

# The Investing for Income Round Table

The Taking Stock panel discuss investing for income amid extreme volatility and uncertainty in financial markets.

**Our panellists are:**

- Michael Kerley**  
(Henderson Global Investors)
- Bruce Stout**  
(Aberdeen Asset Management)
- Ross Watson**  
(Martin Currie)
- Andrew Watkins**  
(Invesco Perpetual)

**Is now the right time for investors to be looking at income shares given the challenges you all see as Fund Managers on a day to day basis?**

**Ross:**

I think it's time to start looking, but I certainly don't think that in the current market conditions it's time to commit all your liquidity to the market. You might think about putting some money in just now and then another month putting in some more. Given the volatility that's out there, I don't think any of us can say that we've seen the bottom in share prices around the world, so there is no rush.

**Andrew:**

There are really two questions here – have we seen the bottom of the market and is now as good a time as any to buy income stocks? I looked at the data before I came here expecting that over the last ten years income would have outperformed growth quite handsomely but it hasn't, so it's not an easy call to make.

**Michael:**

I think the two issues are, if we are looking at absolute gain from this point, then it is tough

investing now. If you're saying is income going to be better than growth over the next 6 to 12 months, I would be expect it probably is, but are people going to make money? It's a difficult call.

**Bruce:**

If you look at the bond yields versus earnings yields in the market today, you'll see that equities are now looking much better value than bonds. In fact the bond yield/earnings yield spread has crossed for the first time since March 2003. The big question mark in 2008 is what is the quality of earnings and what kind of dividends can they support? So, although the signal is most definitely there, it really does come down to the balance sheet of each individual company and how they will be able to cope with a tough growth outlook for the next two or three years.

**What is the sustainability of income within the market?**

**Michael:**

I cover Asia and I don't think the problems we've got in Asia, either from a corporate perspective or even top down are the same. Clearly things are going to get slower. But when I look at individual companies it's quite

easy really to look at the sustainability of corporate cash flows especially with sectors like banks, which I can imagine in the UK and the US is incredibly difficult at this point.

**Ross:**

I think in common with an awful lot of long-term orientated fund managers I've spent most of the last few weeks sitting on my hands. The key point is the sustainability of income, looking at the sectors where the income and cash flows are well underpinned and where the company's dividend policy is based upon a sustainable level or earnings. I'm quite relaxed, for example, at having a great big position in the tobacco sector, where there is strong cash flow, it has good dividend growth, and a lot of it is earned in currencies other than sterling.

**Bruce:**

We are in a slightly more fortunate situation because with a global remit you have a global universe from which to choose, which makes it slightly easier than being boxed into one region or one country. The outlook for company dividend growth in Asia and Latin America is extremely good, in our opinion, apart from in areas such as the financials.

When we look around the world and see things like Dow Chemical on a 5% yield and Schneider in France on a 5% yield, even though we know their earnings are going to come under pressure, historically these companies have been able to continue with very healthy payouts during tough periods.

**The benefit of that global view obviously leads us on to the question of, is there a need really to look outside the UK?**

**Ross:**

I think in the UK we start off in the position that more than 60% of the profits declared by UK listed companies are not earned in the UK. They are earned overseas. There are a lot of very solid earnings out there which are declared in dollars from companies operating on a global basis, particularly the big oil companies, all the miners, HSBC etc. So there's more security there than you'd think.

**Bruce:**

It's also interesting to note that over the last three years the area with the fastest dividend growth in the world is Japan. Now it has come up from a very low base, admittedly, but it is now common to be able to get yields of 3% in Japanese equities. It is not that long ago that many of us will remember that you were lucky if you got a 1% yield in Asia, up until 1998. I suspect that in the next few years you'll be able to pick up 4% and 5% yields in Japanese equities.

**Michael:**

I suppose the question going forward, is whether strong companies – which obviously are going to appear stronger after all this – whether a corporate buying splurge could actually have a negative impact on dividend growth going forward, it may well do.

