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Investors' Guide to **Equity Income**

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Important Investment Notes

All stock market investments can fall in value as well as rise, so investors could get back less than they invest and they should be regarded as long-term investments. This guide is based on our understanding of the current tax rules and regulations. Whilst the tax benefits we refer to are those that currently apply, they can change over time and their value will depend on individual circumstances. This guide is written for investors who like to make their own investment decisions; it is not personal advice. If you have any doubts about the suitability of an investment for your own circumstances please seek expert advice. Correct as at 1 July 2016.

A great investment for almost any portfolio

Danny Cox
Chartered Financial Planner

There is one investment we have highlighted throughout the history of Hargreaves Lansdown. We believe it can form the cornerstone of most portfolios, from the first-time investor to the seasoned professional.

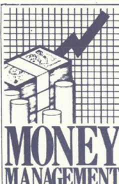
The investment is an equity income fund.

In the very first newsletter we wrote in October 1981 we highlighted two equity income funds. Subsequently we had an article published in Accountancy Age in October 1986 on the same topic.

Since our 1981 newsletter markets have endured numerous crises and political events - Black Monday in 1987, the 2000 technology crash, 2008's financial crisis and most recently the vote to leave the EU. Yet throughout this period we have continued to suggest equity income funds to our clients. Like all stock market investments, they

Peter Hargreaves of Hargreaves Lansdown, Embassy House, Queens Avenue, Clifton, Bristol BS8 1BR Avon discusses the use of income unit trusts in all investors portfolios. Re-printed from Accountancy Age 23 October 1986.

An income unit-holder doesn't fear the future



Peter Hargreaves, a partner with independent investment managers Hargreaves Lansdown, examines the advantages of income unit trusts and tracks some spectacular performances.

There is one investment which no investor can afford to ignore. Whatever the clients' age, tax rate, personal circumstances or requirements are, there is use in their portfolio for an income unit trust.

The investment has the following potential:

- ☐ Capital growth.
- ☐ Growth of income.
- ☐ Reasonable stability.
- ☐ Inflation beating total performance.
- ☐ A realistic income.
- ☐ Useful for anyone.

Obviously there are specific types of clients for whom income unit trust are most useful and in general they are perfect in the following cases:

- ☐ The retired client.
- ☐ A widow.
- ☐ The infant.
- ☐ The majority of trusts.

Unfortunately in many cases capital is acquired at a time of maximum insecurity (viz the retired couple or the widow).

In the first instance the retired person feels insecure with the loss of his salary and the widow's insecurity of course needs no explanation. Therefore there is always a temptation to place the capital to provide the absolute total maximum income. Of course not just in the case of widows but in the case of retired couples, their life expectancy could be a further 20 years.

It may well be that we have no inflation in the next 20 years and hopefully never again that which was experienced in the 1970s but 20 years is a long time in the future when you consider that 20 years ago £50,000 was considered to be more than enough to retire on without any other income.

In general deposit will always bring you maximum income at any time but deposit can be a folly.

During the periods of maximum inflation in the 1970s the income from deposit was actually going down, whereas the income from actuaries all share index went up every single year even during periods of dividend restraint.

Also during the worst four years of inflation 1975-78, the yield from deposit went down in every year except 1977 when interest rates rose slightly.

When one adds to that performance the extra management that an income unit trust affords it can be seen how income unit trusts can much improve an investors return.

Figure 1 shows how Prolific's high income has improved its income year after year until now the income unit trust is providing four times as much income as an equivalent investment in the building society.

Although we are not offering capital growth for the retired client I don't think they would be too disappointed with the value of their capital now. We have always wondered why income unit trusts can provide more capital performance than the so called pure growth funds.

We do have a theory: if one watched share prices they tend to do very little other than reflect the general market for fairly long periods of time. But a particular investment comes in vogue, is mentioned in various stockbrokers circulars in the Sunday press and suddenly the share price goes up very rapidly.

In a growth fund the fund manager has no incentive to sell and buy something else but of course in an income fund the fund manager must sell since the yield has not increased and therefore his unit trust is more highly valued and new investors will not get the same yield as old investors. We believe this enforced management is one of the reasons for the success of income unit trusts.

