

# fundstrategy

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THE INCOME ISSUE



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# ON THE HUNT FOR INCOME



COMMITTEE CHAIRMAN

Adam Lewis

EDITOR  
FUND STRATEGY

It was reported last month that following a large rise in dividend payouts in Europe, global dividends hit record highs in the second quarter of 2014. Research from Henderson Global Investors showed that global dividends grew 11.7 per cent in the second quarter on the same period last year, paying out a total of \$426.8bn.

For the purposes of *Fund Strategy* these numbers were particularly timely, given this month's somewhat income-slanted theme. Over the past decade there has been an expansion in the use of funds investing globally for equity income as opposed to the traditional focus of just the UK. However, with many portfolios seemingly adopting a developed market bias in their holdings, our cover story (see page 20) asks how global these funds are?

Those funds that did adopt this bias may take comfort from the Henderson research, which shows that not only did Europe lead the way in terms of payouts but Japan posted 18.5 per cent higher dividends than a year earlier while every sector in the US paid higher dividends than the previous year.

Meanwhile, dividends from emerging markets fell by almost 15 per cent because of weaker currencies and index changes.

We asked the committee where they feel the best hunting grounds for income are right now. Do they favour the traditional areas of equities (UK, US, Europe) and corporate bonds or have they extended to other parts of the globe or other asset classes. And are global equity income funds what they make themselves out to be?

We have enlisted the help of Henderson Global Investors, which in its report says 2014 is on track to post the highest growth in dividends since 2011. Ben Lofthouse, co-manager of the Henderson Global Equity Income fund, gives his take on where, from a macro perspective, the best regions for yield are right now.



Mike Deverell

INVESTMENT  
MANAGER,  
EQUILIBRIUM  
ASSET  
MANAGEMENT

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In a world of ultra-low interest rates there has been a big hunt for yield. Asset values have been pushed up, driving down yields. The UK equity market yield is about 75 per cent of its long-term average. A 10-year gilt yields about half its long-run norm, as does a typical corporate bond. However, in equity there are now more options even in emerging markets. For example, the Hang Seng China Enterprises index yields about 4 per cent. There is greater risk in these areas, which may not suit an income investor, although good fund management can mitigate this. Another asset class that looks decent value is commercial property. The rental yield on the IPD benchmark is currently 5.8 per cent per year, below its long-term average of 6.7 per cent but this looks pretty cheap relative to other asset classes. For example, this is 3.2 per cent above the 10-year gilt yield compared with an average spread of 0.6 per cent above gilts. Unfortunately, you can't buy an IPD index tracker. A typical fund holding property and cash yields about 4 per cent net. Still not bad.

We view corporate bonds as about the most overvalued in history, given yields as they are. Clearly, the search for yield has moved to large-cap equities, especially in the US. You have to wonder, if short-term rates rise even a tad, what that will do to the assumptions informing the valuations. With the German DAX index down 5 per cent, just in July, and the FTSE lower than over a year ago, we remain uncomfortable with Western equities – dividend payers or not. If – big if – Western shares have a sizeable correction (à la 2011) then we would probably go into European Equity Income, via Invesco Perpetual, especially if Mario Draghi, the European Central Bank president, pulls quantitative easing out of his wizard's hat (as there is no QE in the hat at this point – ECB rules specifically disallow it). We have said since the beginning of 2014 that the place to be is in Government bonds, and that is where we are. We're getting capital growth and income. What's not to like? We see potential for further growth in this area.

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Jonathan Davis

MANAGING  
DIRECTOR,  
JONATHAN  
DAVIS WEALTH  
MANAGEMENT

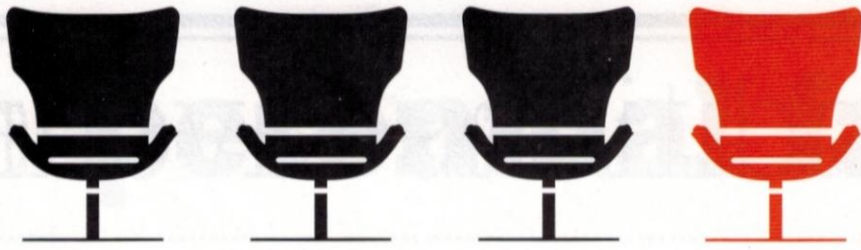
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James Calder

HEAD OF  
RESEARCH,  
CITY ASSET  
MANAGEMENT

Our bespoke DFM service does not provide income-specific mandates. Rather, we tailor real return mandates to provide an income if clients so desire. Historically, the hunt for income was split between UK equity income and corporate bonds (UK and maybe some US). However, the range of options has grown considerably. Just in equities, all the traditional classes now provide income offerings, although choice is limited in some areas. A stated targeted yield appeals to clients but can be difficult to achieve at some points in the economic cycle. Our policy is to create “natural” income from the portfolio, which will therefore fluctuate. We have at least one income offering in all equity asset classes except Japan. Global equity income funds are useful, although they can be biased to developed markets. However, one can find managers exploiting a global emerging market theme through developed listed markets, e.g. Saracen Global Income & Growth. We tell clients equity income investing is an important source of yield but that it will vary through the cycle.



