The Investment Podcast

Episode 38: The return of equity income
13 May 2024

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Romil Patel: Hello, and welcome to *The Investment Podcast* brought to you by M&G Investments. My name is Romil Patel, and I'm delighted to be joined in the studio today by Alex Araujo, Global Listed Infrastructure Fund Manager, and Stuart Rhodes, Global Dividend Fund Manager. Welcome to you both. It's a real pleasure to have you on *The Investment Podcast*.

Stuart Rhodes: Thanks for having me.

Alex Araujo: Thank you.

Romil: Well, today's topic is income. In the aftermath of the global financial crisis (GFC), income investing and equities found itself in the wilderness for the next decade, becoming somewhat of a forgotten art form. The only way to outperform between 2010 and 2020 was to be at the growth end of the spectrum, specifically the US. That all changed abruptly in 2022, with spiralling inflation and rising interest rates. So, why did income find itself out of favour? What were the ramifications having snapped out of that anomalous decade, and where are we now?

Stuart: I think the last decade is a good place to start when addressing this question. Because really, the global financial crisis did change a lot of things, and it did affect how income investors could perform against the wider markets. Really, this became very noticeable in the second five years, so [around] 2015 up until the Covid period. I would say that was when growth really was starting to ramp up and take over the vast majority of performances, especially in the US indices, which make up the vast majority of the global index.

This provided a fair amount of a headwind towards anyone who is investing in equities for income and income growth because the main drivers of performance was coming from the US tech sector. A lot of those companies, up until very recently, didn't pay dividends. Then, I guess, really, during Covid, we had this last surge of growth. This is not from the big mega-cap tech names, but actually from what we would describe as the much more speculative areas of technology, which didn't have any cash flows, and was very much dependent on longer-term growth.

That almost became a bubble. In 2020 and 2021, that was when life got very challenging to perform from an equity dividend perspective. That's quite a long period of time. Anyone doing this was forgotten about because all the performance was elsewhere. As we know, things changed very abruptly in January 2022, when rates and yields started to move up and move up quite aggressively. That put a dent in pretty much most of the growth spectrum of the equity market.

It especially dented the speculative side, and that bubble really did burst. That has made a lot of people think again about being a little bit more diversified than they potentially were. Equity income strategies had a fantastic year that year, and very much feel like they're competing on a much more level playing field than they were in that previous decade.

Romil: Thanks, Stuart. So, what do equities offer? In other words, why equity income, Alex? What makes this compelling?

Alex: Without overcomplicating it, it depends what term of fixed income. What kind of cash are we talking about? My son's just started saving from his job, and he's very tempted by the one-year rates being offered at 4%. But in a year he'll have to decide what to do next, whereas equities provides some permanence. It's that growth in the income and the increased cash flow streams – particularly in an inflationary environment – that provide protection. That's absolutely key.

We're investing in the equity market for the long-term, and the duration of the underlying businesses, business models and assets are what provide that consistency and that ability to deliver long-term dividends, and particularly ones that grow. It's really thinking about your investment horizon ultimately, rather than just being attracted by a very short-term, higher-yield type of offering.

Stuart: I'll just add, I think really most of the long-term successful track records within dividend investing have had that focus on growth because that is what you need to protect yourself against longer-term inflation rates. Alex put it very nicely, but you've really got to be obsessed by why that dividend stream can grow because otherwise, if you sit there receiving a dividend yield of six or seven, that might feel good in year one and year two, but inflation quickly eats away at that.

Also, growth companies catch up with that level quite quickly. We are very much looking for those businesses offering decent starting yields of three, four, five, six, but they really need to have that capability of growing that dividend rate at a rate that competes or hopefully betters inflation.

Romil: Speaking of these companies, both in terms of sectors and geographies, where are you seeing opportunities in this renewed world of income investing, Alex?

