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Some thoughts on equities and bonds

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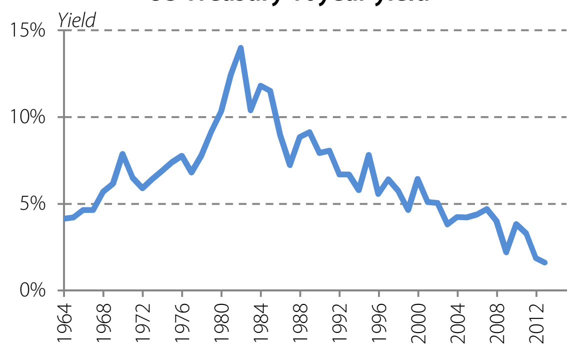
December 2012

The search for safety is a perennial theme in investors' portfolios, just like the hunt for income. Should investors shun equities and move their investments into fixed income, or vice versa. Rising and falling appetites for risk have prompted some aggressive rotations on this question, as a quick glance at the Investment Management Association retail sales of unit trusts and OEICs will testify.

There are times when investors seek to avoid the pain of short-term volatility in equities and instead enjoy bonds' 'guarantee' of a return of their invested capital in the future and an agreed coupon payment in the interim. But what risks are investors actually taking? We are all too aware that there is no such thing as a 'free lunch'. In its most simple form equity investment risk is often thought of as volatility, whereas fixed income investment must take account of credit, duration, and potentially leverage depending on portfolio construction. We believe the most important measure of risk, however, is the risk of a permanent loss of capital in real terms.

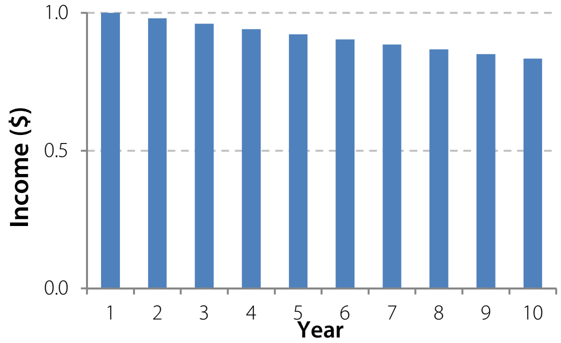
In the current environment of low interest rates and high demand for safe investments, bond yields have dropped to historically low levels. For example, the 10 year US treasury yield is now trading at 1.6%, down from 1.9% in 2011, and 3.3% in 2010. Such meagre income is unlikely to provide a sufficient return for most investors. Many are reaching for yield via lower credit-rated corporate bonds, or bonds with longer duration; both of these increase the inherent risk of investment. Currently short-dated corporate bonds might only have a yield of 1 to 1.5%, but longer-dated, 20-year high grade corporates might yield anything up to 4%. The risk of an interest rate rise to the market value of the long-dated bond, however, could be severe; a 2% interest rate rise on a hypothetical 20-year bond yielding 4% would be greater than 20%. The investor would not necessarily have to crystalise this loss if they could hold the bond to maturity, but such large moves in market value may surprise those who believed they were purchasing an asset with lower 'risk' than an equity investment.

US Treasury 10year yield



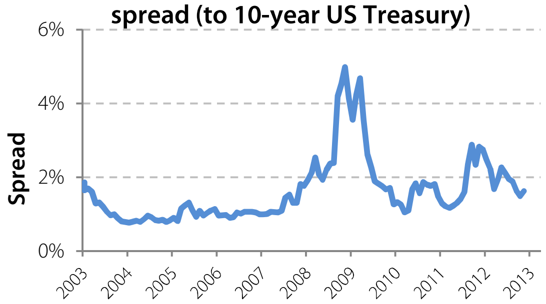
Investors aiming to hold long-dated bonds to maturity will also suffer a loss of purchasing power due to the compounding impact of inflation over time on both the principal and income stream (as the coupon payments and principal value remain fixed in nominal terms). In an inflationary environment of just 2%, a hypothetical 10-year bond paying an annual coupon of $1 will see the value of that coupon, and the principal, decline by 17% in real terms over the life of the bond.

Bond coupon: real spending power with 2% inflation



The beneficiaries of unusually low rates and investor demand for safe sources of income have been the corporations themselves. Unsurprisingly they have been happy to issue longer-dated debt and in turn lock-in low borrowing costs; for example, Microsoft recently sold $750 million of 10-year bonds with a coupon of 2.125%, and $900 million of 30-year bonds at 3.5%. Considering 10-year US government treasuries are currently trading with a yield of 1.6%, this implies a credit spread of just 0.525% for Microsoft's 10-years bonds. If we look at all investment grade corporate bonds in aggregate (using the Bloomberg Active Investment Grade Bond Index as a proxy) we see that credit spreads have been contracting since the start of 2012 and are now at approximately 1.5%, only 0.5% higher than the 1% average over the more economically stable 2003 to 2007 period. This either implies the market believes economic conditions have improved significantly since the start of the year, or inflated demand for higher-yielding investment grade credit has pushed prices above their intrinsic value. Only time will tell but we fear the driving factor is more likely the latter, which may leave investors who arrived 'late to the game' particularly exposed.

