

## COMMENT

## FUND FOCUS

## Beware the income chasers



Investors need fund managers that aim to grow income over time rather than chase high yields at any cost, says **Meera Patel**

Income has never been so important as it is today, now that interest rates are only 0.5% and gilt yields are falling. Equity income is returning to favour in this environment, but the key is in picking the right manager. The focus should be on fund managers that aim to grow income over time rather than those that chase high yields at any cost. Investors looking for income and are willing to take the equity risk should consider funds like the Newton Higher Income Fund.

This is a traditional equity income fund which adopts a strict yield discipline. Companies in the portfolio must yield more than the FTSE All Share and those considered for new purchase must have yields that are at least 15% higher than the market yield. This discipline narrows the investible universe from 350 stocks to around 140. There is also an automatic sell discipline and companies in the portfolio that fail to meet the yield criteria are sold.

The fund has been managed by Tineke Frikkee for the last five years. Over that time she has outperformed her peers by almost 13% (Source: Lipper, from 01/04/04 to 24/03/09). What's more, the fund has also grown its dividend payments at an annual compound rate of 10% since 1995. Even in today's difficult climate Tineke Frikkee expects the fund's yield to grow by 6% after its final dividend payment in June.

## Seeking dividends

Clearly, the earnings of UK companies are vulnerable in the current environment which is why selecting those that can grow their dividend is vital. During the last five bear markets in the UK, earnings fell by 19% on average while dividends grew by 3%. This is why having a yield discipline can have its rewards. Furthermore, dividends can also provide a degree of insulation in difficult markets.

Having said that, the FTSE All Share dividend yield reached a historic high of 6.11% in November 2008 but it has since fallen back to currently 5.15%. According to Tineke Frikkee, this is still too high. A realistic yield should be closer to that of 10 year gilts, around 4%. We are therefore

likely to see a raft of further dividend cuts from companies and this fund will aim to avoid those most at risk.

## Thematic philosophy

What makes this fund different to its peers is it utilises Newton's thematic philosophy, which has also been a key driver of returns. For example, the thematic process has meant the fund has favoured the more defensive companies with earnings resilience like the utilities over the last year which has proven beneficial. The preference has been towards the less geared and less regulated utilities which Tineke Frikkee believes should grow their dividend this year albeit at a slower pace compared to last year.



Frikkee: favourite

Conversely, the fund has stayed away from some of the troubled banks and the mining companies. Staying away from the banks has been a very important for the fund in terms of both income and capital; in other words the fund has not been subject to these losses on both accounts. Interestingly, in 1998, the banks accounted for 14% of the market's income. This figure peaked at 28% in 2007 and is expected to drop to around 10% this year. These calls have driven the fund's outperformance in the last year.

The main risk to the fund is its exposure to companies that derive a large proportion of their earnings in US dollars. In terms of income, the fund is currently 50% exposed to the dollar. This means if the dollar weakens, the amount of income the fund receives in sterling will be lower. Tineke Frikkee is aware of this and will ensure she does not become complacent as her focus is to deliver income growth over time.

Clearly markets have been volatile and investors have fled to the safer havens of cash and gilts. The problem with these is neither provides income growth and the returns can be inflated away. According to Tineke Frikkee, she expects dividend yield and dividend growth to represent more than 70% of total equity market returns and this fund, which yields 7.58%, is well placed to beat inflation and grow its dividend.

Meera Patel is senior analyst Hargreaves Lansdown

## THE BROADER PICTURE

## Looking behind the hype on bonds



Martyn Ingram explains why he hasn't been tempted to buy any corporate bond funds in the current environment

Retail investors have been making new investments into corporate bond funds in their droves, but the performance results achieved by most funds this year continue to disappoint. After taking account of any reinvested income, many corporate bond funds ended the first quarter of 2009 at least 5% to 10% into negative territory. Investors who've been drawing a high income from their corporate bond investments may now be wondering whether further falls in the capital value of their investments could make it necessary for them to consider cutting back on the income they are taking.

Investors who've had no need to draw income could have invested almost exclusively in the ultra-safe end of the corporate bond credit-risk universe. Those who did would have avoided large short-term losses, especially if they were invested in funds that had limited exposure to financials. Most corporate bond funds failed to deliver the level of protection from capital losses that investors were hoping for because the funds were positioned for a recovery (rather than for further weakness) in the corporate bond markets.

Understandably, investors who will be buying corporate bond funds during the summer will be drawn into buying the funds that have performed the best in the recent past. The investment case for holding corporate bond funds looks rather compelling. But if investors truly want to adopt cautious investment strategies, it is questionable whether they should have large corporate bond investments.

There are alternative investment strategies that cautious investors could follow. For example, they could use an investment strategy that is based on holding a combination of gilts (the index-linked and/or the fixed-rate variety, as considered appropriate) and equities. Rather than buying corporate bond funds, they could protect their downside risks through the gilt market (which will be a challenge all the time that there is upward pressure on yields) and they could target growth by selectively gaining exposure to equities.

Most investors wouldn't want to use just a combination of gilts and equities at the moment as the overall return achievable is likely to be very low. In addition, cautious investors would be required to maintain a low level of exposure to equities for some time and they would need to accept a very low yield. The need to generate more income was a factor that led many investors to corporate bonds. Some investors needed a high income that wasn't achievable elsewhere, so

they have been easily persuaded to believe that the downside risks are now limited and that the upside potential is still good.

Having made a decision to invest in corporate bonds, many cautious investors thought that buying investment-grade corporate bond funds was all they needed to do. Many thought that if they focused on investment-grade corporate bond funds then they would have a cautious investment strategy, and that they could take advantage of the attractive yields achievable. Unfortunately, in reality, they were taking risks with their capital in order to achieve a higher level of income.

As a result of the poor performance over the first quarter of 2009, the corporate bond funds that have been underperforming within their IMA peer groups will continue to be ignored by the vast majority of new investors. Some of these funds will almost certainly end up being the stellar performers in their peer groups over the years to come, but at the moment investors don't have the appetite to invest in them. Many of these underperforming funds now produce much higher yields than those on offer from the better-performing funds.

Investors who want an income stream that is stronger than the income stream achievable from alternative sources such as gilts and cash deposits may well choose to stick to strategies that involve investment into corporate bonds.

Corporate bond fund managers know that it is difficult for them to change the profiles of their portfolios while illiquidity remains a serious problem in the secondary markets. Downside risks remain in the corporate bond market, so an asset-allocation strategy that captures the best-performing areas of the market will be crucial, as will the quality of the stock-picking.

While investors continue to lack the confidence to take risk, the corporate bond funds that are following the most cautious investment strategies will be at the top of the buying lists for many investors. However, I feel that the best investment opportunities are to be found in the higher-yielding end of the corporate bond market. I consider manager selection and timing to be crucial. Once a decision to invest has been made then investors rely on the manager to perform well. Buying the right fund at the right time can substantially enhance returns, which is why I've not been tempted to buy any corporate bond funds just yet.

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