

Client: Gravis Capital Partners
Source: FT.com (Web)
Date: 30 September 2016
Page: N/A
Reach: 235375
Value: 6318

Buchanan

Hunt for elusive income turns to niche investments

Andrew Summers, head of fund research at a large wealth manager, is unimpressed. It should be quite easy to find income. Bonds - through which investors lend money to governments or corporations - pay a regular "coupon". Equities - shares in a company - tend to reward through dividends.

The problem is that interest rates have never been so low for so long. This is great news for anybody in debt - including anyone with a mortgage - but terrible news for savers and investors. Whereas getting a decent income for not taking much risk used to be easy, it's now a task that makes even the most optimistic fund manager glum.

Mr Summers is among the fund selectors forced to add an array of increasingly specialised investment trusts to his clients' portfolios, just to get the thing going - but, he says, there is little out there to get excited about. "These aren't inspiring times, I'm afraid," he says. "We've dipped our toes into property, floating rate notes, asset-backed debts . . . nothing really stands out, to be honest."

Between 1986 and 2008, if you were an investor looking for income, your best bet would have been to invest in bonds. The calculation was that the yield - your income coupon expressed as a percentage of the bond price - would be higher in bonds than the equivalent dividend yield on most stocks. But in 2010 this changed, and stocks became the better yielders.

Many investors in bonds duly took refuge in stocks, in particular in so-called "bond proxy" shares. These include utilities and telecoms companies, which are more likely to offer a safe and steady income stream.

But those looking to the stock market as a source of income also face problems. Ten FTSE 100 companies cut their dividend in 2015, amounting to a total loss of Â£4.5bn of income for investors (and the equivalent to the market capitalisation of EasyJet). Another four - Barclays, Rio Tinto, Rolls-Royce, BHP Billiton - slashed dividends in 2016.

Such has been the pressure on dividends that the UK's asset management trade body, the Investment Association, is considering scrapping its yield target for income funds because too many managers - including those from Schroders, Jupiter and Invesco Perpetual - are failing to meet it. Mark Wharrier, manager of BlackRock's UK equity income fund, says the dividend game is tough. "It's a challenging environment even within equity income because you shouldn't expect a great deal of equity growth and you shouldn't expect a great deal of dividend growth," he said.

The latter is a particular obsession among fund managers. The theory is that a growing dividend pushes up the share price of the company, because investors looking for income pile into stocks where dividends are rising. This share price growth pushes up the investor's total return.

Asset manager Miton cites Legal & General, the insurer, as an illustration of dividend growth in action. In 2011 the company paid a dividend of 6.4p on a share price of a little over a pound, giving a dividend yield of around 6.2 per cent. Fast forward to the end of August 2016 and the company's share price has almost tripled - but so has its dividend. "The dividend is what you get in your hand, but it is the dividend growth that powers the share price," says Eric Moore, Miton's equity income manager.



Client: Gravis Capital Partners
Source: FT.com (Web)
Date: 30 September 2016
Page: N/A
Reach: 235375
Value: 6318

Buchanan

Although most income fund managers predictably insist that they can still find those juicy income-yielding stocks, there is plenty of concern at the sustainability of the dividend growth around in the FTSE at the moment. "For the last couple of years, dividend growth has been more than earnings growth," said Mr Moore. "That can't carry on forever."

The UK's vote to leave the EU in June surprised markets, wiping 9 per cent off the UK's blue-chip index in early trading.

But Brexit, perversely, has helped those looking for equity income. About 70 per cent of FTSE 100 companies make their earnings overseas and pay dividends in either dollars or euros. The sudden depreciation of the pound means that investors in those stocks saw a rise of approximately 15 per cent in the income payments they received. Before Brexit, Milton said it was expecting an average dividend growth of around 2 per cent for the year for large-cap stocks. Now it expects around 7 per cent.

