



Reinvesting income boosts total returns

Overview

The need for income generation is becoming increasingly important as an ageing population demographic combines with historically low interest rates meaning that the usual safe havens for income investors such as deposits and bonds are not currently generating sufficient returns. Whilst not providing a capital guarantee, equity income investing has moved to the top of many investors' agendas and in this document we explore why equities are an attractive option and what is driving these returns.

Key points

- Equities offer an attractive option for income seekers in the current low growth inflationary environment.
- Dividends are as important as ever – they are a major driver of overall returns.
- Equity income is not just a UK phenomenon – investors can look further afield.

We have produced a range of documents called the *Threadneedle Income Series* which explore the need for income and the economic and demographic factors driving this trend.

Threadneedle Income Series 1 – Financial markets are being shaped by a flat economic outlook.

Threadneedle Income Series 2 – Retirement is going to need to become more flexible.

Threadneedle Income Series 3 – Reinvesting income boosts total returns.

Visit threadneedle.co.uk/income for more information.

The financial income argument for income-generating investment

The financial argument for income-generating investment rests on the critical component that reinvested income plays in the total return of an investment.

- For some investors, the income from dividend payments is needed to meet living costs.
- For others, reinvesting income adds a significant amount to the total return from an equity investment. And the longer the time horizon, the greater part that income plays in total return.

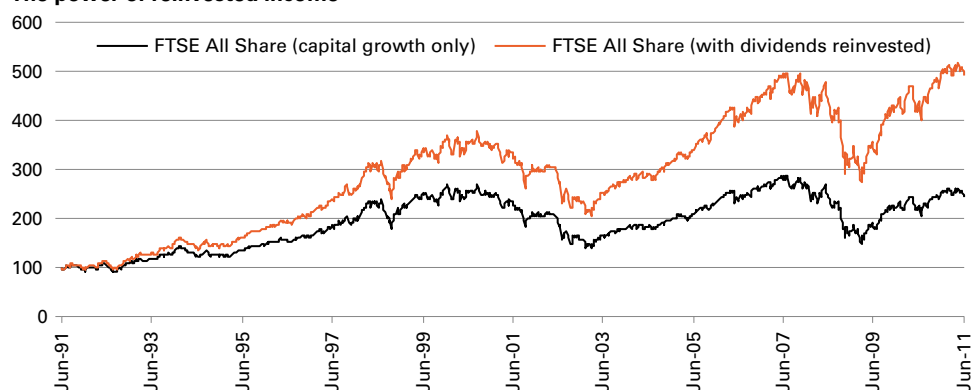
Equities are an attractive option for income seekers

With interest rates at 0.5% in the UK (September 2011) and a higher rate of inflation combined with uncertainty about its future direction, cash on deposit and government and corporate bond yields are relatively unappealing to investors. These factors are leading income seekers to search for alternative sources of yield, and equities are proving an attractive option. Moreover, the diversification benefits offered by an international approach mean that global income funds are likely to become increasingly popular. Investors should remember that returns on equities can be volatile, especially over the short term and offer no capital guarantee.

Equities have historically been a good source of income for investors because well-managed companies have been able to raise their dividends faster than the rate of inflation, providing real income growth that is hard to achieve in other asset classes. Add to this the prospect of healthy capital gains and the case for equities looks even stronger.

Over the long term, a critical component of the total return from shares has been reinvested income, as illustrated in the graph below. Dividends are the investor's share of a company's profits. If a company is making good profits and decides to share this with investors rather than reinvest it all in the business, it will pay a dividend. One of the most attractive things about dividends is that they can be more predictable than share prices because companies will usually continue paying dividends even if their profits fall temporarily. In fact, some company directors tend to view the dividend as a sign of corporate strength. Some companies actively target rising dividends. This is particularly true of companies that attract investors for a good source of dividend income.

The power of reinvested income



Source: Datastream, 20.06.2011.

Note: The difference between the black and the orange lines demonstrates the effect of reinvesting income. The orange line is the FTSE All Share with dividends reinvested.

The importance of dividends – a return to the norm

The breakdown of total return between capital growth and income will vary from company to company, with younger businesses tending to produce lower dividends but the potential for premium growth. Conversely, higher yielding companies tend to be more mature and often operate in industries with highly predictable revenues, such as utilities. These factors help them to pay high and rising dividends.

The attractive combination of capital appreciation and dividend growth was upended by the credit crunch, when share prices fell sharply and a number of previously dependable companies were forced to cut or suspend their dividends. However, economic conditions have now stabilised

sufficiently for companies to be generating robust cash flows and looking to the future with increasing optimism. The tendency to reduce or stop dividend payments has now started to reverse and a profitable business should be able to grow its dividends over time, providing income investors with a degree of inflation-proofing that conventional bonds cannot currently match.

Over the past few months companies as diverse as BP, Fiat and Wosleley have resumed payments and Tiffany, Domino's Pizza and Aggreko have all announced significant rises in their dividends. Companies are usually loath to increase dividends unless they are confident that the higher rate can be maintained. As such, the recent actions suggest a high degree of confidence in future trading. This list of companies also shows that income-generating stocks are available across a wide range of sectors. From a stock selection perspective, of particular interest now are stocks that can grow in a low-growth world and stocks where there is a clear valuation opportunity.

