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Moving with the times

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Special Report

Moving with the times

How investors can combine a best-of-both income and growth mandate…

The outlook for income-focused investors is ever-changing. Looking back 15 years, the standard 60/40 portfolio provided benefits: the 60% equity portion gave good growth and a decent income, while the 40% bond portion gave predictable income and protected your capital when stock markets fell.

Fast-forward to the post-financial crisis period and while bonds provided protection, they generally failed on the income side due to low interest rates, moving investors up the risk curve with equities and alternatives taking up the slack.

Coming full circle, bonds again offer attractive income, with the 10-year gilt yielding c. 4.7%, so have a role to play in an income portfolio. As seen during 2022, though, they have become more correlated with equities: UK government bonds' correlation with global equities has been low over 10 years, at 0.28, but over three years it's risen to 0.65.

With the potential for more inflationary episodes moving forward, this could be a running trend. Cash, meanwhile, might look attractive on the face of it, but interest rates are now on a downward trend, so you're leaving yourself open to reinvestment risk: if you'd put cash into a one-year fixed-term bond paying 5.5% at the start of 2024, you'd only be able to get c. 4.7% if you wanted to reinvest.

Bonds and cash also offer little to no prospect of capital growth, as opposed to more productive assets such as equities, property and infrastructure. Schroders' forecasts suggest that gilts will return c. 4.8% per year for the next decade – well below stock markets.

One asset class that has maintained its negative or low correlation to global equity markets is property. UK commercial property's correlation with global stocks has been 0 over 10 years and 0.07 over three years.

The higher-yielding stock markets today look to have better potential future returns, too. As shown in the graph below, that's particularly true of the UK, emerging markets and Japan, with Schroders forecasting annual returns of 10.5%, 10% and 7.9% respectively, while the lower-yielding US market has expected returns of 6.6% over the next decade.

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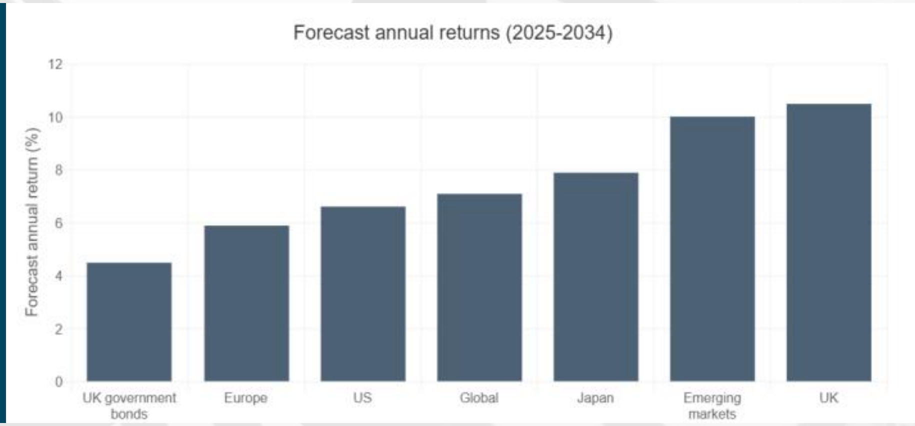
FIG 1: 'Looking beyond the US for growth'



Source: Schroders (December 2024)

