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Firing on all cylinders

Why Schroder Income Growth offers investors the best of both worlds...

It's been a tale of two cities (or countries...) for US and UK equities over the last year. Fuelled by excitement around AI, US technology mega-caps have headed into the stratosphere while UK equities have flat-lined. None of this will come as any surprise to investors given the column inches dedicated to 'unloved' and 'ailing' UK equities facing their 'darkest days' to name but a few of the most popular descriptions.

But one adjective features more than any other and that's 'cheap'. It's fair to say that the numbers support this view, with the FTSE All-Share Index trading below its long-term average at a forward price-earnings of 12, compared to 19 for the MSCI World Index (as at 22/04/2024). That said, capital growth is only one component of total returns and UK equities have long appealed to income seekers for their premium roster of high-dividend payers.

However, traditionally investors have faced a trade-off between income and capital appreciation: the FTSE 100 blue-chips may top the table for dividend yields but lag some of their smaller counterparts when it comes to growth potential. The solution to this perennial challenge may well lie in an actively-managed fund such as **Schroder Income Growth (SCF)** which aims to offer the best of both worlds, blending higher-yielding companies with lower-yielding companies offering higher growth potential.

A cut above

As mentioned earlier, UK equities have been a traditional refuge for income-seeking investors, offering some of the highest yields amongst their peer group. In fairness, they have faced mounting competition from other asset classes in recent years, with cash-based investments offering attractive returns after a decade of ultra-low rates.

However, UK equities also offer a cash yield above and beyond their dividends. The last two years have seen record levels of share buybacks by FTSE 100 companies, with billions of pounds returned to shareholders.

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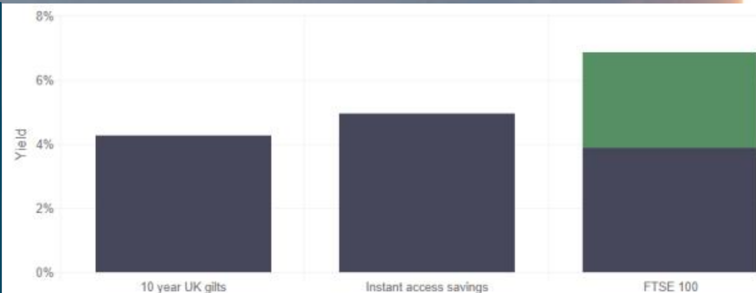

FIG 1:

'The FTSE 100 offers a high yield'

Yield by type of asset

Source: AJ Bell (as at 22/04/2024)

As the chart adjacent shows, this pushed up the overall yield to almost 7% in 2023, comfortably eclipsing the return from the other asset classes.

The AIC 'dividend hero' status of SCF is testament to the strong income offered by UK listed companies, with SCF achieving a 28-year consecutive track record of dividend increases. SCF aims to deliver a dividend return in excess of inflation, which it has achieved over the last ten years (and the life of the trust).

The investment trust structure also offers an advantage for income-seeking investors, by allowing trusts to hold up to 15% of annual income in reserves.

Powering growth

Although SCF has typically paid covered dividends, dipping into reserves allowed SCF to continue to increase dividends even through the global financial crisis and covid pandemic.

As mentioned earlier, SCF takes a differentiated approach to some of its peers, balancing both income and capital growth by allocating the fund to different areas of the market: some to higher-yielding, lower growth companies, some to average yield (but better-than-average growth) companies, and the remainder to lower-yield but higher-growth companies.

Higher-yield companies include FTSE 100 stalwarts such as HSBC, Shell, Legal & General and BT from the utilities and financial sectors. At the other end of the scale, the higher-growth companies drive capital returns and, unlike some equity income funds, span the full market-cap spectrum. The managers believe that there is currently a great opportunity in mid and small-sized companies given their compelling valuations in absolute terms, and relative to large companies. As a result, the fund is significantly overweight small and mid-cap companies relative to the FTSE All-Share Index.

Managers Sue Noffke and Matt Bennison have a combined investment experience of more than four decades, and can draw on the expertise of the wider Schroders equity research team. The trust is style-agnostic, unlike the traditional value-orientation of many UK equity income funds. The managers can invest 20% of the portfolio overseas but are currently not using this option due to the attractive valuations of UK equities. However, the trust still has global reach through existing UK holdings which often derive a significant proportion of revenue from overseas.

Themes include companies positioned to play a key role in the energy transition, such as mining companies Anglo American and Glencore which should benefit from the forecast increase in demand for commodities to support decarbonisation. Sue and Matt also favour companies with resilient franchises, including Hollywood Bowl and 3i Group, and companies able to weather the higher-inflationary environment of the last few years.

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A stock-picker's paradise

Coming back to valuation, the UK All Share Index remains below its 10-year average, as well as global peers. **In a recent Kepler webinar**, Sue discussed how the disparity in valuation is often attributed to the "Jurassic Park" of sectors in the UK stock market relative to the US. However, she challenged this view by noting that most UK sectors are trading at a discount of 25% to 50% of the forward price-earnings ratio of their equivalent sector in the US (as at 31/01/2024).

As a result, current valuations present significant upside opportunity for an actively-managed fund such as SCF. A recent addition to the portfolio was food manufacturer Cranswick, which Sue describes as a 'multi-bagger' (offering a multiple return on the initial investment). The company has been a consistent performer, having delivered a ten-year total return of more than 290%, compared to just over 50% for the FTSE 250 (ex-IT) Index (as at 18/04/2024).

However, Cranswick has suffered a widening divergence between its valuation and fundamentals due to negative investor sentiment towards companies further down the market cap scale in recent years. The company's price-earnings ratio fell from 25 to 14 in the two years to 30/09/2022, despite the company achieving a 39% increase in earnings per share during this period. Its valuation has risen on the back of a positive outlook, including expansion into the pet food market via a partnership with Pets At Home (another SCF portfolio company).

SCF has a proven track record of delivering against its dual mandate of income and capital growth, achieving a net asset value total return of 24% over the last five years, together with a current dividend yield of 5.1% (as at 19/04/2024), which compares favourably to the FTSE All-Share Index's yield of around 3.9%. This also puts the trust in the top two of the investment trusts in the AIC UK Equity Income Sector on the basis of capital growth and dividend yield.

The increased level of interest from corporate and private equity buyers, together with an improving macroeconomic environment, may prove the catalyst for the long-awaited recovery in UK equities, as we explored in our recent note.

The timing of this recovery is harder to predict but investors willing to take the plunge ahead of the crowd may reap the best returns. In the meantime, funds such as SCF offer investors an attractive income stream as well as potential upside from the managers' stock-picking skills. ■

Read our analysts' latest research on Schroder Income Growth Fund

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