Lifting the lid on Equity Income Funds

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neptune
Invest in depth

Welcome

Whether you are looking to supplement your income or harness the power of reinvested dividends to help build your savings in the long term, we believe the case for investing for equity income has never been stronger.

The simple fact of investing is that, if inflation continues at today's rate of around 2.0%, £10,000 in cash will be worth £8,171 in ten years and £6,676 in twenty years in real terms, so finding investments that will outpace inflation is of paramount importance for even the most conservative investor. And the opportunities to do this through investing in equity income funds have grown considerably in recent years.

> "Equity income funds can be an important part of any portfolio, and may be suitable for a range of investors of different ages and investment goals."

A core portfolio holding

Equity income funds are generally associated with those nearing or in retirement, as they tend to be lower risk and can be used to generate a cash income from the dividends paid by the underlying company stocks. However, equity income funds can also be an important part of any portfolio, and may be suitable for a range of investors of different ages and investment goals. Equity income funds especially come into their own in times of market volatility, when instead of receiving the cash paid by a fund's holdings an investor can choose for them to be reinvested into the fund, thereby boosting the value of the investment. Over the long term, this 'compounding' can have a significant effect on an investment.

Diversifying your income

Historically, equity investors in the UK have tended to focus on UK companies and the UK stock market, and there are still many excellent businesses to invest in here. However, investors need no longer rely on the performance of one market. There are increasingly attractive dividend opportunities abroad, particularly in markets such as China and the US that have not traditionally been thought of as dividend markets.

We hope you find this brochure informative.

What is Equity Income?

A simple definition of equity income is 'dividend income that is earned through an investment in stocks'.

Dividends are the share of profits that shareholders receive from the company they have invested in and are usually paid twice a year. Dividends are denominated both in terms of cash — the amount per share that is paid to the shareholder — and in terms of yield. The yield is the percentage of the share price that the dividend represents, so a share with a value of £1 that pays a 3p dividend will have a yield of 3%.

Income and capital growth

Of course, investments in a company's shares and the dividends they generate rely on the ongoing performance of the company. There is no guarantee that a company will pay a dividend, even if it has done so in the past, and the capital value of a share as well as any income it pays can go down as well as up. On the other hand, some companies can increase their value as well as their dividend payments so investors can potentially enjoy capital growth as well as a rising income over the long term.

Other sources of income

Cash offers the reassurance of capital stability but this does not take account of inflation, which will see £10,000 worth £8,171 in ten years' time in real terms. A savings account will pay interest on a regular basis — but at a relatively low level these days.

Bonds are effectively loans by an investor to a government or a company at a fixed rate of interest and with a defined date for repayment of the loan amount to the investor. Typically bonds pay interest twice a year. They tend to be less volatile than equity investments and, in the event of company failure, bondholders are more likely to receive some compensation. However, in a period of rising inflation, the real value of the amount of income paid by bonds falls, as with cash, which can make this asset class less attractive.

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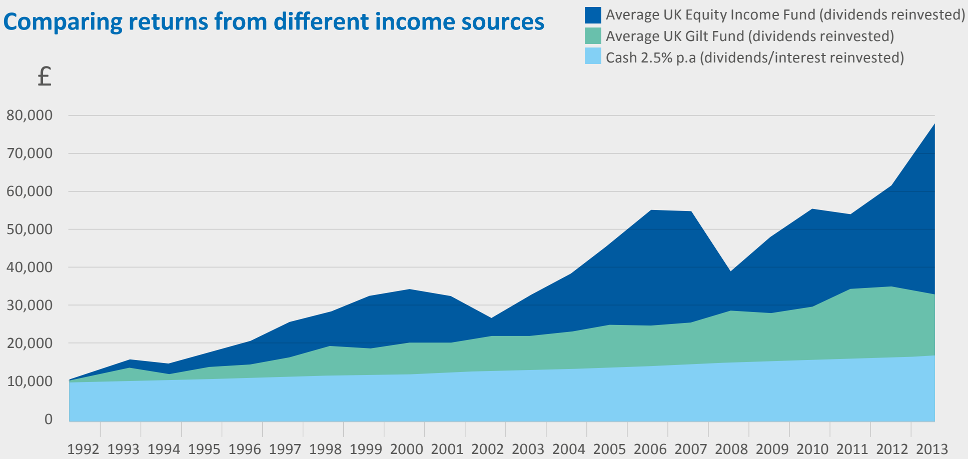
Comparing returns from different income sources



SOURCE : Lipper & Neptune, December 2013. Based in sterling. Past performance is not a guide to future performance.