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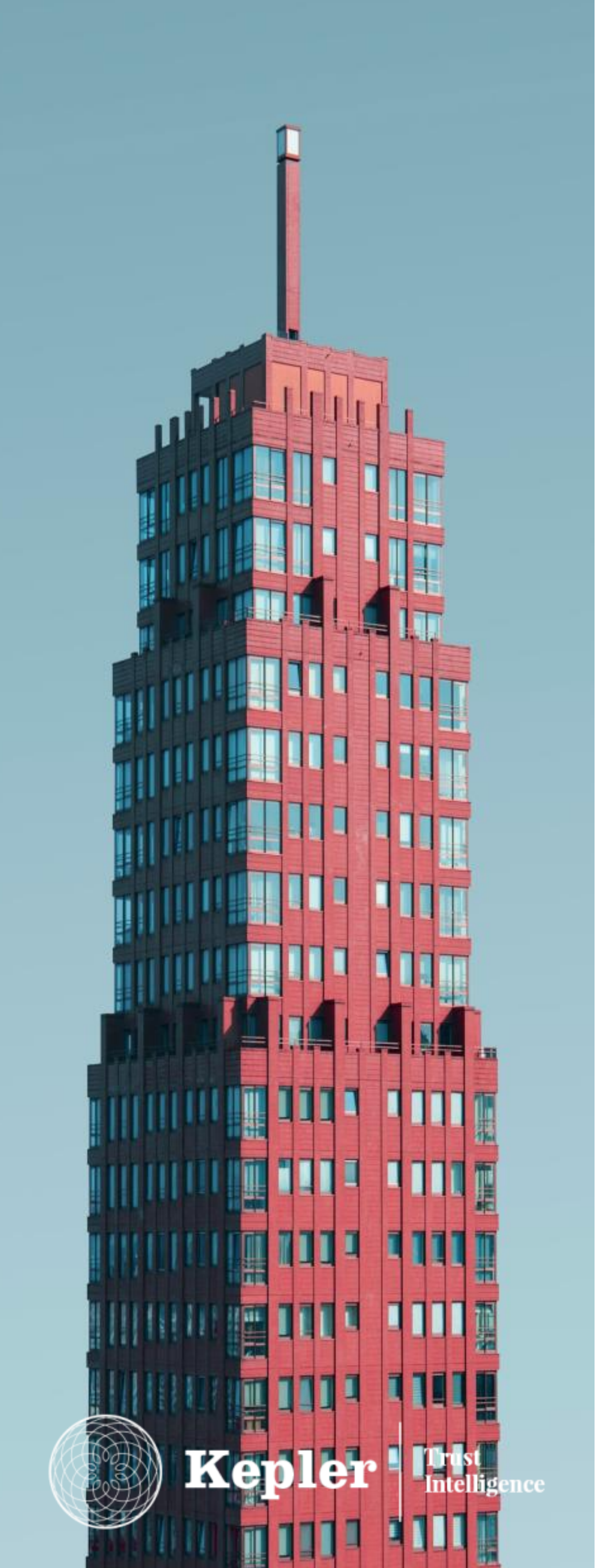

The anatomy of an income portfolio

Bonds remain a key component of any income portfolio, with their current high and attractive yields at c. 4.7% for the 10-year gilt. However, diversifying across other sectors could enhance the growth potential of a portfolio.

PROPERTY

Real estate investment trusts (REITs) have a history of delivering consistent and growing dividends, with yields in the AIC: Property – UK Commercial sector of between c. 5.4% and 8.7% attractive, given the 10-year UK gilt yield of c. 4.7%.

Those gilts have little to no prospect of capital growth; property's positive supply and demand dynamics and potential for sustainability improvement offer good income and capital growth prospects.

The economic backdrop looks to have become more constructive, too. The MSCI UK Monthly Property Index clocked up a 1% gain in the three months to November 2024. That's stemmed the tide, after a two-year bear market where capital values fell by c. 25%. Encouragingly, rents, in aggregate, actually grew by a solid 7.5% during that two-year period. Further reductions in the interest rate should also be positive for REITs.

THE UK PAYS DIVIDENDS

The UK stock market ranks highly versus most other countries and is on a par with what's available from gilts and savings accounts, as you can see from the table below.

The FTSE 100's c. 3.5% yield provides a solid base, but the FTSE 250's c. 3.3% yield looks attractive, too, and gives you the potential for more of a total return. Mid-cap stocks have outperformed their large-cap counterparts by c. 190 percentage points over the past 30 years.

UK plc's dividend cover is the healthiest it's been for over 10 years, too, and share buybacks are becoming more prevalent in the UK market. Adding together dividends, buybacks and takeovers, the FTSE 350 has an estimated cash yield of 8.3%, according to the investment platform AJ Bell.

