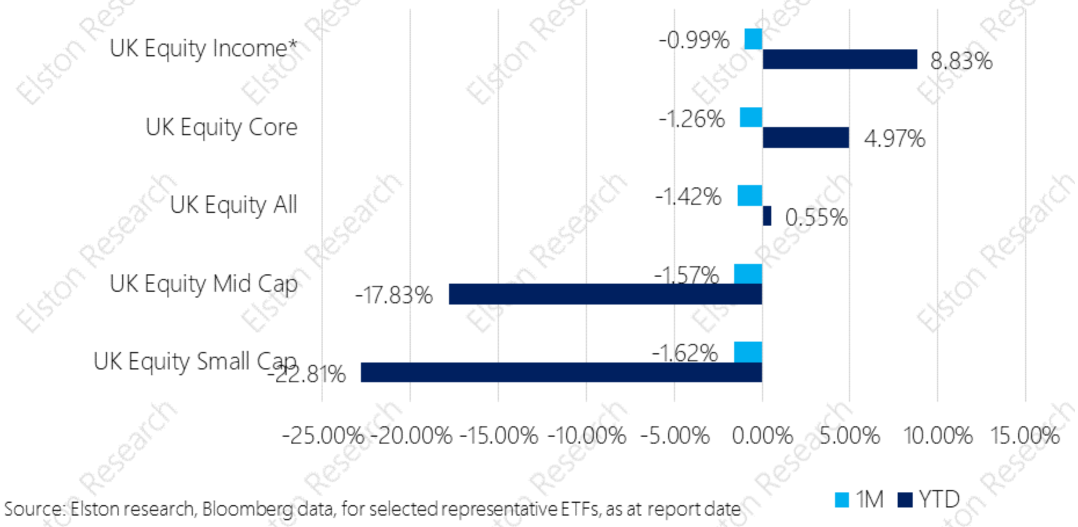
Comment
January 2023

Yield is back

2022 proved to be a strong year for the fund.

The Fund is benchmarked to the Elston Smart-Beta UK Dividend Index. The performance of this index (for UK Equity Income), relative to other UK equity indices (such as Core, All, Mid-Cap and Small-Cap) is summarised below.

Fig.1. UK equity segment performance, total return in GBP as at Dec-22



*UK Equity Income represented by Elston Smart-Beta UK Dividend Index

It's interesting to note the level of dispersion between the different segments of the UK equity market. UK Equity Income was the best performing segment at +8.83%, UK Small Cap was the worst performing segment at -22.81%.

The key drivers for returns in UK Equity Income was the inherent bias to Value and Income within the index that is a function of the forward-looking dividend-weighted index methodology.

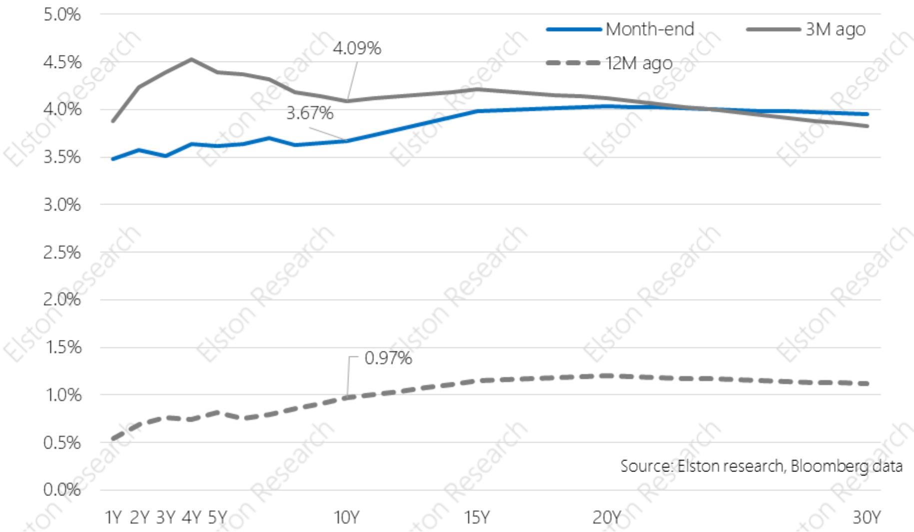
In this Comment, we look at potential key drivers into 2023.

Yield curve has shifted upwards

Following over a decade of yield suppression by Central Banks with near-zero interest rate policies following the Global Financial Crisis, yield is back.

Comparing UK Government Bond yields (risk-free rate) across maturities shows the extent to which the yield curve has shifted up, compared to 12 months ago. The benchmark 10 year gilts yield is at 3.67% in Dec-22, from 0.97% in Dec-21, slightly down from 4.09% in Sep-22 following the Truss/Kwarteng budget. Changes in the yield curve, illustrated below, force a repricing over returns for given terms across asset classes.