The graph highlights the different returns that would have been generated had £10,000 been invested over the long-term (with dividends reinvested) in a UK equity income fund, a UK government bond fund and a savings account paying an interest rate of 2.5% per year.

Successful Equity Income Investing

We believe there are some key principles that should inform equity income investing.

1 Invest in strong companies

Companies that pay regular growing dividends tend to share certain characteristics. They are high-quality businesses with strong management, which are positioned to do well in the current economic environment.

In volatile markets, a premium is placed on companies in 'defensive sectors' because they are solid, high quality dividend-payers which have historically outperformed in periods of uncertainty and low growth. Defensive sectors include consumer goods, utilities and healthcare – industries there is typically always a demand for, regardless of the economic climate.

2 Invest for the long term

Equity income investing provides the potential not only for a growing income stream but for capital growth over the long term. By paying a good and rising dividend a company can evidence its financial strength to the market, which is likely to result in a rising share price too. Investors who do not need income in the short term can see improved long-term growth of their investment by reinvesting the dividends it pays.

Those who invest in this sector through equity income funds can see further benefits from active fund management. By focusing on companies with healthy fundamentals, it is possible to not only benefit from increasing dividends as companies pay out more of their rising profits, but also from capital growth as markets reward these attributes. Similarly, selling a company when its dividend is in doubt can help protect capital, as share prices can often fall if dividends are decreased – especially as this can indicate underlying problems with the company.

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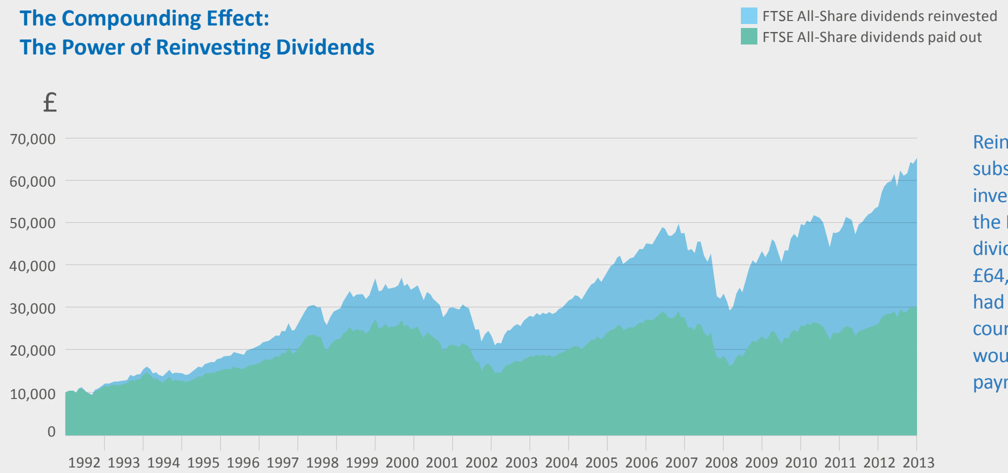
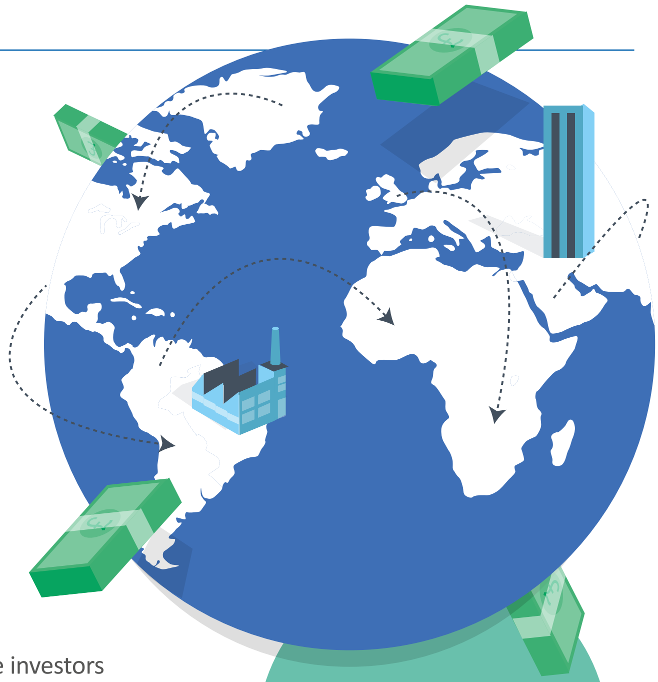
The Compounding Effect:
The Power of Reinvesting Dividends



SOURCE : Lipper, December 2013. Based in sterling. Past performance is not a guide to future performance.