DON'T OVERLOOK ASIA FOR YIELDS...

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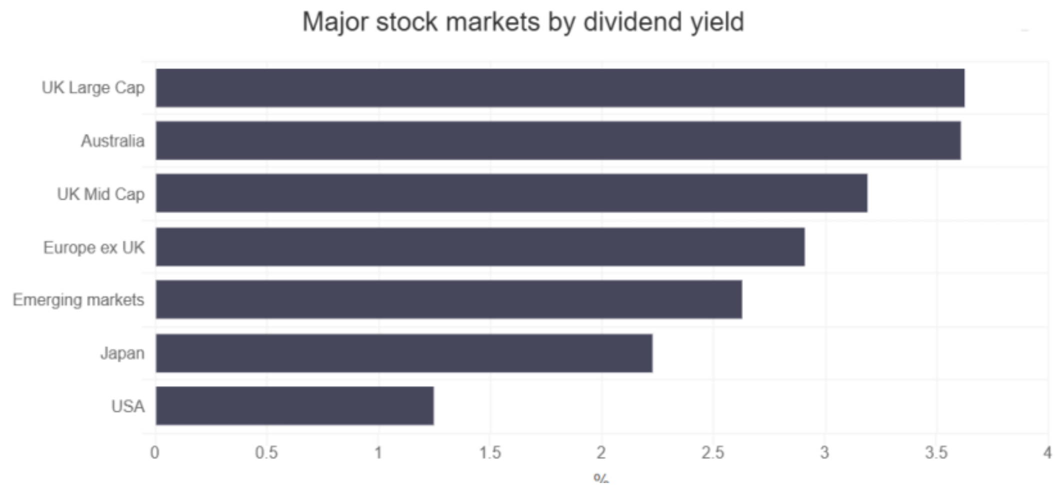
FIG 2: 'THE UK'S INCOME ADVANTAGE'



Source: MSCI

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Asia is also the epitome of a growth story, having recently reached the pivotal milestone of generating more GDP than the rest of the world combined. The next wave of expansion will be driven by a surging domestic consumer class, with the World Data Lab reporting that Asia added 90 million consumers in 2024 alone. With the tailwinds of favourable demographics and strong economic growth, its global influence looks set to increase further in coming decades.

THE BEST OF BOTH WORLDS IN BIOTECH

While biotech isn't traditionally an income sector, the high level of M&A in the biotech sector generates cash that can be reinvested or distributed as dividends to investors. As a result, a small number of investment trusts have adopted an enhanced dividend policy with a NAV-linked payout to provide both income and capital growth for investors.

Turning to the potential for capital growth, healthcare is a substantial and growing market, with the World Economic Forum reporting that global spending hit $10 trillion, or 10% of GDP, in 2022 and spending is forecast to outpace GDP growth in the coming years. Due to its high level of innovation, the global biotech sector is forecast to enjoy significant growth of 12% to surpass $4 trillion by 2033, according to Precedence Research.

How investment trusts provide an advantage

Investment trusts offer several benefits for income-focused investors. A key benefit is their ability to provide stable and sustainable dividends by retaining up to 15% of

annual income in reserves, allowing them to maintain dividend payments during periods of market downturns or economic uncertainty.

The AIC list of dividend heroes is testament to the income-generating advantages of the investment trust structure, with **Schroder Income Growth (SCF)** having increased its dividends for the last 29 years. In contrast, open-ended funds must distribute annual income received, leading to a more variable income stream.

The closed-ended nature of investment trusts also provides the flexibility to invest in less liquid assets, including property and small-cap companies. This includes access to unquoted companies which can offer strong returns, particularly in sectors like biotech, where private firms are increasingly opting for strategic acquisitions over an IPO.

By holding a mix of liquid and illiquid assets, investment trusts can enhance diversification, supporting long-term capital appreciation alongside income generation.

