CHASING YIELDS

Toby Ross, Investment Manager. Second Quarter 2018

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Chasing Yields 31632 0318.indd
Ref: 31632 INS AR 0483

TOBY ROSS

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Toby joined Baillie Gifford in 2006 and is an Investment Manager in the Global Income Growth team and joint manager of The Scottish American Investment Company P.L.C. (SAINTS). Before joining the Global Income Growth team, he spent time at Baillie Gifford as a Global Sector Specialist and as an Investment Analyst in the UK Equities team. Toby graduated MA in English Literature from the University of Cambridge in 2006. Toby is a CFA Charterholder.

CHASING YIELDS

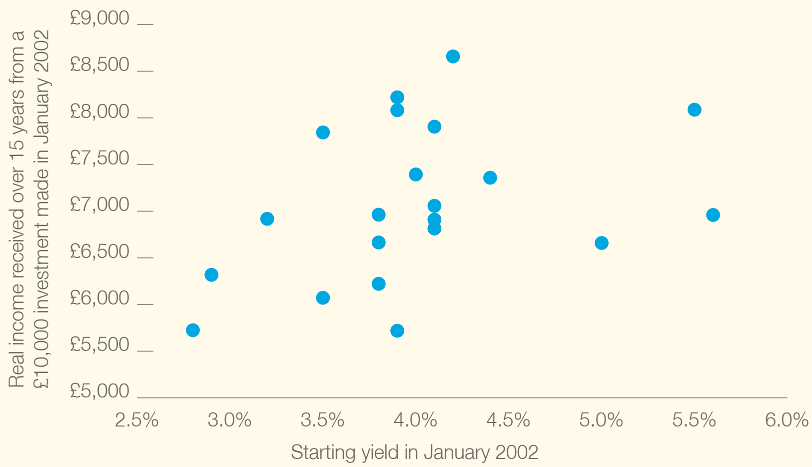
BY TOBY ROSS

One of the most common misunderstandings about income investing is the confusion of long-term income with short-term yield. In our experience, equity income investors tend to have a long-term time horizon. They are often looking for investments that will offer them many years of growing dividends, in the hope that they will then support them as they move into a long and happy retirement. Some people think that the best way of meeting this objective is to invest in funds which offer the highest yield today. But is there any relationship between a fund's starting yield and the amount of income it actually delivers to an investor over the long term?

The example of the UK Equity Income universe over the last 15 years suggests that there isn't. We used Morningstar data to estimate the total amount of income that a £10,000 investment in a range of UK Equity Income funds in 2002 would have generated over the following 15 years, adjusted for inflation:

The relationship between a fund's starting yield and the long-term income it delivers is tenuous

(UK Equity Income funds, January 2002 – December 2016)



Source: Morningstar, Baillie Gifford.

It's not obvious to us that there's any pattern here at all. Some of the funds which had the highest yields at the start delivered far less income than their peers over the next 15 years, despite a big head-start. And many of the funds which generated the most income over the long term looked decidedly 'average' at the start.

The charts in this paper use total return, yield, and dividend distribution data from the Morningstar Direct database. The sample includes all UK Equity Income funds with complete data across the 15 year period, with a starting yield that was higher than that on the FTSE All-Share in Jan 2002 (21 funds). All figures are adjusted by UK CPI, to ensure that funds with a high starting yield were not penalised. The methodology was to treat all distributions announced as 'income', and any remaining component of total return as 'real capital growth'.

SO, WHAT DOES MATTER FOR INCOME INVESTORS?

The main thing we take from the Morningstar data is that for an investor looking to maximise their income over the long run, the starting yield on a fund, taken in isolation, has very little information value.

Why is this? The total income a fund delivers to a long-term investor is a function of three things:

— 1. The **starting level** of income.

— 2. The **resilience** of this income stream during periods of stress, which can rapidly erode the dividends that a fund receives.