It is interesting that M and G regularly commission a chart from *Planned Savings Magazine* showing the performance of M and G Recovery since its launch. Not surprisingly M and G Recovery was the top performing fund over that period. Even more interesting is the fact that in the top 20 funds, 11 of them are income funds (figure 2).

In conclusion we believe that all clients should have some exposure to income equity. It is perfect for the retired client, it is perfect for the trustee who wishes to give a reasonable income to the life tenant and reasonable capital growth to the remainderman.

From 1 January 1987 every taxpayer in the UK will be eligible for a personal equity plan.

This in many cases will be the first time a higher rate taxpayer has become interested in income equity.

We believe that reducing interested rates and the attractions of income equity will make income unit trusts continue to give the same performance we have come to expect from them.

Prolific's high income units were first offered to the public on 2 September 1974 at an equivalent offer price of 16.7p. * The table illustrates the income produced by an investment of £10,000 on that date compared with a similar investment in a building society paid-up share account assuming 1% more than standard rate was achieved.

Year (to 31 Oct)	Prolific high income £	Bid value (on 2 Sept) £	Building society interest £	Capital value £
1975	762	13,040	851	10,000
1976	938	13,840	790	10,000
1977	1,068	19,500	847	10,000
1978	1,252	24,140	715	10,000
1979	1,366	27,420	928	10,000
1980	1,608	28,160	1,168	10,000
1981	1,610	34,940	1,027	10,000
1982	1,746	37,560	1,025	10,000
1983	1,974	48,240	786	10,000
1984	2,310	60,060	820	10,000
1985	2,784	79,260**	881	10,000
	17,508		9,978	

If you had invested £10,000 in the Prolific high income trust when it was launched on 2 September 1974 and had reinvested all the income, your holding would now be worth £151,736. So the Prolific's high income trust has, over this period:

- Substantially out-performed a building society investment.
- Given a return greatly in excess of that needed to match inflation.
- Is now producing an income over three times that being received by the building society investment.

* The original launch price was 50p per unit. On 29 January 1982, each unit was sub-divided into three.
** The capital value would be £112, 140 on 1 July 1986.

Figure 1: how Prolific's income has improved

Unit trust performance table prepared by *Planned Savings* 1 June 1969 (launch of M and G Recovery Fund) to 1 January 1986. Using an original investment of £1,000 with net income reinvested. Offer to bid price basis.

	Fund	Value
1.	M and G Recovery	26,777.3
2.	Framlington Capital	18,210.1
3.	M and G High Income	13,333.0*
4.	Schroder Income	12,407.0*
5.	Henderson Income and Growth	11,817.8*
6.	Midland Income	11,801.3*
7.	Barclays Unicorn Income	11,795.3*
8.	Equitable Pelican	11,745.0
9.	M and G Dividend	11,701.2*
10.	Allied Dunbar High Income	11,562.1*
11.	Henderson High Income	11,353.6*
12.	M and G Midland and General	11,345.6*
13.	Barclays Unicorn '500'	10,820.0
14.	M and G Second General	10,656.1
15.	GT UK Capital	10,354.5
16.	Allied Dunbar Equity Income	10,349.2*
17.	M and G Smaller Companies	10,161.7
18.	S and P High Return	10,080.4*
19.	Allied Dunbar Smaller Companies	9,735.1
20.	Discretionary	9,425.8

Income funds denoted by a *

Figure 2: the top 20 funds.

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fall as well as rise in value. However, those who have invested for the long term in equity income funds will be delighted with the results.

Quite simply, no other investment has endured like equity income. This guide aims to explain why.

£3.00

EQUITY INCOME

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HL Equity Income Guide – 1994

Introduction

People retiring today can usually expect to live longer than their parents and grandparents. This should be to the fore in investment planning. In some cases, investors are saving for future security, and to provide income in retirement. In other cases, they are already using their capital to supplement income. In every case the capital may be needed for the next 30 years or even longer. We believe there is one investment which stands head and shoulders above every other in meeting this objective - equity income.

