Evenlode Investment View

May 2016 - Income Thoughts

This month, we received confirmation from the Investment Association (IA) that Evenlode narrowly missed the UK Equity Income Sector yield criteria at its annual measurement at the end of February. As a result, Evenlode will be moved to the UK All Companies Sector on 1st June. This sector move has no impact on our approach to managing Evenlode, and has not (nor will) result in us making any changes to the Evenlode portfolio. The move is purely driven by the fund narrowly failing a somewhat arbitrary sector classification definition*.

Also in May, the IA has launched a consultation into the criteria for UK Equity Income Sector membership. This follows the removal of several funds from the sector over the last few months – including Evenlode - and the expectation that more will be removed in coming months.

Given these bits of news, I thought it would be worth using this investment view to reiterate our thoughts on income investing, and to share the feedback we will be giving to the IA in relation to sector inclusion requirements.

What Are Income Funds For?

At Evenlode, we think an income fund works best when it delivers a balance between income today and income growth in the future. Both factors are important to the income seeking investor, and neither factor on its own is enough to generate a meaningful, sustainable and inflation-proofed income stream for the long-term saver.

A balance between dividends today and dividends in the future should also drive good capital growth over time. Share prices wobble around a lot in the short-term. But as the holding period grows longer and longer, a share's capital performance tends increasingly towards the growth in its dividend.

We also think that income investors generally have a relatively low tolerance for risk and permanent capital loss, and we aim to generate income and capital returns without taking undue fundamental risk.

Potential Risks

In my view there are two key risks that income focused investors should aim to avoid. The first is 'reaching too high' for dividend yield. If a fund's target yield is too high, it may create a bias towards a handful of high yielding stocks for which dividend growth prospects are low and the risk of dividend cuts is high. More generally, reaching for yield may lead to the degradation of a portfolio's quality and an increasing bias to more leveraged, economically sensitive business models. This risk becomes most pronounced if the market yield is skewed by a few big, troubled companies that are in the process of cutting or cancelling dividends. The financial sector in 2008-9 created this dynamic, as has the commodity sector over the last year.

The second risk is that too much focus on current yield increases the tendency to short-termism. Investors may inadvertently place pressure on management teams to 'place the cart before the horse' by prioritising dividends above organic investment in the future (investment which is necessary to drive long-term dividend growth). This pressure may also lead to weakening balance sheets, and could have implications for the broader economy.

When we engage with companies, we actively encourage investment in the future, even if this sometimes holds back cash flow and dividend growth in the shorter-term. We also much prefer companies that provide the 'best of both worlds' – producing enough cash flow to sustainably finance both dividends and an appropriate level of investment in the future. Asset-light companies that consistently convert profit to cash-flow tend to be well placed to do this, hence our focus on this subset of companies.

Investment Association Consultation

The Investment Association has proposed three options in its consultation document for sector requirements:

1) Leave the yield requirement measure for inclusion unchanged. The current measure requires a fund to yield more than 110% of the FTSE Allshare yield on a three-year rolling basis.

2) Reduce the current requirement so that sector inclusion requires a fund to yield more than 100% of the FTSE Allshare's yield (Evenlode would pass on this measure).

3) Remove any hard yield hurdle and instead replace it with a requirement for better and more consistent disclosure relating to income delivery.

Our preference is for option three. As the IA itself stresses, *market cycles and statistical calculations can conspire to produce results that seem at odds with the original intentions. There remains no intention for sector parameters to dictate fund strategies.* Option three seems the best option in terms of avoiding this undesired scenario.**

In terms of dividend disclosure we currently quote Evenlode's yield and dividend growth history on the monthly factsheet. We think the IA's suggestion of disclosing the amount of income generated over five years from a £100 investment is a good one, and we will add this disclosure to our factsheet from next month. From a long-term income investor's vantage point this is an important measure, and neatly wraps up both initial yield and dividend growth into one simple number. The table below shows this figure over the last five years for the Evenlode fund, compared to the UK market***:

	5Y income from £100
Evenlode Income	£23.94
UK Market	£18.80

A key advantage of this measure (versus just comparing the current yield on the fund to the current market yield) is that it compares dividends produced to the *initial investment value* rather than to *current capital value*. In this way, it does not 'punish' funds that have produced good capital performance over time. Over the five years to February 29th, for instance, Evenlode produced a capital return of +44.7%, compared to +7.7% for the UK market, representing an outperformance of 37.0%****. Ironically, if Evenlode had only performed in-line with the UK market, the fund's yield would have been 5.1% at the end of February, rather than the actual 3.8% yield (and Evenlode would have therefore easily passed the sector requirements).

Evenlode is an income fund and, given this focus, we view its natural home as the UK Equity Income sector. Whatever the result of the IA's consultation we would expect the fund to be reinstated in the future, once the UK's current dividend anomalies wash through. In the meantime, we will continue to manage Evenlode as we have done over the last six and a half years, and the provision of an attractive, sustainable and growing dividend stream remains a key long-term objective.

Hugh Yarrow
Investment Director
May 2016

Please note, these views represent the personal opinions of Hugh Yarrow as at 16th May 2016 and do not constitute investment advice.

*To remain in the IA UK Equity Income sector, funds are required to yield 110% or more of the FTSE Allshare's yield based on a three year rolling average. This average is calculated annually at the end of a fund's year end. At Evenlode's year end on 29th February, its average yield was 3.7%. This would have needed to be 3.8% to meet sector requirements.
**If the consensus view is that a hard yield requirement continues to be preferable, we would be in favour of using a median dividend yield rather than a weighted average dividend yield. The most acute problems with the current measure occur when a few troubled, large index constituents end up on unsustainably high dividend yields, which skews the market yield and makes it more constraining to comply with sector rules. Use of a median dividend yield would have avoided these problems in both 2008-9 and 2015-16.
***Source: Evenlode Investment, FTSE.
****Source: Financial Express, price return only, B Inc shares