



LIONTRUST

for financial advisers only

# pockets of value

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Jeremy Lang, Joint Investment Director, Liontrust, explains why income investing remains crucial and why he believes there is real value to be found.



We are in torrid times. Banks are being nationalised, stock markets have been tumbling and a recession is looming. In particular, with the troubles in the banking sector, advisers and investors are worried about dividend cuts. Dividends are usually the reliable part of stock market returns; sometimes the only part. If they cannot be trusted, it makes for particularly worrying times.

The good news, as I write this article, is the trailing dividend yield on the FTSE All-Share Index is higher than the yield on long dated gilts. As Graham Bentley has highlighted in the previous article, this is a rare occurrence; since 1959, it had happened on only two days (in Q1 2003).

Within a stock market yielding more than gilts, there are pockets of extreme value. More than 150 UK stocks with a market capitalisation over £100 million are yielding 2% more than gilts. This is an unusually high number. Again we have to go back to March 2003 for anything like as many.

## sustainable dividends?

The bad news is that next year's UK stock market dividend is likely to fall. For example, a significant proportion of the stock market dividend last year came from banks. But most UK-based banks are likely to suspend their dividends following the announcement in mid-October of the Government bail-out. Quite rightly, the Government says banks will have to repay taxpayers before dividends are paid to shareholders.

Non-bank stocks will also find it difficult to sustain their dividends over the next 12 months because of the difficult economic environment. This makes it highly likely that dividends in aggregate will fall sharply next year.

But there is nothing unusual here. Historically, the stock market has a high dividend yield when investors are most worried about dividend cuts. This does not make it a bad time to invest. Indeed, the UK stock market has tended to be most rewarding when you have been able to buy it on a high dividend yield.

## income remains key

A worrying outlook does not mean investors should shun equity income funds. Now, more than ever, having an investment that can keep paying you a decent income is important. Also, even though it may be difficult to see how that income may grow over the next few years, having an investment which, given time, will grow its income is vital. Historically, the stock market has done both – and income funds have done it best.

I have managed the Liontrust First Income Fund for more than 13 years, including during sustained periods (like 1998 to 2003) when a lot of companies cut their dividends. Yet, I have grown the dividend of the Fund every year for the past 12 years.

I have done so by balancing the portfolio between stocks on high dividend yields and no dividend growth with safer stocks on lower yields and good growth. By getting the balance right, I have been able to bear the risk of stocks cutting dividends.

## strong cash flows

While many stocks in the market will struggle to hold their dividends over the next year, unlike in 2003 the cash flow underpinning dividends is stronger. Many companies have been behaving prudently in the run up to the storm. There are sensible, sound businesses on rather silly, end of world prices. Thus, there is a lot of upfront dividend yield on offer. I believe this is more than enough to pay for the risks.

What about exposure to banks? Around 5% of my Liontrust First Income Fund is invested in HSBC, which is the only bank that will continue to pay dividends in the short term. The Fund has also held Alliance & Leicester but this has been taken over by Santander so it will be sold.

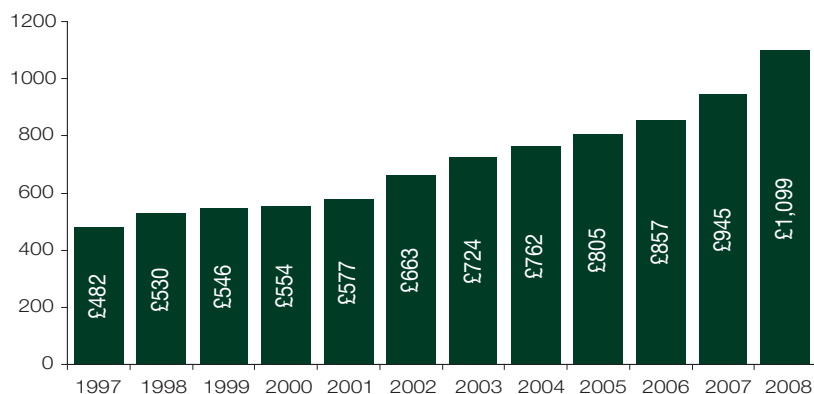
Around 6% of the Fund is invested in Lloyds and HBOS. I had already discounted a dividend payment from HBOS this year so the only real hole in the Fund in terms of dividend payments is Lloyds, which comprises less than 4% of the portfolio.

I will continue to own risk and balance this with dividend growth. I don't believe inflation has gone away, so the Fund will continue to own stocks which can grow their dividends, thus protecting the real purchasing power of the Fund's yield. ●

**The Liontrust First Income Fund is available through Skandia's Life, Pensions and MultiFUNDS fund ranges and the Selestia Investment Solutions investment platform.**

## Liontrust First Income – dividend history

The Liontrust First Income Fund has been managed by Jeremy Lang since 1 August 1996. The chart shows the dividend you would have received each year if you had invested £10,000 in the Fund on that date.



Source: Liontrust Investment Funds Limited. The full offer price of the Fund on 1 August 1996 was 72.26 pence. A sum of £10,000 invested on that date would have therefore purchased 13,838.92 units. The table above shows the income paid each calendar year on this sum. Past performance is not a guide to the future.

The Skandia fund will not mirror the performance of the underlying fund because of Skandia fund charges, taxation adjustments (if appropriate) and the Skandia investment process.

## inflation and stupidity

Governments have been interfering in markets, which were working fine, because they have a pathological fear of the 1930s. This obsession with the 1930s sows the seeds of inflation.

There is too much debt. This can be 'corrected', simplistically, in two ways. First is for the markets to be allowed to work and everyone will save more, spend less and pay off some of their debts. This means a recession and a resetting of living standards to a lower level. It is not the end of capitalism.

Second, the markets are hampered and governments print money to apparently buy our way out of problems. In my view, this allows moral hazard to run rampant (for which we will ultimately pay) and means inflation will accelerate. Moral hazard means stupid risk taking gets rewarded, and is paid for by those of us who do not take the stupid risks. This provides a big incentive for us all to behave stupidly.

The current policy response is riddled with inconsistency, the shape of it is unclear, the immediate consequences confusing. But the longer-term implications look clear to me. Inflation and stupidity are here to stay.

Today, it may be difficult to see when and how UK stock market dividends will grow. But, given time, if inflation stays around, I am pretty sure they will.



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