QuotedData

Special Report | Investment Companies

27 April 2015

The importance of income

Where to find it?

Life used to be simpler. If you had a bit of spare cash or you wanted to save up for something you'd just stick some money in a bank or building society account. If you had a nest egg and wanted to invest it in something safe and live off the income, you'd maybe buy a gilt (UK government debt) or a corporate bond (debt issued by companies). If you were on the point of retiring you'd be forced, eventually, to buy an annuity. Now, although all those options are still open to you, they don't all look that attractive. In this document we try to look at some of the ways you can use the investment companies market to find income producing investments and we talk through some of the available funds.

Investors are trying to find alternative places for their money that will pay them the 4% to 6% levels of income they got used to in the old days. As you can see in the chart on the right, UK interest rates are at all-time lows. As we explain later, low interest rates have been driving down income returns on all sorts of assets. The investment industry has stepped up to the plate and is offering investors a wide range of investment vehicles that were not available before. Not all of these are going to make great long term investments and what sort of assets you buy can make a big difference to returns (see figure 1).

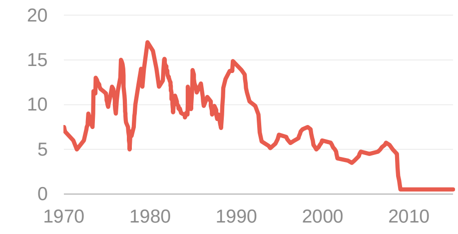
Figure 1: Annualised returns on different asset classes

Five year period	Cash (%)	UK Bonds (%)	UK Equities (%)	World Equities (%)	UK Houses (%)
2010-15	1.0	7.2	8.7	11.0	2.4
2005-10	4.6	5.0	6.5	5.6	0.7
2000-05	5.2	6.0	-3.0	-5.8	14.4
1995-00	7.0	n/a	20.3	19.0	5.8
1990-95	10.1	n/a	9.7	4.3	-1.8

Source: Cash returns are 0.5% over the UK base rate, "UK Bonds" is Barclays Sterling Gilt Index, "UK Equities" is FTSE All-Share Index, "World Equities" is MSCI World Index, "UK Houses" is Halifax. All the figures except "UK Houses" are total returns – in other words they assume income is reinvested. If you own property and rent it out, you'd earn higher returns.

UK interest rates

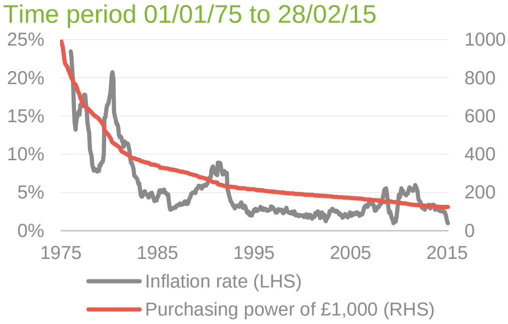
Time period 05/03/70 to 27/04/15



UK Interest rates are at all-time lows this is having a knock-on effect on all sorts of investments

UK inflation (RPI)

Time period 01/01/75 to 28/02/15



The rate of inflation has come down a lot recently but, over the long-term, the pound in your pocket is still worth less and less. A £1,000 today buys you goods that would have been worth just £124 in 1975. In an ideal world you want income that grows ahead of or in-line with inflation

More information about the funds mentioned in this report is available on our website. If you are reading this online, there are links embedded in the document that will take you through to the relevant webpage.