## With dividend payouts at a record high, where do our experts stand on global and developed market income funds?

Over the past five years easy monetary policy by central banks has suppressed bond yields, dampened market volatility and encouraged risk-taking. This has resulted in elevated valuations, causing portfolio construction headaches, particularly for those seeking income. Today, government bond yields in developed economies look expensive. Navigating the bond market remains a challenge. Most discretionary investment managers prefer to outsource this to the managers of strategic bond funds. However, their flexible approach may provide better capital returns but not necessarily a steady income. Aside from thinking differently about bonds, investors with a greater appetite for risk have invested in the higher-yielding equities. The growing number of global equity income funds offer an attractive yield from a diversified portfolio. A global remit seems to make sense. However, the real opportunity lies in Asia Pacific and emerging markets. This may be best pursued through specific country or regional income funds.



**Tim Cockerill**

HEAD OF COLLECTIVES RESEARCH, ROWAN DARTINGTON

The low interest rate environment has driven bond yields down and, despite a few hiccups, that is where they are now. Worryingly, Italian and Spanish government bond yields are trading at levels that appear to indicate very little perceived risk. Likewise the spread between investment grade and high yield seems to be mis-pricing risk. But with bonds looking expensive, the main alternative, equities, are not screaming value either. However, there seem to be better opportunities here to find value and to invest where there are prospects for a growing income. So investors can get a healthy yield from equities, and global equity income funds offer a bigger pool to fish in. These funds are often biased toward developed markets and criticised for such. Their job, though, is to find the best stocks to meet their objectives (quality and balance sheet strength being typical). Furthermore, a stable and growing income features highly on the investor wants list, so the geographical allocation of a fund is often a result of the search criteria.

Our Growth & Income portfolio does have exposure towards Asia and emerging markets income funds. We like these regions for both growth and income as we believe there are many quality companies with strong balance sheets, global franchises and rising dividends. Admittedly, it is developed markets that provide the bulk of the income strategy in our portfolios, as it is these that currently look interesting. Some of the new frontier markets funds are yielding near 5 per cent and the MSCI Frontier Market index is up by some 18 per cent this year. A fund we like in this space is Barings Frontier Markets. We believe global equity income funds are mostly pivoted towards a western-style benchmark, with little or no frontier market exposure. We are not particularly benchmark-driven. In the search for income on behalf of investors we have been well rewarded by UK commercial property although the space is becoming a little crowded. In terms of bonds, we don't see any real value left although we still like UK index-linked and emerging market debt or floating rate notes.

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**John Husselbee**

HEAD OF MULTI ASSET, LIONTRUST

Dividend yields around the world remain at attractive levels compared with history and other asset classes. Overall payouts by listed companies grew 11.7 per cent year-on-year in the second quarter to a new record of \$426.8bn, as shown by the Henderson Global Dividend Index.

On a regional basis, developed markets have been driving the performance, with Europe and Japan, the laggards of recent years, leading the way. Europe dominated recent payouts, accounting for more than two-fifths of the global total. European dividends rose 18.2 per cent year on year, France and Switzerland leading the way. Japan has also demonstrated convincing growth, up 18.5 per cent, with sharp declines in the yen reducing the impact of currency headwinds. The US continued to show broad-based strength, up 13.8 per cent, while emerging markets weakened, down 14.6 per cent.

We believe that Japan and the US have the greatest potential to increase payout ratios, although from a relatively low base as both yield about 2 per cent. Europe and Pacific ex-Japan yield about 3.3 per cent and higher. At a stock level it is possible to find companies in all regions expected to raise their dividends by about 7-8 per cent.

In terms of outlook, we expect the US recovery to continue and the valuation gap between Europe-based international companies and international peers to continue to close. We continue to maintain exposure to certain developed market companies with significant emerging market business streams.

Overall, we are encouraged by the health of global companies generally, with strong balance sheets and disciplined management teams focused on generating good cashflow, which should be supportive for dividend growth.

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**Lee Robertson**

CEO, INVESTMENT QUORUM

THE INDEPENDENT VIEW

**Ben Lofthouse**

CO-MANAGER, HENDERSON GLOBAL EQUITY INCOME FUND

