*For Professional Advisers Only*

# A Spotlight On:
## UK Equity Income

April | 2019

### Introduction to Sector

According to the Investment Association's (IA) January 2019 statistics, the IA UK Equity Income sector had total assets of £49.9bn, ranking it 10th largest of the IA's 36 sector classifications. The sector currently consists of 90 funds, Artemis Income is the largest with assets under management (AUM) of £5.6bn, the TB Guinness UK Equity Income fund is the smallest at a rather modest £200k. Notably, there is somewhat of a concentration of assets among the largest strategies - 18 funds boast assets in excess of £1bn, which in turn, accounts for 71% of the sector's total AUM. At the other end of the scale, there are eight funds with assets of less than £10m.

## Sector Nuance

This sector has often been used as a mainstay of investors' portfolios, and rightly so given the simplistic but powerful impact of compounding returns – i.e. the combination of capital growth and dividend reinvestment over time. Many traditional UK Equity Income funds invest in portfolios of blue-chip companies, with long records of sustained dividend payments. However, the UK stock market has become increasingly reliant on a small number of index heavyweights for dividends. Indeed, a mere 10 companies (including HSBC, Royal Dutch Shell and British American Tobacco) are expected to pay out around half of the total dividends paid by FTSE 100 companies in 2019. It is no surprise, therefore, to see a number of fund managers attempting to diversify this risk, and perhaps more importantly to differentiate their strategies, by investing in overseas listed companies as well as UK firms further down the market capitalisation scale. As investors seek to diversify their portfolios by asset class and/or region, it also makes sense to diversify income streams.

Although inextricably linked, at Square Mile, we seek to separate yield from income distribution. Consequently, we tend to split equity income funds into three sub-categories:

1. **Consistent dividend payers** - as can be seen from chart 1, the level of income generated which is shown as the solid bars, has been pretty consistent over the years. However, the fund's yield, shown as a line, has fallen some way from its peak. This type of fund might be useful for investors who have a known income requirement, or who simply require a more predictable income stream.
2. **Dividend growers** - shows a fund where the actual amount of income distributed has increased each year. However, the yield has fluctuated quite considerably. This type of fund might be useful for investors whose income needs are likely to increase over time, for example to grow in line, or in excess of, inflation.
3. **Targeted yield** - we observe that the level of yield has been very consistent, but the actual amount of income received each year has varied. This type of strategy may be suitable for investors seeking a higher level of income though this could come at the expense of future capital growth.

