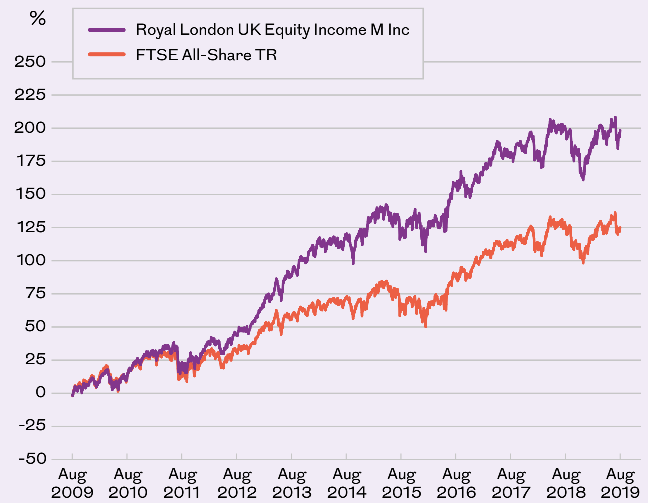
Consistency in equity income investing

Consistent performance is a desirable objective for all investors, but perhaps nowhere is it more important than the world of income investing. Unlike other equity investment styles, frequently focused on capital accumulation, the purpose of income investing is to build high dividends at low levels of risk, while at the same time protecting and enhancing the capital value.

Unfortunately consistency appears to be a rare phenomenon among income investors, with several high profile blow-ups in the space over the past year. Our performance has been an exception. The Royal London (RL) UK Equity Income Fund has outperformed its peer group for nine of the past 10 years. What explains this degree of consistency when so many others appear to struggle?

Performance of RL UK Equity Income Fund



31 August 2009 to 31 August 2019 data from Lipper 2019

	30.09.18 to 30.09.19	30.09.17 to 30.09.18	30.09.16 to 30.09.17	30.09.15 to 30.09.16	30.09.14 to 30.09.15	Five-year cumulative returns
Royal London UK Equity Income A Inc	2.48	4.29	9.48	16.36	3.08	40.35
Royal London UK Equity Income M Acc	3.19	4.92	10.21	17.08	3.71	44.89
Royal London UK Equity Income M Inc	3.12	4.95	10.17	17.10	3.74	44.84
Royal London UK Equity Income Z Inc	3.22	5.01	10.21	17.15	3.80	45.27
UK Equity Income Average	*-0.88*	*3.38*	*10.81*	*11.02*	*3.52*	*31.13*
FTSE All-Share TR	**2.68**	**5.87**	**11.94**	**16.82**	**-2.30**	**38.89**

Source RLAM and Lipper. Table shows returns net of fees, to end September 2019.
Past performance is not a reliable indicator of future results.

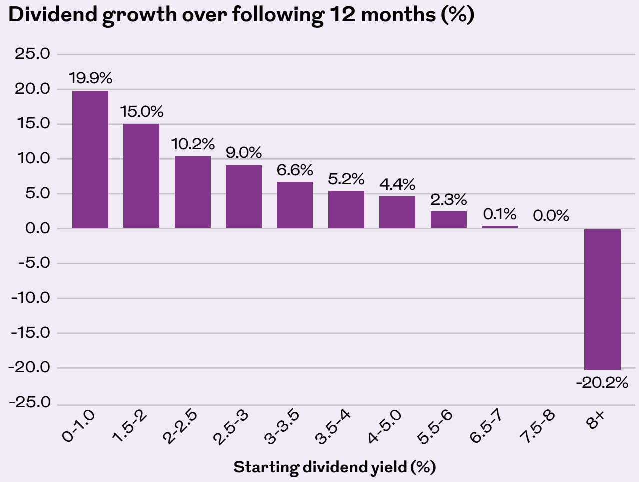
Recipes for disaster

Analysing why things go wrong is instructional. Many fund managers say the right things, but their investment decisions defy their words. Ultimately, this comes down to discipline. Managers can fail to live up to their proclaimed strategies at the first signs of trouble. Consistency does not demand that every individual investment decision succeed. Rather, it depends on applying a repeatable investment process.

It is important, of course, that the process also coheres with the objective of reducing volatility. We believe there should be no place for unquoted stocks in an income fund because they are at the wrong stage of development to pay regular dividends and are more likely to make cash calls. Their lack of liquidity renders their prices unstable, dependent upon the subjective evaluations of a limited number of buyers and sellers. This makes them particularly vulnerable in times of market stress.