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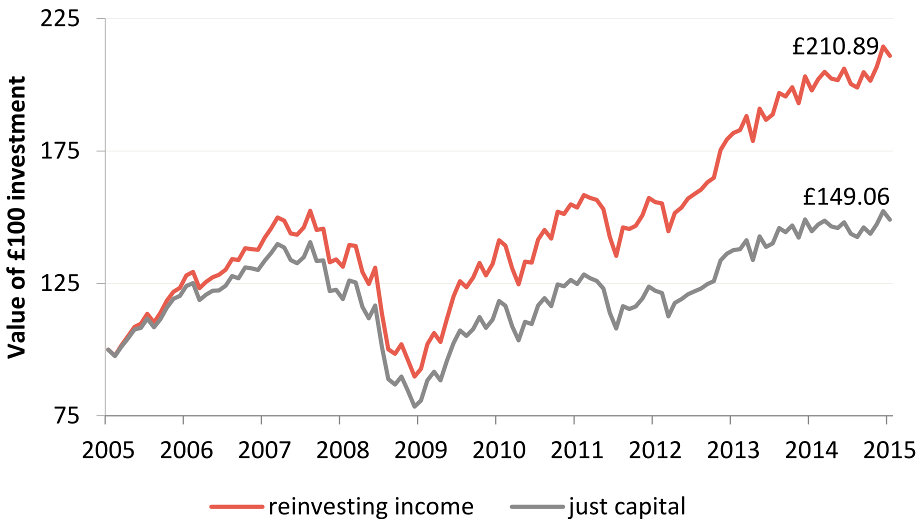
Why is income important?

Maybe that sounds like a daft question but many people underestimate the big difference that income makes to your overall returns. Have a look at the graph in figure 2 below. This shows the difference in the end value of a £100 investment in the FTSE All-Share Index (which is a good proxy for the UK stock market) whether you spend the income generated by that investment so you are left with just the capital value or reinvest it as you receive it. In just ten years, reinvesting the income would have made you £61.83 richer.

Figure 2: The power of reinvesting income



Source: Morningstar

The lesson from this is, if you are saving up for something, make sure you reinvest your dividends and interest.

If you want to live off the income your investments generate however then perhaps the most important thing to remember is the potential impact of inflation that we talked about on the front page, on the value of your income and the value of your nest egg. If we adjust the £149.06 that your £100 had turned into over ten years for inflation, we are left with just £108.28.

Why is it so hard to find income?

Low interest rates are fact of life just about everywhere. They were a deliberate policy introduced by governments and central banks to prop up the economies of the western world when the credit bubble burst in 2008. Today the US looks like it will be the first major country to raise rates but we think it will be very cautious for fear of disturbing their fragile recovery and we think it is unlikely that they will return to "normal" levels any time soon. In the UK the same argument holds true and, if anything, February's zero inflation figure will have delayed the first interest rate rise in the UK even further.

Low interest rates on cash have a knock-on effect on the returns / yields available on other asset classes. As investors switch money out of low yielding cash investments into alternative income producing assets, they drive up prices and this drives down yields. At the time of writing most cash ISAs seem to pay less than 2%, five year gilts pay 1.2%, you can find corporate bonds that yield 4%, 5% and even 6% but not always issued by companies that you can be completely convinced will still be around to pay you back the money when its due.

If you accept that it is likely that low interest rates are here for a while, then it makes sense to seek out alternative ways of sourcing income. Remember though, if you disagree and think interest rates might shoot back up again soon, then some investments that are valued purely in relation to the stream of income that they generate may fall in value.

What can investment companies offer?

The universe of investment companies has been expanding in recent years in response to the demand for income.

Making sure your investments are adequately diversified is important – you want to avoid having all your eggs in one basket. Having exposure to a range of asset classes – cash, bonds, equities, property and other investments – a range of economies and a range of industries is a good idea. Investing in funds makes that easier than buying individual investments.

Fortunately the universe of investment companies is a lot smaller than the universe of open-ended funds (like OEICs and unit trusts) which makes it easier to choose between them. The range of assets available through investment companies is much wider however. Remember, as figure 1 on the front page showed, the returns on different asset classes can vary quite a bit and can sometimes be negative.

For an investor looking for predictable income, investment companies have an advantage over open-ended funds as they have the power to smooth the dividends they pay to shareholders, accumulating reserves in the good times and using these to sustain dividend payments when the environment is less rosy.

Investment companies are good vehicles for investing in assets that cannot be quickly turned into cash. Things like investments in infrastructure projects, property, private equity and some parts of the debt market can make good long-term investments but are unsuitable for an open-ended fund.

How can QuotedData help?

