28th January 2022

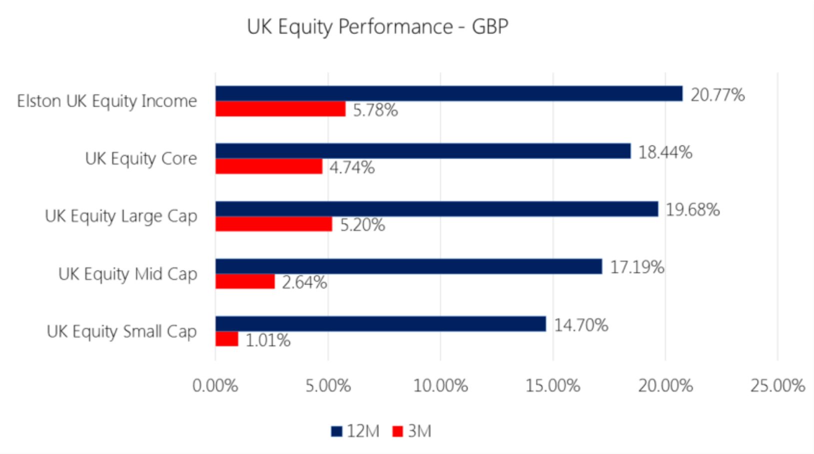
UK Equity Income: value provides resilience

- Equity Income total returns are underpinned by dividends
- Equity income has a Value bias, which typically translates to outperformance in an inflationary regime
- "Shorter-duration" equity income exposures make more sense with rising rates/ inflation

Review and outlook

In our 2021 market roundup we noted that UK Equity Income has been one of the strongest market segments owing to a recovery in dividends, fears of rising inflation and the quest for yield.

Fig.1. UK Equity segmental performance 2021



Source: Elston research, Bloomberg data as at end December 2021

In our 2022 outlook, we explained why inflation will remain hotter for longer and will settle above pre-pandemic levels. Advisers should consider how to adapt portfolios for inflation across each asset class – equities, bonds and alternatives. Within equities, we advocate a tilt towards Value and Quality.

Year to date performance has underscored resilience

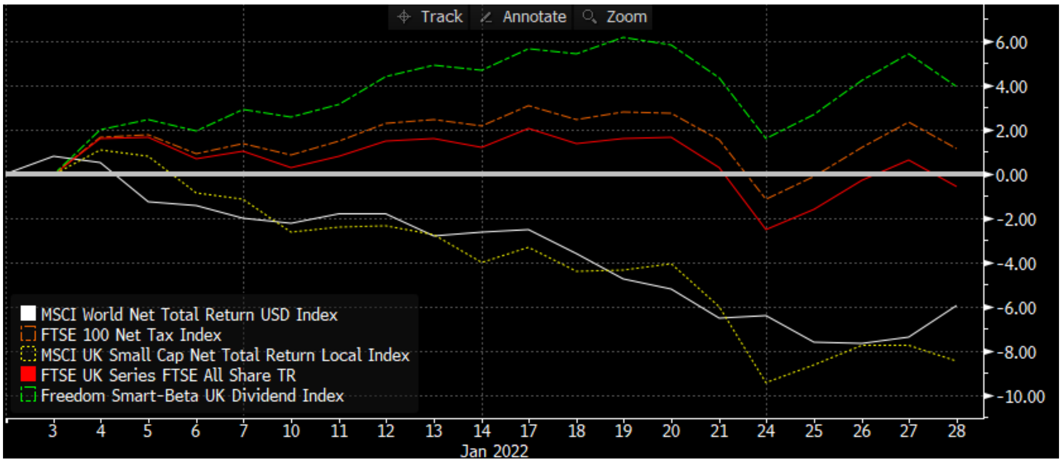
The dispersion between styles and segments within equities continues in the UK.

Given recent market stress over the prospect of a rising interest rate environment, inflation pressure and geopolitical tensions, year-to-date performance underscores the relative resilience of Value/Income-biased equities relative to other UK equity segments, and world equities.

Year to date, world equities are down -5.93%, and the FTSE All Share is flat at -0.55%. UK Small Caps are down -8.49%, the FTSE 100 is +1.14% and UK Equity Income (Freedom Smart-Beta UK Dividend Index) is +3.97%.

This is because returns are underpinned by dividend income, as well as an exposure to energy and financials that both benefit from a high oil price/rising rate environment.

