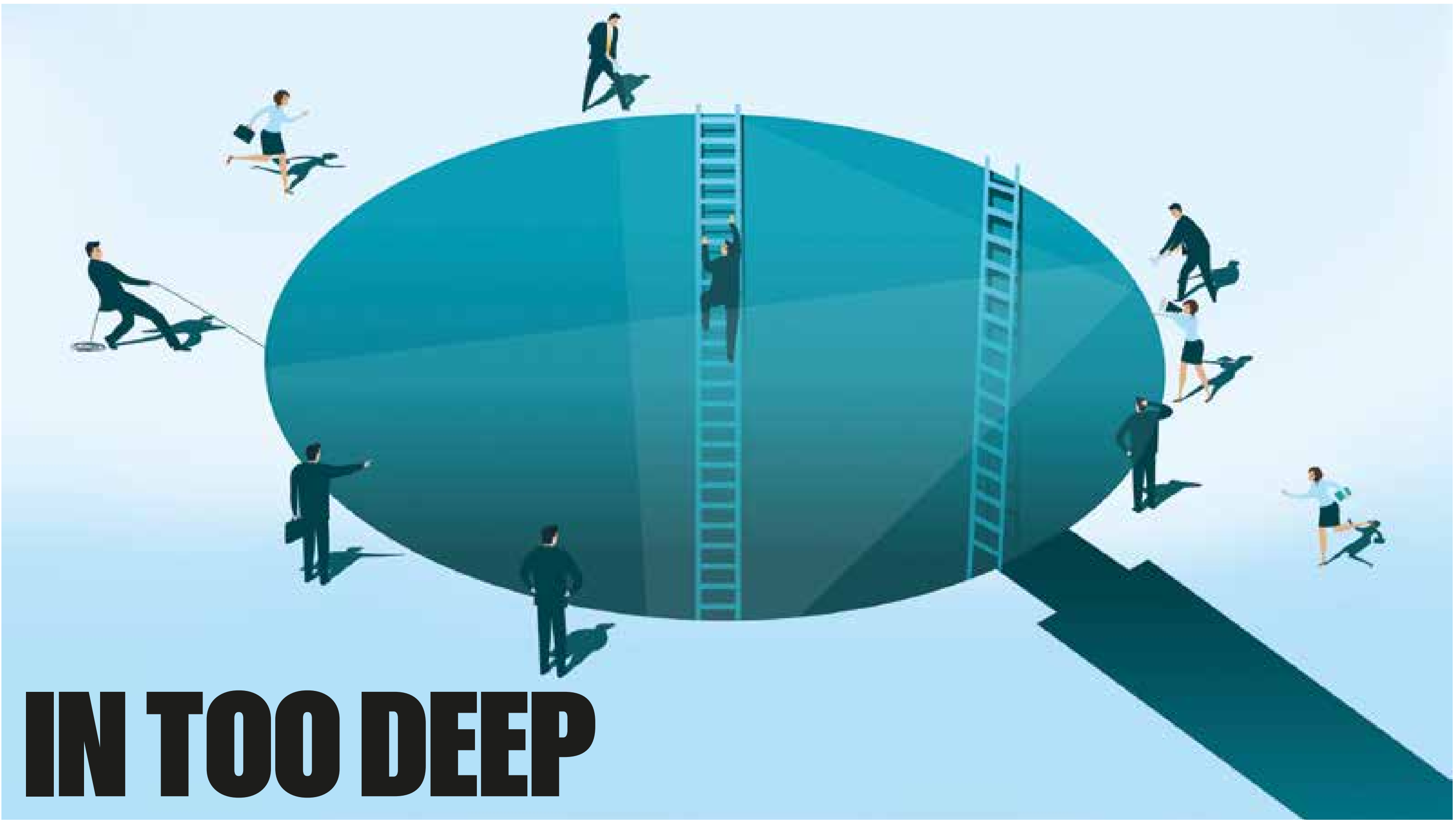


IN TOO DEEP

The most popular fund sector with domestic investors is home to a multitude of strategies, although deep-value tilted portfolios have struggled of late

As countless studies have shown, although investors usually buy equities in anticipation of capital appreciation, it is dividends that drive long-term returns.

Although these are almost entirely explained by the starting dividend yield and annual dividend growth, re-investment of that income is an additional driver of long-term performance.

Illustrating this, the *Barclays Equity Gilt Study* (2015) calculated that £100 invested in equities at the end of 1899 would be worth just £184 in real terms without the re-investment of dividends, whereas the portfolio would have grown to £28,261 with re-investment of dividend income. This formula for long-term success, against a backdrop of rock-bottom savings rates, has increased demand for equity income funds.