At QuotedData we recognise the value that investors put on income. The data pages on our website allow you to sort similar funds by attributes such as yield and performance. We have created a page on our site on which sits an excel spreadsheet, updated daily, with all the funds that have declared meaningful dividends, how much they are paying, when, when you'd have to own them to be entitled to the dividend and how much income you'd get from that dividend if you had £1,000 invested in the stock. Over time this should build up into a useful dividend database that you can use to forecast the income you should get off your portfolio.

Each month we publish research on investment companies that shows information such as who is performing well and badly, who looks cheap and who looks expensive, who is raising money from investors and who is giving it back plus all the major new stories from the sector. To this we are adding a section on income that shows how investment companies are growing their dividends year on year.

We hope you find this information useful. If there is something else you think that would help please let us know – our mission is to make your life easier when it comes to understanding and researching investment companies.

A selection of income paying funds arranged by type

We thought it might be useful to run through the options available to you. Peppered throughout the document are links to useful information on our website including data tables on every investment company organised by type of fund. For the sake of simplicity, in this document we have excluded small funds (those below £40m market capitalisation) and funds we know are winding up. Performance numbers relate to net asset values – this gives you the best idea of how well the individual investment managers are doing.

There are a number of equity funds that buy shares in companies dedicated to paying a decent level of income. Companies increase their dividends as their profits grow and, over time, that income has a good chance of growing in line with inflation. A good manager will try to do better than this. The first few sections cover funds that invest predominantly in equities. We then go on to look at funds that invest in private equity (companies that aren't listed on a stock exchange), some sector specific funds such as funds investing in utilities, infrastructure, renewable energy and insurance. Then we look at funds that lease assets, funds investing in debt and then briefly look at property (which is a big topic that we think we'll cover more deeply in a future report).

UK Equity Income

Let's start with equity income funds, funds that that are looking to pay above average income and are investing predominantly in shares in companies (but not exclusively) and, since it is our home market, with UK equity income funds.

They may not have as high a yield as a UK equity and bond income fund or a UK bond fund (both of which incorporate investment in debt into the mix) but they ought to be aiming to grow their dividend over time at least in line with inflation.

- Largest fund in the sector – Edinburgh Investment Trust
- Highest yielding – Merchants Trust
- Best performing over past five years – Finsbury Growth & Income
- Special mention – City of London (longest record of increasing its dividend – every year for the past 48 years)

Edinburgh Investment Trust yields 3.4% and the dividend, which is paid quarterly, grew by 3.1% last year. It used to be an unloved UK equity trust but was rejuvenated in 2008 when the management contract was handed to Neil Woodford at Invesco Perpetual. After he left to set up his own business the fund was handed to Mark Barnett, keeping it in the Invesco stable. Mark manages a number of other UK equity investment trusts and has a pretty good track record – Perpetual Income & Growth, one of his, ranks second in the performance tables behind Finsbury Growth &

Income. There are sectors and companies that Mark doesn't like that he won't invest in and this makes his portfolios look quite a bit different to the average UK equity fund.

Merchants Trust has a bias towards investing in the largest companies on the UK stock market. It yields 4.9% and pays quarterly dividends. The dividend went up by 1.7% over the year ended 31 January 2014 but so far in this accounting year, there haven't been any dividend increases. It is managed by Simon Gergel of Allianz Global Investors. The portfolio is quite concentrated. The yield is boosted by the company's borrowings (which are quite expensive but 65% of the cost is charged against capital) and some writing of options.

Finsbury Growth & Income is managed by Nick Train. His investment style is based on that of Warren Buffett's and involves building a concentrated portfolio of "quality" companies that have strong brands and/or powerful market franchises. Unlike Buffet however, Nick's portfolio is dominated by UK companies. Its yield is just 1.9%, the lowest in the UK equity income sector but dividends, which are paid twice a year, grew by 7.6% last year and this year's interim dividend is up 7.8%.

City of London, managed by Job Curtis at Henderson, is the second largest fund in the sector after Edinburgh. It yields 3.7% and grew its dividend by 3.2% last year, recording the 48th year of dividend increases. Now, while we are obliged to point out that past performance is no guide to the future, this seems to be the "holy grail" for anyone looking for income from an investment.

