News & Views

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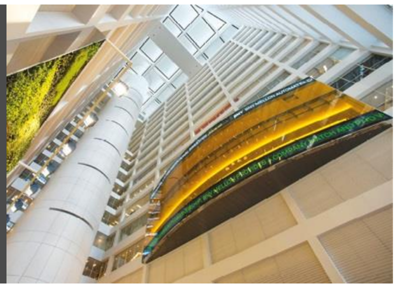


WHY BREXIT UNDERLINES THE IMPORTANCE OF A GLOBAL OUTLOOK

Newton's Nick Clay explains why looking beyond the UK may make sense for income investors over the long term, particularly given recent political events.

By Nick Clay, Newton Investment Management, a BNY Mellon Company

So far in 2016 the economic backdrop has been turbulent to say the least: stock markets started the year with a dramatic China-led sell-off only to rebound from mid-February, with some of the sectors and regions that were most aggressively ditched rallying the most. Now, following the UK/EU referendum result we're seeing turmoil in everything from currencies to shares and through to bonds.

In the wake of June's vote, UK stocks were especially hard hit as the FTSE100, the UK's leading stock index, dropped more than 8% on 24 June - its biggest fall since the global financial crisis of 2008. The pound also plunged the day after the vote, losing close to 10% against the US dollar, to a level last seen in 1985.

I believe recent market gyrations of this kind speak to the importance of having a global outlook when it comes to investing, especially for those seeking a steady income. In our view, a focus solely on UK companies – or indeed to any single geography – is potentially detrimental when viewed through the prism of long-term returns.

We can see this if we take into account the issue of "concentration" in the UK stock-market (see Figure 1), and the fact that just 10 companies account for 50% of income from the FTSE. While corporates like BP and AstraZeneca may be established, well-respected companies, it's hard to escape from the fact that the UK's largest dividend payers are mostly concentrated in just three industry sectors: oil, banks and pharmaceuticals. That means a downturn in any one of these sectors (as in the oil sector over the past couple of years, for example) could have a disproportionate effect on investors' portfolios and income streams.

Figure 1:

Over 50% of UK Income comes from 10 stocks

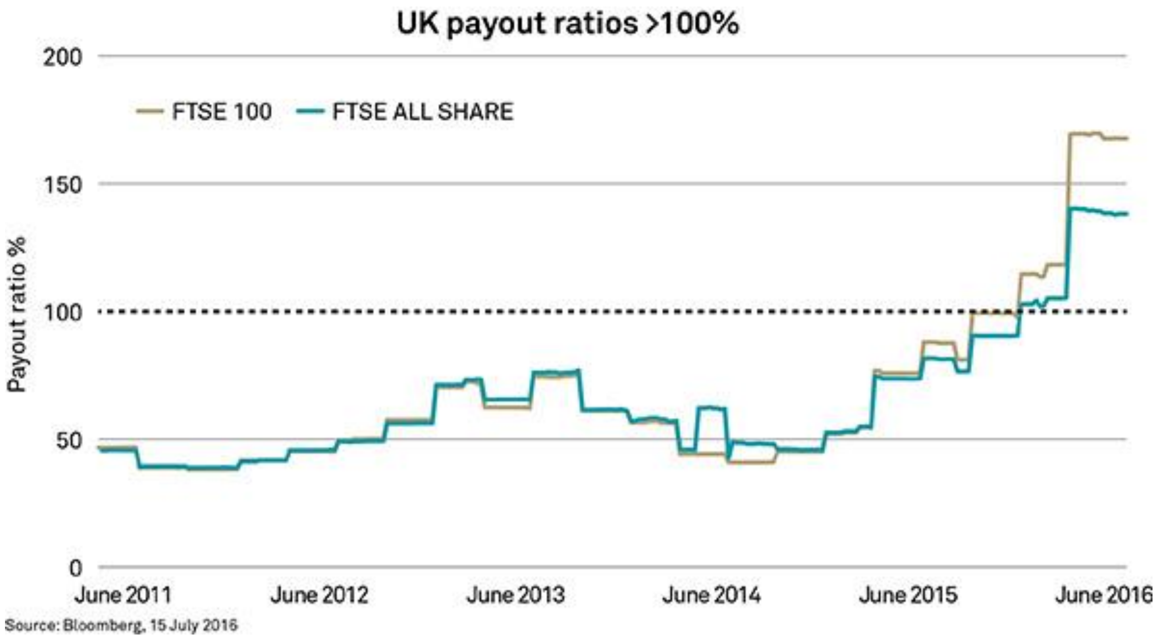
	2015 dividend paid (£bn)	2016E dividend % FTSE
Royal Dutch Shell PLC	7,874	10%
HSBC Holdings PLC	6,370	12%
BP PLC	4,822	9%
GlaxoSmithKline PLC	3,893	5%
British American Tobacco PLC	2,796	4%
Vodafone Group PLC	2,998	4%
AstraZeneca PLC	2,306	5%
National Grid PLC	1,615	2%
Diageo PLC	1,416	2%
Lloyds Banking Group PLC	1,122	3%
Total	**35,212**	**56%**

Source: Bloomberg, 15 July 2016

The same holds true should any of these companies suspend or lower their dividends. Given their size within the index, the "hit" to returns would be larger than to a broad-based portfolio with exposure across a wide range of sectors and geographies. Yet suspension of dividends is exactly what we expect at least some of the larger companies in the FTSE100 to do.