The UK Equity Income sector was the best-selling Investment Association (IA) sector in 2014, and is on course to repeat that achievement in 2015, having been the best-selling sector for five of the 11 months to November.

IA statistics show total funds under management for the sector of £61bn, significantly smaller than the £165bn UK All Companies sector but larger than the £55bn Targeted Absolute Return sector, which has also been growing strongly. It is hard to envisage the popularity of the sector waning anytime soon.

The long-term outlook for growth has to be promising, supported by ongoing adjustment to the lower-for-longer interest rate environment combined with the huge tailwind of demographics.

Retirement challenge

Between 1970 and 2013, average life expectancy in the UK increased by almost 10 years, and by 2050 the ratio of the population aged 65 and over to the labour force is forecast to have nearly doubled compared with the start of the century. This poses a hugely challenging problem in terms of retirement planning, which equity income strategies could help solve.

The UK equity market provides a rich universe for investors, given its entrenched dividend-paying culture and hundreds of companies to choose from. It is straightforward to achieve geographical diversification as well, with so many multinational businesses listed in London.

In aggregate, businesses with a global footprint, such as in the energy, mining and pharmaceutical sectors, account for a substantial part of the UK market, but derive most of their revenues from overseas. Less than half the revenues of companies within major indices are sourced from the UK.

Andrew Hardy
Portfolio manager, Momentum Global Investment Management

Concentrated effort

The presence of so many mega-cap stocks in the UK market introduces a risk for equity income investors, in the form of dividend concentration. The current dividend yield on the MSCI UK Index is approximately 4.5%, but the top 10 contributors make up more than half of this, reducing the likely diversification of the dividend stream for passive or low tracking-error strategies and increasing vulnerability to dividend cuts.

Furthermore, this top 10 includes the likes of Royal Dutch Shell, BP, Rio Tinto and BHP Billiton: stocks that most investors would have preferred to limit exposure to recently and where there is a real risk of dividend cuts, given the collapse in commodity markets.

In combination, the energy and materials sectors contribute almost a fifth of the total income. Another big contributor to the total income is from the consumer staples sector, driven by dividend stalwarts such as British American Tobacco, Imperial Tobacco, Unilever and Diageo.

Investors in passive equity income strategies have suffered underperformance versus the UK index in recent years, largely due to these size and sector biases working against them. Despite providing the benefit of lower fees, the opportunity cost in terms of total return versus active strategies has been significant. Our analysis of the peer group suggests the average actively managed UK equity income fund outperformed by 6% net of fees over one year, and by 4% pa over three years. This represents the strongest three-year period of relative performance for the sector average in the past 10 years.

Furthermore, successfully selecting a strategy that broke into the top quartile would have further increased the outperformance, leading to an absolute return of 8.5% last year, making a big difference to portfolio outcomes in a year when overall equity markets recorded poor returns.

Variety performance

Although funds in the UK Equity Income sector share some important characteristics, including targeting a distributable yield in excess of 110% of the market yield, there are still significant differences that ultimately drive variation in levels of income and long-term total returns.

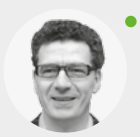
The manager's investment style and the typical market-cap distribution of their portfolio are generally the most impactful. The sector average tends to display defensive characteristics, with the greatest outperformance coming in weaker markets such as 2008 and 2015. This is not surprising given most funds jointly target a modest yield premium, along with stability and growth in the distributions, naturally leading them towards a portfolio of high-quality stocks in less cyclical sectors.

Unlike in other markets globally, investment style – value, growth or quality – has not had as great a bearing on fund performance trends, with a mix of styles represented towards the top of the rankings. In common with other markets, more deep-value-tilted strategies have struggled of late.

Instead, market-cap positioning has been the differentiating factor, with mid-cap focused strategies performing best. In 2015, mid-caps were up by 5.1%, compared with a decline of 5.9% for large caps.

