

UK equity income webchat transcript

On Thursday 23 September 2010, we hosted a live web chat with investment experts Andy Parsons, advice team manager at The Share Centre, and Clive Beagles, senior fund manager of the JO Hambro UK Equity Income fund, to discuss how you could benefit from investing in UK equity income.

Thank you to everyone who joined in and asked questions. Here are the responses

I presume UK Equity income means you invest in only UK based companies? If so, what is the past performance of these funds and do future prospects look good? Also, what would be the minimum investment criteria? I presume the investments would be long term to realise the best results?

Andy: The UK Equity Income arena invests principally as it says on the tin. However, investors should note and be aware that just because a company is listed on the UK market, its business operations could well be overseas. A significant number of the FTSE100 companies generate earnings from overseas.

Investors should also be aware of a funds investment objectives as some allow the flexibility to identify and invest in companies listed overseas. As for minimum investment levels, these vary – at The Share Centre you can invest from as little as £10 per month. Finally, investing in funds should be for the medium to long term i.e. 5 years plus, and past performance is no guarantee to the future.

Clive: Yes, our fund invests solely in UK-listed companies. However, many UK companies generate much of their revenues from abroad. We believe our track record demonstrates that we can add value for our clients over the long term: our fund has generated a 60% total return since its launch in November 2004 (for the retail accumulating share class), a period that included the global financial crisis.

With nearly 5% of your portfolio invested in BP how has, or will this affect the fund performance now that they have cut their dividend? Also, what is the rationale behind keeping a holding in a non dividend paying company when this is an income portfolio?

Clive: We think BP will reinstate its dividend earlier than expected, most probably in the first quarter of 2011, albeit the dividend will be reinstated at a lower level, more likely closer to 10 cents a share rather than 14 cents a share. More broadly, we think the sell-off was overdone, while a slimmer, more focused BP should emerge from the crisis. We have an overweight position in the stock and have been adding to our holding in recent weeks.

What do you think the outlook for the FTSE might be in the coming 12 months?

Clive: Equities look very undervalued relative to most other major asset classes and we don't see a double dip as a likely outcome therefore we see it being 10-20% higher than where it is today.

Andy: I'd concur with Clive and would also point out that investors should not think the volatility has completely diminished as there will be bouts of volatility along the way. But we do not see a double dip occurring either.

Given that just five UK companies now account for close to 50% of the total annual dividend distribution of the UK stock market, and that most funds investing in this sector will invest in these same five companies, wouldn't it be less risky to invest in a global equity income fund, particularly following the volatility of a single stock like BP over recent months?

Andy: It is only in the last couple of years that investors have broadened their investment horizons and started to look outside the UK shorelines for equity income.

That said, investors should appreciate that the vast majority of companies within the FTSE100 derive a significant amount of earnings from their overseas operations. Investors should also note that there are UK equity income funds out there such as Clive's which do look further down the market cap scale to find opportunities – this helps distinguish them and set them aside from the main core.

Clive: We do currently own the five largest stocks within the index (HSBC, Vodafone, BP, Glaxo and Royal Dutch Shell), but this is highly unusual for our fund. In contrast to many of our multi-billion pound competitors, our smaller size means we can own much smaller companies within the fund, reflected in the fact that 45% of the portfolio is currently held in small and mid-cap stocks.

Given the international focus of the FTSE All-Share index and the significant current undervaluation of UK stocks, selling a UK income fund to buy a global income fund arguably means selling undervalued international companies that happen to be UK-listed in order to buy more expensive international peers that happen to be listed elsewhere. It also leaves you open to currency risk - sterling can go up as well as down!

Why is it a good idea for companies such as Santander to buy up our ailing banks/ building societies, when you hear that the Spanish economy is failing? Will this have a greater impact on our economy and can these shares still be included in the UK Equities funds?

Clive: The Spanish economy may be in the doldrums but Santander is one of the strongest capitalised banks in the whole of Europe with a very strong balance sheet. Santander has been growing its market share in the UK by exploiting the financial crisis by buying Alliance & Leicester and Bradford & Bingley. Should it decide to list its UK operations then these shares could be held in UK equity funds.

Is there any point in investing in, say five different UK Equity Income Funds, with different fund managers, with regard to spreading risk, when the chances are the portfolios will be very similar, focusing of Blue Chip stocks with big dividends, as if stocks are duplicated the risk is therefore increased?

Andy: When looking to diversify any investment to help spread the risk, investors should carefully read the stated aims and objectives. This will then ensure investments can be truly diversified and ensure as little identical replication is incorporated within a portfolio. In terms of UK equity income funds – there will of course be some replication in respect of some big blue chips, however there are funds such as the JO Hambro UK Equity Income fund which does look further down the market cap scale and therefore offer some real diversity.