UK Equity & Bond Income

The UK Equity & Bond Income sector contains funds that invest wholly or mainly in the UK. They invest both in equities and bonds (they cannot hold just bonds / debt or just equities) with the aim of producing a high income. The IA definition (which the AIC sectors relate to) says the yield on the fund should be at least 20% higher than the yield on the FTSE All-Share Index. The attraction of mixing bonds and equities is the hope that when one asset class is doing badly, the other may be doing well enough to offset that. In practice sometimes both asset classes to well or do badly at the same time.

- Largest / Highest Yielding – CQS New City High Yield
- Best performing – Acorn Income Fund

CQS New City High Yield achieves its 6.8% yield by having a much higher proportion of its assets invested in high yielding preference shares, loan stocks, corporate bonds and government stocks. Most of these are issued by companies you would have heard of. Because a large proportion of these stocks pay a fixed rate of interest, this is one fund that would be affected by an interest rate rise.

Acorn Income Fund is a split capital investment trust. The ordinary shares yield 4.0%, a figure which is boosted by the gearing effect of its zero dividend preference shares. The zeros have been a big help to performance as well in the good times. This can work both ways however and, in falling markets, the fund could underperform. The portfolio is invested in a mixture of UK smaller companies and fixed interest stocks with a smattering of high yielding investment companies.

Global Equity Income

For a UK investor, sticking to investments in your home market might seem safer but it shuts off some areas of the investment universe. Many UK equity income funds were caught out when BP had to cut its dividend after the Deepwater Horizon disaster and the UK banks were hit by the credit crunch. A bit of diversification is a good thing.

The Global Equity Income sector is comprised of funds that are looking to pay above average income and are investing predominantly in equities (but not exclusively) and have the freedom to invest wherever they want in the world. The asset allocation (which countries they choose to invest in and which asset types they use) varies quite a bit from fund to fund. Producing income from a globally diversified portfolio should, all things being equal, allow for less risk because of the diversification benefit but it does heighten currency and political risks.

- Largest – Murray International
- Highest Yielding – BlackRock Income Strategies
- Best performing – London & St. Lawrence

Murray International, managed by Bruce Stout, has a yield of 4.3%. Last year's dividend was up 4.7% on the year before but they had to dip into revenue reserves to achieve this. For a global fund, Murray International is quite light in the US at the moment. The manager is quite worried about the excesses of debt that have built up around the world over the past decade.

BlackRock Income Strategies used to be British Assets. BlackRock just took over the management of the fund with the express aim of remodelling it as a fund for pensioners looking for a home for their pension pot and they are going to manage it a as a mix of UK equities and the balance of the portfolio invested on a tactical asset allocation basis, including global equities, debt securities, derivatives, exchange traded funds and unlisted alternative assets. It yields 4.8% currently.

London & St Lawrence aims to provide long term capital and income growth through investing its assets in British Government Securities and other bonds, approved investment trusts, authorised unit trusts and other financial securities. It is one of a number of investment companies that are associated with a particular family, in this case the Ashfields who have been managing the fund since it became an investment trust in 1957 and have a large stake in it. It yields 3.9%.

Global High Income

The Global High Income sector contains funds who invest globally and have a remit that emphasises income generation over capital growth. In practice this seems to mean that they have a bias to debt securities which makes them quite similar to some funds in the debt sector. The two funds in the sector are:

- Henderson Diversified Income
- Invesco Perpetual Enhanced Income

The funds yield 5.5% and 6.4% respectively. Neither one is particularly big but Henderson Diversified Income, managed by John Pattullo and Jenna Bernard, has been expanding quite fast recently. Both funds had a tough time in the wake of the collapse of the credit bubble in 2009 but have recovered well since.

Regional income funds

Quite early on, the demand for income resulted in a dramatic expansion of funds trying to generate income from specific regions or countries.

- Aberdeen Asian Income
- Henderson Far East Income
- Schroder Oriental Income
- JPMorgan European Trust Income Portfolio
- European Assets
- Aberdeen Latin American Income
- Middlefield Canadian
- BlackRock North American Income
- North American Income
- JPMorgan Global Emerging Markets Income

The three Asian income funds from Aberdeen, Henderson and Schroder were, for some time, amongst the best performing of all Asia excluding Japan funds but have fallen back down the performance tables over the past year or so. The highest yielding of these is the Henderson fund, with a yield of 5.1%. Aberdeen's yields 4.2% and Schroder's 3.6%.

