced climate risk—these two objectives don't always go hand in hand. At Allspring, meeting our investors' needs is our primary objective, so exploring the dynamics between income and climate risk has been a key area of focus for us.

## Why is it difficult to deliver income and reduce climate risk?

KANDARP ACHARYA, CFA, FRM

+ Senior Portfolio Manager
+ Systematic Edge Team

As Sophie said, the search for income has led investors to move from fixed income assets to riskier equities. Fixed income assets, or bonds, have long played a dominant role in an income-generating portfolio over the past four decades—or as long as anyone seeking income likely can recall. Investors received not only a fixed coupon payment but also additional price returns during this period when the interest rate was downward trending. For example, the Moody's Seasoned Aaa Corporate Bond Yield declined from 14.6% at the end of March 1982 to 2.65% at the end of December 2021. However, in the current rate

1. Global Sustainable Fund Flows: Q4 2021 in Review, Morningstar

environment, bond yields don't provide investors with sufficient income and bonds will lose value as rates rise. So, the question remains: How can investors achieve the desired income without sacrificing value?

This leads to dividend income from equities as another potential source of income while also providing growth. For example, global equities (to be more specific, the MSCI All Country World Index, or ACWI) had a trailing 12-month dividend yield of approximately 2% as of March 9, 2022, according to Bloomberg L.P. While this is low, we can certainly aim to include companies that have a higher dividend yield.

If one were to include only the companies that have a dividend yield higher than 3% (1% better than the index's dividend yield), we would find a portfolio of 630 out of 2,956 stocks in global equities that meet our higher-dividend-yield criteria (as of February 25, 2022).

Compared with the ACWI, this portfolio would have lower exposure to the U.S. market, where dividend yield in general is lower. Perhaps more importantly, the high-dividend-yield portfolio would have more weight in the industries known to have a higher carbon footprint and intensity—like utilities, mining, and construction—and a lower weight in the industries with low carbon footprints/intensity—like software, the internet, and communication equipment, among others.

Unfortunately, the higher-yielding portfolio's carbon intensity (the average amount of carbon by weight per unit of energy consumed, expressed in metric tons of $CO_2$ emitted/$1 million revenues) is significantly worse, at 417 versus 218 for the ACWI.

What we've found is that companies that provide high income in the form of dividends are often in sectors that tend to hold some of the worst carbon-emitting companies. A naïve/simplistic approach for finding high-income equities may be correlated with higher carbon emissions. This illustrates why it can be difficult to deliver income while reducing climate risk.

# How do you solve this, from a security-selection perspective?

JONATHAN CANGALOSI

- Co-Head Systematic Product
- Systematic Edge Team

Despite the apparent challenges, after conducting more research, we found that reduced climate risk and dividend income generation can actually coexist in a portfolio.

To build such a portfolio, our first step is to identify fundamentally sound companies that demonstrate an ability to produce strong free cash flow to provide the desired dividend income stream. Interestingly, we've seen a high correlation between our quality indicators and environmental, social, and governance (ESG) scores, suggesting that income and an improved ESG profile can be achieved simultaneously. We view poor ESG scores as signs of poor management and are wary of holding such companies for fear of value traps. Avoiding investments in poorer ESG-scoring companies while targeting companies with higher ESG scores for the portfolio appears to align well with our goal of seeking high-quality companies that can afford to pay their dividends.

**From a climate perspective, we seek to deliver a portfolio that targets a carbon intensity and carbon footprint that's at least 30% below the ACWI. This aligns with the starting point for the European Union's climate transition benchmarks and is designed to tilt the portfolio to benefit from the transition to a decarbonized economy.**

As Kandarp mentioned, some of the more natural income-generating sectors—such as utilities, mining, and construction—can prove difficult to balance from an income and carbon-emissions perspective. A key focus here is to appreciate the overall portfolio context—that is, looking to meet investors' climate-risk objectives at the overall portfolio level rather than on a company-by-company basis. While income is a primary objective, total return is also important. We have the ability to invest up to 10% of our income-focused portfolios in low-to-zero dividend-paying companies. This flexibility helps us take advantage of attractively ranked companies and, in turn, can provide an opportunity to improve the overall carbon emissions if such companies are in low-emitting industries.