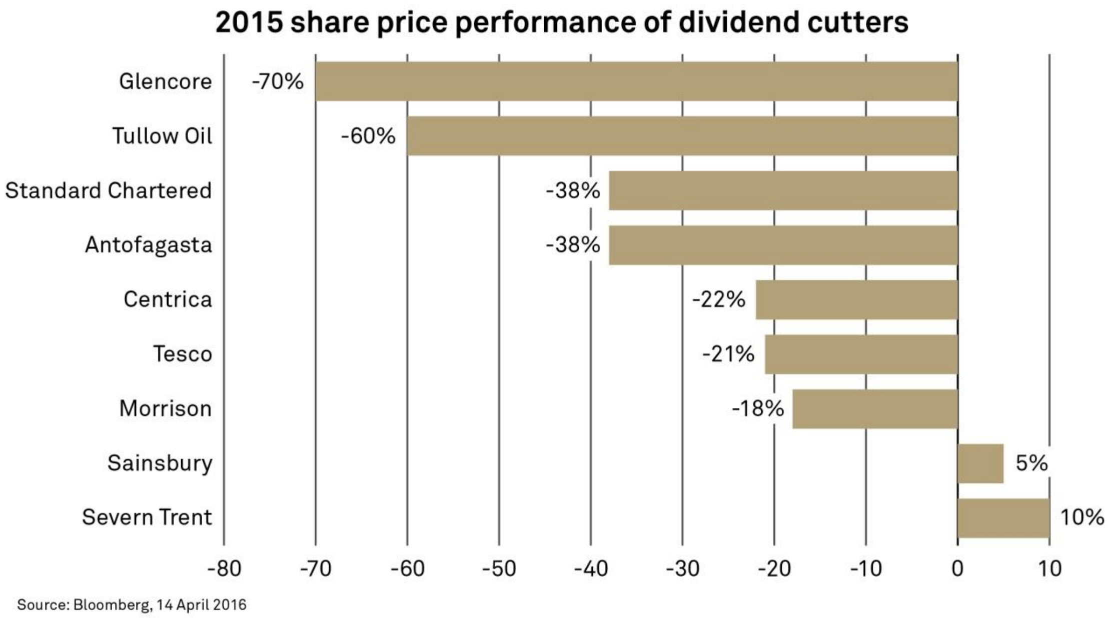
As Figure 2 shows, the dividend pay-out ratio in the UK's largest companies has been at or above 100% for almost a year. In effect, this means companies have been using all of their profits – and more – to service pay-outs to shareholders. While that might be pleasant in the short-term, in the long-run we believe it is unsustainable.

Figure 2:



And, as Figure 3 shows, investors tend to vote with their feet when faced with the prospect of reduced income. In 2015, for instance, the likes of commodities trader Glencore, oil company Tullow Oil and bank Standard Chartered all saw sharp share price declines when they announced a reduction in shareholder pay-outs.

Figure 3:

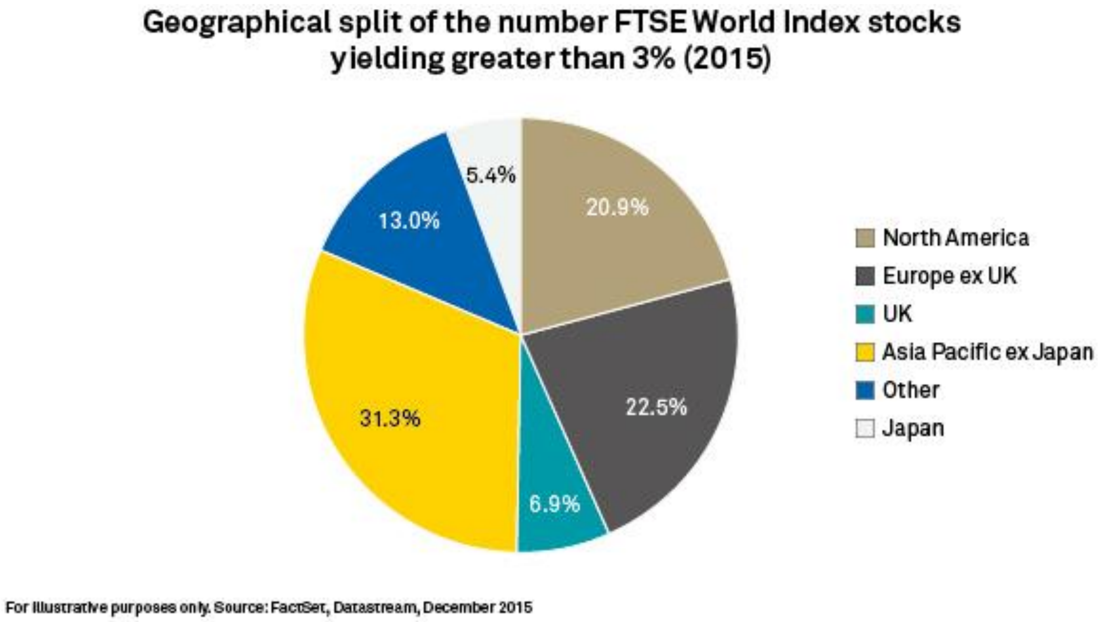


Our conclusion is clear: When dividends do get cut, investors with focused exposure to just a small number of FTSE100 companies are likely to suffer the most.

Beyond borders

We believe one solution to the FTSE's 'concentration' conundrum is to look beyond the UK's borders and to the wider world of international investing. By doing this we hope to address the concentration issue in a number of ways. If we consider the FTSE World, for example, we can find over 800 companies whose dividend yield is above 3%. Of these, 93% are located outside the UK (see figure 4).

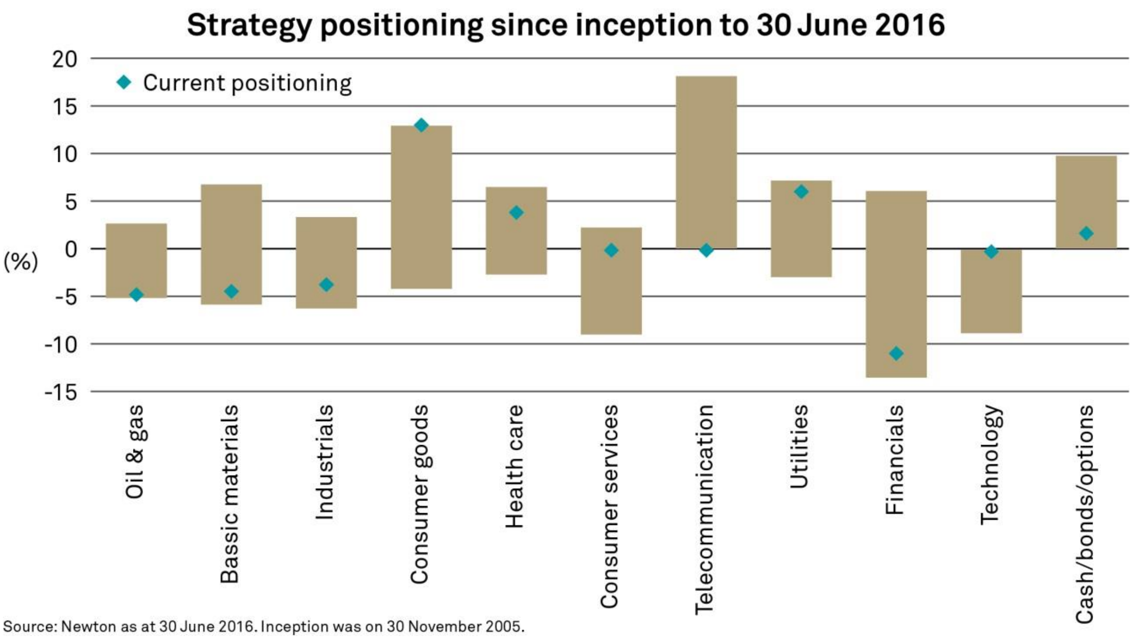
Figure 4:



By the same token, investing globally can broaden exposure beyond just a small number of industry sectors. We can see this in the long-term track record of Newton's Global Income Strategy since inception (see Figure 5) where a global approach has enabled exposure across a broad and diversified range of industries over the past 10 years.

Figure 5:

Strategy positioning since inception to 30 June 2016.



Source: Newton as at 30 June 2016. Inception was on 30 November 2005.

This is not to say international income investing is trouble-free or altogether straightforward. Each country has its own challenges and headwinds and not all stock-markets are alike. But for us, a disciplined approach to investing on the global stage is one of the best ways of finding businesses that can not only generate surplus cash and return it shareholders but can do so sustainably over the long term.

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