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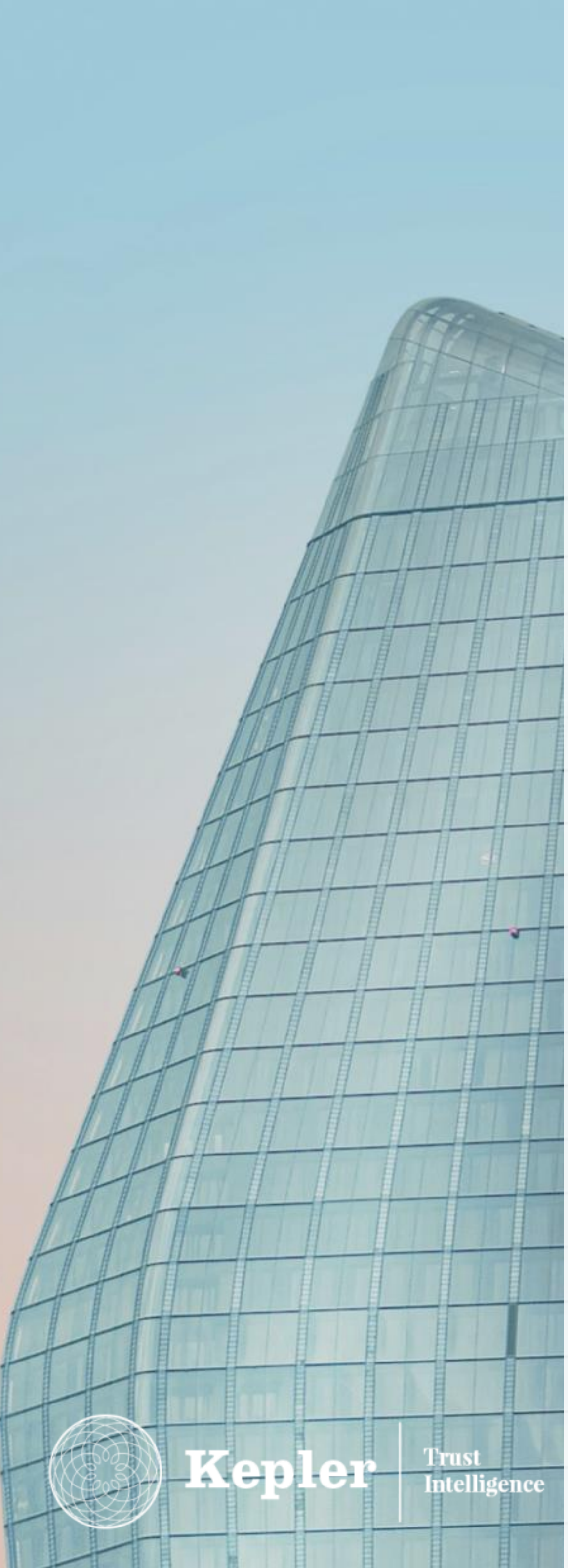

How to improve diversification without sacrificing income

Investing across a range of income-generating sectors improves diversification, preventing a portfolio from being overly reliant on one single source of income such as the FTSE 100.

As illustrated in the graph below, the FTSE 100 Index, commonly used as a benchmark for the UK equity income sector, demonstrates a high positive correlation with the S&P 500 and MSCI World indices. In contrast, it shows a much lower correlation with Asian and biotech indices, while the UK property sector remains largely uncorrelated to the FTSE 100.

HARNESSING THE GREEN PREMIUM

The fact that commercial property rents increased during a tough backdrop of rising interest rates and, consequently, falling capital values, shows that the income side holds up.

The self-help factor can cement REITs' income advantage, as demand grows for environmentally friendly buildings. The managers of **Schroder Real Estate (SREI)** believe that tenants are increasingly willing to pay a premium for energy-efficient buildings and for a good environment for employees. This could have a triple impact by boosting rents, improving vacancy rates and raising capital values.

SREI's unique strategy of turning brown buildings green should help it deliver on its dual mandate of providing income and capital growth while achieving meaningful and measurable improvements in its sustainability profile.