The first home for savings and investments is sensibly the bank, the best understood of all investments. Deposit in a building society or bank provides a fluctuating income, but certainty of capital. This is appealing to investors who value the security of knowing how much capital they have, as well as instant access.

For short-term needs, and a rainy day fund, cash savings are perfect. However, longer term, the complete stability of cash can be disastrous for anyone who requires their capital to see them through the next 30 years. An historically modest inflation rate of just 2% would reduce the real value of £10,000 to £8,171 over 10 years, to £6,676 over 20 years and £5,455 over 30 years.

Equity income provides the potential for not only a growing income but for capital growth too, giving investors a hedge against the effects of inflation on their income and capital. Traditionally, there have been two sticking points when investors compare equity income with deposit savings accounts. Firstly, the initial yield in the building society was invariably superior to that from equity income. Secondly, some investors are uncomfortable with the fact that their capital fluctuates; equity income does not include the guarantee of capital provided with bank and building society deposit.

Today, with interest rates languishing at historic lows, the first objection no longer exists. Everyone should have some capital accessible in the short-term for emergencies. However investors should not be so concerned about fluctuations in the value of capital that they have no intention of spending. This portion of their portfolio could be invested in equity income funds, which aim to provide a rising income over time, as well as some capital growth, although naturally there are no guarantees.

An investment for all seasons - equity income

Equity income is a key way to invest to provide a reasonable income which also has the potential to improve year by year. Currently, the average share produces a yield of 3.8% (FTSE 100 at 30 June 2016 and many equity income funds yield in the region of 4%.

When one considers that nowadays investors can place part of their equity income portfolio into an ISA, where there is no UK tax to pay on any income, the idea becomes even more attractive, but please remember tax rules can change, and the value of benefits will depend on individual circumstances.

Equity income - a brief summary

Equity income is investing in the purest sense. When you buy shares in a company you (quite literally) own a share of that company and will receive a share of any profits by way of dividends (the income). The best companies will find ways to increase their revenue over and above the rate of inflation, or reduce their costs, significantly increasing their profits. Nothing is guaranteed though; some companies will fare poorly, profits and therefore dividends and ultimately the share price, will fall. However, for companies where the dividend rises, the value (and therefore the price) of each share should also rise, so as well as a healthy level of income, investors could also benefit from capital growth. These are the types of companies equity income investors seek.

A growing income?

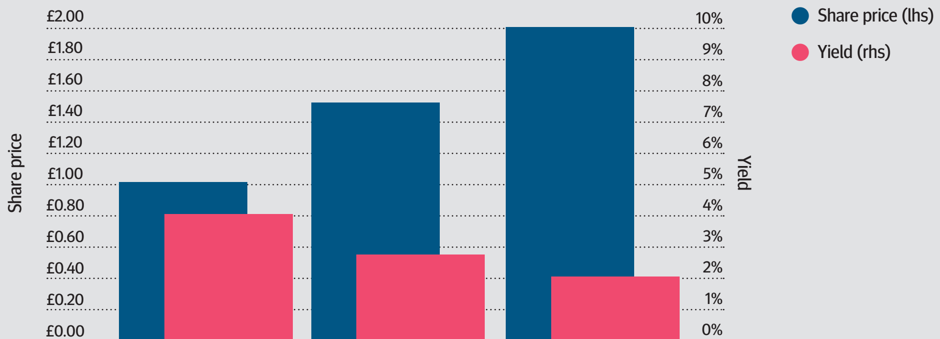
There are many quoted companies which have historically provided not only reasonable dividends, but a track record of growing profits and consequently improving dividends. These companies tend to be long-established and in lower-risk industries.

We show opposite the dividend growth for the company, Reckitt Benckiser. They have managed to significantly improve their dividends over the course of the last two decades. Thus an investor in 1997 is now obtaining an annual income considerably greater than that when they originally invested, and indeed the value of the income has more than kept pace with inflation. The dividend growth shown is quite impressive. This performance is exceptional and all dividends are variable and not guaranteed.