Clive: We believe our fund offers something different from other UK equity income funds. We can and do invest along the market cap scale, ensuring the profile of our fund is very different from our competitors. As you've probably gathered, we are currently more upbeat on the UK economy than the consensus, although the performance of our fund is not geared on the prospects of the UK economy; we think our stocks will do well even if growth is sluggish.

What makes JO Hambro's equity income funds different from other income funds?

Clive: Compared to most of the high-profile competitor funds, our fund is significantly smaller in size, currently around £550m in assets, which enables us to invest a much higher proportion of the fund in smaller to mid-sized companies. Right now, only 55% of the fund is invested in the FTSE100 - which is less than the average. We would expect these smaller to mid-sized companies to deliver higher dividend growth and greater capital growth than many of the FTSE-100 stocks which may dominate many of our peer group's funds.

For example within the retail sector our biggest investment is with Majestic Wine - with a market cap of around £200m. Last Christmas it delivered 12% like-for-like sales growth and has been the best-performing retail stock so far this year.

Andy: We like Clive's fund because of its flexibility in viewing across the entire FTSE market cap. Many of the core UK equity income funds do not do this.

Do all UK equity income funds invest in the same group of companies or do some focus on small caps, large caps etc.?

Andy: Not all UK equity income funds focus on the same companies and market cap size. Whilst there will be some natural correlation given the significant size and distribution offered by the very largest FTSE100 companies, there are funds around such as the JO Hambro which seeks opportunities from further down the market cap.

With the announcement of substantial cuts in Government spending and the inevitable loss of jobs and reduced purchasing power, does Clive feel that company profits will come under strain with a consequent fall in dividends?

Clive: The gloom surrounding public sector job cuts is completely overdone, consistent with the unwarranted tales of woe found in the media on a daily basis. Let's look at the facts. The Coalition Government has targeted 100,000 public sector job cuts per year. Yet the private sector created 340,000 jobs in just the last three months - a record level of job creation. It seems that the private sector is picking up the baton from the public sector, but this story is not being followed by the media.

Let's put these numbers in a historical context as well. Public sector job cuts were much greater in the recession of the early 1990s - 250,000 jobs in both 1992 and 1993 - than the stated cuts. It's also worth noting that public spending will not actually fall in the coming years; it will simply be growing at a slower rate than witnessed in recent years. Again, the obsessively negative news agenda is obscuring these fundamental facts. In terms of dividends, I reiterate that companies are growing their dividends substantially and we expect this to continue.

As a student I would like to know whether there are savings or investments out there to help me maximise any excess income I have with minimal risks.

Clive: With rock-bottom interest rates meaning returns on cash are paltry, UK Government bonds yielding around 3% and corporate bonds yielding only a little more, we believe UK equities currently offer the best home for income investors.

Why invest in high cost funds, when you could buy individual stock with high dividend?

Andy: First of all, not all funds are high cost. Investors should look closely at the Total Expense Ratio. More importantly a fund offers real diversification across a broad range of individual stocks or bonds, whereas whilst purchasing an individual stock means placing all your eggs in one basket.

Clive: I would add that ultimately fund managers are to be judged by our performance and the high-yielding stocks of today will not necessarily be good investments. Three years ago, Lloyds and Royal Bank of Scotland were two of the highest-yielding stocks in the UK market, but of course haven't paid a dividend in the past two years.

What do the team think about Rockhopper Exploration?

Andy: This company has certainly been in the news recently following their drilling results. However, it is unlikely to be found in a UK equity income fund as the company does not pay a dividend.

Clive: It's not a stock we follow as it doesn't meet our yield requirement.

I can see this fund has attractive levels of dividend income, would you say this fund is more suited to investors looking for income, growth or balanced?

Andy: By the very nature of being an equity income fund, investors will naturally invest for the income return on offer. However, when reviewing funds such as this, investors need to consider how the fund is able to maintain and develop capital appreciation, over the long term whilst the returns can help supplement any income needs – it is important the value of investments keeps pace with inflation and providing a real return.

Clive: Our fund offers both income and capital growth. Every stock we hold has to yield more than the FTSE All-Share index on a forward-looking basis. However all the stocks we hold also have scope for capital appreciation.

I have £100k to invest, do you think it is a good idea to invest it in UK equity?

Clive: Firstly, always get professional advice from an independent financial adviser. As mentioned above, we believe UK equities currently compare very favourably to cash, government and corporate bonds and residential property. Valuations are broadly compelling and the yields on offer are attractive and growing.

If I buy an ETF based on the FTSE100, do I get a return based on the increase in the index, or one that reflects the increase in the index plus dividends disbursed?