'UNLIKE IN OTHER MARKETS GLOBALLY, INVESTMENT STYLE HAS NOT HAD AS GREAT A BEARING ON FUND PERFORMANCE TRENDS, WITH A MIX OF STYLES REPRESENTED TOWARDS THE TOP OF THE RANKINGS'

FUNDS TO WATCH
3-YR PERFORMANCE

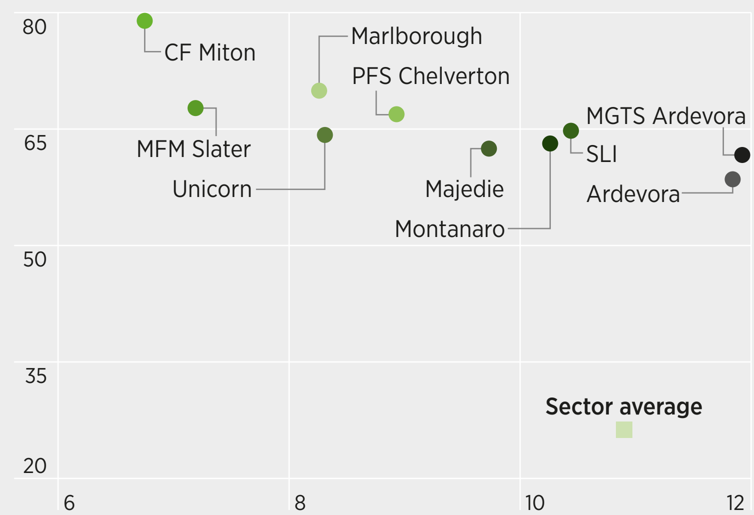


- Headed by Jeremy Lang (pictured) and William Pattisson, the **Ardevora UK Income Fund** is one of the more growth-oriented strategies in the sector, aiming to capitalise on market mispricing created by behavioural biases. Fund performance has benefited from the outperformance of growth style factors in recent years.

- The **PFS Chelverton UK Equity Income Fund** focuses on mid-cap stocks yielding at least 4%. Its strategy has been well rewarded in recent years, leading to strong outperformance, including versus the more relevant mid-cap indices, and has one of the best records for distribution growth in the sector.

- The **Montanaro UK Income Fund** has also benefited from the strong outperformance of small and mid-caps in recent years. Montanaro is an independent boutique that has specialised in the management of UK and European small-cap strategies for more than 20 years. The bulk of this fund is invested in the UK but the team also leverage their continental European expertise, with a 15% allocation to non-UK listed stocks at present. All holdings fulfil the team's well-defined quality growth criteria.

Risk and return 3-year performance
Return vs standard deviation %



Source: Morningstar

Top-ranked UK equity income funds 3-yr performance

Fund	3-year chg (%)	3-year Alpha	3-year Beta	3-year R^2	3-year volatility	Morningstar rating	Fund size (£m)	Domicile
❶ CF Miton UK Multi Cap Inc Ret A Acc	78.94	10.36	0.46	22.49	6.75	★★★★★	557.89	UK
❷ Marlborough Multi Cap Income A Inc	69.94	5.24	0.68	38.45	8.26	★★★★★	1,435.65	UK
❸ MFM Slater Income A Inc	67.7	6.11	0.59	33.02	7.19	★★★★★	105.83	UK
❹ PFS Chelverton UK Equity Income A Inc	66.91	4.64	0.69	34.81	8.93	★★★★★	443.75	UK
❺ SLI UK Equity Income Uncons Ret Acc	64.78	1.58	0.87	52.18	10.44	★★★★	1,119.41	UK
❻ Unicorn UK Income B Inc	64.24	6.01	0.56	27.17	8.31	★★★★★	669.35	UK
❼ Majedie UK Income A	63.14	1.89	0.82	52.09	10.26	★★★★★	1,084.94	UK
❽ Montanaro UK Income STG Unhedged	62.48	2.37	0.78	49.49	9.73	n/s	126.08	Ireland
❾ MGTS Ardevora UK Income Retail Net Acc	61.66	-0.36	0.96	58.32	11.94	★★★★★	69.03	UK
❿ Ardevora UK Income A	58.53	-0.88	0.95	58.15	11.84	★★★★	233.75	Ireland

1 Dec '12 – 30 Nov '15. Bid to bid, £, gross income, no cap. Source: Morningstar

'THE COLLAPSE IN COMMODITY MARKETS HAS DECIMATED THEIR EARNINGS, AND THE MARKET IS INCREASINGLY SCEPTICAL AROUND THEIR ABILITY TO MAINTAIN DIVIDENDS'

Indeed, this trend has supported the strong overall performance of the UK Equity Income sector for some time, as most funds are underweight large caps. This has the benefit of reducing stock-specific risk but, if it were to reverse or if the energy and materials sectors bottomed and started to outperform the rest of the market, then many active strategies would be facing severe headwinds to relative performance.