Reinvesting dividends earned can have a substantial impact on the total value of an investment. For example, £10,000 invested in the FTSE All-Share index in 1991 with all dividends reinvested would be worth over £64,000 today – more than double the return had all the dividends not been invested. Of course, by not reinvesting dividends, investors would have benefited from regular cash payments.



3 Diversify your investment

No company can guarantee to increase its dividends every year, or even pay a dividend at all, so most investors choose to invest in a portfolio of companies, which can reduce the impact should one reduce or stop its dividend. They do this either by buying shares in each company themselves or, more conveniently, by investing in an equity income fund that holds a number of companies in its portfolio.

Effective fund managers understand the importance of diversifying a portfolio, avoiding over-reliance on one country or currency. This helps to spread the risk and take advantage of growth in different parts of the world, thereby maximising the potential for returns.

4 Look outside the UK

Historically, equity income investors in the UK have focused on their home market, which remains an important source of dividends. However, this can mean returns are too strongly linked to the fortunes of one economy. And most UK equity income is concentrated in the largest companies, which reduces an investor's ability to gain exposure to some of the faster-growing, small and medium-sized companies.

Investors are now seeing increasing levels of dividend payments from companies based in developed and emerging markets overseas. However, looking outside the UK can also mean investing in global companies based in the UK but which draw their revenues from overseas. The UK offers a stable investment environment, but also lower growth than the emerging markets. By investing in companies generating sales and revenue in these faster growing markets, investors can potentially benefit from both the stability of the UK and the returns offered elsewhere.

> **"It is important to consider funds that offer geographical diversity – whether this is based on where companies are physically located or where they are generating their profits."**

A Timely Opportunity

The current low interest rate environment and sluggish growth in many markets worldwide makes the equity income sector particularly attractive at the moment.

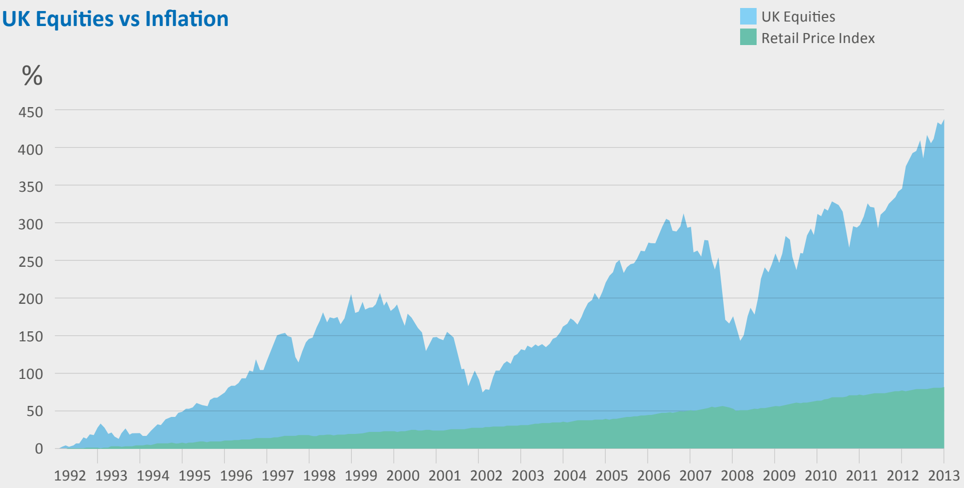
In sharp contrast to government finances, companies are in the best health they have been in for decades, due to efforts to reduce their costs and debts in the wake of the financial crisis. Many have strong balance sheets and substantial cash reserves, which offers good potential for dividend growth. Such companies attract a premium when investors and markets are nervous – and these companies have been some of the rare beneficiaries of the recent uncertain market conditions.

Higher inflation

Whilst economic trends are notoriously hard to predict, most experts agree that the ultimate result of the unprecedented levels of economic stimulus by governments, including quantitative easing, will be higher inflation. Therefore we believe that equity income investment is better placed than investment in either cash or bonds to protect the value of investors' money in inflationary times.

> “
> **The inevitable consequence of quantitative easing is that at some stage we are going to get higher inflation.**
> *Robin Geffen,*
> *CEO and Fund Manager*
> ”

UK Equities vs Inflation



SOURCE : Lipper, December 2013. Past performance is not a guide to future performance.