SREI's 6.4% dividend is well covered (c. 104%) by earnings and backed up by a reversionary yield of 8.4%, hinting that its already impressive five-year record of c. 5.6% per annum dividend increases can continue.

In addition, a 4% NAV total return in the three months to 31/12/2024 was the company's strongest quarterly performance since June 2022, suggesting that while it's early days, managers Nick Montgomery and Bradley Biggins seem to be harnessing that green premium.

SECURING A TOTAL RETURN FROM THE UK

The high yields on offer from UK equities already gives our domestic market an income advantage. Yet, there's an argument that the UK is a fertile hunting ground for total return investors. It's rare that the FTSE 250 has a yield on a par with the FTSE 100 and provides the potential for higher income and capital growth than ordinarily might be the case.

Active management can harness this most effectively, as yields in small- and mid-cap land are high for a reason, with plenty of value traps out there.

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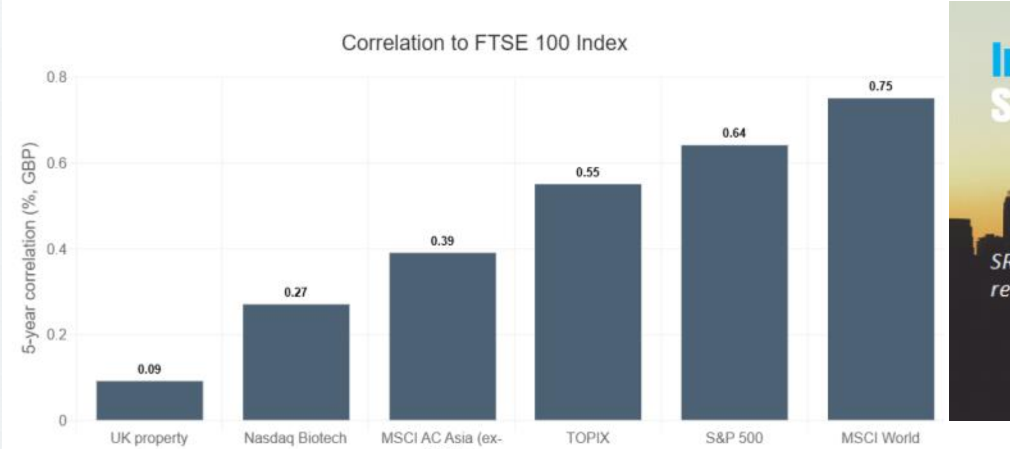
FIG 3:
'HOW SECTOR DIVERSIFICATION CAN REDUCE CORRELATION'



Source: FE Analytics, correlation of 5-year total returns in GBP, UK property based on FE UK Property Proxy (as at 24/02/2025)

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Step forward SCF, where managers Sue Noffke and Matt Bennison look for businesses with healthy cash flows and solid balance sheets, giving them firepower to pay healthy and growing dividends, invest for growth and engage in share buybacks where appropriate.

In addition, Sue and Matt can call on the deep resources within Schroders' UK equities team, allowing them to fish from a bigger pool that includes the whole market-cap spectrum, a pond from which many of its peers are unable to fish.

The benefits of this approach shine through. SCF's unbroken record of dividend increases is impressive, while 60% of its portfolio holdings conducted buybacks in its most recent financial year, up from 38% in the previous year.

TAPPING INTO ASIA'S GROWTH STORY

Asia offers diversification for a UK equity income strategy by offering a unique mix of growth and income drivers. The region offers a compelling blend of high-growth economies such as Vietnam and the Philippines, alongside mature yet dynamic markets like Singapore and Australia (which still boast higher GDP growth forecasts than most G7 nations).

Given its diversity, Asia is arguably best suited to an active strategy and **Schroder Oriental Income (SOI)** is well-positioned to capitalise on the unique growth drivers across the region. Manager Richard Sennitt, supported by Abbas Barkhordar, together have a combined five decades of experience and leverage extensive on-the-ground resources to identify the most attractive opportunities.