Alex: It's fascinating to see that the market has been quite indiscriminate in penalising dividend-paying stocks. It's remarkable that just by virtue of not paying a dividend or paying a low dividend, certain segments of the equity market have significantly outperformed those that do deliver the dividend. That's ignoring the companies actually delivering the earnings and the cash flow and the growth to back those dividends.

In my world, I'm an infrastructure investor, one of the most compelling areas currently is the utility sector, which continues to deliver consistent earnings growth – in fact, higher than market this year, yet because these are dividend-paying stocks, they've been punished by the market. It's ironic to me that last year the utility sector globally underperformed the broader market by the most in decades at a time when earnings were robust, were growing, and dividends were growing on the back of that, so that's one area.

This is particularly true in the US where the market is pretty savage. It typically means that in any given market, sectors that are winning mean that by definition there need to be sectors that are losing badly. Utilities have been caught up in that, as have companies structured as real estate investment trusts (REITs), which are companies with real assets at their core but are perceived to be interest-sensitive. Yet those that deliver earnings growth continue to be absolutely compelling.

Stuart: I would add two other sectors to that as potentially starting to offer up what we would describe as pretty compelling value, or at least much better value than what we've been used to for the last five or six years. Alex has mentioned utilities and REITs, some of the other more defensive sectors have also been caught up in this. I'd highlight consumer staples and healthcare as two traditional defensive areas of the market which have not really provided you with those defensive returns recently. Their valuations have moved back and moved back quite materially.

Consumer staples, for example, it went through – I won't say bubble, but it went through a very elevated period in terms of what people were prepared to pay for some of these businesses, really from 2014 to 2020. We've started to see those valuations come back and, in some cases, come back quite a long way. I've been running this dividend strategy since 2008 and felt like it's been a long time before we've started to get the types of entry points within consumer staples that we got back when I first launched the fund in 2008.

We're certainly getting a little bit more interested in that area than we have been for some time. As I mentioned earlier, healthcare is the other sector which I think shows some pretty compelling value at valuations meaningfully cheaper than that of the market level. Yet with, in some cases, decades of track record of paying a very compelling dividend that grows nicely. There are certain areas of the market that really are starting to offer much better value than we've been used to in those areas for some time.

Romil: Stuart, what are some of your favourite types of dividend-paying companies and what does a typical investment look like?

Stuart: I would say a typical investment over the years has tended to look like a company where the starting dividend yield is maybe 3.5-4%, but then they're able to grow that dividend at north of 7-8% level. If we can get as close to 10% growth as possible, then we feel that's a pretty compelling entry point for this business because not only is your starting dividend yield quite competitive and at a decent level, but also compounding at 7% on top of that is really quite powerful.

The longer you're able to keep that growth rate at 7-8% per annum, the more upward pressure there is on the share price because that dividend just gets bigger and bigger and bigger each year. Therefore, naturally, there's a lot of upward pressure for that share price to move alongside that dividend, and therefore you get that powerful combination of not only all those dividend payments but also the capital re-rates with it.

Alex: Coming back to the utility sector which is a real area of focus for me, if you look at the long-term track record of earnings growth and dividend growth for that sector. What it ultimately means is a very strong performance in total return because of that compounding of the income and how much of the return is made up by that growing dividend stream. Ultimately, what some people think of as a bit of a boring sector despite all the excitement around the energy transition and energy security, turns out to be a sector that can very capably compound and generate high total returns.

Romil: Well, unfortunately that's all we have time for on today's episode of *The Investment Podcast*. Alex, Stuart, it's been a real pleasure to sit down and spotlight income investing in equities with you both. Thanks indeed for sharing your insights.

Alex: Thank you.

Stuart: Thank you.

Romil: Thanks to you, our audience, as ever for tuning in. We look forward to welcoming you back next time, but it's goodbye for now.

Speaker 2: For further information, please view the notes which accompany this episode. This podcast is for investment professionals only. The value of investments will fluctuate, which will because prices to fall as well as rise, and investors may not get back the original amount they invested. Past performance is not a guide to future performance. The information and views expressed should not be taken as a recommendation, advice, or forecast.

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