Macrobites

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Ian Kernohan, Economist at RLAM, explores economic sentiment in Ireland and the conundrum over the future of Eurozone countries.

Robert Talbut, RLAM's Chief Investment Officer, looks at shareholder relations and highlights the need for management and shareholders to work together on decision making if they are both to benefit.

Martin Cholwill, Manager of the Royal London UK Equity Income Fund, explains the risk to investors from the mega-cap domination of UK dividend income.

Ian Kernohan

Economist

The Bundesbank have upgraded their 2011 GDP forecast for Germany again, from 2.5% to 3.1%. In theory, with German (ie Eurozone) interest rates set to remain very low, there is a good chance that growth and inflation differentials between core Eurozone and the periphery will help to ease tensions within the zone via strong growth in Germany. However, in practice, these trends are not playing out quickly enough.

Spending a few days in Ireland, it was clear how aggrieved everyone was about what has happened to the Irish economy. Complaints are directed mainly against "the bankers", everyone's favourite bogeymen, but also against the largest Eurozone countries, and France in particular, for exacting such a high price for the financial assistance offered. There is also open debate about leaving the Euro and bringing back the punt, although the practicalities of this must be considerable, never mind the fact that it would mean the whole country defaulting on its debt, a decision which would hang over Ireland's creditworthiness for years to come. Starting from a clean sheet, the better option might be to restore the link between the Irish punt and Sterling, given the close trading relationship, although politics of such a course would be tricky to say the least. On balance, and it's not a great choice on offer, the better option, or rather the least bad option, would be to cling onto the skirts of mother Euro, for fear of something worse.

This land of confusion was of course predicted by the Eurosceptics more than 20 years ago, most vocally by Margaret Thatcher and her Chief Economic Adviser, Alan Walters. At the time, few wanted to listen, since the important thing was to get on that Euro train, even though no one knew where it was going. I recall that one of the main arguments in favour of joining was that it would save time having to change currencies. A large price is being paid for such small benefits.

If the economics of the single currency didn't add up, the politics were even more suspect: voters in the south of England may grumble about large transfer payments to the north, but at the end of the day, this is an accepted part of being in the single currency area known as the United Kingdom. Large and ongoing transfer payments from one country to another would be quite a different matter, but this is just what a single currency area requires in order to function properly.

Robert Talbut

CIO

There is a marked shift in management attitudes towards shareholder voting which risks leading both to more open dissention towards boards and a further hardening of shareholder views on voting at meetings. I refer to the emergence of opposing views over when a win is not a win and my concern that management attitudes will inevitably lead to an unwelcome deterioration in shareholder relations.

In the days of less active shareholder voting, management appreciated that successful leadership from a position of strength required the support of the overwhelming majority of shareholders. It would therefore re-think a decision if faced with even a reasonably significant minority of dissenters. More enlightened management leaders claim that even a minority is worth listening to, as their views are probably well-founded and ignoring them would reflect badly on the management team.

Once was that if even a small number of board members expressed reservations over a decision, a strong chairman would request the decision be deferred and further work be conducted to ensure all members were comfortable with the decision. Are managements now saying that board members unhappy with a proposal are regularly ignored because they do not constitute a majority? And are decisions regularly steamrollered through irrespective of the degree of unanimity?

If management do wish to play hard-ball with shareholders, I foresee several potential outcomes. On the one hand, shareholders may decide that the chance of attaining a 50% majority is so slim that they consider stewardship to be a waste of time. Conversely it may prompt many to become more hard line - if they are in the least unhappy, they have no option but to vote against, given management's start position that a win is a win no, matter how secure. We may also see more public criticism of management if they are disinclined to listen to even a reasonable proportion of shareholder unease.

Overall none of these potential outcomes is conducive to improved stewardship or is in the best interests of management. However if management continue to adopt such an uncompromising position regarding shareholder dissention and votes, then such actions may well be the result.

Martin Cholwill

UK Equity Income Fund Manager

Recent US data has indicated softening economic activity, consistent with a mid-cycle slowdown but very far from suggesting a double-dip recession. In contrast, corporate results remain strong across many industries, with decent dividend increases reflecting management optimism. Banks and retailers may be struggling, but many quality companies are more upbeat, including Johnson Matthey, a specialty chemicals company, which recently announced an 18% dividend increase.

Dividend growth prospects are good; despite headwinds from an indebted UK consumer and high government debt, corporate balance sheets are strong as decisive cost-cutting has borne fruit. Aggregate Bloomberg dividend forecasts suggest 15% growth over the next 12 months.

Any analysis of longer term equity returns highlights the importance of dividend growth, a key reason for optimism over stockmarket prospects. It is the norm over the longer term and demonstrates the inherent 'inflation hedge' in UK equities. Nonetheless, there are two risks to this positive view.

The first, a global economic double-dip, is unlikely, as governments strive to avoid deflation, thereby erring towards inflationary policy. The post-credit crunch economic climate remains very different, with ongoing government intervention in many high profile industries. A key strategy is therefore 'survivor bias' and balance sheet strength to capture the winners.

The second risk is mega-cap shares. The UK stockmarket has become increasingly concentrated over the last 20 years, with the largest 15 dividend payers now accounting for nearly 60% of total dividend income. The risk is highlighted by the banks in 2009 and BP after the Gulf of Mexico oil spill – large company dividends can disappear overnight and are inherently no safer just because the companies are large. Crucially, BP accounted for 12% of all UK dividend income prior to suspending payments.

This is key for equity income fund investors. Large funds are often dominated by mega-caps, partly because of potential liquidity issues outside the FTSE 100. Some funds may diversify overseas, but continue to face the same liquidity issues in other markets. There are many good opportunities outside the mega-caps and the top 15 dividend payers account for less than 40% of the Royal London UK Equity Income Fund's total income. Over 35% of the portfolio is currently invested in mid-caps, many of which look set to deliver good dividend growth over the coming years. Strong corporate balance sheets and cashflows suggest increased M&A activity. Mega-caps are more bid-proof and likely to be the acquirers, whereas mid-caps are more likely to be the potential targets; owning the targets is typically more lucrative.

Large funds may struggle to adapt to quickly changing circumstances and suffer from inadequate liquidity lower down the market cap spectrum. Anaemic economic growth and interventionist government policy demands a nimble approach and a more interesting portfolio than just the usual mega-cap names.

Source: rlam as at 24 June 2011 unless otherwise stated.

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