Share price, income and yield

They are not the same, but they are intrinsically entwined. Income is the actual amount of money you receive from a share's dividend. Yield is this income expressed as a percentage of the current share price. If a company pays a consistent dividend, but its share price changes, so will the yield. Imagine you purchased a share for £1. The company pays a consistent dividend of 4p per share - a 4% yield when the shares trade at £1. However, as the share price (blue) appreciates, the yield (purple) falls, as the dividend represents a smaller proportion of the value of each share. If the share price doubles to £2, the yield falls to 2%. Note however that the amount of income does not change - you still receive 4p per share.

HOW SHARE PRICE APPRECIATION AFFECTS YIELD WHEN DIVIDENDS ARE CONSTANT



Year	Net dividend per share (p)	Annual dividend increase
1997	24	N/A
1998	25.5	1.5%
1999	25.5	0.0%
2000	25.5	0.0%
2001	25.5	0.0%
2002	25.5	0.0%
2003	28	2.5%
2004	34	6.0%
2005	39	5.0%
2006	45.5	6.5%
2007	55	9.5%
2008	80	25.0%
2009	100	20.0%
2010	115	15.0%
2011	125	10.0%
2012	134	9.0%
2013	137	3.0%
2014	139	2.0%
2015	139	0.0%

Past performance is not a guide to future returns. Dividends can fall as well as rise.

This represents a total improvement in income since 1997 of 479.2%.

Source: Bloomberg, to 01/04/2016.

Most private investors prefer not to invest in just one company, even though it has a good growth of income record. No company, whatever its size and strength, can guarantee to increase its dividends every year, so we suggest investors consider holding a portfolio of companies, including higher risk smaller firms and established heavyweights. For most investors this will mean investing via collective investment products, where a professional manager chooses the underlying investments on investors' behalf. Two of the most popular types are unit trusts and open ended investment companies (OEICs). Most collective funds hold many different investments (60-100 is typical), which helps manage risk.

How to buy equity income

A convenient way of investing in equity income is through unit trusts or OEICs. The fund managers make an annual charge, often deducted from capital. In other words, investors will receive the quoted yield in full. If they invest in an ISA or SIPP there is no further tax payable on this income, whatever their tax rate. Please remember tax rules can change and the value of benefits will depend on individual circumstances.

Rathbone Income is a long standing equity income fund available through Hargreaves Lansdown. The following impressive table shows the income achieved each year from the Rathbone Income Fund since 1995, based on £10,000 invested.

Unlike cash, stock market investments are not guaranteed so their value and income can fall as well as rise, so investors could get back less than they invested. Also, inflation will erode the spending power of capital and income over time.

Year	Rathbone Income	Interest on cash
1995	£497.47	£637.29
1996	£524.39	£573.23
1997	£571.41	£637.19
1998	£638.51	£698.01
1999	£703.61	£520.69
2000	£737.36	£582.13
2001	£792.81	£496.69
2002	£822.15	£392.85
2003	£856.31	£362.65
2004	£890.46	£430.91
2005	£916.98	£454.97
2006	£1,019.45	£454.96
2007	£1,151.65	£538.57
2008	£1,244.07	£452.55
2009	£1,073.30	£62.28
2010	£1,084.54	£49.89
2011	£1,093.79	£49.89
2012	£1,128.34	£49.89
2013	£1,174.96	£49.89
2014	£1,215.95	£49.89
2015	£1,271.39	£49.89
Total income	**£19,408.90**	**£7,594.31**

Past performance is not a guide to future returns. Dividends can fall as well as rise.