### Consistent Dividend Payers

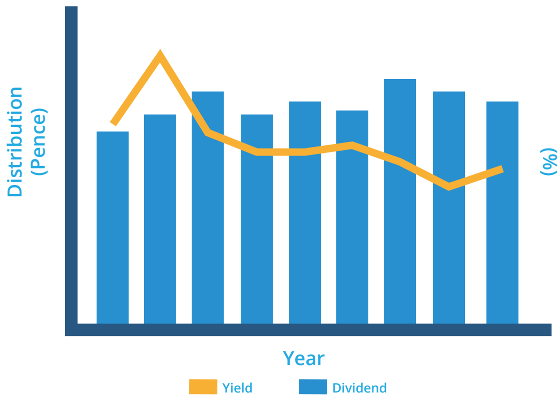



*Chart 1*

### Dividend Growers

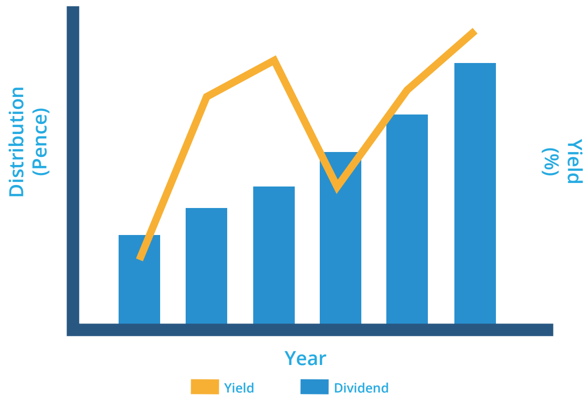



*Chart 2*

### Targeted Yield

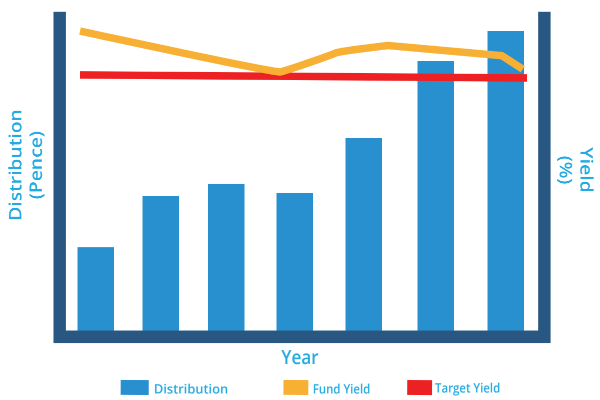


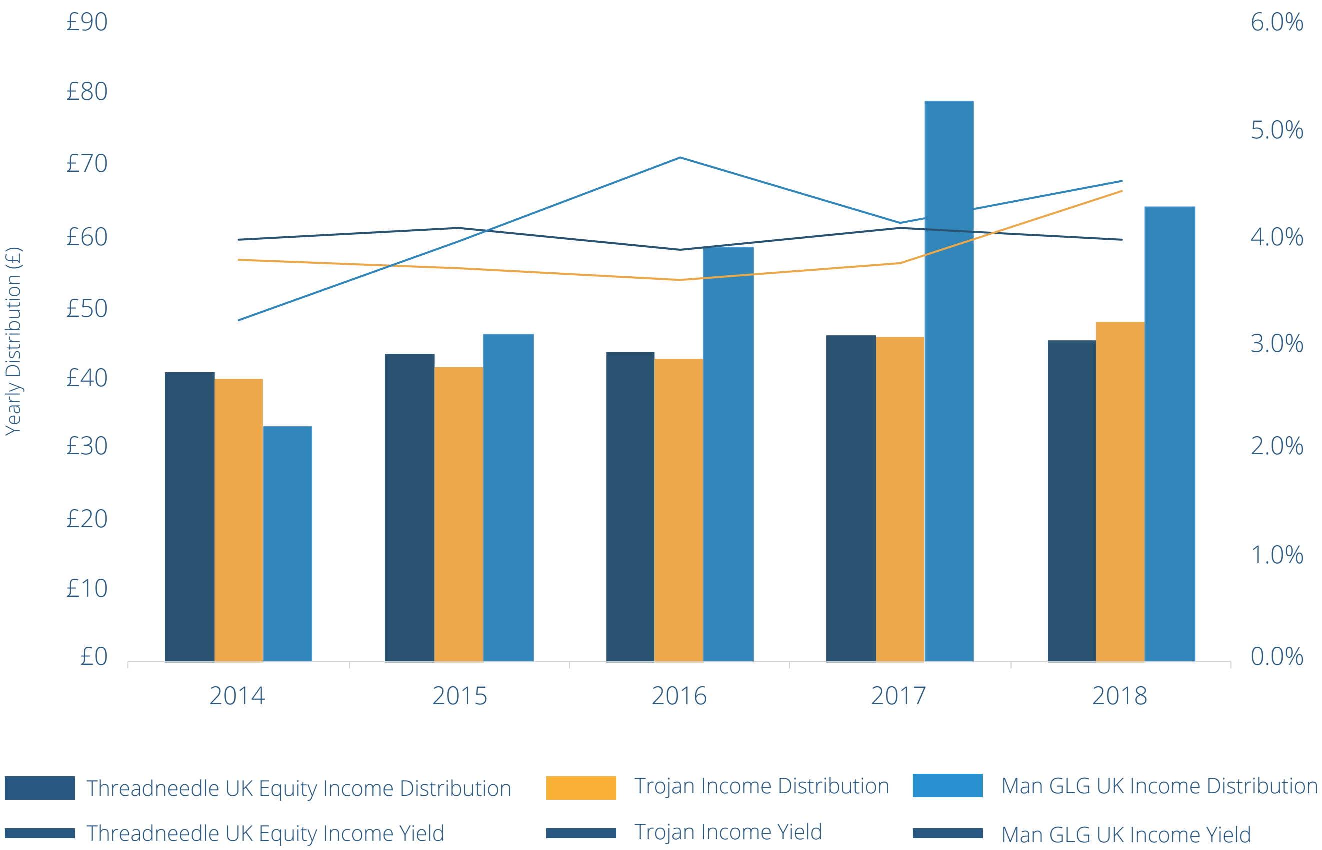

*Chart 3*

## Funds in Focus

The first strategy to highlight is one we would very much describe as a traditional, core UK equity income product and that is the Threadneedle UK Equity Income fund. It is managed by industry veteran, Richard Colwell, who also leads the firm's large UK equities team. The team operates using a highly collegiate approach but recognises that fund managers must be accountable for decisions within their respective portfolios. As such Mr Colwell builds this portfolio on conviction and can take sizeable positions away from the index. The preference for attractively yielding companies does lean the portfolio towards a value bias, as opposed to seeking growth opportunities. However, as Mr Colwell is also mindful of the fund's requirement to deliver income, he strives to keep the style of the funds balanced in aggregate.

The Troy Trojan Income fund possesses one of the most enviable records within the IA UK Equity Income sector in that it is the only fund, operating under the same investment approach, to have grown its annual distributions every year since its launch in 2004. It is managed using a conservative approach that considers risk in terms of the potential for the permanent loss of capital rather than its positioning relative to the FTSE All Share index. The managers take pride in the fund's ability to provide protection in more volatile periods, but this does come at the expense of lagging performance during times of market exuberance. Nevertheless, we think that the consistency of its returns, protection in down markets and commitment to grow its distributions should provide a rewarding investment for investors over time.