Over the last 20 years the UK Retail Price Index – a measure of inflation – has risen by 82%. Or, more simply, the cost of a basic basket of goods is 82% more expensive than it was in 1992.
By comparison, the FTSE All-Share Index has risen by 439% over the same period indicating that investing in equities over the long term has the potential to significantly outpace inflation and help to protect your capital from sharply rising living costs.

The financial crisis

During the financial crisis, large amounts of money were invested in government and corporate bonds as investors sought their relative safety and the security of receiving high regular interest payments. This demand pushed bond prices up.

Quantitative easing

In recent years, central banks around the world have embarked on rounds of 'quantitative easing', often known as QE. This policy typically involves central banks, such as the Bank of England, reducing interest rates and buying government bonds. This releases money into the economy with the aim of stimulating economic growth.

Following successive rounds of QE, bond prices have risen and as a result of these increases their yields have fallen. Relative to history, government bonds now look very expensive, with many offering interest payments that are less than the rate of inflation.

Inflation

As the UK economy recovers from the crisis, we expect the additional money released into the economy by QE to push the cost of goods up and therefore for inflation to increase. This will mean that eventually interest rates will rise, causing bond prices to fall. Company shares on the other hand are generally capable of generating an income greater than the rate of inflation, as well as offering the potential for capital growth. Company shares tend to increase in value with inflation too, potentially offering better protection against rising prices.

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>
> *Robin Geffen,*
> *CEO and Fund Manager*

Dividends & Tax Benefits

Having taken into account the growth of your investment and the effect of inflation on its real value, it is also important to consider the impact of tax.

Like interest earned on cash savings and bonds, dividends are subject to tax. Whether you are receiving dividend income directly from the shares you own in a company or from your holding in an equity income fund, all dividends are taxed the same way.

However, the amount of tax applied to dividends differs significantly to the tax on interest from cash savings and bonds. A basic rate tax payer will see their dividends taxed at 10% whereas tax on interest earned in a cash account and from bonds is 20%.

Further, all dividends carry a 10% tax credit and so for the basic rate tax payer, the tax liabilities are cancelled out.

Of course, the amount of taxation will depend on which income tax bracket you fall into, but even in the higher tax brackets, dividends are taxed significantly less than the interest from both cash accounts and bonds.

It is important to remember though that your tax liabilities depend on your own personal situation and where your investments are located. If you are in any doubt as to your tax position you should contact a financial adviser.

Companies Displaying Good Dividend Growth

We highlight three companies to illustrate the potential for successful dividend growth. As ever, it is important to remember that dividends can fall as well as rise and these examples are not recommendations to buy these companies.

1 Diageo

Companies with exposure to global markets are better placed to remain profitable and grow in the long term, compared to companies that rely principally on one economy.

Diageo, the global beverage giant, is a good example of a business that has built, and continues to build, a strong presence in emerging markets as well as having an established franchise in the developed world.

In particular, Diageo is the biggest whisky producer in the world. Over the past ten years, whisky exports have grown by 60% and Diageo has been a primary beneficiary of this growth, particularly through its Johnnie Walker brand, where China is one of its main markets.

In June 2012 Diageo announced a £1 billion investment in Scotch whisky production over the following five years, with at least one new distillery to be constructed, several existing facilities to be expanded, and overall production capacity to be increased by 30 to 40%.

Diageo – A History of Consistent Growth

SOURCE : Diageo company accounts, October 2013. Past performance is not a guide to future performance.

Dividend payments by Diageo have increased every year since 1998 and sustained growth in volumes of whisky sold and a strong resulting cash flow give every indication that this dividend growth will continue.

2 Lyondellbasel

Lyondellbasel is a US-based global petrochemical company producing ethylene and propylene, which are used to manufacture plastics.

As one of the world's largest plastics, chemicals and fuels companies, they are involved in the manufacturing of products used in many everyday goods. These include personal care products, fresh food packaging, lightweight plastics, construction materials, automotive components, durable textiles, medical applications, biofuels and many others.

The manufacturing process is energy-intensive and cheap US natural gas gives the company a strong competitive advantage, given the higher cost of energy in other markets where petrochemical manufacturing takes place.

The company is cash-generative with a strong balance sheet, which allows it to pay healthy dividends, including special dividends in addition to its regular, scheduled payments.

3 Jiangsu Expressway

Jiangsu Expressway is a road constructions and operations enterprise. It is engaged in the investment, construction, operation and management of toll expressways in Jiangsu Province, China.