“The key point is the sustainability of income, looking at the sectors where the income and cash flows are well underpinned...”

Ross Watson

The Panel



**Company:** Henderson Global Investors  
**Fund Manager:** Michael Kerley  
**Trust:** Henderson Far East Income Limited  
**Market cap:** £162.4m  
**Yield:** 5.9%  
**Gearing:** 0%  
**Premium/Discount:** -3.4%  
**Source:** Henderson

**Investment style:** 'Bottom-up' value driven process with a focus on management quality and sustainability of business model, earnings, cash flow and dividends

**Key risks for 2008 and beyond:** Expect the next 6 to 12 months to remain volatile as investors digest the fall out from the credit crunch and its implications for global growth. Asia, from an economic standpoint, stands out as a relative safe haven although is not immune from volatility within global financial markets. Following the recent steep falls, value is appearing and some interesting opportunities are presenting themselves. We remain very positive on the region in the medium to long term.



**Company:** Aberdeen Asset Management  
**Fund Manager:** Bruce Stout  
**Trust:** Murray International Trust PLC  
**Website:** www.murray-intl.co.uk  
**Market cap:** £559m  
**Dividends paid:** Quarterly  
**Yield:** 4.1%  
**Gearing:** 20%  
**Premium/Discount:** +1.6%  
**Source:** Aberdeen Asset Management

**Investment style:** The primary aim is to achieve a total return greater than its benchmark by investing predominantly in equities worldwide. Within this objective, I look to increase the Company's revenues in order to maintain an above average dividend yield.

**Key risks for 2008 and beyond:** The present outlook for economic growth, corporate earnings and personal consumption looks grim. A period of sub-trend growth is likely to persist until corporate and consumer indebtedness is reduced and savings are rebuilt. During this time capital preservation will remain key, but as markets decline in response to such harsh conditions, we expect attractive longer-term investment opportunities to emerge



**Company:** Martin Currie  
**Fund Manager:** Ross Watson  
**Trust:** Securities Trust of Scotland  
**Market cap:** Net Asset Value £119m  
**Yield:** 5.2%  
**Dividends Paid:** Quarterly  
**Gearing:** 11.6%  
**Premium/Discount:** +10.7%  
**Source:** Martin Currie

**Investment style:** Securities Trust aims to achieve a rising income and long-term capital growth for shareholders. Ross Watson and his team manage a diversified portfolio of 45-60 UK companies that have the potential to deliver strong earnings and dividend growth. With no stock or sector constraints, only the most attractive stocks are included.

**Key risks for 2008 and beyond:** It is difficult to overstate the importance of dividends to long-term stock market returns. So investing in companies that can pay a healthy dividend to shareholders represents a good long-term investment policy. Looking ahead to 2009, despite all the economic gloom, we continue to forecast above-inflation growth from UK companies.



**Company:** Invesco Perpetual  
**Fund Manager:** Paul Read & Paul Causer  
**Trust:** City Merchants High Yield Trust plc  
**Market cap:** £81m  
**Yield:** 8.3%  
**Gearing:** 123%  
**Premium/Discount:** +6.4%  
**Source:** Invesco

**Investment style:** City Merchants seeks to provide both income & capital growth from high yielding fixed interest securities, including up to 20% in equities.

**Key risks for 2008 and beyond:** Equity markets, particularly financial stocks, are likely to drive sentiment in credit markets over the coming months. The financial sector remains fragile and without stability and further repairing of balance sheets, continues to cause headwinds for credit markets. Some support should come in the form of interest rate cuts.

**What signals have you all been looking for from the global marketplace to maybe give you a little bit more comfort about the sustainability of income going forward?**

**Andrew:**

I would have thought the US rescue package was as close to a comfort blanket as you are likely to get. Of course, with the concerns over how that's to be financed and the impact on the US tax payer in particular, the aftermath will shake markets for a bit longer I think. However, I do also think that we should be able to look back in some months' time and say that it was the turning point.