Although Henry Dixon has only been the lead manager of the MAN GLG UK Income fund since November 2013, he has managed money using the same approach since 2008. Mr Dixon and his team are entirely focused on uncovering out of favour opportunities in order to provide both an attractive income and also total return for investors. The strategy is definitely managed with an ethos of exploring where others fear to tread and given the contrarian nature of the process and willingness to invest in medium and smaller sized companies, as well as holding small exposures to bonds and overseas stocks, the fund, at times, may look and act very differently to its peers and benchmark. We very much see this as a differentiated strategy and one that may be worthy of consideration by more benchmark agnostic investors.




Source: FE Analytics (28/02/19)

*Figure 1: Absolute Yearly Distribution from £1000 Invested on 31st December 2013*

## Sector Outlook

We should firstly remind ourselves that the markets' woes experienced at the end of last year were not solely related to the UK. Global stock markets began Q4 2018 on a weak footing as they digested the implications of rising US interest rates, only for the falls to intensify towards the end of the quarter as concerns emerged about the sustainability of economic growth. Much of this has dissipated following what seems to have been a change of direction from Federal Reserve chairman, Jerome Powell, when he announced in early January that the Fed was in no hurry to raise interest rates, hence a recovery in more economically sensitive areas of the market.

Nevertheless, UK equities, generally, remain an unpopular destination for investors at the current time given the far from clear resolution to the Brexit situation. But, UK equity managers do not have the luxury of holding large elements of their portfolios outside of the UK. Many of the managers we have spoken to have little conviction in backing one Brexit outcome over another. One common theme, however, is that the fairly universal malaise around UK domestically-orientated companies, has presented some attractively valued opportunities.

Managers recognise that not all companies should be treated the same and there will be winners and losers as and when there is some clarity around Brexit. Following what has been a challenging few years for active UK equity investors, perhaps now is the time to rekindle faith in active management.



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