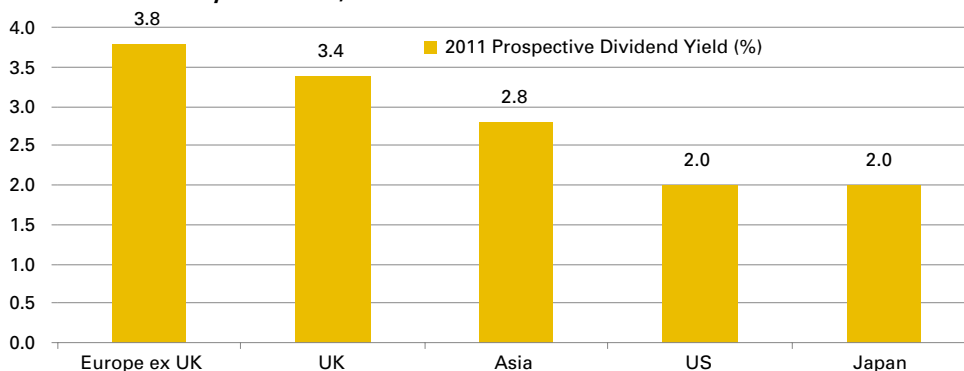
Opportunities for equity income abound in the UK and overseas

UK-based equity income investors have traditionally focused on the domestic market. This remains a valid approach, with the UK offering a wide range of companies with the potential to deliver healthy growth of capital and dividends. One reason for emphasising a UK focus is because of its strong culture of dividend distribution. Dividend cover (the amount by which company earnings cover dividend payments) for the UK market is, on aggregate, 2.6. This low figure reflects a management culture keen to pay a reasonable proportion of profit to shareholders on an ongoing basis, and compares favourably with international markets: in Japan it is 3.3, emerging Asia 3.2, 2.8 in Latin America, 3.5 in Central and Eastern Europe and the Middle East, and in the US, the dividend cover is 3.8. (Threadneedle, 13 May 2011).

International markets offer greater scope for diversification and there are some good opportunities available. In particular, European equities currently offer a higher dividend yield than that in the UK. Furthermore, yields on many good quality European stocks are higher than those available on the corresponding corporate bonds. This is an unusual state of affairs and one that typically indicates the potential for equity market outperformance.

Further afield, Asian companies have generated impressive earnings in recent years as a result of strong economic growth in the region. At the same time, there is a growing trend for Asian businesses to distribute excess cash to shareholders. Today, Asian yields are not far behind those on offer in the UK, and there is every chance that the gap will narrow in the coming years as Asia's relatively strong economic fundamentals continue to feed through to higher earnings and dividends.

Estimated dividend yield returns, 2011



Source: Threadneedle, 17.06.2011.

The healthy dividend yields available in international markets mean that well-resourced managers can now offer more geographically diversified income portfolios. A global approach allows fund managers the flexibility to allocate actively to the markets that offer the best combination of growth and income.

They also permit investment in high growth stocks in areas such as technology, where the current yield may be modest but there is significant potential for rapid dividend growth. Casting the income net more widely also offers greater opportunities for sector diversification. For example, in the technology sector, there are currently no companies yielding more than 4% in the UK. However, a global approach increases this opportunity set to 37 stocks. It is a similar story in the basic materials and industrials sectors, where a global remit also exposes investors to a wider range of world-beating, high-yielding companies.

Threadneedle for income

Over the longer term, the income component of total return on equities is significant enough for investors to think of this asset class when considering how to meet their income requirements as well as for realising optimal returns through the combination of reinvesting income and capital appreciation. Of course, past performance is not a guide to future performance and the value of investments and any income derived from them may fall as well as rise. Investors should remember that returns on equities can be volatile, especially over the short term and offer no form of capital guarantee.

Threadneedle has an outstanding track record in developing both income and growth from a selection of equity income funds. Our range covers both core UK equity income funds as well as a global offering which offers the potential to access a diverse and exciting range of markets not usual open to equity income investors.

For more information on Threadneedle's income funds visit threadneedle.co.uk/income or speak to your usual representative.



Find out more

Speak to your usual Threadneedle Investments contact.
Visit threadneedle.com

Important Information: For Investment Professionals use only, not to be relied upon by private investors. Past performance is not a guide to the future. The value of investments and any income from them can go down as well as up. This material is for information only and does not constitute an offer or solicitation of an order to buy or sell any securities or other financial instruments, or to provide investment advice or services. The mention of any specific shares or bonds should not be taken as a recommendation to deal. The research and analysis included in this document has been produced by Threadneedle Investments for its own investment management activities, may have been acted upon prior to publication and is made available here incidentally. Any opinions expressed are made as at the date of publication but are subject to change without notice. Information obtained from external sources is believed to be reliable but its accuracy or completeness cannot be guaranteed. Issued by Threadneedle Asset Management Limited. Registered in England and Wales, Registered No. 3701768, St Mary Axe, London EC3A 8JQ, United Kingdom. Threadneedle Investments is a brand name and both the Threadneedle Investments name and logo are trademarks or registered trademarks of the Threadneedle group of companies. threadneedle.com