BlackRock, the world's largest asset manager, says sterling's fall is masking a lack of actual dividend growth. "Overall, you should be looking in the 3 to 5 per cent range [for FTSE 100 dividend growth] in this year, but it's entirely driven by currency," says Mr Wharrier. "I don't think there is any real dividend growth in the FTSE 100." The smaller companies in the FTSE 250, the UK's mid-cap index, are likely to grow faster once the currency effects are stripped out, he adds - but only because their dividend yield was lower to begin with.

The disappointing performance of traditional asset classes has left investors scratching their heads about where to go next. Wealth managers and multi-asset fund managers, who tend to manage a fund of funds and can have their pick of almost any asset class, are at the forefront of the struggle.

"The challenge is making more income without taking on ever-increasing levels of risk," says Justin Oliver, deputy chief investment officer at Canaccord Genuity wealth management. "We could get some yield on Indian bonds at around 7 per cent at the moment - but that wouldn't fit the risk profile [of our portfolios]."

Many retail funds are turning to the weird and wonderful world of investment trusts: closed-ended funds that tend to specialise in niche and often illiquid investments. Infrastructure, renewable energy, peer-to-peer lending, and odd corners of the property market, such as GP surgeries and student accommodation, are all currently popular.

Andrew Summers of Investec Wealth is among the professional fund pickers who are sceptical about property as an investment. He is unsure that rental growth can continue in a post-Brexit world. "In an economy where things are going well, landlords can increase their rent in line with inflation," he said. "But I don't think that will happen."

However, he is keen on what he views as "inflation-linked" ways to invest in property. GP surgeries are an example. Doctors have the national health service as their landlord, and their leases are often explicitly inflation-linked. MedicX, the healthcare property fund, plays on this theme with a portfolio of 151 properties that includes GP surgeries, care homes, retirement housing and private hospitals. The properties are typically let for about 20 years directly to the NHS.

It's proven to be a hit among investors and currently trades at almost twice its net asset value, meaning investors will pay double what the underlying property is worth just to get exposure. The fund is also heavily geared so its dividend yield is high - at nearly 7 per cent (but if that changes the leverage will magnify losses).



Client: Gravis Capital Partners
Source: FT.com (Web)
Date: 30 September 2016
Page: N/A
Reach: 235375
Value: 6318

Buchanan

Student accommodation is another good property niche, says Mr Summers. "It's about students coming from overseas and they'll keep coming - overseas students are effectively now paying less because of the sterling weakness." Empiric Student Property, trading at a 12 per cent premium to net asset value with a yield of 5.2 per cent, and GCP Student Living, at an 8 per cent premium for a 4 per cent yield, both cater to this trend.

Infrastructure investments have been another popular choice. Fund managers take the view that infrastructure companies, whose loans are often underwritten by the government, are in the "too important to fail" camp. The trusts invest in everything from schools and hospitals to roads and sewers, and throw out an average dividend yield of 4.5 per cent despite trading on a hefty premium of 16 per cent to net asset value.

Rob Burdett, head of the multimanager arm of BMO Asset Management, says he holds GCP Infrastructure in his portfolio, a trust that makes government-backed loans to infrastructure projects. "It's not quite a gilt, but it's the same cheque book," he says.

He has also taken a punt on a fund which he says will make him money if the economy tanks: Darwin Leisure Property, which runs caravan parks. "Caravan parks are recession beneficiaries - there's a grey pound element to them," he said. "They're in great shape."

The fund, which has about £400m in assets under management, owns caravan parks in Cumbria, Devon, Wales and Somerset. Once it has control of a park it effectively gentrifies it, replacing tents and touring caravan bays with upmarket "static caravan" and "lodge properties" to push up its income stream. It delivered a total return of 7.1 per cent in 2015.

But even these alternatives to the traditional stocks and bonds mix are becoming passé. Mr Oliver says his portfolio managers are now looking even further up the risk scale. "One area we have looked at - although it's become a bit specialist - is private equity," he says. "There are a couple of big closed-ended private equity trusts out there yielding at attractive levels of 4 per cent, but trading at quite significant discounts."

