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DISCOVERING THE EQUITY INCOME GEMS:
ANALYSTS IDENTIFY INCOME STARS OUTSIDE THE UK AND GLOBAL SECTORS

With HSBC, Shell and BT among the many income stalwarts forced to cut or suspend dividends, income-seeking investors face lots of challenges. Investment companies in the **UK Equity Income**, **Global** and **Global Equity Income** sectors may be well known for their long track records of dividend growth, but are there **other equity sectors generating healthy yields** which investors might not have not considered?

The **Association of Investment Companies (AIC)** has spoken to investment company analysts who named investment companies in the **Japan**, **Biotechnology & Healthcare**, **Asia Pacific Income** and **Global Emerging Markets** sectors as ones to watch for income-seekers hit by COVID-19. Their top choices are below.

Annabel Brodie-Smith, Communications Director of the Association of Investment Companies (AIC), said: “Many income-seeking investors know the mainstream UK and Global sectors, but they might not have considered the income possibilities of sectors like Japan, Biotechnology & Healthcare and Asia Pacific Income. With the dividends of so many household names under pressure at home, this could be a good time to look further afield.

“Investment companies, unlike open-ended funds, can hold back some of the income they receive each year and tuck it into a revenue reserve. This means investment companies can use this reserve to boost dividends during more difficult times, like those we are seeing now. Many investment companies outside the conventional income sectors have built up substantial revenue reserves, which could help them continue to pay dividends to their shareholders even as many businesses are cutting theirs. Of course, dividends are never guaranteed and it’s the responsibility of investment companies’ independent boards of directors to decide on a dividend strategy that is in the best interests of shareholders.”

Preferred equity sectors for income-seekers

Anthony Stern, Analyst at Stifel, said: “We think the **Asia Pacific Income** funds offer a different source of income. Asia was the region first into the COVID-19 crisis and the first out. The Asian funds offer dividend yields of 5% or more and these dividends are fully covered by revenue income, unlike some trusts in the investment company world. The funds have been recognised for increasing their dividends over the long term and are part of the AIC’s next generation of dividend heroes. All of the funds have substantial revenue reserves which should allow them to maintain their dividends through their lean times.

"**Aberdeen Asian Income** is clearly the value play in the sector at a 13% discount and offering a 5.5% dividend yield. **Schroder Oriental Income** has been managed since inception by the highly experienced Matthew Dobbs. It has one of the best track records of the Asia Pacific Income funds on a total return basis and offers a dividend yield of 5.3%."

Anthony Leatham, Head of Investment Trust Research at Peel Hunt, said: "Outside of UK and Global Equity Income, there are a number of sectors and regions that offer attractive yields. We would highlight the differentiated equity income story in **Japan**. Richard Aston has been manager of **CC Japan Income & Growth Trust** (CCJI) since its launch in December 2015, boosted by the focus on shareholder return from Abenomics. CCJI currently offers a yield of 3.8% and an unconventional sector mix versus other developed market equity income strategies.

"**Healthcare** has historically been a valuable source of equity income for investors. However, this can be at the expense of capital growth. **BB Healthcare** pays its dividend out of capital and currently offers a yield of 3.0%. The benefit of this approach is that it allows the managers to adopt an unconstrained and high conviction approach, without being tied to the high-yielding, often ex-growth stocks in their universe."

Simon Elliott, Head of Investment Research at Winterflood Securities, said: "In our view, there is an attractive opportunity for UK-based investors to broaden their revenue streams, particularly away from the UK market, which has become increasingly concentrated in recent years. The prospect of both capital and income growth is a compelling combination and we have a bias to the Asian market. Our favoured investment trust in this area is **JPMorgan Asia Growth & Income**, which actually pays an enhanced dividend, i.e. an element is paid from realised profits or capital. Its dividend is reset every quarter, with 1% of net assets paid to shareholders. As a result, its dividend will vary in absolute terms, but we believe that it is justified by the fact that the strategy allows exposure to high growth internet companies such as Tencent and Alibaba that do not pay dividends.

"Similarly, we believe that the wider **Global Emerging Markets** universe offers increasingly attractive income opportunities and are recommending **JPMorgan Global Emerging Markets Income*** at present. The fund seeks to pay a covered dividend and has a significant exposure to financials. In addition, it has revenue reserves equivalent to 1.3 times the previous year's dividend."

The trend towards dividends

Anthony Leatham, Head of Investment Trust Research at Peel Hunt, said: "The **Japanese equity income** story is a more recent phenomenon, underpinned by strong company balance sheets and net cash positions as well as the increased focus on return on equity as the key performance metric. **Healthcare**, particularly large-cap pharma, has been a valuable source of income in the UK market but the global opportunity set has evolved and the exciting growth stories are unlikely to be the dividend paying stocks."

Risks – active management is "key"

Simon Elliott, Head of Investment Research at Winterflood Securities, said: "With any investment trust investing in equities overseas for income, there is always the potential for adverse currency movements. These can be meaningful and counter any increase in the level of the underlying dividend, however, this obviously works both ways. Sterling has proven relatively weak in general so far this year, which provides a following wind for overseas equity income mandates."

Anthony Leatham, Head of Investment Trust Research at Peel Hunt, said: "Given the disruption in markets and the uncertainty surrounding future earnings, corporate dividend policies are being reviewed. In the case of **Japan**, the dividend culture has been quick to take hold and shown resilience. However, active management has been key to navigating away from higher risk sectors."

Outlook – high yields from a wider range of sources

Simon Elliott, Head of Investment Research at Winterflood Securities, said: "A large number of companies around the world are under pressure at present as a result of the impact of COVID-19 and this will ultimately result in lower dividend payments. However, investment trusts investing outside of the UK for income have the significant advantage of selecting from a wide array of sources. In addition, many have the benefit of revenue reserves built up over a number of years. These should provide some support in the event that there is a meaningful decline in revenue.

"The ability of investment companies to pay enhanced dividends has been an interesting development in recent years. With shareholder permission, investment companies are now allowed to pay income out of capital in the form of realised profits. This means that the portfolio could in theory be invested for capital growth, while the structure of the listed closed-end fund generates the income. This has meant that asset classes that were not historically noted for generating income can now offer investment companies with high yields. This includes **Biotechnology & Healthcare** (**International Biotechnology**), **Private Equity** (**BMO Private Equity** and **Standard Life Private Equity***) and **Japanese Smaller Companies** (**JPMorgan Japan Smaller Companies**). This practice is not uncontroversial and some have objected to the tax inefficiencies of converting capital into income. However, the rationale is that investment companies offering income appeal to a wider investor base and could see discount levels narrow in time as a result of a pick-up in demand."

Anthony Leatham, Head of Investment Trust Research at Peel Hunt, said: "There has and will continue to be dividend disruption facing the market as a result of COVID-19 and its economic impact. Revenue reserves have helped investment companies to deliver income to shareholders through periods of stress and we expect to see this play out again. Volatility may also give certain investment companies more opportunity to use option strategies to enhance the income generated by their portfolios. In addition, investment companies can employ gearing to take advantage of market dislocations, boosting the yield.

"Finally, the closed-ended structure protects portfolio managers from becoming forced sellers. Open-ended fund managers have had to deal with redemption requests and this can have a detrimental impact on portfolio performance and income generation."

- ENDS -

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members add value for shareholders over the longer term. As at the end of March, the AIC had 363 members and the industry had total assets of approximately £184 billion.

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