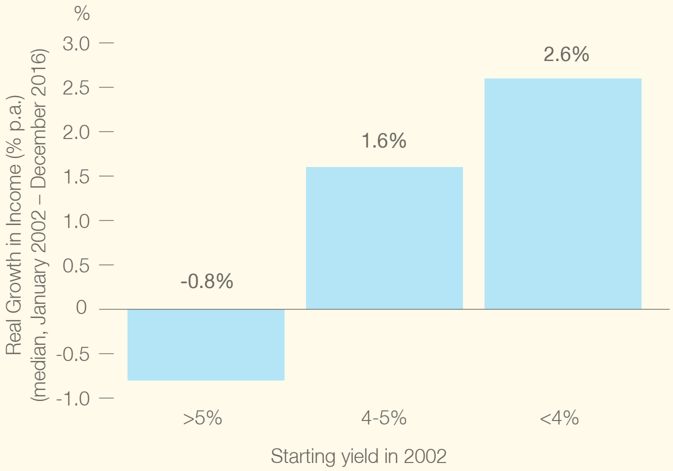
— 3. The **real growth** rate of the income stream, which is critical given the power of compounding over long periods.

The latter two tend to be overlooked, but over the long term, their effect can be profound. Let us explore these latter two points further.

First, with regard to resilience, it is worth noting that all of the highest-yielding funds came under significant pressure during the financial crisis and were forced to cut their distributions by 10–22% during 2008–10. The high degree of income concentration in the UK stock market no doubt contributed to this: 55% of the All-Share Index's dividends in 2008 were paid by just 10 companies, largely banks and oil companies. Five of these top 10 payers went on to cut their dividends. As these were widely owned by UK Equity Income funds, it is not surprising that many of the funds in this sample also cut their distributions. However, the few funds that managed to steer a path through this with their income streams intact tended to have been less aggressive in maximising short-term yield. This perhaps gave them more freedom to manoeuvre in a difficult environment.

Second, in terms of the real growth rate of the income stream, the funds with lower starting yields typically grew their income streams faster in real terms.

Real Growth in Income (% p.a.)
(median, January 2002 – December 2016)



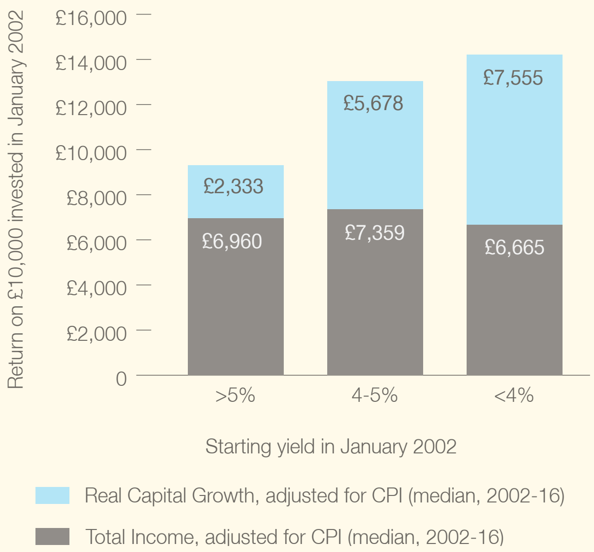
Source: Morningstar, Baillie Gifford.

The difference between -0.8% and +2.6% p.a. may sound modest, but compounded over 15 years it matters greatly. In real terms, the income on the highest-yielding funds fell by 10% over the period, while the lower-yielding funds typically grew by almost 50%.

This pattern makes total sense to us. We strongly believe that the best businesses for a long-term income investor to own are businesses that can deliver significant real profit growth *and* pay dependable dividends at the same time. Such companies are rare. A fund that restricts itself to only the highest-yielding part of the market today is unlikely to pay enough attention to the real growth prospects of the businesses it invests in. In time, emphasising near-term income too much will have a big impact on its ability to deliver significant real income growth over the long run.

This difference in growth rates doesn't just affect the level of income that an investor receives. The graph below uses the same Morningstar data to estimate the median income and capital returns of UK Equity Income funds over the last fifteen years, expressed as the real return that an investor would have received on an investment of £10,000 in January 2002. At the time, the yield on the UK market was a little under 3%.