While we accept that there's some element of tradeoff in delivering income, total return, and reduced climate risk, it's our view that by following our time-tested process and improving climate risk at the overall portfolio level, we can meet our investors' objectives, so perhaps investors can have their cake and eat it, too!

## What else can we do to enhance investors' income?

MEGAN MILLER, CFA
+ Head of Systematic Options
+ Systematic Edge Team

We can introduce an additional source of income with an options overlay. The most common options strategy to augment income is a covered call. With covered calls, immediate income is generated by selling call options in exchange for sacrificing future and uncertain upside equity participation.

For investors looking to boost their income, we manage the dual objective of harvesting option premium income and maximizing expected total return with an active and dynamic approach. In an equity covered call overlay, we sell out-of-the-money index-level options to preserve the stock-specific upside within the equity portfolio. The aim is for the equity portfolio and basket of index and exchange-traded fund options to track similar systemic risks, thereby maintaining a tight link between both legs of the portfolio. At the same time, we introduce an uncorrelated return source by selling overpriced options and actively assessing the relative value of the options in our investment universe.

We typically manage the option overlay strategy dynamically to adjust to changing yield environments. When equity dividend income is lower, we can seek to generate more option premium to make up the shortfall and provide investors with a potentially stable, high level of income.

**By enhancing portfolio income through the use of options, we seek to deliver a more consistent income stream and maintain a more balanced equity portfolio.**

## What else could we do from a sustainability perspective?

HIMANI PHADKE
+ Senior Sustainable Investing Strategist
+ Allspring

As Kandarp and Jon have shown, companies that historically have paid higher dividends may not have been the best role models in terms of climate awareness. But with some focus, it's possible to find companies that are more climate aware and build portfolios on that basis. What else could we do? Well, clearly the ideal situation would be to have a much wider array of companies across all sectors of the economy that are able to pay income to investors while managing their businesses with awareness of sustainability objectives.

One way to encourage this direction of travel is through active ownership: to engage with the companies that need to move up the curve and as investors be explicit about the expectations for sustainability-focused management. The other aspect is more fundamental in nature: Is it reasonable to think that companies that do manage their climate transition—and contribute to both thoughtful ESG risk management and sustainability progress—will be able to consistently pay the levels of dividends investors are seeking? Increasingly, it appears that this type of corporate behavior can help with long-term resiliency and with being positioned on the right side of the sustainability megatrends currently underway.

# How does this approach benefit investors?

EDDIE CHENG, CFA
+ Head of International Portfolio Management
+ Systematic Edge Team

Bringing this all together, our approach centers on three key pillars:

Starting with a well-diversified, dividend-focused equity portfolio using our climate-aware investment process to provide a strong income foundation as the first source of income

Enhancing this income by collecting premium through an actively managed options strategy as a second source of income

Leveraging our decades of experience in asset allocation to dynamically balance and manage these two sources of income across business cycles

As a result, our active, diversified approach allows us to solve for some of the key challenges in equity income investing. This helps the team provide a consistent source of income, maintain an equity-like total return focus, and deliver an improved climate and ESG profile compared with the ACWI.

## To learn more

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us:

## Contact details

- To reach our U.S.-based investment professionals, contact your existing client relations director, or contact us at **AllspringInstitutional@allspring-global.com.**
- To reach our U.S.-based intermediary sales professionals, contact your dedicated regional director, or call us at **1-888-877-9275.**
- To reach our U.S.-based retirement professionals, contact Nathaniel Miles, head of Retirement at Allspring Global Investments, at **nathaniel.s.miles@allspring-global.com.**
- To discuss sustainable investing solutions, contact Hannah Skeates or Christopher McKnett, co-heads of Sustainable Investing at Allspring Global Investments, at **hannah.skeates@allspring-global.com** or **christopher.mcknett@allspring-global.com.**
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