Threadneedle thinks

Viewpoint

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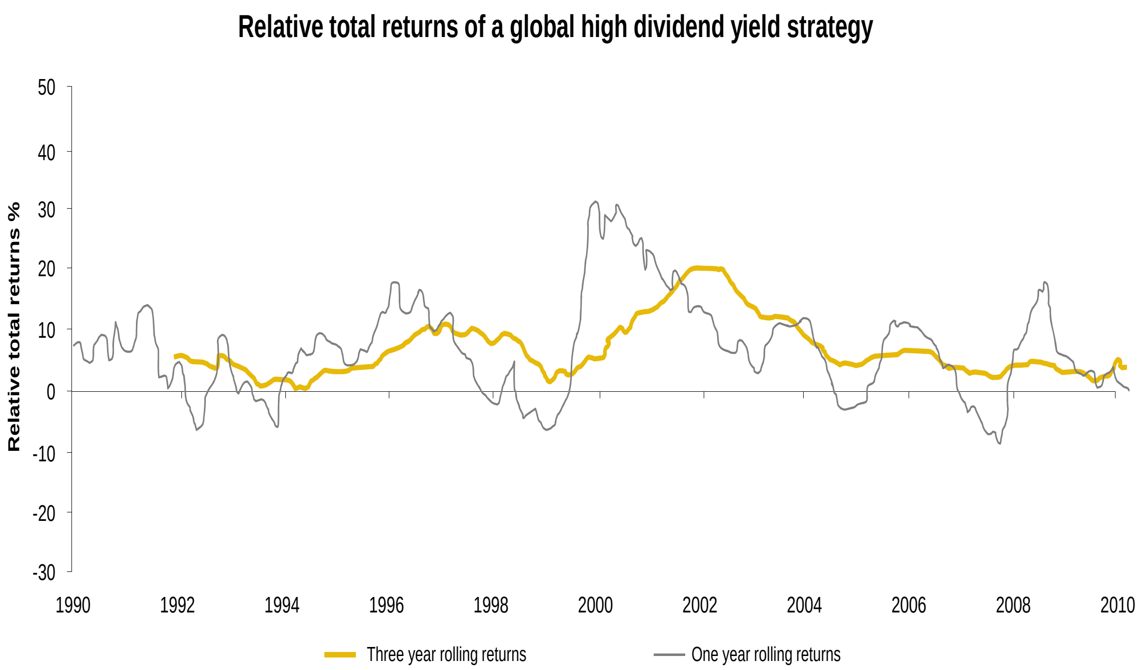
Stephen Thornber
Fund Manager

Is equity income investing a fad or a long-term strategy?

Equity income funds have performed particularly strongly recently and this has generated considerable publicity, while there have also been a number of new products launched. However, they are not just a short-term fad, but rather a valuable long-term strategy. Indeed, there is a good body of research, comparing the performance of high yield stocks against the overall market, which supports our view that high dividend strategies consistently perform well or indeed outperform. Societe Generale, for example, has looked at the performance of markets over the past 20 years and found that, while on a year-on-year basis income strategies can underperform, on a rolling three-year return basis there is no period over the past 20 years when a high dividend strategy has underperformed the world market (see Figure below).

Figure 1: Income strategies have consistently outperformed the market

- Using rolling 3 year periods, the strategy has outperformed every year during the last 20 years



Source: SG Cross Asset Research. I/B/E/S, FTSE, FTSE World high yield basket relative to equal weighted benchmark.

"There is no period over the past 20 years when a high dividend strategy has underperformed the world market"

We are also see increasing demand for income products, reflecting increasing population growth and changing demographics – people have longer and more active retirements for which they need to provide. Yet yields in bond markets are extremely low, among both government and corporate bonds. Consequently, equity markets are perfectly placed to fill investors' needs, delivering attractive yields that are typically superior to those found in these bond markets. Moreover, and this is particularly important for pensions and long-term savings, the income stream generated by equities grows over time, while the income from fixed income is exactly that – fixed, thus an investor's purchasing power is eroded over time by inflation. Certainly, dividend growth has outstripped inflation over the past 20 years, thus supporting purchasing power. Another positive feature of equities is that they hold the potential for capital appreciation so that not only can the income stream rise, the value of your holdings could also rise. In conclusion, we believe equity income strategies have a very important role to play in the savings market.

Are we seeing a return to the cult of the equity?
No, we do not believe we are. If, for example, you compare the dividend yield of high-quality companies such as Royal Dutch Shell, AT&T and Vodafone, equities are yielding two to three times as much as those companies' bonds and we believe that differential reflects a lack of investor confidence in financial markets in general and more particularly in equities. There has been a huge shift in search of safety in recent years and bonds are clearly more secure than equities.

What are the benefits of a global approach to equity income investing?
There are a number of advantages:

- You can gain exposure to underlying economies, which may be growing much faster than your domestic economy and to a different mix of sectors and themes. The global telecoms company Vodafone, for example, is an excellent business and features in the global equity income portfolio. However, 70% of its revenues are generated in Europe with just 30% emanating from the rest of the world, including the rapidly-growing emerging markets. But as a result of our global mandate we are able to invest in telecoms businesses with direct exposure to surging economic growth. Thus we own telecoms stocks in Malaysia, Singapore and Thailand, all of which are benefiting from booming demand for mobile telecoms services in their domestic markets. Consequently, a global approach allows us to choose the companies and the economies that we want to invest in rather than being limited to a business such as Vodafone which derives the bulk of its profits from the troubled European economies and provides only diluted exposure to the dynamic emerging economies.
- In addition, selecting companies on a global basis provides a much wider set of stock opportunities than would otherwise be true and enables the construction of a much more efficiently diversified portfolio. Globally, there is a more diverse range of income opportunities than is available, for example, in the UK. The latter market is highly concentrated with just 10 companies generating around 50% of UK dividend income. Opportunities for equity income in the UK are thus focused on a small number of large companies operating in a limited number of sectors. Moreover, there are no mining stocks in the UK with a dividend yield of 4% or more (the threshold we use our global equity income strategies), whereas globally we can find 40 to 50 such stocks. It is a similar story in technology – there just two UK technology stocks paying a yield of more than 4% but there are around 40-45 globally. We can thus gain more exposure to mining and technology than would be true if we simply focused on the UK, allowing for the construction of a more diversified portfolio. In addition, if technology and mining happened to be the most dynamic and exciting areas of the market, the opportunities for a UK-focused income strategy would clearly be limited.