The mileage of highways that the company currently manages has already exceeded 700km. The business generates a lot of cash and has limited capital expenditure requirements so is able to pass around 75% of profits on to shareholders as dividends.

The future is bright for automotive related businesses in China as ownership of cars is set to increase substantially from its current very low base. Truck freight will also increase as the economy grows, meaning more journeys and more toll payments. The stock has maintained or increased its dividend every year since 2005.

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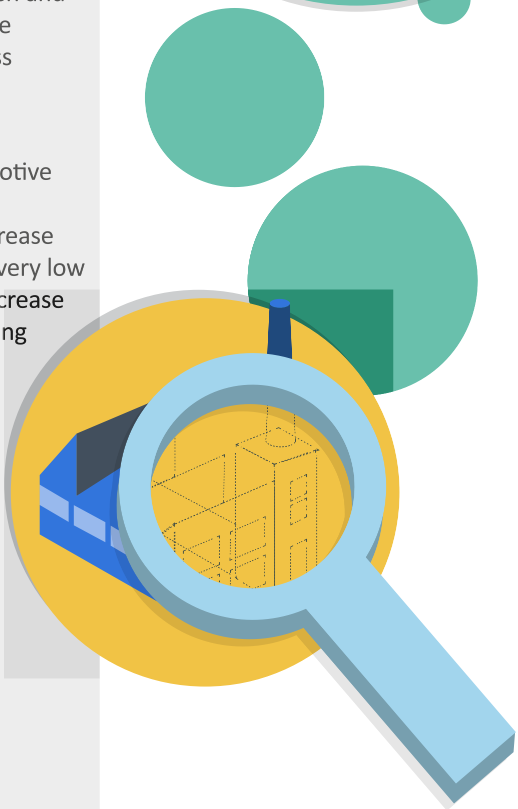

References to specific companies are for illustration purposes only and should not be taken as a recommendation to buy or sell these companies.

Why Consider Neptune Equity Income Funds?

There are a number of equity income funds available in the market and as part of your own research we are sure you will find a fund that meets your individual requirements. Remember though, if you are unsure about the suitability of an investment, you should consult an authorised financial adviser.

At Neptune, our equity income funds focus on the regions which, in our view, offer most potential for investors but all follow our approach to investing.

We think global

We do our own global research which identifies patterns of demand and industry sectors with attractive investment opportunities. We have found that such industries tend to deliver higher margins and long-term growth.

Our stockpicking process aims to identify companies worldwide with the best potential within these industry sectors and, by analysing balance sheets and cash flows, those with sustainable dividends.

We think for ourselves

Our fund managers have the independence to build their own portfolios based on our in-house research and to manage them actively. And they back their decisions with significant investment. While many competitors have portfolios that hold in excess of 100 companies, typically our funds have no more than fifty stocks and the average stock weighting is relatively significant: 2 – 4%.

We take a long term view

Too many funds are driven by short-term strategies and quarterly results. In our view, if you are rigorous with your global research and stock selection, you should have the courage of your convictions.

We have a wide range of funds investing in the UK and around the world.

For more information on our fund range visit our website:

neptunefunds.com

“We do our own global research which identifies patterns of demand and industry sectors with attractive investment opportunities.”

Next Steps

We hope you have found this introduction to equity income informative. There is further information about the sector and our funds on our website:

neptunefunds.com

Ready to invest?

Before investing in a fund from Neptune or any other UK provider, you will need to read the latest version of a Key Investor Information Document (KIID) specific to the fund and share class you are interested in. In addition, our Supplementary Information Document (SID) contains further useful information about Neptune, including information on our terms and conditions, tax considerations and your rights as an investor.

KIIDs and our SID can be downloaded from our website or requested by calling our Customer Services Team.

www.neptunefunds.com

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If you require literature for the blind or partially sighted, please contact us on the details above and we will endeavour to provide documentation to meet your needs.

Once you have read the relevant documents:

To invest by phone
Call our dealing team on

0800 587 5051
(+44 (0) 1268 44 3920)

Phone lines are open on weekdays from 9am to 5pm UK time. Please note that for security purposes phone calls may be recorded and monitored.

To invest by post
Please complete an application form which can be downloaded from

www.neptunefunds.com

or requested by calling our client services team on the above number.

Return it to us at:

Neptune Investment Management
PO Box 9004,
Chelmsford
Essex CM99 2WR

Alternatively, you can buy our funds through a number of online fund supermarkets and platforms. Search online for the term ‘fund supermarket’ to find a number of companies to choose from.