Is your UK equity income fund safe?

Webconference transcript

Robin Geffen

Protection from dividend risk

Analysing the holdings of UK equity income funds reveals some quite startling results: 63% of funds within the IA UK Equity Income sector rely on just one company to deliver over 8% of their yield; 24% of income funds rely on one company to deliver more than 10% of the total yield. Further, 39% of income funds rely on BP and Shell to deliver more than 10% of the yield of the entire fund. Finally, 33% of income funds rely on their top ten holdings to deliver more than half their yield.

These are staggering numbers and we believe they show how, inadvertently, a number of UK equity income funds are relying on very few stocks to deliver a very large part of their yield. The Neptune Income Fund, however, has only ever had 33 equally-weighted stocks. In addition, no one company accounts for more than 3.6% of the Neptune Income Fund's yield. Furthermore, the top ten holdings in the Neptune Income Fund account for just 20.6% of its yield, against 45% for the average UK equity income fund.

Morningstar data shows that there are some funds which rely on one company to deliver up to 15% of the yield. There are others where 80% of the yield comes from the top ten stocks. We believe this should prompt the question, is your UK equity income manager doing enough to protect you from dividend risk?

We believe a vast majority of them are not and we would encourage all investors to look at the holdings of their income fund and find out how exposed they are to individual stocks. Looking back to the financial crisis, the banks slashed their dividends and some of them have not even returned to paying them. Furthermore, we do not have to go back very far to when BP slashed its dividends following the Macondo disaster. We believe there are funds out there running an unacceptably high level of risk to produce the required yield.

Our 3 silo approach

Since the inception of the Neptune Income Fund, we have adopted a three silo approach to portfolio construction. The Fund is made up of eleven steady eddies, the core income stocks with a five year dividend growth track record. Secondly, there are the tactical plays, which comprise another 11 stocks and reflect our in-house sector views. Finally, there are the hidden fruits, which are recovery plays in which we have identified a catalyst for change. There will be times when one silo may outperform the others, however, the Fund has a very carefully balanced portfolio. It is a structure that we believe is designed to suit all market conditions, whilst we also have a long-held large-cap bias.

Revenue diversification

The portfolio holdings' revenue by location, as at the end of January, stood at 33.1% from the rest of the world, 30.4% from North America, 19.8% from Europe and 16.7% from the UK. It came as no surprise to us that the recent attempted bid by Kraft Heinz focused on a UK stock, Unilever, which has very well diversified global earnings. We look at the world in a similar way, as we put the UK in the context of global economics and we are interested in global companies, a clear sign of this is shown by having approximately 19% of the Neptune Income Fund directly invested in the US.

Income generation

Since the inception of the Neptune Income Fund in December 2002, the Fund is the fourth highest income generator in the sector. Furthermore, the current yield of the Fund is 5.01%, which is also higher in comparison to its main competitors. In terms of dividend growth, we saw 13.3% growth in 2016, which we were very pleased with given the volatile nature of the markets. The Fund also grew its dividend by 4.5% in 2015, 6.4% in 2014 and 11.8% in 2013. We remain focused on growing the Fund's distribution through continued strong ordinary growth. Some of the companies that we invest in also generate extra cash that they return to shareholders through special dividends.

What has driven the returns of UK income funds?

By looking at performance in the IA UK Equity Income sector in recent years, we can see that the main generator of returns has been overweighting small and mid-cap stocks. Currently, UK equity income funds have an average of c. 40% invested in small and mid-cap companies. Historically, that has been a good way to try and achieve outperformance. However, that has been an allocation decision rather than necessarily good stockpicking. For example, looking at the UK small and mid-cap focused funds, 117 out of the 121 funds in the IA UK Smaller Companies sector have outperformed the FTSE 100 since 2009. Then we had low interest rates, low inflation, strong sterling and high consumer and business confidence. Now we have higher rates in the US and the likelihood of them in the UK. We have higher inflation, a weak sterling and political, social and economic uncertainty. Therefore, we believe this 'free lunch' is now over.

> "The Neptune Income Fund grew its dividend by 13.3% in 2016"

James Dowey

The UK in the context of the world

The economic conditions have changed in the UK and we would characterise the UK economy at present as in the middle of an uncertain period, where we have had the outcome of Brexit, but we are yet to feel the full impact of the decision. The economy has been strong post Brexit, and this has been powered by consumption, which has run in excess of 3% annually. However, we believe it is going to be very difficult for that to be maintained in 2017 for three key reasons.