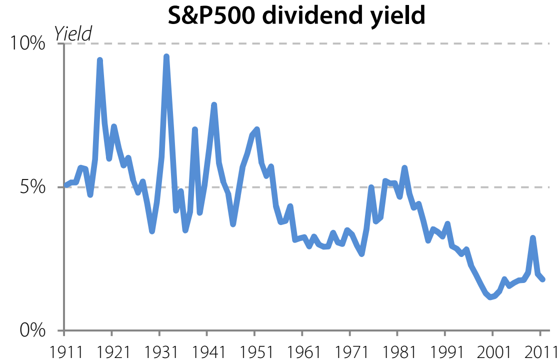
Bloomberg investment grade credit spread (to 10-year US Treasury)



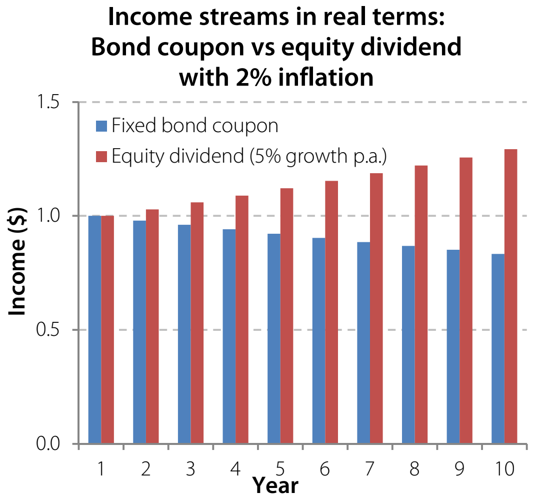
So where can investors find yield? We believe in the current environment that equities offer a good balance of risk and reward for investors looking for income. In the short term we are likely to continue to experience volatile markets, but for the long-term investor this should in fact provide opportunities.

Equities have not been immune to the gradual decrease in yields over the last few years, as companies have been bolstering their balance sheets and conserving cash, and share prices have been rising. The S&P500 yield, for example, currently stands at a paltry 1.8%, versus an average of 3.1% over the last 50 years.

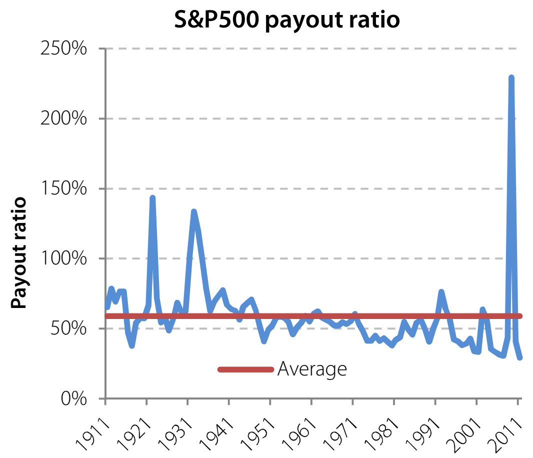
S&P500 dividend yield



So why would you take on the volatility of the S&P500, which has been as high as 1465 and as low as 1022 in the past 3 years, for an extra 0.2% yield versus the US treasury 10-year bond? The main reason is the ability of companies to grow their earnings over time, and in turn grow their dividend payments; this means the purchasing power of the income generated is not diminished over time as it would be for a static coupon received on a bond. Indeed, over the past 50 years the compound annual growth rate of dividends from the S&P500 has been just shy of 5%. If we compare the hypothetical 10-year bond with an annual $1 coupon to that of an equity with a $1 annual dividend that is growing at 5% per year, we see that in a 2% inflationary environment the dividend of the equity will have grown 29% in real terms - versus the 17% decline seen in the bonds coupon payment. A well-run company should also be able to grow its equity value over time which should result in capital appreciation of the investor's principal investment, again offsetting the effects on inflation over the longer term.



We also believe there are many companies who have the ability to increase their income payments quite significantly in the near future. Many corporations have been holding back cash and keeping it on their (ever expanding) balance sheets. For example, the payout ratio of the S&P500 is currently running around 30%, which is well below the average payout ratio of 50% over the last 50 years, and leaves a lot of head room for companies to boost their dividend payments.



The discussion above only considers the S&P500 index as a whole, of which 20% of companies pay no dividend whatsoever and thus drag down the overall yield quite dramatically. The S&P500 also only consists of US-listed companies. If we instead focus only on those companies that pay a dividend, and look at all stocks listed globally, then it is possible to find many more companies that pay a reasonable yield, but more importantly a yield that is significantly higher than that of government treasuries or short-dated corporate bonds. Our aim is to refine this search further; looking for companies which can generate significant cash flows, which can invest those cash flows in high return projects, that don't have stretched balance sheets, that have long histories of paying a dividend and that we believe have a very high probability of growing those dividends in the future.

In conclusion, therefore, we believe the risks to investors chasing yields in the bond sector maybe misunderstood, or at least underestimated, and that well capitalised, cash generative companies with established and growing dividends may very well provide a better proposition for those people searching for income who are able to invest for the long term.

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