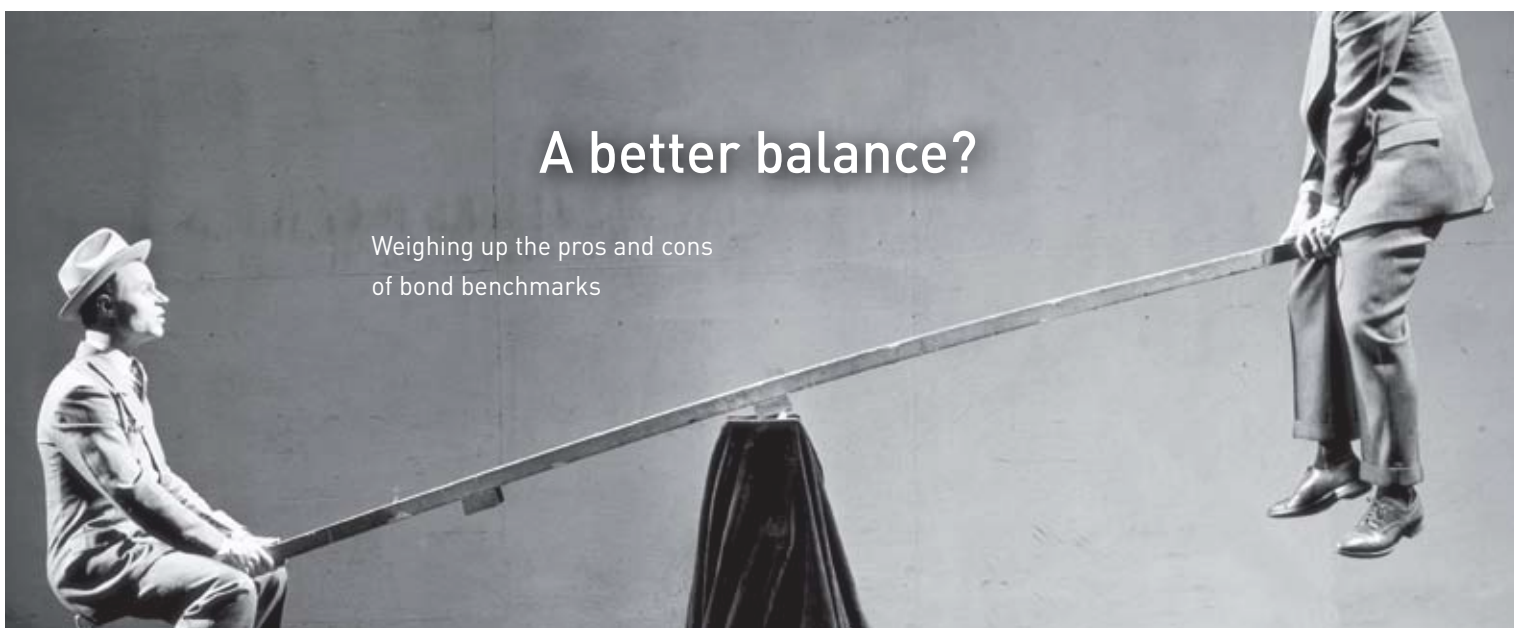


portfolio institutional

Issue No. 6 | December 2011 | £19.50 | www.portfolio-institutional.co.uk | Independent analysis for institutional investors

A better balance?

Weighing up the pros and cons
of bond benchmarks



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Private equity secondary markets: Why are UK investors so drawn to the secondary markets despite the narrow spreads? Is now the right time to invest and what is the best way to access the market?

Portfolio deconstructed

Newton Global Higher Income fund

By James Smith

Newton is a long-term incumbent in the world of equity income investing, adding European, Asian and Global funds to its UK flagship in recent years.

According to James Harries, who runs the Global Higher Income fund, the group sees a yield-focused strategy as sensible, particularly in light of the ongoing tough economic background, as it centres on more stable stocks.

“Companies paying a solid dividend are typically cash generative, conservative and have avoided over-gearing their balance sheets - all attractive attributes in the kind of slow-growth environment that we expect,” he says.

Explaining the increasingly global focus among income investors, Harries says the UK market – where most have sought yield in the past – forces concentration in a small pool of companies, as well as to sterling in isolation.

“The UK economy clearly has its problems, which is likely to mean sterling fluctuates in value over the coming years. With that in

mind, we feel it is sensible for investors to have exposure out of sterling, in countries boasting stronger fundamentals.”

Newton launched its own global income product back in 2005, looking to capture growing dividend distribution trends across the world.