The first is sterling depreciation which, although it has given a temporary boost to the economy, is starting to result in a build-up in inflation. Inflation before the Brexit vote was 0.3%, it is now 1.8% and is heading to at least 3% in our view. This will be a head wind for consumption, similar to 2011 and 2012 and the cost of living crisis. It is probably not going be quite as dramatic, but it is not going to be easy from a cost of living perspective for UK consumers.

The second point is that unemployment is now very low at 4.8%. That is in line with most sensible estimates of as low as it gets and as tight as it gets. We might see it fall a little bit further but there is not much of a labour market tailwind to push the economy forward from here. The third point is that a boost in consumption in the second half of last year was due to a drop in the savings ratio. Households have decided to draw down on their savings to fund that consumption. But the savings ratio today is fairly low, it is as low as it has been since the eve of the global financial crisis and we not do not see that providing much of a tailwind to consumption either in 2017.

In combination, we expect a pretty tricky set of conditions for the engine that has powered the UK economy over the past six months. The economy has defied the doomsters on Brexit but we think it is now that you actually see tougher conditions for UK-based firms.

Robin Geffen

A difficult year for UK equity income managers

In 2016, less than 10% of UK equity income managers outperformed the FTSE All-Share Index. In contrast, looking back to 2015, 2014 and 2013, over 80% of income fund managers outperformed the FTSE All-Share Index, largely due to significant overweights in small and mid-caps. In 2011 and 2012, this figure was approximately 60% in both years. We believe the low percentage for 2016 reinforces the point that we are at the end of a five year free lunch for UK small and mid-caps and that is why so many UK equity income managers underperformed considerably last year and also why very few of them grew their dividends significantly.

The Neptune Income Fund is and always has been primarily positioned in large and mega-cap companies. If you aggregate the Fund's holdings, over 80% is invested in large and mega-caps, with just under 20% in the top end of the FTSE 250 Index. Post Trump's victory, it has been large-caps in the UK that have outperformed.

> "We believe the small and mid-cap 'free lunch' is now over"

The importance of stock selection

As well as small and mid-caps, recent UK equity market performance has also been driven significantly by bond proxy-type stocks. However, they rolled over in 2016 and we believe they are going to carry on rolling over, as look very expensive to us. For example, quality growth is now trading at a 45% premium to the wider market. We think stock selection is therefore absolutely crucial in the current environment.

Examples of bond proxies that we believe are currently overvalued and have started to roll over include: Reckitt Benckiser, British Land, and National Grid. Overpriced quality stocks that are much loved by income fund managers include: Halma, Sage and Bunzl. In performance terms, the share prices of some of these stocks have gone up by more than 100% in five years, but earnings continue to disappoint.

In the Neptune Income Fund, we aim to invest in attractively priced companies with international exposure. Currently, the Fund's holdings include companies like Compass, UBM, British American Tobacco and Microsoft.

Anna Merttens

Compass– a classic steady eddie

A classic example of an aforementioned steady eddie is Compass. Foodservice is widely seen as very unexciting because it has comparably low

Anna Merttens

Compass– a classic steady eddie

but it actually has very attractive dynamics. It is a very fragmented industry and has quite defensive qualities but it still has good growth opportunities, both in emerging markets but also as companies shift towards outsourcing more and more of their services in the developed markets.

It is seen as low margin, but those margins are very stable because only about 30% of costs are fixed, so most costs can be passed onto clients. Compass in particular has had a very successful framework of cost cutting in recent years, which has seen some good margin expansion. Furthermore, their scale gives them an enduring advantage in the industry and you have seen the benefits of this flow through in their strong cash flow generation. This has supported consistent dividend growth.

Over the last five years, Compass have grown their dividend at more than 10% CAGR, which makes it a pretty attractive long term holding. For example, when the Neptune Income Fund was launched in 2002, Compass was paying a 7p per share dividend and it is now paying nearly 32p per share.