Hard choices

Fund managers have some important and difficult decisions to make around these particular issues. The UK mid-cap index has been on a tear for 15 years, outperforming large caps by more than 6% pa along the way, and most UK equity income funds still have substantial exposure in this area. Such outperformance is unlikely to continue forever. Indeed, at this juncture the UK market appears to be good value relative to markets like the US, but this is driven by the large caps that dominate market indices.

Oil majors and mining companies are among the principal drivers of the lower valuation metrics. The collapse in commodity markets has decimated their earnings and the market is increasingly sceptical around their ability to maintain dividends.

At the time of writing, Royal Dutch Shell was offering an indicative yield of 9%, the highest in over 20 years of Bloomberg history and a clear sign investors fear management will have to sacrifice the dividend.

However, the company has a proud history of not having cut the dividend since the end of World War II, even when oil was trading at below $10 per barrel. Management also has room to cut costs along with the support

FUNDS TO WATCH NEWCOMERS

- Far from being a genuine newcomer, Neil Woodford (pictured) is a veteran investor with more than 30 years' experience in the sector. The **CF Woodford Equity Income Fund** is managed according to the same disciplined, bottom-up approach that he has successfully employed throughout his career, with the focus on building a portfolio of high-quality, undervalued businesses.

- Chris Reid at Majedie manages the **St James's Place UK Income Fund** following an approach he has employed while managing other income funds with since 2011. He focuses on investing in dividend-paying stocks that the market views as average to poor, but which have the potential to significantly improve operational performance and benefit from a valuation rerating.

- The **Insight Equity Income Booster Fund** offers a higher level of income than most others in the sector, with a trailing 12-month yield of over 8%. This is achieved via a call option overlay strategy, whereby the fund sells options on its equity holdings. This significantly boosts the level of income received, but reduces the potential upside from capital growth.

Risk and return Newcomers
Return vs standard deviation %

Source: Morningstar

Top-ranked UK equity income funds Newcomers

Fund	1-year chg (%)	1-year Alpha	1-year Beta	1-year R^2	1-year volatility	Fund size (£m)	Launch date	Domicile
❶ CF Woodford Equity Income C £ Acc	17.72	10.14	0.82	76.71	10.41	8,102.26	2 Jun '14	UK
❷ Old Mutual Woodford Equity Income A £ Acc	15.01	7.45	1.01	82.87	12.53	138.12	9 Oct '14	UK
❸ St James's Place UK Income Inc	6.31	0.29	0.6	46.84	7.67	206.69	10 Nov '14	UK
❹ Old Mutual Newton Higher Income A £ Inc	4.72	-1.2	0.71	77.22	11.68	28.82	12 Apr '13	UK
❺ Threadneedle UK Equity Income 1 Net CHF Hedge Acc	4.53	1.3	0.16	1.71	19.78	3,344.62	3 Apr '14	UK
❻ Old Mutual Artemis Income A Inc	4.41	-1.91	0.82	71.18	10.9	160.99	27 Mar '13	UK
❼ Insight Equity Income £ Inc	0.15	-6.43	0.98	79.31	12.01	196.28	9 Feb '13	UK
❽ Insight Equity Income Booster £ Inc	-1.22	-7.83	0.96	79.92	11.23	85.71	9 Feb '13	UK

1 Dec '14 – 30 Nov '15. Bid to bid, £, gross income, no cap. Source: Morningstar

of a strong balance sheet, so a cut is by no means guaranteed.

Cases like this create a headache for equity income funds. If the dividend is maintained then not holding large index constituents with very high yields makes it that much harder to achieve the yield premium needed to stay in the sector.

However, the damage caused by holding a stock when the dividend is cut, such as Anglo American or Glencore recently, must be avoided. Most funds are neutral to underweight energy and materials, with only a few exceptions, including one of the biggest funds in the sector, JOHCM UK Equity Income, which has small overweight allocations to both.

Realistic expectations

However, it is important to be realistic about the type of style exposure an investor can expect from an income strategy; many funds hold a range of stocks across the style spectrum, from low yields with high growth through to high yields with low growth.

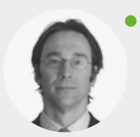
There are fewer strategies with a clear value or growth bias due to funds in the UK Equity Income sector having to achieve a higher dividend yield than the market. While many high-yielding stocks may be undervalued, the very best value opportunities may be in businesses that have had to cut their dividend, after which most income fund managers may sell the position rather than top it up.

An income target makes even less sense for growth-oriented strategies; the best growth businesses should have strong re-investment options within their own business, so distributions are often low or non-existent, or the overall yield is very low due to investors valuing the stock on a high multiple of earnings.