Income fund managers that include unquoted stocks in their portfolios are often forced to purchase extremely high dividend yielders to meet their income requirements, as part of a barbell strategy. This sets them up for value traps, with the following chart showing that, on average, higher dividend yields have lower growth prospects. Thus, the strategy often combines a lack of yield from unquoted stocks with an excess of risk from high yielding ones. In our view, this is no formula for consistency.

UK dividend growth by yield vs dividend group since 1990



Source: SG Cross Asset Research/Equity Quant, FactSet 1990-2016

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Getting the macro calls wrong

Another occurrence that we often observe is that capable fund managers can poison their portfolios by making macroeconomic calls. There are certainly a number of fund managers with long track records of making money through asset allocation. As equity income investors, however, our skill is in picking stocks, rather than making big macro calls. The problems emerge when managers step outside of their circle of competence, thereby undermining what they actually do well.

Unquestionably nobody can pick stocks in a vacuum, and so we have a clear macro framework within which we select our investments. However, we do not try to position our fund for any particular macroeconomic outcomes, preferring to focus on where our skills lie. While our fund is underpinned by a set of macroeconomic assumptions, we are ultimately looking for companies that can provide resilience across the spectrum of possible economic outcomes.

Demonstrating that opportunities can be found without a need to focus on macroeconomic forecasts, of our four more recent top performing stocks, two are domestically exposed and two are internationally exposed. Our contrarian decision not to shy away from the UK due to Brexit fears unravelled some fantastic opportunities. The companies have strong market positions, cashflow-backed dividends and robust balance sheets, and so we believe should prosper in any environment.

The keys to our success

In light of our track record, the simplicity of our fund may be surprising. We are a traditional equity income investor. There are no bonds, derivatives or unquoted securities in our portfolio. The portfolio is long only and entirely contains UK equities, over 90% of which are listed on the FTSE 350. We seek to invest in quality companies when they are out of favour, and every stock that we purchase must be able to stand on its own, contributing to the yield of the fund.

As long-term contrarian investors, we are intensely focused on the underlying fundamentals of companies, and how they change over time. Fundamentals are far less volatile than stock prices due to the widespread obsession with short-term earnings forecasts. Rather than earnings, we are concerned about cashflows, which determine dividend sustainability. We try to find attractive entry points for companies with long-term abilities to generate cashflows.

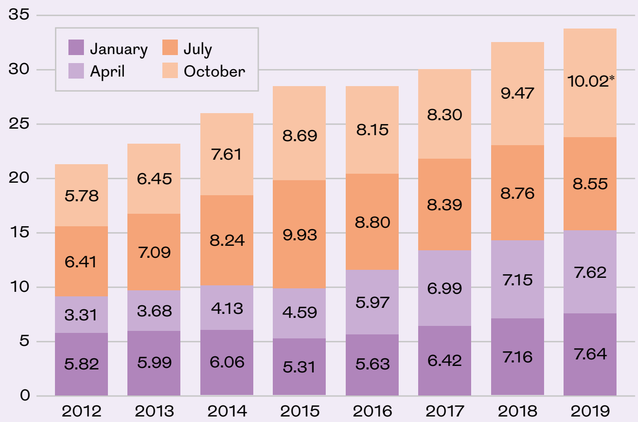
Since we have a conviction driven portfolio, giving us scope to outperform passive funds, we are very conscious of the needs for managing risk and optimising portfolio construction. We have a broad industry spread, with every stock contributing in an uncorrelated way. No single stock is of overwhelming importance to performance and our bias towards quality helps us to avoid rollercoaster returns. Our concentration on mid and large cap companies also ensures that we do not suffer from the liquidity and scalability issues that would be associated with micro-cap stocks.

The winning formula

The consistent outperformance that we have been able to achieve over the past 10 years owes much to our discipline in sticking to a clear and proven investment process. Every element contributes to our generating sustainable, above-market, dividend yields. By focusing on the areas in which our specialist skills lie, and by avoiding any style drift, we have shown that it is possible to achieve long-term market-beating returns.

Distribution history of RL UK Equity Income Fund

Net income in pence per unit



Source: RLAM, for A share class. Accounting years to 31 August, net of 10% tax.
* Provisional and subject to change
Data as at 30 June 2019

Contact us

For more information about our range of products and services, please contact us.

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