LWM Consultants Ltd

Meeting the fund manager

Income Solutions

One of the biggest debates at the moment is how to deliver income, in 1999 a Cash ISA delivered around 6% interest a year which could be used to provide income and a small amount of capital growth.

Today the average cash ISA is paying around 2% - with inflation there is little chance of any capital growth let alone income. Of course people have favoured fixed interest investments (bonds) as an alternative to cash however although bonds have done well in the last ten years many feel that the party is coming to an end, we just don't know when.

Of course the alternative option is equity income funds. We recently received marketing material outlining the success of an equity income fund over the last 25 years. However, the fund is very different to what it was 25 years ago and the question is whether it can continue to deliver the same returns (both in terms of growth and income) over the next 25 years.

So the question is how can you get growth and income?

In our latest round of fund manager meetings we met Thomas Moore and Will James of Standard Life Investments to see how they drive income and growth from their funds. Thomas runs the UK Equity Income Unconstrained Fund which we have written about in the past and is part of the portfolios, and Will runs the European Equity Income Fund.

Overview

Our first discussion was with Thomas who started by looking at the typical top holdings in UK Income Funds. GlaxoSmithKline is in 92% of UK Equity Income Funds with an average holding of 7.5%. Other names include AstraZeneca, BAT, Imperial Tobacco, BAE et el. The problem is that these are mega cap companies and there are risks with investing with the old favourites similar to the argument with bonds, cracks are starting to appear as we have seen with the likes of Aviva.

Even AstraZeneca is being challenged; the new CEO inherits a company which needs to consider how it will increase revenue growth going forward. In fact it is predicted that revenue growth will fall over the next five years. Of course it has cash which it can use for acquisitions or buy backs to slow down the fall but it could hit the dividend they pay, so rather than dividend growth we could see this stagnate or even fall.

So effectively what you have with these companies are almost bond like stocks which deliver dividend returns but little or no returns. In Thomas' view dividends in FTSE 100 will come down and therefore you need to find the next generation of companies which will drive dividend yields and growth and in his view these companies are found in the FTSE 250.

If we take the argument further the average dividend growth of the top 10 holdings in the average UK Equity Income Fund is around 5%, the top ten holdings for the SLI UK Equity Income Unconstrained Fund have delivered 17%. The average earnings per share for the funds in the top ten is 10% compared to 3% for standard top 10 holdings.

So effectively through this fund you are buying into tomorrow's companies, the fund doesn't take undue risk and does hold companies like BT, and Cineworld. Cineworld in particular benefits from a large amount of repeat business. Easy jet is another successful business. These are effectively his core holdings and these don't tend to move around.

He also looks to take short term positions to take advantage of opportunities. So it is a blend of styles and this fund is delivering nearly a 4% yield. Effectively he is looking for the sweet spot where companies are getting the balance between holding cash back to invest in growth but equally giving some back to shareholders.

Thomas believes that with cracks starting to appear in the more traditional income funds you have to look deeper and with a smaller, more nimble, fund he can do that, so not only delivering income but also growth. We believe that this fund blends well with the Schroder Income Maximiser Fund which we also use in the portfolios.

Turning to other sources of income we do use the M&G Global Dividend Fund in the portfolios, the size of the fund does raise concerns but whilst it continues to deliver we do not believe this risk warrants the removal of the fund. However, we have considered alternative options including US Income options and in this meeting we discussed the opportunities in Europe.

Europe is very much about the headlines, so we hear about Italy and Cyprus but actually Europe is a lot more than that. It is about 25 countries at different stages of the growth cycle. Will James the fund manager is used to the headlines and is able to navigate around this. What he feels is that these bouts of fear deliver opportunities and he believes that being an active manager means he can avoid the big dividend cuts which end up destroying value.

For him it is about avoiding the traditional payers (to some extent similar to Thomas' argument) so avoiding telecoms, utilities and banks. The fund is split into three areas. Dividend upgrade, these are short term opportunities were an asset is held to take advantage of a particular opportunity. Ryanair is an example of this where last year they decided not to invest in planes but give money back to shareholders whereas this year they are re-investing in planes.

He then has what he calls Dividend Growth, these tend to be the core of the portfolio and provide the opportunity to grow dividends. So Syngenta is paying around 2.5% and has seen a year on year growth of 19%. These holdings make up around 38% of the fund.

He then looks to High Dividend Payers where there is little growth but they are compensated by the Yield. Turnover is higher than Dividend Growth but lower than Dividend Upgrade. A good example of a holding is Unibail which operates French Shopping Malls. Their debt is paying 1.7% over 5 years and 3% over 10 years. Their current dividend is 4.8% and the company is in a growth phase which could see dividends increase by 5 – 10% a year, so not as high as dividend growth but still a healthy return.

The point that Will was making that away from the what we hear and see there are opportunities, and uncertainty and volatility delivers these. So to some extent the market as it stands benefits Will's style of management. The fund itself is delivering a healthy yield of 4.6%.

In summary although equities provide more volatility than cash and bonds and the potential for loss of capital it also provides an alternative for those seeking income returns. Clearly what these managers are doing is avoiding the standard income providers where they see greater risks and looking across all sectors to find the companies that can deliver either short term opportunities or sustainable long term opportunities.

Conclusion

We have to accept that the traditional way of driving income has gone, cash is no longer king and there is no end to low interest rates. Whether you believe in the idea of a bond bubble or not clearly yields from bonds will come down and growth will be stifled. Turning to equity income you can follow the herd but there are cracks starting to appear so finding alternative drivers of income are important together with understanding the risk they take. We believe the SLI UK Equity Income Unconstrained Fund is one of those funds which offer opportunities and certainly the European Fund also offers the same.

The source of information in this note has been provided by Standard Life Investments and is correct as at 19 March. These are notes from meeting the fund manager or representative and should not be seen as a recommendation to purchase this fund. Any reference to shares is not a recommendation to buy or sell. Should you wish to make a decision based on these notes we cannot take responsibility for this and you should carry out your own research before making a decision. You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise.