The hunt for yield

Few things whet the appetite for investors quite as much as yield. Hefty dividends and or chunky interest payments can go a long way to compensating for the volatility and risk of capital markets. Nowhere is this more pertinent than in equity income funds. The attractions of this category mean that they merit not one but two sectors in the UK; Equity Income and UK Equity & Bond Income where the labels are fairly self-explanatory.

To put them into context the average yield for the funds in the UK All Companies Sector is 1.8%* while that for Equity Income is 4.2%* and Equity & Bond Income is an even better 4.3%*. Clearly the yields from these income sectors are substantially higher than the yields available in the All Companies Sector which is currently 3.8%*.

The reason for this can be deduced from the name of one of them; Equity & Bond Income. Funds in this sector must have 80% of their assets in the UK, between 20-80% in UK Fixed Income and 20-80% in UK equities. The funds aim to yield 20% more than the FTSE All Share Index. The rules for the UK Equity Income sector are not so very different. Funds in this category must have at least 80% of their assets in UK equities and aim to beat the yield of the All Share by 10%. You might think then that the UK All Companies sector would simply be just funds invested in UK equities. But no, funds invested in this sector only have to have 80% of their investments in UK equities but with a focus on capital growth.

What is slightly embarrassing about this is that over the last ten years the Equity & Bond sector has grown 58.5%, the Equity Income sector by 63.5% and the All Companies by 68.3%. This last sector, supposedly focussed on growth, has grown more than its income rivals but hardly by a convincing amount.

What is clear is that the two income sectors have attained their premium income by investing a lot into bonds rather than higher yielding equities and benefitted hugely from a rising bond market. Even now that bond yields in developed countries have fallen below 2% it is still possible to get more than that in emerging markets and junk bonds. The corollary of course is that funds doing that achieve the yield but with a higher level of risk.

In the past the Equity Income sector has given almost as much growth as the All Companies, but with higher yield. Equity Income funds have benefitted from rising bond prices in recent years so although yields might have dropped total returns have been good. The problem is that starting from current bond yields it will be difficult for them to maintain that income, let alone grow in capital terms. Instead these funds will have to migrate from bonds to fish in the already evaporating pool of high yielding equities where even the existing ones have issues. The oil companies are struggling with low prices and the drug companies seem unable to accept that they are no longer growing as fast as they were. Oddly, mining companies are no longer a problem as they have already accepted reality and cut their dividends. Banks, with exception of HSBC, are still a long way from their pre-crash levels in terms of cash distribution.

This narrowing of yield differentials between the asset classes has already resulted in some funds in the UK All Companies sector offering higher yields than the average for the other two. But, since they have a higher equity component, are likely to have better long term prospects than the mixed asset class sectors.

Over the last few decades bonds have given us growth and income. Given the low interest rates now prevailing Equity Income funds will have to find those attributes from equities alone. And that is not going to be so easy.

*Source: FT Advisor