SOI's portfolio balances export-led industries with domestic consumption plays. Around a quarter of its holdings are in Taiwan, where TSMC has delivered impressive returns thanks to its partnership with NVIDIA. Meanwhile, rising financial inclusion across Asia is fuelling demand for banking, insurance and real estate services, with SOI overweight in these sectors.

Rather than simply chasing high yields, Richard and Abbas focus on companies offering both income and growth potential. SOI currently offers a 4.4% dividend yield, comfortably above the 2.7% and 3.5% for the MSCI AC Pacific ex-Japan and UK indices respectively (as at 28/02/2025).

It's also delivered a ten-year share price return of 104%, compared to 85% for the FTSE 100, compensating investors for the extra risk of investing in Asia.

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WHY JAPAN LOOKS SET TO SHINE

Not only is Japan the fourth largest economy, it's also home to a number of world-leading companies such as Toyota, Sony and Mitsubishi. As mentioned earlier, it's also projected to deliver an impressive annual return of 8% over the next decade, above both global and US markets. And Japanese equites have the ultimate seal of approval from Warren Buffett, who plans to increase his stake in five major Japanese trading houses.

Japan is strategically positioned to benefit from Asia's growth story, supported by an improving macroeconomic environment. Inflation has returned, restoring corporate pricing power for the first time in decades and supporting a positive cycle of wage growth and increased corporate earnings. Japan also offers a diversified range of sectors that should benefit from the China+1 strategy as well as smaller, innovative companies capitalising on megatrends such as robotics, artificial intelligence and decarbonisation.

Schroder Japan (SJG) is the highest-yielding trust within the AIC Japan sector, offering an enhanced dividend policy that distributes 4% of NAV, resulting in a current dividend yield of 4.6%.

Managed by Masaki Taketsume, SJG focuses on high-quality companies with the potential for a re-rating in valuation driven by company-specific factors. This has provided the foundation for the trust outperforming the TOPIX index with a share price total return of over 110% over the past decade.

RIDING THE BIOTECH TAILWINDS

Biotech is a high growth sector, driven by strong structural and idiosyncratic tailwinds from an 'older, richer and sicker' global population.

One of the most significant growth drivers is a demographic 'time bomb', with the United Nations forecasting a doubling of the over-65s within the next 30 years, increasing the incidence of age-related chronic diseases such as heart disease and cancer.

Global healthcare spending is also forecast to rise, fuelled by increasing expenditure from developing nations. According to the OECD, healthcare expenditure in India and China remains below $1,000 per capita compared to over $6,000 in most G7 economies.

The biotech industry has also seen record numbers of clinical trials, with breakthroughs in gene, RNA, and cell-based therapies for previously untreatable conditions, as well as game-changing anti-obesity drugs.

The biotech sector is best suited to active management with the specialist expertise to optimise returns while managing downside risk. One such example is **International Biotechnology Trust (IBT)**, which has out-performed its benchmark with a 10-year share price return of over 110% compared to 70% for the Nasdaq Biotechnology Index (as at 17/02/2025).

M&A activity has been a key driver of returns, with large pharmaceutical companies turning to acquisitions to plug the projected $200 billion 'patent cliff' by 2030. Since 2020, the acquisition of 21 quoted and 5 unquoted companies from the IBT portfolio has highlighted the stock -picking prowess of Ailsa Craig and Marek Poszepczynski.

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Final thoughts

While cash and bonds are popular choices for income-seeking investors, other asset classes offer the potential for a reliable income stream without sacrificing capital growth. Although income-focused investors have traditionally focused on the UK equity income sector, this overlooks some of the high-yielding opportunities in other sectors.

Diversifying across a broad range of asset classes provides exposure to a range of unique growth drivers, from the burgeoning middle-class consumer base in Asia to the green premium in the commercial property sector. Combined with the benefits of an investment trust structure, these diverse opportunities offer the potential for both sustainable income and long-term capital growth.

Data as at 12/03/2025 unless otherwise specified.

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Read more about the Schroders range here

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