Fig.2. UK yield curve, as at Dec-22

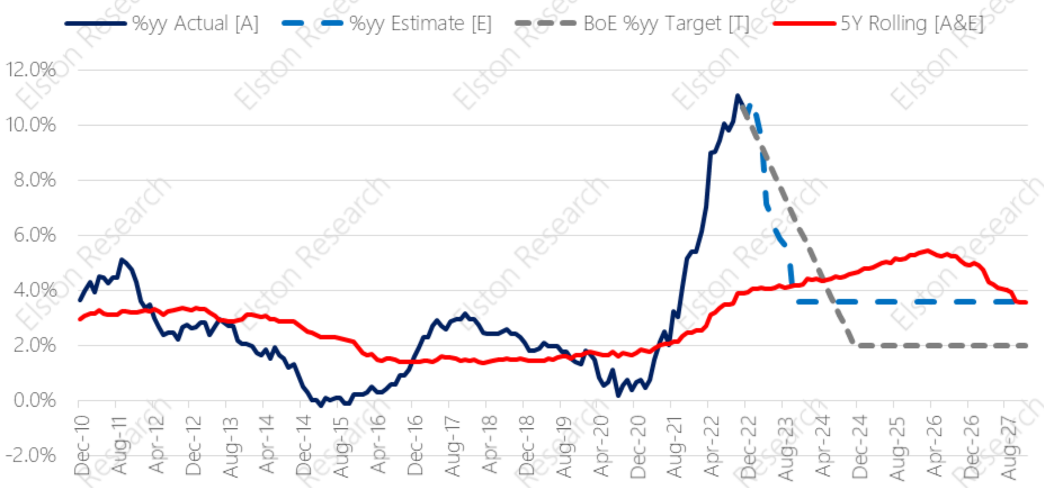


Inflation: past the peak, but still a problem

The UK may be getting past the peak for Inflation: mainly due to "base effect": comparisons are now made against a higher base. But this does not mean inflation is no longer a problem. Looking at market-implied break-even inflation rates, inflation continues to be sticky at above-target rates. This is because inflation pressure has broadened, beyond supply constraints into wages too. We expect to be "living with inflation" for the next few years: with the situation worse in the UK, compared to the US.

In this context – as in the 1970s – equities that have potential to keep pace with inflation become attractive for inflation-protection, particularly when equity valuations are underpinned by solid dividends.

Fig.3. UK inflation expectations, as at Dec-22

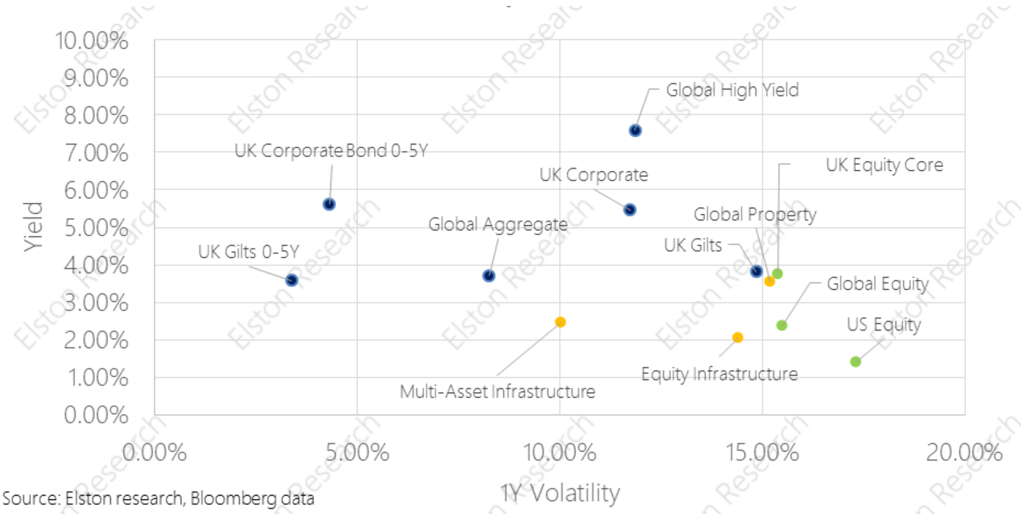


Source: Elston research, Bloomberg data

Volatility risk vs inflation risk

For managers and advisers targeting income with a focus on volatility risk, bonds are becoming more attractive. However bonds may struggle to keep pace with inflation, even as we move past its peak, so this means accepting higher inflation risk (the risk that capital value is eroded by inflation). For managers and advisers targeting income, but with a focus on inflation risk, equity income strategies remain more attractive as there is potential to keep pace with inflation. But this necessarily means accepting higher volatility risk. The trade off between current yield and realised 1 year historic volatility is summarised in Fig.4. below for representative asset class exposures. The volatility profile of UK Gilts (all maturities) is particularly surprising.

Fig.4. Yield vs realised historic 1 year volatility, as at Dec-22



Source: Elston research, Bloomberg data

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