“If you go back a few decades to previous investment generations, dividends always formed a key part of total returns. Dividend paying was seen as basic corporate activity and investors like Benjamin Graham are quoted as saying that only poor companies did not make distributions. If we fast forward to the 1990s, equity markets across the world were on a strong upward trajectory and this dividend culture was lost in many countries.”

In recent years, the culture of regular distributions has begun to reassert itself across the world, due – in no small part – to the well-trailed desire for income from retiring baby boomers.

For global managers such as Harries, this means a broadly diversified pool of potential yield-producing names, from traditional

markets like the UK to wider Europe, the US and increasingly Asia, emerging markets and Latin America.

He says much of this dividend largesse was possible as companies were thriving for much of the last decade and no one could be sure whether it was a structural change in corporate behaviour or a temporary phenomenon that would end when times grew tougher.

Despite some dividend cutting and suspensions among troubled Western banks, Harries believes most companies have largely proved willing to defend distributions so far.

Highlighting the US market, he says: "In the past, many senior executives at US firms took share options as a large part of their compensation, which meant they were not entitled to dividends. This meant the people responsible for setting dividend policy could not benefit from it and distributions clearly suffered as a result. More recently, many companies have moved towards restricted stock remuneration packages after several option back-dating scandals and we have seen dividends move to the fore once again."

For Harries, another benefit of dividend discipline is that it dampens the pro-cyclicality of share buybacks – another typical way companies will look to use surplus capital. "In our experience, companies will typically tend to buy back shares when things are going well and their price is elevated and stop when things are tougher and the price is lower – which runs counter to basic investment sense," he adds.

The starting point for construction of the Global High Income fund is Newton's group-wide thematic framework, which looks to distil and capture key trends at play across the world. Harries says this currently breaks down into two broad cautionary tales and two areas of opportunity.

Of the former, the first theme is deleverage, with Newton believing central banks' ability to stave off slowdowns and augment economic activity through collapsing interest rates is over.

With governments and individuals forced to pay down debt in this environment, the

group expects a period of shorter, more volatile economic cycles and low investment returns from most asset classes against a sluggish backdrop.

"Considering this background, we are focusing on well-financed companies with stable end demand, which is exactly what you would expect to find in a yield-oriented portfolio," he adds.

Second of the more cautionary themes is Chinese influence.

Harries says the group is worried about



Picture: Newton Investment Management

overheating and misallocation of capital after the country's aggressive lending through the credit crunch.

On the more positive thematic opportunities, Harries highlights what the group calls the "networked world" and "large-cap laggards". The first is a basic play on huge opportunities in areas like data traffic and smartphones, with several companies involved in these sectors held within Global Higher Income. As for the second theme, Harries says this currently highlights a major anomaly in markets, with the largest and strongest companies best placed to withstand volatility and yet still priced very cheaply.

"With financing so cheap, larger stocks can allocate capital to areas of the world with the strongest fundamentals, which means they can be diversified geographically." With this intellectual framework in place, Newton's

analysts get to work researching companies to produce recommended stock lists and build a global equity model.

Harries says there are three basic themes for a stock to merit inclusion – fitting the thematic framework, attractive fundamentals and an appropriate valuation – with a fourth dividend yield requirement for his portfolio. Global Higher Income has a strict yield discipline in place for buying and selling stocks.

The manager will only buy companies yielding at least 25% more than the FTSE World Index on a 12-month prospective basis – which, at the current level of 3%, sets the bar at a minimum of 3.75%. Stocks are automatically sold if they fall to the market yield. Post-credit crunch, Harries says Newton as a house has been rather too cautious, expecting the various structural fragilities that remain to weigh on the market recovery more than they have. Maintaining a quality defensive bias has seen the fund struggle to keep up with the market throughout 2009 and 2010 but Harries is confident these large-cap laggards represent serious value.

"We see it as a major irony that investment-grade equities, if you can call them that, remain so inexpensive while offering exactly the kind of stable end demand and strong cashflow profile investors want in tougher times," he adds. With that in mind, the fund remains overweight in solid dependable areas such as pharmaceuticals, consumer staples and telecoms. Over 12 months, as well as five years to mid October (according to Morningstar figures), the fund is among the very best of its onshore global equity peers, ranking 10th and 11th respectively out of 225 and 197 vehicles.

Looking to the future, Harries remains positive about exploiting the disconnect between cheap valuations and strong fundamentals on large caps, particularly in an environment of low returns from most financial assets.

"Our general view is that prevailing valuations of equity markets are not really attractive," he adds. "But many large stocks have the kind of attributes that should serve them well in a tough environment, as well as solid yields."