Clive: I don't know the answer to that. It won't surprise you to hear me extol the virtues of active fund management as we believe it can add value, while passive management concentrates investors' money in stocks that have already performed well.

If you were to make a 'heat map' of yield versus risk, what would be the investment choice with the best yield for the least risk?

Clive: A good question. We think about risk in terms of valuation risk rather than sector risk; protection comes in the form of low valuations. To that end, we are currently avoiding tobacco and utilities stocks. These are popular with many UK income managers but we believe their valuations are unattractive once you adjust for the high levels of debt many of these companies carry on their balance sheet. Conversely, a stock like property company British Land offers an attractive yield for relatively low risk. It has a secure revenue stream with an average lease length of 12 years and 98% of its revenues up to 2013 already safeguarded.

In the preview it says UK equity income is a good way to make additional income from your portfolio - what if I don't have a portfolio? Is this fund a good starting point for a first time investor?

Andy: Whilst I am unable to provide specific advice, any investment needs to be fully considered against an individual's attitude to risk, investment objectives and investment horizons. To fully appreciate the risks associated with any form of investment we would always recommend researching through the many websites available offering guidance and assistance about the risks involved - such as The Share Centre's website (www.share.com), where we have additional information on funds such as JOHCM UK Equity Income fund.

Clive: What can I say - yes this would be a great starting point! It's a fund with a diversified portfolio of around fifty stocks, generating a yield of 5% on top of which we hope to deliver some capital growth going forward.

Clive - What percentage yield do you look for in a company before adding it to your fund?

Clive: Every stock in our portfolio must yield more than the market average, looking forward twelve months, which means, today, that stocks in the portfolio yield greater than 3.5%.

Andrew - Regarding UK equities and their income stream, shouldn't good equities offer growth too? Or does one always come at the cost of the other?

Andy: Depending upon the type of business, a company may or may not offer investors an income stream. The mining sector for instance has always predominantly been seen as a growth sector, whilst the utilities sector has always been seen as an income provider. Investors should always consider why they are investing and what their investment objectives are. It is worth remembering that even income producing companies do generally over time see appreciation of their share price – just not at the extent of those seen as pure growth.

What does the panel think about fund of funds? Are these a better bet for the cautious investor?

Andy: Whilst it is not possible to provide specific advice as to whether a fund of fund is more suitable for a cautious investor, they are designed for a purpose. For those investors that wish to have a well diversified / asset allocated portfolio without the need to continually monitor it themselves, fund of funds can potentially provide the solution.

What is your current view on financial stocks?

Clive: We are overweight financials, where we like life insurance and real estate stocks. We are underweight banks but hold HSBC, where we think the dividend could double in two years. We are also overweight other financials that offer similar characteristics to banking stocks.

I am 65 and have just funded a SIPP from various pension pots. I am intending to go into income drawdown and need to find investments that will generate this income. How reliable do you think UK equity yields are, and where do you think they're going?

Clive: The last two years have seen disappointments for the UK Equity market on the dividend front, firstly from the banking sector and secondly from BP. However, as we sit today, we anticipate a healthy rate of dividend growth of around 10% or more, as some of these companies return to the dividend list or reinstate previous levels of payment. This leaves us with a market yielding 3.5% and the potential for double digit growth in income over the coming years.

Do you think a double dip is likely and how would that affect the fund?

Clive: We are more upbeat than the consensus on the prospects for the UK economy and believe a double dip is unlikely. We think the private sector is picking up the baton from the public sector, as it did in the last two recessions. The economy is benefiting from the delayed impact of the stimulus, the employment picture is improving and growth in emerging markets is good news for a number of UK-listed companies. Meanwhile, the public finances are in much better shape than the Coalition would like to publicise, helped by strong corporate tax receipts and an improving employment picture. Even if economic growth is weak, starting valuations for UK equities are so low that we still believe we can make money.

Andy: I agree with Clive, we believe that a double dip for the UK economy is unlikely.

What are the immediate prospects for UK consumer spending?

Clive: The negativity towards the UK consumer is overdone. We think consumer spending will surprise on the upside over the near term, especially as people realise that the public sector cuts are not as bad as feared and as unemployment worries recede. The household savings ratio is closely correlated with the unemployment; people save more when they are worried about losing their job.

As these worries fade, the savings rate may well drift lower, which will have a powerful positive effect upon consumer spending. Although the portfolio is not positioned as a play on economic growth and consumer strength, we are happy to look at stock-specific opportunities among domestic-facing cyclical stocks. In the consumer space, we have added Marks & Spencer, cruise ship operator Carnival and Debenhams to the portfolio in recent weeks. In each case there are specific reasons why we like these stocks, but this is set against a background of unduly low valuations for UK consumer-facing stocks.