The European funds stand out in that they both have unusual corporate structures. The JPMorgan fund, which yields 3.4%, is one half of a larger fund that embraces both an income portfolio and a growth portfolio. Investors can switch between the two. European Assets, which is managed by Sam Cosh at F&C, is a European smaller companies fund. It is domiciled in the Netherlands. It pays a 5.3% yield by distributing capital and so the portfolio is managed to produce high overall returns rather than a high income.

Within Latin America, Aberdeen Latin American has had a difficult time in recent years as Brazil has been out of favour with investors. Corruption scandals have dogged the government and falling commodity prices have held back economic growth. It yields 6.6% however.

In North America, Middlefield Canadian generates a 5.0% yield by investing in a broad selection of Canadian companies. The Canadian economy has been hurt by falling commodity prices but the portfolio was not overexposed to that part of the market. The fund is asking shareholders to let it invest more of its portfolio in countries outside Canada, principally the US. BlackRock North American Income and North American Income, which is managed by Aberdeen, both yield about 3.3%/3.4%. Their performance fell some way behind the only fund in the sector that doesn't have an income bias, JPMorgan American, as technology and biotech stocks, which don't yield much, topped the performance tables.

The last fund we have highlighted here is JPMorgan's Global Emerging Markets Income trust. The increase in the number of Asian stocks paying reasonable dividends, which led to the boom in the Asian income sector, highlighted a wider trend towards dividend payments across emerging markets as a whole. This fund yields 4.1%.

Private Equity funds

- Princess Private Equity
- F&C Private Equity

- JZ Capital
- NB Private Equity

Private equity funds don't tend to yield much as a rule (unless they lend money to companies). A number of funds though saw the demand for income and reasoned that, if they made regular distributions of capital, they would make themselves more attractive to investors.

Princess Private Equity pays the most with a yield of 6.8%. F&C Private Equity, which until December 2014 was a split capital fund, has a yield of 4.8%. The other two funds are split capital funds by virtue of their zero dividend preference share issues (which, as for Acorn Income above, enhances income and makes returns more volatile both in rising and falling markets). JZ Capital yields 4.4% it invests in an eclectic mix of US and European private equity, property and mezzanine debt. NB Private Equity has been switching large parts of its portfolio into income producing assets and is targeting a 4% yield on net assets. In their most recent results, they say gross cash flow from their income portfolio would have covered the dividend 1.3x at the end of December.

Utilities

- Ecofin Water & Power Opportunities
- Premier Energy & Water
- Utilico

The three funds that have a bias towards investment in utilities, which are naturally high yielding investments in most developed markets, have enhanced their returns by adopting a split capital structure. Ecofin yields 4.6%, the Premier fund 7.0% (1.5% of which relates to a special dividend), and Utilico 6.5%. The best performing of these in recent years has been Premier Energy & Water. It is also the purest play on the utility sector as Ecofin has a large exposure to a US shale company and Utilico has also diversified beyond the sector.

Infrastructure

The infrastructure sector invests in assets like schools, prisons, hospitals and roads that governments have been funding through PFI type schemes. The revenues are overwhelmingly based on ensuring that the assets are available rather than on how often they are used and the revenue comes from governments and local authorities, which makes it fairly low risk. These relatively safe, predictable returns (assets with 20-30 year lives with contracted revenues which often even have an inbuilt element of inflation protection built in) have been much in demand in recent years and most of the companies in the sector seem to be questioning the values that new investors are paying for old assets as they seek to get exposure. Many of the companies are looking to regimes outside the UK for new investments.

- Largest – HICL Infrastructure
- Highest yielding – GCP Infrastructure
- Best performing – 3i Infrastructure

HICL Infrastructure yields 4.8%. GCP gets to be the highest yielding, 6.5%, by doing something different to the competition – it provides debt finance to infrastructure projects. 3i Infrastructure, which yields 4.2%, is the best performing over five years but it takes more risk than most by investing in places like India and having more exposure to investments where the revenue is less predictable.