Ewan Thompson

Rio Tinto – a tactical play

In 2016, we increased our exposure to both the energy and commodity sector. One of the first mining stocks we purchased for the Fund in the middle of 2016 was Rio Tinto, as we saw 2016 as the year that the cycle inflected. The last five years have been a terrible period for mining companies as they tried to to stay afloat and Rio Tinto is one of the strongest in the peer group in our opinion. The company has equally spent five years savagely cutting capital expenditure, cutting costs as much as possible, destocking their inventories and stabilising their balance sheet.

What happened in 2016 was first a stabilisation of commodity prices, due to a pickup in global demand, particularly in China. We have also seen that industry inventories were incredibly low by the end of 2015, as everyone has spent five years destocking inventories. Therefore, as well as absolute demand, you are also getting a restocking cycle coming through.

This has resulted in a normalisation in the industry rather than a return to the super cycle we saw in the years preceding the financial crisis. For example, Chinese steel demand last year was slightly negative, so all of what we saw in the industry last year was not based on a huge Chinese stimulus which will disappear. Instead, we are seeing a normalisation of expectations and a stabilisation and increase in inflation expectations as well.

The key thing for mining companies is that management has learnt from past mistakes. The recent round of results showed that management emphasised the point that they understand that the next stage of the cycle is shareholder returns and that shareholders will be rewarded because of the pain they have suffered. As free cash flow improves, we have seen balance sheets being de-geared and capital expenditure cut back, meaning that this cash is available to give straight back to shareholders.

In Rio Tinto's recent results, this was exemplified with a dividend announcement and a $500 million buy back. Ultimately that leaves Rio Tinto with a very attractive yield of 5% at present. In response to the thoughts that commodity prices are very high and they might fall, I would say that prices are currently at 50% above most people's expectations of where they should be. So we expect commodities to drift lower as we move through 2017 as supply increases. However, for a company like Rio Tinto, every month that prices remain above consensus, they earn a huge excess in free cash flow generation which is going towards further shareholder returns

Ali Unwin

Microsoft – a tactical play

We have owned Microsoft for several years and it has been a very interesting holding from the perspective of being very underappreciated by income investors. This is because it is a monopolist that generates huge amounts of cash and has historically paid quite a good dividend. This begs the question, what was underappreciated about it?

We believe Microsoft is a turnaround story which began when Satya Nadella became CEO in 2013 and initiated a massive culture change. This was all about moving the business to the cloud. The company had a very successful Windows franchise, and that remains successful, however they have invested billions of dollars in capital expenditure to build the global cloud network that they are only just beginning to monetise.

The cloud is growing at nearly 100% a year and is dominated by Microsoft and Amazon Web Services. Approximately 10% of IT workloads currently take place in the cloud and we think that this will rise to around 70% or 80% in time, with Microsoft well-placed as one of the major beneficiaries.

We also believe that Microsoft is becoming a much better capital allocator. Amy Hood, who used to run the Investor Relations Department, has been a fantastically good CFO and she has cut costs very aggressively, so Microsoft's revenues have grown while their cost base has come down as well.

Robin Geffen

Sector positioning

The Neptune Income Fund is overweight in information technology, financials and materials and remains neutral in energy. We are underweight real estate, healthcare and consumer staples and consumer discretionary. The main shift has been in commodities, which has been a very positive one for the Fund's performance profile.

Fund performance

Due to the Neptune Income Fund's large-cap focus, we increased our dividend last year by 13.3%, whilst the Fund is currently yielding 5.01%. The Fund is one of the best performers in the IA UK Equity Income sector over 1 and 3 years and we look forward to this year with a great deal of optimism.

For investment professionals only – not for retail clients.

Investment risks

This Fund may have a high volatility rating and past performance is not a guide to future performance. The value of an investment and any income from it can fall as well as rise as a result of market and currency fluctuations and your clients may not get back the original amount invested. References to specific securities are for illustration purposes only and should not be taken as a solicitation to buy or sell these securities. Neptune funds are not tied to replicating a benchmark and holdings can therefore vary from those in the index quoted. For this reason the comparison index should be used for reference only. Please remember that forecasts are not a reliable indicator of future performance. The content of this document is formed from Neptune's views as at the date of issue. We do not undertake to advise you as to any change of our views. Neptune does not give investment advice and only provides information on Neptune products. Please refer to the Prospectus for further details.