SPOTLIGHT

Challenging some of the myths surrounding equity-income investing

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Equity-income investing: debunking the myths

With income levels on traditional assets such as cash and government bonds having fallen in recent years, pension schemes have found it harder to meet their future liabilities, as well as continuing to achieve sustainable growth. Additionally, as austerity and scheme closures have caused contributions to many local authority and private pension schemes to decline, schemes are often struggling to manage cash flow effectively in order to meet near-term commitments. Inefficient cash-flow management can be costly as schemes resort to continually selling assets or holding large amounts of cash. This can act as a major drag on overall returns and hinder growth.

Achieving the necessary income to meet objectives without taking on an unacceptable risk burden therefore presents a real challenge. Dividend-paying equities can offer significantly higher levels of income than bonds and cash, but investors have often not followed such an approach. This is perhaps because equities have traditionally been associated with income volatility, as well as a perception that the growth potential of such a strategy may be limited. However, by focusing on companies with a disciplined approach to capital management, we believe an equity-income strategy can provide returns that remain relatively stable, even in down markets, as well as the prospect of attractive long-term capital growth.

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MYTH 1 | Equity income is only for income-seekers

Dividend payments have clear appeal for investors who may require a regular income, but have often been overlooked as a platform for growth. However, thanks to the exceptional power of compounding, the reinvestment of dividends over time can turn equity income into an effective growth strategy for the long-term investor.

A recent study illustrated how capital gains accounted for the growth of $1 invested in US equities at the beginning of 1900 to $215 at the end of 2011. However, the additional effect of income and its reinvestment turned that original investment of $1 into $21,978. Accordingly, dividends and their reinvestment accounted for 99% of US equity returns over the period.[1]

Exhibit 1 further demonstrates how real returns over the last 45 years from various equity markets, including the UK and the US, have been dominated by the compounding effects of dividend yield.

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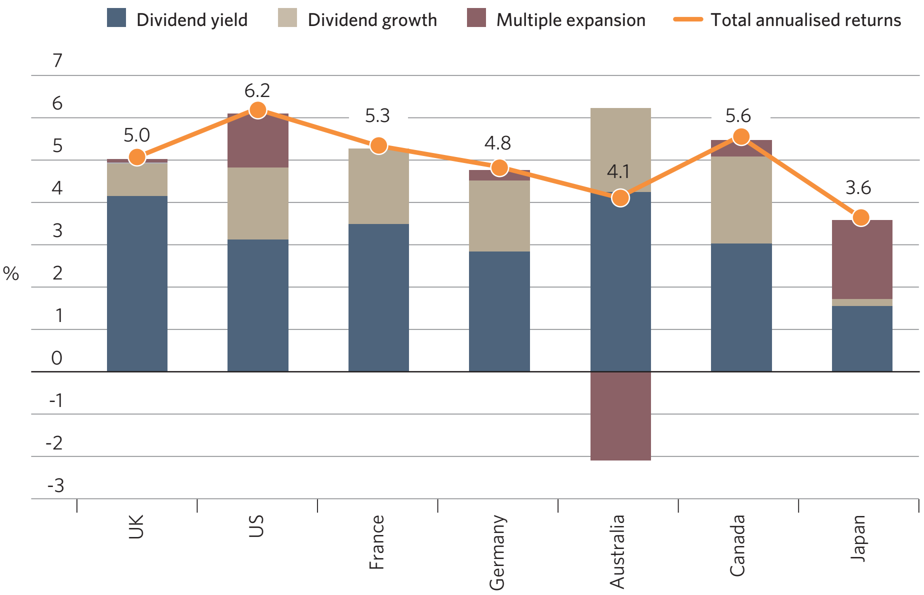
EXHIBIT 1: COMPOUNDING EFFECT OF DIVIDEND YIELD DOMINATES REAL RETURNS IN THE LONG TERM (1970-2014)



For illustrative purposes only.
Source: SG Cross Asset Research, MSCI, total annualised real return in local currency, to 31 December 2014.

MYTH 2 | Dividend-paying companies have little growth potential

Many investors presume that, by following an income-focused strategy, they are likely to suffer by investing only in bond-like businesses that have little or no growth potential, since paying a dividend may be viewed as evidence of the scarcity of a company's investment opportunities. But there is much evidence to suggest this argument is flawed.

In a now famous study of US equities by Arnott and Asness, it was shown that there was actually a positive correlation between a company's pay-out ratio and subsequent earnings growth.[2] Further analysis indicates that the same is true in other equity markets.[3]

These studies suggest that the payment of a dividend actually encourages greater capital discipline. Contrary to popular belief, many companies are poor at allocating capital, with most driven by the desire for growth over and above returns. One of the most obvious examples of this dynamic is that merger and acquisition (M&A) activity tends to peak at the point valuations are rich (or overpriced), whereas logic would dictate that M&A activity should peak at the troughs in markets.