Certain income strategies play a key role for us at Momentum, particularly when the yield profile is actually a by-product of a disciplined investment process. This is most often the case with quality-oriented strategies, such as with the TB Wise Evenlode Income Fund we invest in.

When selecting funds in this sector or in any other, we believe it is vital to identify and understand the underlying investment style, ensuring the historical consistency of the approach through rigorous interviewing of the managers and detailed analysis of past performance and holdings. That helps us understand what to expect from our managers across different market environments, allowing us to construct robust and genuinely diversified investment solutions. **LW**

FUNDS TO WATCH
ASSETS UNDER MANAGEMENT

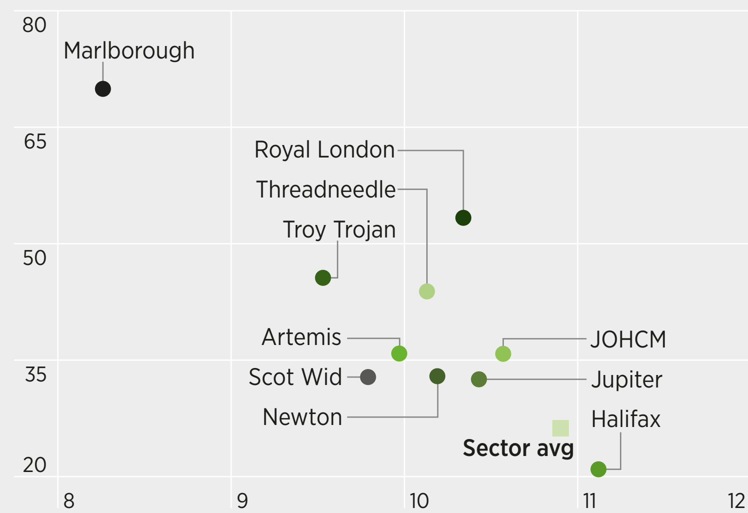


- In 2013, management of the **Jupiter Income Trust** was passed to Ben Whitmore (pictured), who has also managed an unconstrained UK equity strategy since 2006 that follows a disciplined contrarian approach. He is an experienced investor who has built a strong track record by investing in high-quality, undervalued stocks with limited reference to benchmark weightings.

- The **Artemis Income Fund** has grown to almost £7bn with the support of a strong long-term performance track record and a stable and experienced team. It has a bias towards large caps, reflecting the impact of high assets under management as well as the manager's view that there are limited attractive ideas in small and mid caps at present.

- The **Newton UK Income Fund** represents a relatively flexible investment strategy with a less consistent style bias. It invests in those businesses that should benefit from key long-term themes identified by the research team, while also fulfilling fundamental and valuation related criteria.

Risk and return Assets under management
Return vs standard deviation %



Source: Morningstar

Top-ranked UK equity income funds Assets under management

Fund	3-year chg (%)	3-year Alpha	3-year Beta	3-year R^2	3-year volatility	Morningstar rating	Fund size (£m)	Domicile
❶ Artemis Income Inc	35.85	-4.58	0.84	60.24	9.97	★★★	6,970.82	UK
❷ Threadneedle UK Equity Income Ret Net £	43.85	-2.73	0.85	59.78	10.13	★★★★	3,344.62	UK
❸ Halifax UK Equity Income C	20.94	-10.25	0.97	61.72	11.12	★	2,536.19	UK
❹ JOHCM UK Equity income B £ Inc	35.81	-6.39	0.96	57.16	10.57	★★★	2,525.57	UK
❺ Troy Trojan Income O Acc	45.6	-1.66	0.8	56.03	9.53	★★★★	2,467.57	UK
❻ Jupiter Income Trust	32.53	-6.13	0.89	64.17	10.43	★★	1,902.91	UK
❼ Royal London UK Equity Income A	53.33	-1.54	0.91	60.85	10.34	★★★★	1,846.31	UK
❽ Newton UK Income £ Inc	32.93	-4.75	0.81	60.12	10.19	★★★	1,715.04	UK
❾ Marlborough Multi Cap Income A Inc	69.94	5.24	0.68	38.45	8.26	★★★★★	1,435.65	UK
❿ Scottish Widows MM UK Equity Income A Acc	32.82	-6.12	0.89	65.56	9.79	★★	1,401.1	UK

1 Dec '12 – 30 Nov '15. Bid to bid, £, gross income, no cap. Source: Morningstar