**Ross:**

It may be that as a result, particularly the forced merger of HBOS and Lloyds, that there will be more concentration in the market. The sustainability of UK banks earning twice their cost to capital on an ongoing basis is good news for the dividend payments. The danger would be that in exchange for allowing this merger to go ahead, the government does impose more controls on what the banks can do and on their pricing structures

**Bruce:**

I think one of the main issues that we have in terms of the UK banking sector is that we don't know what comes next. What we can say is, what is coming next will not be what went before; what went before was an extremely favourable environment to make money in the banking sector, whereby you had very lax credit controls and huge credit expansion. Now that scenario is gone. There's likely to be a much slower growth scenario with more regulation.

**Should individual investors just sit on cash and wait and see or should they dip their toes in now for a little bit of income?**

**Andrew:**

Well certainly our view is that we must be close to a market bottom. And, on that basis, I think we'd say to people with cash, consider investing carefully. Returns from Building Society deposit accounts are only likely to go down as interest rates reduce so investing in a quality income & growth trust with, say, a 4-5% yield looks quite timely.

**Bruce:**

I think that's absolutely correct. The money that is sitting in your building society deposit account is about to go down, and can go down very sharply if they have to reduce rates. There's no way that any of us are smart enough to time the exact market bottom. All you can do is say, okay, this stock is cheaper than it was last month and we'll buy a bit more because the fundamentals are sound.

**Ross:**

The other great buying signal at the moment is that there's lots of money flowing out of UK retail funds which usually suggests you're close to the bottom of the market. I agree you can never get the bottom of the market exactly right. So if you're private investor and you want to invest money, you buy some today. In another week's time you buy a bit more, three weeks time you buy some more. The investment trust that I manage, Securities Trust, is on a 5.7% historic yield and 5.9% prospective plus – along with an 8-10% discount to asset value. That has to be good value.

*“...with a global remit you have a global universe from which to choose, which makes it slightly easier than being boxed into one region or one country.”*

*Bruce Stout*



**Andrew:**

For those seeking a much higher level of income, I would like to mention City Merchants High Yield Trust, a tax-efficient onshore investment trust with a portfolio of fixed interest and high-yielding equities. This trust is now yielding over 8%. Following a re-pricing of credit, spreads have widened and the managers, Paul Read & Paul Causer, have built a portfolio of bonds with high coupons and very real prospects for capital growth over the medium term.

**Michael:**

As you know, I think the long-term case for Asia looks great. You have sustainable dividends and Henderson Far East Income Ltd offers a 5.9% yield from a portfolio of Asian shares. So, on a medium to long-term basis you can buy that for roughly a 7% discount to net asset value. The discount has never been so wide, the yield is probably sustainable and most of the downturn in Asia is partly sentiment rather than a change in fundamentals.

**Is it an opportunity for the private investor to lock into the attractive yields that are currently available with trusts you manage?**

**Andrew:**

Yes, definitely. Whilst we have witnessed unprecedented market conditions, one positive aspect that has emerged is that it now presents investors with an opportunity to take advantage of well-managed income & growth trusts with yields that have not been seen for many years. They have strong balance sheets with decent revenue reserves and offer excellent prospects for dividend and capital growth.

**Ross:**

It's worth pointing out that investment trust boards are more prepared nowadays to use revenue surplus for dividend if need be. They used to be a bit overprotective with the revenue, thinking it was not to be touched. They are now much more prepared to use an element of revenue surplus to smooth out the dividend payments.