Real returns on £10,000 invested in UK Equity Income funds for 15 years in January 2002



Source: Morningstar, Baillie Gifford.

As we can see, there has been little relationship between the starting level of yield and the level of income generated by a fund over a longer time period.

However, there has been a significant difference in the level of real capital growth that these funds delivered. Funds which strained most for yield ended up delivering little real capital growth over the long term, while those which were less aggressive on yield were able to deliver both income *and* capital growth. This may be accounted for in several ways. Investors who strain for yield can often, as a result, end up with a portfolio that is over-reliant on only a small part of the market, and run the risk that the profits, dividends and capital generated may not be as resilient to market shocks as they would have been had there been greater diversification across the portfolio's income stream. In addition, they often end up underemphasising the importance of real growth in their stock selection, instead focusing on yield.

This has big consequences for the end investor. One of the main attractions of equities for a long-term income investor is the prospect of real capital growth. This capital can be used in the future to help meet the expenses that may arise in retirement, whether that be for cruises or grandchildren. Many investors will want to dip into this capital growth from time to time as their retirement progresses, using it interchangeably with income. But an investor who pursued a high-yielding strategy would not have seen much benefit from real capital growth (never mind any more income), despite a strong period for equities.

Of course, some investors may have a high requirement for near-term income and so are less inclined to value real capital growth highly, if at all. However, we believe that a high yielding *equity* income strategy might not be the most appropriate vehicle for those investors who are relying on a higher level of near-term income. This is because the income streams from the highest-yielding equity funds are more likely to be volatile, and there is less room for them to manoeuvre in difficult periods, which could prove particularly problematic for those investors who are relying on a higher level of near-term income. Rather, such an investor is probably better served by a well-constructed multi-asset portfolio, which can invest in a wider range of income-generating assets. The broader opportunity set in such a multi-asset approach should allow it to deliver a much more diversified income stream; and the ability to move between asset classes provides an additional lever to reinforce the income in times of stress.

DON'T BE MISLED BY A HIGH STARTING YIELD

The environment for income investors has changed a lot since the early 2000s, and the opportunity set is arguably much broader today. However, we think that many equity income investors still focus far too much on a fund's short-term yield. The example of the UK Equity Income universe has shown that the starting yield doesn't help you predict a fund's long-term income at all. In fact, the income 'head-start' that the high-yielding funds get comes with dividend streams which are not resilient, leading to a greater risk of losing income in times of economic stress; and weak real growth prospects over the long term.

We therefore believe that the relevant question for a long-term equity income investor isn't "how high is the fund's yield?" Instead, we think they should ask:

— Does the manager have a process that puts emphasis on real growth, as well as income? Do they have a genuinely broad opportunity set to pick from?

— How do they ensure the fund's income stream is truly resilient over time? Are they able to fully diversify their concentrations?

— Is the manager well-aligned with me and my time horizon? Are they able to take a long-term view of their investments? Do they keep costs low, to avoid eating into my long-term returns?

THE THINGS THAT MATTER

GROWTH

Our process puts as much focus on growth as it does on income potential. We're greatly helped by being able to build on Baillie Gifford's world-leading research on growth companies, and an unconstrained, global universe.

RESILIENCE

For every investment, we assess the dependability of the dividend during times of stress. Our global universe allows us to avoid big stock or industry concentrations, and we limit any stock to 5% of the portfolio's income.

ALIGNMENT

We take a 5+ year time horizon in everything we do, and focus on long-term income, not short-term yield. As a private partnership, we don't answer to any external shareholders. The costs of our Global Income Growth strategy are among the lowest in the global equity income peer group when comparing against the eVestment Global Dividend Focus universe.

CONCLUSION

Our Global Income Growth strategy has a near-term yield of around 3%. So while there are many equity income funds available which offer higher levels of near-term income, and we could easily chase a higher near-term yield if we wanted, we choose not to. Instead, we think we've got strong answers to all the questions that matter, and believe our approach will deliver much better outcomes for our clients over the long run. Why don't you ask us?

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