A triple threat

Three managers tell us why the time is nigh for equity income...

Update

29 November 2024

With inflation easing and interest rates on a downward path, the theme of this week's event was "A new era for equity income". The managers of CC Japan Income & Growth, abrdn Equity Income and CT UK Capital & Income joined us to talk through their strategies for delivering investors a sustainable income, alongside capital growth, in a shifting economic landscape.

Due to unforeseen circumstances, our session with Steve Farkas, manager of BlackRock American Income (BRAI) was postponed until Tuesday 3rd December at 2pm. You can sign up to watch that **webinar here**.

A new dawn in Japan

Richard Aston, manager of **CC Japan Income & Growth (CCJI)**, started proceedings with a deep-dive into Japanese equities. Unlike its growth-focused peers, CCJI targets both capital and income growth, with significant corporate governance reforms and an improving macroeconomic backdrop propelling the Japanese stock market to record highs this year.

Richard talked through the noticeable change in the mindset of Japanese management teams towards shareholder returns, and some of the key drivers. He spoke about the continued evolution of corporate governance reforms to raise awareness of the cost of capital, particularly the recent Tokyo Stock Exchange initiative to put pressure on companies trading below book value (which was around half of companies in 2024). Upcoming initiatives include the proposed reduction in dual parent and subsidiary listings and the sale of cross-shareholdings which have been a headwind to returns.

Richard also spoke about the attractive investment universe in Japan which includes global market leaders that are well-positioned to benefit from friend-shoring and the relocation of supply chains. Finally, Richard highlighted that more than 50% of the companies on Topix are in a net cash position and, despite an increase in dividends and share buybacks, this ratio is increasing.

In terms of outlook, Richard pointed to the strong income potential in Japan, with payout ratios below the US and Europe, and high dividend cover (which provided protection during the pandemic). CCJI looks to capitalise on the continued inefficiencies in Japanese equities, including half of listed companies receiving no sell-side analyst coverage, which supports alpha generation for active managers.

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A three-pronged approach in the UK

Thomas Moore, portfoilio manager at **abrdn Equity Income (AEI)**, highlighted companies from each of the three buckets (dividend yield, dividend growth and valuation re-rating) AEI invests through, that are driving returns for the trust.

Some worry that tobacco volumes are falling in developed countries, meaning that Imperial Brands (IMB) is ex-growth. However, by focusing on what it does best (prioritising its key brands and geographies), IMB is consistently producing excellent cash flows year after year, which allows it to pay dividends and do share buybacks. In fact, IMB hits all three of Moore's buckets: its dividend yield is 5.8%, the dividend has grown 10% since 2021 and shares have more than doubled since their Covid lows.

Galliford Try, one of the UK's largest construction business, has gotten its act together since it was spun out of the homebuilder Vistry, by focusing on what it's good at, like IMB. One niche at which

Galliford is particularly adept is water infrastructure, which, considering the perilous state of the UK's waterways, has helped drive growth in dividend per share, alongside a special dividend paid to shareholders last year.

It could be argued that TP ICAP, the interdealer broker, is a more diversified and lowly valued version of LSE Group. Instead of focusing just on equity trading, as LSE does, TP hosts trading in the full range fixed income, commodities, equities and foreign exchange. LSE's data business propelled LSE to become one of the best businesses in the world in its industry and Moore thinks the same will happen with TP ICAP. That will help to drive the re-rating in shares, which are already up 150% since 2022.

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Why valuations matter

Julian Cane, manager of **CT UK Capital & Income (CTUK)**, reinforced the point that valuations matter and today, UK equities sit in a sweet spot of trading below their average historical price-to-earnings ratio but above their average historical dividend yield.

While predicting the future 10-year return of equities is less scientific for predicting the returns you get from investing in bonds, the basic principle remains the same: the more you pay for an investment, the lower the return it will generate.

At the stock market level, historically there has been a very close correlation between the price you pay and the return you get. Julian included a chart showing that on the two occasions markets have had a starting price to earnings ratio (PE) valuation of 40 times earnings, subsequent 10-year returns have been 5% a year and 3% a year.

Using a line of best fit, if you start at a PE of 10x, your compound return should be in the region of 15% a year over the next decade. If you start at a PE of 40x, your expected 10-year return should be closer to 2.5%.UK markets are currently below 15 times PE, so valuations look attractive.That's certainly been shown by private market investors, who continue to snap up cheap British businesses. In addition, the move to companies replacing some of their dividend payouts with tactical share buybacks makes sense and Julian dug into the nuts and bolts of that phenomenon.

In terms if the outlook, Julian noted that while confidence, both from a consumer and business standpoint, is pretty low right now, fundamentals look reasonable. Company balance sheets and individuals' disposable incomes are robust, for instance. That's a good place to start and should support valuations when confidence starts to slowly return.

Click here to watch the recording

Don't forget to **sign up here** for the BRAI webinar, due to take place at 2pm on Tuesday 3rd December.

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