The investment trust structure is also forcing managers with an eye on returns to look elsewhere. Because trusts issue shares, their price can be bid up or down by supply and demand. If the shares are in demand, they can become more expensive than the fund's net asset value. "What's the catch [with these trusts?]" asks Mr Summers. "That catch is that I'm not the only one thinking [of investing]. These things are trading on big premiums."

For now it is unclear what fund managers, who have a duty to buy liquid, low-risk assets while hitting decent income targets, can do. One alternative the government is keen to promote is peer-to-peer lending, which involves matching lenders and borrowers through websites. The asset class has been notionally granted its own tax-friendly Isa wrapper in the as-yet-unlaunched Innovative Finance Isa, but its rise, along with that of equity crowdfunding and mini-bonds, has troubled some.

This year, the former Financial Services Authority chairman Lord Adair Turner predicted that "the losses which will emerge from peer-to-peer lending over the next five to 10 years will make bankers look like lending geniuses". The nascent industry hit back at the accusation, rejecting the suggestion that its loans remain untested through the credit cycle and pointing to the strong interest in the sector from yield-starved fund houses.



Client: Gravis Capital Partners
Source: FT.com (Web)
Date: 30 September 2016
Page: N/A
Reach: 235375
Value: 6318

Buchanan

P2P is certainly a hot investment among income-hungry fund managers. BlackRock bought Â£12.7m worth of shares in Funding Circle's investment trust earlier this year, joining Invesco Perpetual, Aviva, M&G Investments, Legal and General, Newton Investment Management, Woodford Investment Management and Brooks Macdonald - all of which hold positions in one of the three major investment trusts offering exposure to the niche.

But investors looking for the returns available on the loans can also invest directly, buying loans themselves from the peer-to-peer lenders and enjoying returns of around 6 per cent, according to a metric run by investment bank Liberum. Despite questions over whether P2P can withstand an economic downturn, the sector has grown in popularity with retail investors on both sides of the Atlantic, originating just over Â£8bn in the UK alone.

So where does this leave investors? To get an income worth having, their money managers are making ever-riskier investments. Multi-asset funds are looking at private equity; strategic bond funds, which used to remain in gilts and investment grade debt, are now to be found buying Argentine bonds.

Ben Yearsley, co-founder of Wealth Club, a wealth manager, says he has been looking at a debt offering from a company selling back-up battery power to the National Grid. "It's a mini-bond, that's the problem," he said, referring to the higher-risk debt instrument. "But this is where you're forced to go to get a decent level of income."

The shift into riskier assets is something retail investors need to be aware of, he says. "The more income you want the more risk you have to take," he says. "To me that's obvious - but there may be a proportion of people who don't realise that."

Above all, he advocates knowing what you buy. "If you've got an adviser, go back and ask the questions. Just because you have a wealth manager you still have a duty to understand the degree of risk you're taking."

The UK's love affair with property has been expressed through both direct buy-to-let holdings and property funds. Buy-to-let assets hit Â£1.2tn in June, while retail investors have long loved commercial property funds.

Recently, though, stamp duty changes by former chancellor George Osborne threaten to damp the profits made on buy-to-let, while property funds braved a storm of outflows in the immediate aftermath of Brexit - so much so that they were forced to suspend trading.

It is unclear whether the funds, which are just reopening, will replenish their lost cash, although asset managers are generally still confident that property will continue to yield income. Adrian Benedict, of Fidelity International's real estate arm, told the FT in July that he expected to see income return on property continue to be around 5 per cent over 30 years.

FT.comsite

[sourcelink]

<http://www.ft.com/cms/s/83774dd6-83c5-11e6-8897-2359a58ac7a5,s01=1.html>

[/sourcelink]



Client: Gravis Capital Partners
Source: FT.com (Web)
Date: 30 September 2016
Page: N/A
Reach: 235375
Value: 6318

Buchanan

Copyright The Financial Times Ltd. All rights reserved.