Do you think UK funds will outperform global funds in the short to medium term?

Clive: In the short-term the relative move of sterling will dictate that answer. Over the medium term, whilst economic growth rates in the emerging world will clearly be higher than in the UK, valuations are also much higher there, therefore capital growth may be less than hoped for. For example, the worst-performing stock market so far this year is Shanghai despite it being situated in the fastest-growing major economic country in the world. This is because valuations there are already very high.

Andy: Short term performance should not be considered when looking at funds. This type of investment is always for the medium to longer term and, in any event, a well-diversified portfolio would consist of both UK and global fund exposure.

How often is income paid out from your fund?

Clive: Great question! Simple answer...income is paid out quarterly.

I have a number of shares in Lloyds TSB. Do you think they will ever re-instate their dividend?

Clive: I think it is likely Lloyds will begin paying a dividend in 2012.

Are UK equity funds a good short term investment? Being in my 20s I am not exactly thinking about retirement but rather making a "fast buck" so to speak - is that a reasonable possibility?

Andy: Investment in funds should not be seen as a short term investment, they are for the medium to longer term. However, the earlier an investor is able to start investing the more beneficial the reward should be later in life.

How might the new austerity of the current government affect the economic climate in which these UK companies operate?

Andy: Whilst the austerity measures are likely to affect all of us in some shape or form, their actual impact on businesses will vary. For those large FTSE100 operations with significant earnings derived from overseas, the impact is likely to be less, however, for those businesses involved with and reliant on Government projects, the outlook may prove more difficult depending upon how and where the cuts are made. Also retailers may potentially feel a tighter squeeze as consumers change their lifestyle and spending habits.

How much influence is the 2011 rise in VAT having on current consumer spending

Clive: Currently the effect is modest but retail companies have been planning for it for some time - and in some cases are pushing through price rises ahead of the January VAT increase. However, the key determinant of consumer spending will be the savings ratio which, in turn, will depend upon consumers' confidence about their employment prospects. We believe the private sector will create far more jobs than the public sector will shed over the next 24 months, as indeed it has done in the last three months. This point appears to have been ignored by vast swathes of the media.

Andy: There is no doubt that consumer spending patterns will rise post the VAT rise and any direct implications they suffer following the austerity measures, i.e. unemployment potentially.

According to Warren Buffett, you should get scared when everybody else is getting greedy and get greedy when everybody else is scared. Would you say that people right now are generally scared or greedy?

Clive: I would say that around 80% of investors are very fearful, which is why you can buy a raft of well-established, well-run, UK companies on around nine or ten times earnings - which is highly unusual.

Andy: The last couple of years have been totally unprecedented times, and therefore investors should look for managers with proven track records in identifying the investment opportunities that exist.

Clive - How often do you change the companies within your fund?

Clive: Our average holding period is two years.

I've been burned on UK funds recently and was thinking about emerging markets instead. The UK economy just isn't very strong at the moment. What does the panel regard as the key indicators to watch for as a turning point for the markets and why?

Andy: The timing of investment when selecting funds is not so much of an issue, the investment should be seen for the medium to longer term, and therefore market timing and inflection points should not be so much of an issue. Investors should also appreciate that just because a UK company is listed on the UK market that doesn't necessarily mean that all their business operations are linked to the UK economy.

Clive: Having met a number of major UK companies over the last few weeks, it's clear to me that economic activity in the UK is much stronger than the average commentator suggests already. For example, Mitchell and Butler, Carnival Cruises, Next, Restaurant Group all suggest that the UK consumer is beginning to spend more freely once again and for the moment the stock market is ignoring that.

You mention that Rockhopper does not meet your income requirement, but at the present time neither does BP. Given the potential that Rockhopper has, could it not also be a major yield player in the future. Plus, there is no certainty that BP will recommence paying a dividend

Clive: BP does meet our future income requirements as we believe it will return to the dividend list in 2011. We have a very strict yield discipline in our fund, as discussed earlier.

Host: That's all we've got time for today. I hope you found the webchat insightful and useful.

Clive: In conclusion, interest rates in the UK are likely to stay low in the coming years - in which case funds such as ours, yielding almost 5%, ought to have wide appeal to investors. I hope I have been able to provide some helpful insight in to our fund this afternoon, and thank you to everyone for your questions.

Andy: I would like to thank everyone for your time and questions, and I hope that we have been able to demonstrate that the UK equity income sector offers funds that vary in their investment strategies and that will look to cover stocks across the entire market cap. If investors wish to find out more they can visit our website and find the JOHCM UK Equity Income fund within our Platinum 120 range.