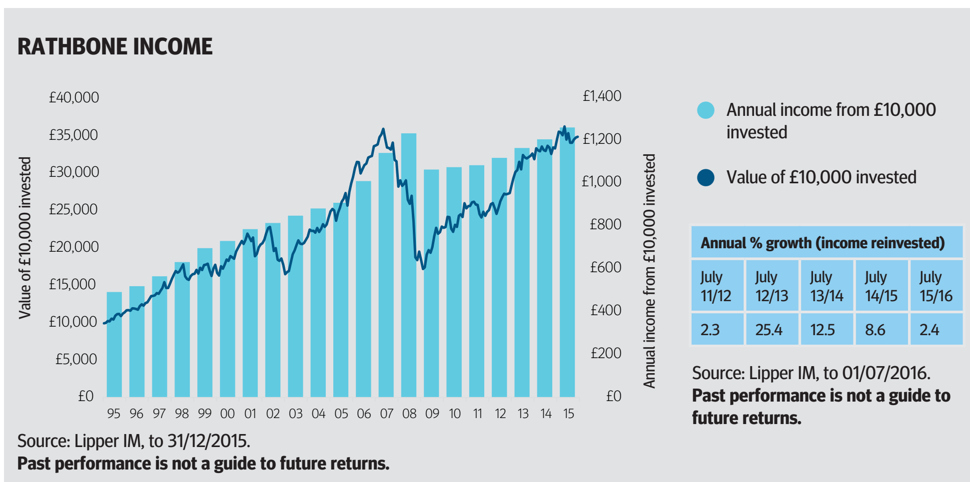
Source: Rathbone Income - Lipper IM, from 03/01/1995 to 31/12/2015. Building Society returns are those you would have received from an account tracking the Bank of England Base Rate, without any tax deducted.

The total yield from equity income

When an investor chooses to buy an equity income fund, we believe that they should be utilising investment capital that they are unlikely to touch. This is because capital invested in the stock market is likely to fluctuate in value. Certainly there may be times when investors will commit themselves to equity income and always find their investment in profit, but there are other investors who will certainly see a short-term capital decline in line with stock market fluctuations.

There is no doubt that any investment which can potentially improve its income year by year should also in the medium-to-long term become more valuable. We would expect most equity income funds to improve their income over time although there are no guarantees. As it rises, new investors should, in theory, be prepared to pay more for that income. It is therefore not unreasonable to assume that the share price will improve in line with the dividend improvement. However, some companies will go into decline for any number of reasons and lose investors money. It is the job of the fund manager to try and avoid these.

In the long term, dividend growth and capital growth are both potential returns to investors in equity income, as shown in the chart to the right. You will note that there has been strong income improvement. We would also draw your attention to the excellent capital growth, although there has been considerable volatility along the way, and remember past performance is not a reliable guide to future returns.



Annual % growth (income reinvested)				
July 11/12	July 12/13	July 13/14	July 14/15	July 15/16
2.3	25.4	12.5	8.6	2.4

Source: Lipper IM, to 01/07/2016.
Past performance is not a guide to future returns.

Source: Lipper IM, to 31/12/2015.
Past performance is not a guide to future returns.

Equity income beyond the UK

In the past most foreign companies paid negligible dividends, so investors seeking income were effectively limited to the UK. This meant the fortunes of an equity income portfolio were largely tied to the performance of the UK stock market, and opportunities in other parts of the world were forfeit.

Today the situation is changing and many overseas companies are realising there is considerable investor demand for dividends, especially if they can be increased over time. Dividends represent commitment and discipline on the part of companies, so those that can reward shareholders with growing payouts earn their trust and their investment.

While investing beyond the UK can offer the potential for greater returns from higher-growth regions such as Asia, it involves taking more risk. It also increases diversification; the performance of an equity income portfolio is no longer solely reliant on the direction of one stock market.

One other point to consider when investing beyond the UK is the effect of currency movements. UK investors would benefit from investing in a country where the currency strengthens against sterling, but the reverse is also true. Therefore we suggest investors allocate a healthy percentage of their assets to investments denominated in their home currency, i.e. sterling.

Why do income funds often outperform growth funds?

There is no textbook answer to the above question. However we believe the management of equity income funds commands great discipline. This is because the fund manager must provide a reasonable income all the time to maintain their fund's yield.

A company which is paying a good and rising dividend often communicates strong financial wellbeing, since dividends ultimately come from earnings and profit. As these companies attract investment, the price is pushed up and the yield down. At this stage an equity income manager will often sell, looking to reinvest in the next high-yielding opportunity. It is this enforced discipline that can help an equity manager avoid holding on to stocks that become overpriced.

This discipline means the equity income fund manager's strategy also causes them to buy shares when they are cheap and sell them when they are expensive - the best way of making money in the stock market.

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