**Bruce:**

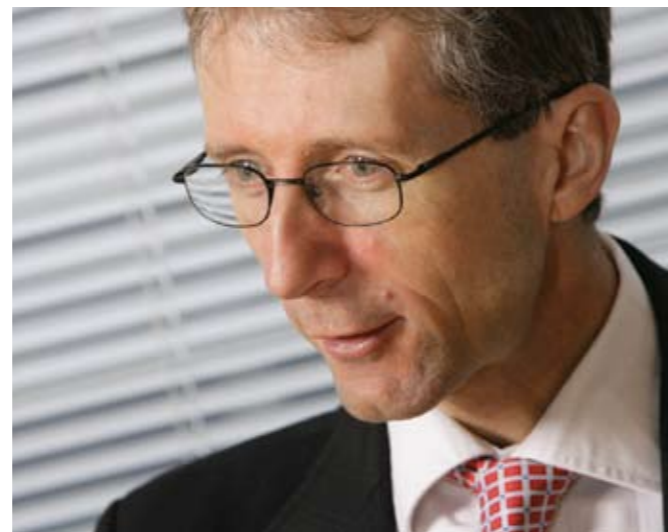
At Murray International in the last four years we've had a fully covered growing dividend. But we did have a period between 2001 and 2004 when for four years we had a flat dividend and we had to dip into revenue reserves each year to cover the flat dividend. And clearly that was not a situation that could have gone on indefinitely. So that issue was rectified by becoming a more internationally focused trust with more exposure to both better quality yield and better dividend growth elsewhere in the world.

**Michael:**

We've been going since 1989 and we didn't cut the dividend in 1997 during the Asian crisis. Asia is a far better spot now than it was back in the mid-nineties. So if we didn't cut the dividend then, it's a very, very slim chance that we'll ever cut the dividend in this environment.

*“Well certainly our view is that we must be close to a market bottom. And, on that basis, I think we'd say to people with cash, consider investing carefully.”*

*Andrew Watkins*



**We have four representatives from different sectors here, namely Global Growth and Income, UK High Income, Asia Pacific ex Japan and UK Growth and Income. Could we finish off with everyone outlining what are the key benefits of investing for income in their sector?**

**Andrew:**

Whilst the income & growth sector has underperformed the UK growth sector over the last 10 years, I can see this reversing. Prices of equities and fixed income securities have declined by so much during this bear market that, as already mentioned, great opportunities have presented themselves to fund managers to build portfolios of high quality holdings that offer very real prospects for income growth and capital growth over the medium term. City Merchants High Yield is a great example of a fixed interest trust that should benefit from improving market conditions and provide shareholders with decent total returns

**Michael:**

The current yield from Henderson Far East Income offered is about 5.9% which is also paid gross. Investing for income in Asia is the least volatile way of investing in the region. The Asian dividend story is very much intact. We haven't had the same problems in Asia as we've had in the West, especially in the financial sector. I think dividends in Asia look well placed for income growth for the next two to three years.

**Ross:**

For a UK specific fund, it is Securities Trust of Scotland, a listed investment trust, current yielding 5.7%. The prospective yield will be nearer 6%, and certainly we expect the dividend to grow at least ahead the rate of inflation in the current year. What is key for a UK shareholder is that a great chunk of the revenue and the profits that come into the fund are generated overseas. So, even if the aggregate dividend payment earned from UK companies are going to get squeezed, those that are coming in from overseas are going to be very strong indeed. You're able to buy into a fund like this on a discount of perhaps 8%, maybe even 10%, just now. That has to offer good medium-term value, particular when

you've had a period of about two years when high yield shares have underperformed quite sharply in the UK. It does now appear that the trend of high yielding investments in the UK outperforming has already started again.

**Bruce:**

Murray International is a capital growth and income company. It has a dual investment mandate and therefore if you're buying or looking to buy an investment trust on pure yield basis alone it has a lower yield than the other trusts here. What Murray International has is very widespread global diversification. It has 80% of its assets outside of sterling and it gives you significant exposure to high growth areas such as Asia and Latin America. So from a market timing point of view, if you are looking for capital growth but at the same time picking up the current yield of about 3.4%, then that is the story for Murray International. Within its peer group, it is, or it seeks to be, the most international, to give investors who don't have a high tolerance for risk a very diversified exposure to the global market.

*"I think dividends in Asia look well placed for income growth for the next two to three years."*

*Michael Kerley*



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