Renewable infrastructure

The UK government has been subsidising vast investment in renewable energy, principally onshore wind and solar projects. A number of funds have been launched to invest in these projects. The revenues are split between government subsidies and electricity sales with a bias towards the former. Falling electricity prices have affected the sector in recent months but the biggest impact is coming from falling subsidies – the solar funds in particular have been rushing to get money invested before subsidies fall.

- Largest – The Renewables Infrastructure Group
- Highest yielding – Bluefield Solar Income (also best performing over one year – three year figures aren't available)

The Renewables Infrastructure Group – often just called TRIG for short – invests in a mix of onshore wind farms and solar projects. Bluefield Solar is the highest yielding, 6.4%, because it operates on a different model to the other infrastructure funds. The others keep part of their income back to reinvest in new projects while Bluefield distributes just about everything it earns.

Insurance

A couple of funds have been launched that write reinsurance contracts. They get hit when the really big disasters happen, such as the Japanese earthquake, but otherwise collect premiums and pay out high dividends. You are making something of a gamble by investing in these but the managers would argue that it is a calculated one.

- BlueCapital Global Reinsurance
- CatCo Reinsurance Opportunities

BlueCapital's historic yield is 6.4%, CatCo's is 5.2%.

Asset Leasing

In recent years a number of funds have been launched that buy assets and then lease them. This activity can generate quite high yields. A number of these (and all of the ones highlighted below) invest in aircraft but there is also a fund that leases marine vessels and another that manages a diversified portfolio of leased assets. The cash flows from these are good unless the end client runs into trouble or the second hand value of the asset falls dramatically.

- Largest – Doric Nimrod Air Two
- Highest yielding – DP Aircraft 1
- Best Performing – Doric Nimrod Air One (one year)

The three Doric Nimrod Funds, which yield between 7.4% and 8.0%, all own Airbus A380s that they lease to Emirates. DP Aircraft, which yields 8.5%, leases Boeing Dreamliners to Norwegian.

Debt

The sector that has probably expanded fastest in recent times is debt. There are all sorts of ways of generating high income from debt investments. Almost all the funds operating in the debt market lend money to borrowers who would not be classified as investment grade – that is to say a ratings agency has either said the investment should be considered speculative or has not rated the borrower at all. Funds get higher yields by lending to riskier borrowers or by agreeing to take the first part of any loss if the borrower defaults. Having said that, often the borrowings are secured against assets that can be sold to repay the debt. Many of the loans pay floating rate interest. This has the attraction of providing investors with some protection if interest rates rise (though it might be reasonable to assume that rising rates could be accompanied by rising default rates).

- Largest – NB Global Floating Rate Income
- Highest yielding – Carador
- Best Performing – Real Estate Credit
- Special mention – P2P Global

NB Global Floating Rate Income, which yields 3.8% has two different classes of shares that let you have either US dollar or Sterling exposure to the portfolio. It holds a global portfolio of below investment grade senior secured corporate loans (in other words loans made to companies where NB Global ranks ahead of other creditors in the event something goes wrong and where the loan is secured on assets that can be sold in the event of a default). They try to minimise the potential hit from any default by diversifying the portfolio.

Carador invests in junior tranches of securitised debt, which means it agrees to absorb the first part of any losses. For this it gets paid a higher return. It yields 11.8%. Real Estate Credit is a bit like Carador but it invests in loans secured on property and yields 6.4%.

We wanted to mention P2P Global because it is the first and largest of a new breed of funds that are making loans through peer to peer lending platforms. Here the borrowers tend not to be rated by any credit rating agency. P2P Global is targeting a yield between 6% and 8%.

Property

The UK property sector has been through considerable change over the past few years. There used to be a clear distinction between property companies and property investment companies but the government introduced legislation to create Real Estate Investment Trusts ("REIT"). This gave tax breaks to companies focused on collecting rents and paying dividends. Companies focused on developing new buildings still sit within the property sector. In recent months a large number of property investment companies have announced that they intend to become REITs. The area is also peppered with the remains of companies that borrowed too much money in the mid-2000s and came unstuck. We think, given the complexity of the sector, we'd do better to release a separate report on the topic – watch this space!

QuotedData

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