If capital is allocated correctly, there is a better chance of supporting and sustaining returns on invested capital. A disciplined attitude to allocating capital, in turn, leads to surplus cash flows being returned to shareholders in the form of dividends.

Consequently, it is possible to gain exposure in a deliberate fashion to very different end markets. Stable, durable, predictable non-cyclical stocks, such as utilities and health care, can be selected as well as pro-cyclical economically sensitive ones, such as mining companies, industrials and financials. What dictates those choices is an appreciation of the position in the capital allocation cycle within those industries and an understanding of the correct valuation to pay for such stocks.

1 Source: Credit Suisse, *Global Investment Returns Yearbook (2011)*, and Elroy Dimson, Paul Marsh and Mike Staunton, *Triumph of the optimists: 101 Years of Global Investment Returns* (Princeton University Press, 2002), with updates from the authors; February 2012. Copyright © 2011 Elroy Dimson, Paul Marsh and Mike Staunton.
2 Arnott and Asness, *Surprise! Higher Dividends = Higher Earnings Growth*, Financial Analysts Journal (2003).
3 Gwilym, Seaton, Suddason and Thomas, *International Evidence on the Payout Ratio, Earnings, Dividends and Returns*, Financial Analysts Journal (2006).

MYTH 3 | Dividend payments are unreliable

Investors may shy away from using equities for income purposes on account of the perceived unpredictability of dividend yields, especially during market downturns or when conditions are volatile. However, we contend that dividend income can be relatively stable across both up and down markets.

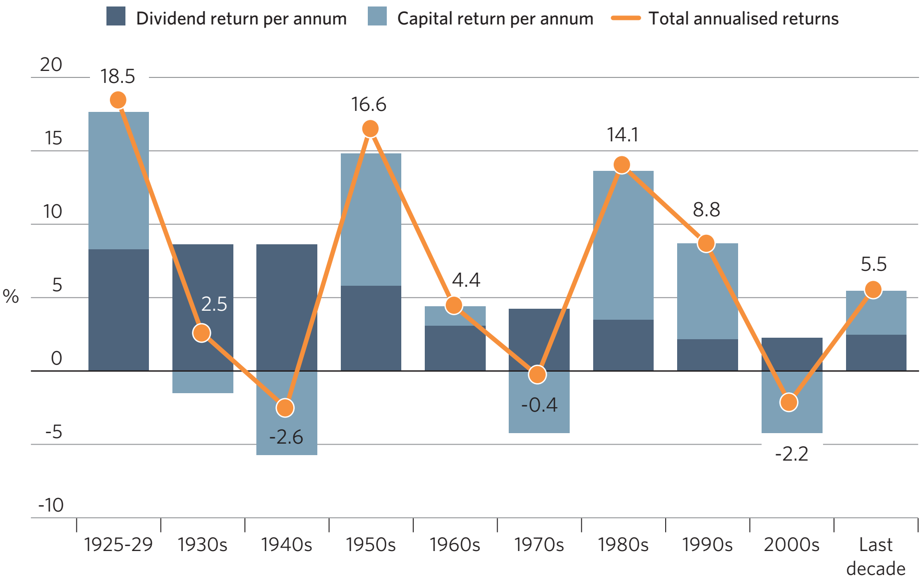
Once a dividend is established, companies tend to maintain payments in order to avoid sending a negative signal to investors. This is demonstrated by exhibit 2, which shows the relative resilience of dividends across varied market conditions.

In an uncertain environment, investors may be drawn behaviourally to the relative certainty of a dividend payment, and they attach greater importance to the signal given by the solidity of a dividend payment in a downturn.[4] This leads to the outperformance of dividend-paying companies in down markets, and so lends an 'asymmetry' to returns. Therefore, investors may, by concentrating on the income they receive, better withstand the volatility in the economy and in the capital value of their portfolios.

Furthermore, with near-zero interest rates unlikely, we think, to rise dramatically in the near future, income returns on assets such as government bonds and cash deposits remain at historic lows, and in many cases below the rate of inflation.

In such a challenging environment, investing in dividend-paying equities – which provide yields that are high compared to other assets – can offer investors the comfort of an attractive income stream in an otherwise low-return environment, and provide a shield against inflation.

EXHIBIT 2: RESILIENCE OF DIVIDENDS



For illustrative purposes only.
Source: Newton, Global Financial Data as at 31 December 2012.

MYTH 4 | It's all about chasing yield

While returns from traditional income-generating assets remain suppressed, investors are more likely to focus on those equities that promise the highest yields. However, simply chasing stocks which promise the highest returns can be dangerous. While higher forecast income levels may initially appear attractive, in many cases they may be indicative of heightened risks. In the longer term this can lead to disappointment through cuts in dividends. For example, following the 2008 financial crisis, earnings for US and European banks fell to such an extent that many of these companies could no longer sustain their dividend payments.