Do equity income stocks exhibit any particular qualities during market downturns?

They tend to be defensive in nature and to be found in the more defensive and slower-growing sectors that exhibit relatively stable earnings growth - such as telecoms, utilities and food retailing. Consequently, during periods of economic weakness and market downturns, equity income stocks tend to outperform. The reverse, of course, is also true in fast-growing economies and rising markets, when defensive stocks tend to underperform.

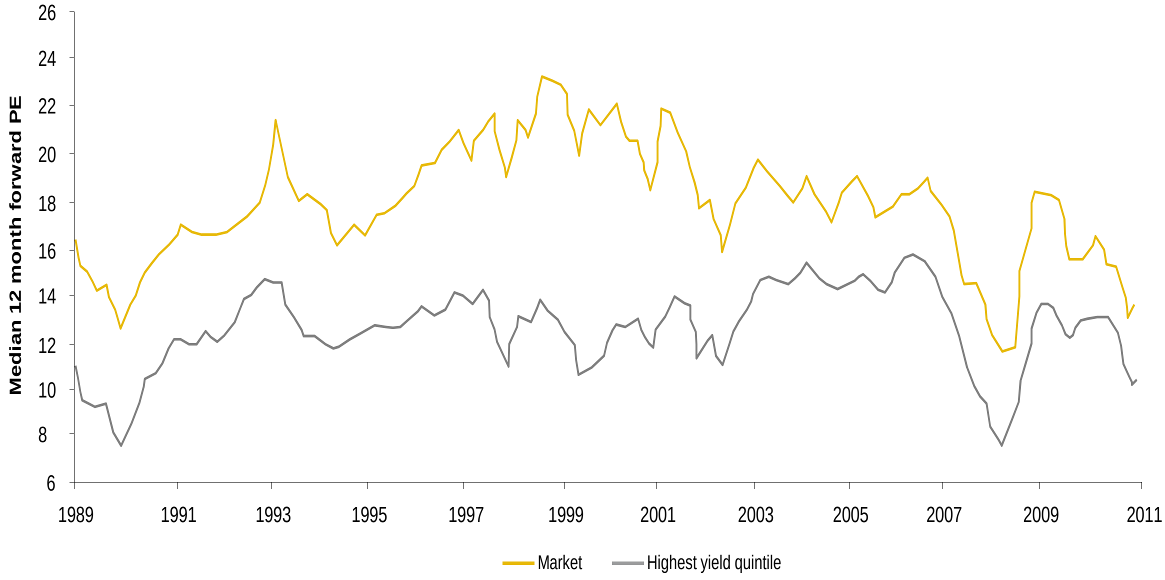
Income stocks thus often provide downside protection in difficult markets. This is partly because dividends tend to be far more stable and sticky than earnings through the economic cycle. This is because once companies pay a dividend they commit to pay that dividend over the long term and are reluctant to reduce it. In difficult economic conditions they will continue to pay the dividend, a valuable characteristic for an investor, which income stocks tend to reflect.

Given the growing investor interest in equity income strategies, do you feel that valuations have become expensive?

We do not believe that income stocks are particularly expensive and our view is confirmed by research from Societe Generale (see Figure 2). Income stocks typically trade at a discount, partly because they are focused upon more stable areas of the economy, such as utilities and telecoms. While they tend to trade at a discount to the market that discount does vary depending upon investor confidence and the economic cycle. Over the past five years when income stocks have come under greater scrutiny than usual, that discount has not narrowed materially. Thus there is no evidence that income stocks have been re-rated. This is also true when one looks at different geographical markets with income stocks around the world trading at a discount to local markets.

The one exception is the US where income stocks have been re-rated over the past few years. This suggests that there could be good potential outside the US for income stocks, since it is clearly possible for the asset class to be re-rated. Moreover, the fact that income stocks in the US are now trading at a premium and arguably are now expensive underlines the importance of careful stock selection on a global basis. There are a lot of opportunities but it is important to be mindful of valuations.

Figure 2: Income stocks remain attractive valued



Source: SG Cross Asset Research, I/B/E/S, FTSE.

How do you talk to companies that you are interested in about their dividend policies?

Dividend policies form an integral part of our discussions with companies. We seek to understand a company's dividend policy, and critically how sustainable the dividend will be given that we are looking to invest for the long term. We also want to understand the potential for dividend growth. Overall before we invest in a company we need to be confident that management is committed to the dividend and that the financial structure and business model of the enterprise can sustain the dividend and enable it to grow over time.

Has the launch of QE3 in the US and the recent actions by the ECB had an impact on the appeal of equity income?

The implementation of Quantitative Easing (QE) is designed to lower government bond yields in order to spur investment and borrowing. If the income that investors receive from bonds falls, the appeal of alternative sources of income such as equity income strategies should increase.

In addition, QE raises the risk of inflation over the longer term. While inflation is not necessarily positive for all stocks, the dividend growth offered by equity income stocks should offer protection against falling purchasing power and provide some capital appreciation.

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