The difference between forecast and realised dividend yields shown in exhibit 3 overleaf demonstrates that a passive investment approach based on forecast yields is not appropriate. In order for an equity income strategy to be successful, careful analysis of how companies and governments allocate their capital is critical. Entities with a disciplined approach to capital management should be better positioned to provide consistent and sustainable returns.

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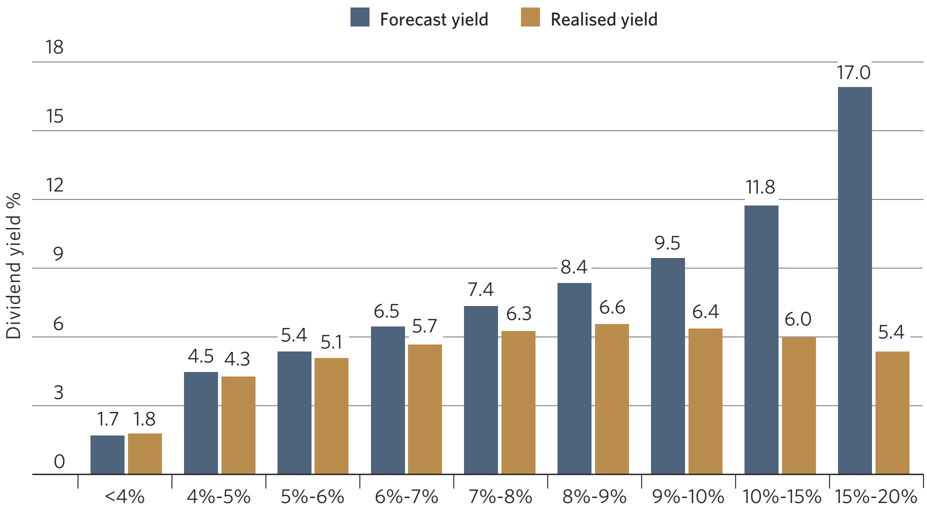
At Newton, we employ a yield discipline in our equity-income strategies, dictating

4 Fuller and Goldstein, *Do dividends matter in a declining market?* (University of Mississippi and Babson College, 2005).

EXHIBIT 3: COMPARING FORECAST AND REALISED DIVIDEND YIELDS – END 1995 TO 30 SEPTEMBER 2015



Source: SG Quantitative Research, Factset / Newton as at 30 September 2015.

strict parameters (in relation to the relevant equity index) at which a stock may be bought and must be sold. This provides an element of objectivity to the management of those strategies. Nevertheless, we argue that a share should never be bought on the basis of its dividend yield alone.

By being alert to the evolutions in industries and changing valuations, one can better understand how to position the portfolio and avoid the trap of high yields and the risk of dividends being cut. We use thorough analysis, underpinned by our long-term framework of global investment themes, to identify those companies which offer a sustainable dividend yield.

Conclusion

An equity income strategy:

- has the potential to deliver higher returns than non-income-focused strategies owing to the power of compounding
- may also offer attractive long-term capital growth for investors
- has been shown to be less volatile than a growth-oriented approach to equity investment
- may offer some protection from inflation
- benefits from an active investment approach that focuses on companies that have a disciplined approach to capital management and are able to provide sustainable returns.

Nick Clay Nick is lead manager of the Newton Global Income Fund and BNY Mellon Global Equity Income Fund and has been a member of the global equity team since 2012. He is a member of a number of investment groups, and chairs the equity income group.

Prior to joining Newton in 2000, Nick acquired a range of experience as a UK equities manager at Morley Fund Management and as an analyst at Sun Alliance. Nick is an associate member of the UK Society of Investment Professionals.

Past performance is not a guide to future performance. The value of investments and the income from them can fall as well as rise and investors may not get back the original amount invested. The FTSE World index is used as a comparative index for this strategy. The strategy does not aim to replicate either the composition or the performance of the comparative index. Please read the important disclosure at the end of this document.

Newton Global Equity Income strategy – summary

By investing over the long term in income-generating equities, our Global Equity Income strategy aims to provide investors with increasing annual distributions together with capital growth.

- Investing in cash-generative companies with attractive dividend yields, according to our analysis
- Conviction-based strategy with globally diversified approach
- Aiming for asymmetric returns, with valuation screen to help achieve dividend yield above that of the comparative index

Performance aim
To outperform the FTSE World Index by over 2% per annum over rolling five-year periods

Strategy inception
1 January 2006

Strategy size
£6.1 billion (31 December 2015)

Investment policy

- All new holdings must have a prospective yield 25% greater than the FTSE World Index yield
- Any holding whose prospective yield falls below the FTSE World Index yield will be sold[5]
- Portfolio of 50-80 stocks, not constrained by any country, regional, sector or industry restrictions

Your capital may be at risk. The value of investments and the income from them can fall as well as rise and investors may not get back the original amount invested.

FURTHER INFORMATION

Please contact:
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5 On account of liquidity, it may not be possible to dispose of an entire holding immediately.

Important information

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