Fig.2. UK Equity segmental performance 2021, YTD



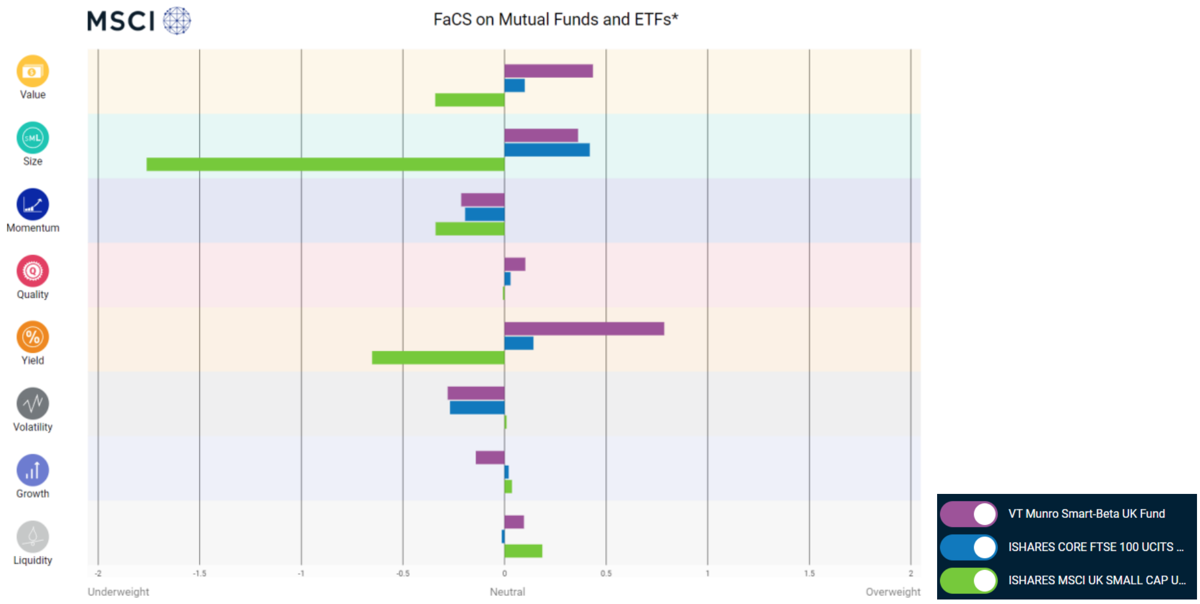
Source: Bloomberg data as at 28-01-22

UK Equity Income strategies have an inherent bias to Value

Looking at the Factor exposures on a UK equity income fund[1], relative to UK large-cap and UK small-cap, it is clear that there is a pronounced overweight to Value factor for UK equity income funds, relative to a moderate overweight for large-cap and underweight for small-cap.

[1] The VT Munro Smart Beta UK Fund is benchmarked to our Freedom Smart-Beta UK Dividend Index (ticker: ELSUKI Index), a dividend contribution weighted index that reweights each month based on forward-looking dividend estimates of UK companies))

Fig.3 Factor exposure of selected UK Equity segments (by index fund)



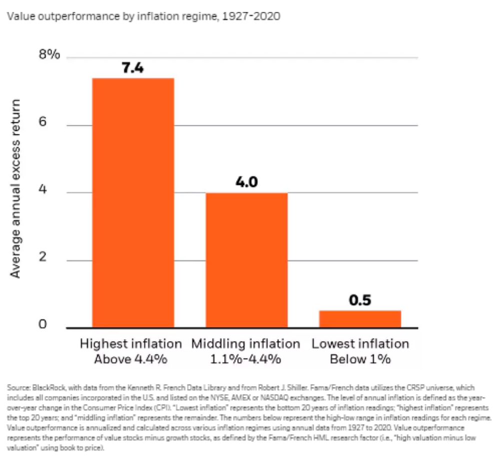
Source: MSCI FaCS, December 2021

Regime context: Value tends to outperform Growth during inflationary regimes

Value strategies have struggled to outperform Growth strategies from 2008 to 2020, during a period of ultralow interest rates, QE and low inflation.

A study of the US stock market 1927-2020 suggests that Value-style significantly outperforms Growth-style investing during higher inflationary regimes.

Fig.4. Value outperformance by inflation regime (US, 1927-2020)

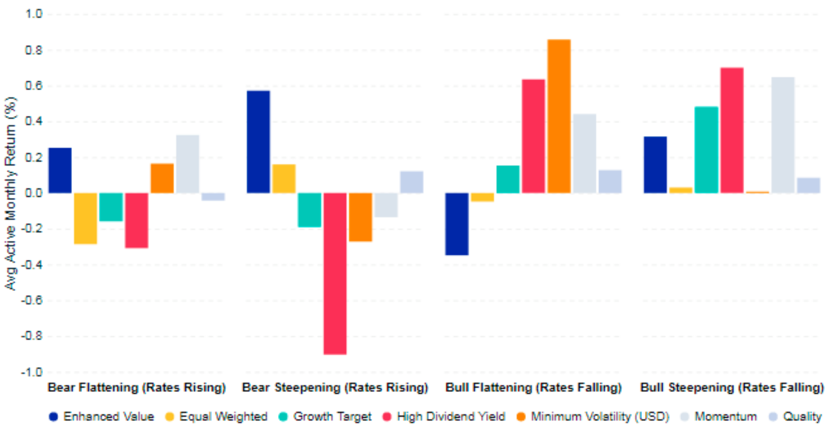


Source: BlackRock, Opportunity still alive in value stocks, de Spirito March 2021

Regime context: Value tends to outperform in rising rate regime

More broadly, growth, interest rates and inflation – and resulting changes in the yield curve – can be used to define different economic regimes. A separate study by MSCI shows that Value factor investing has traditionally outperformed in a rising-rate environment, based on historical data 1994-2021.

Fig.5. MSCI World Factor performance, by regime

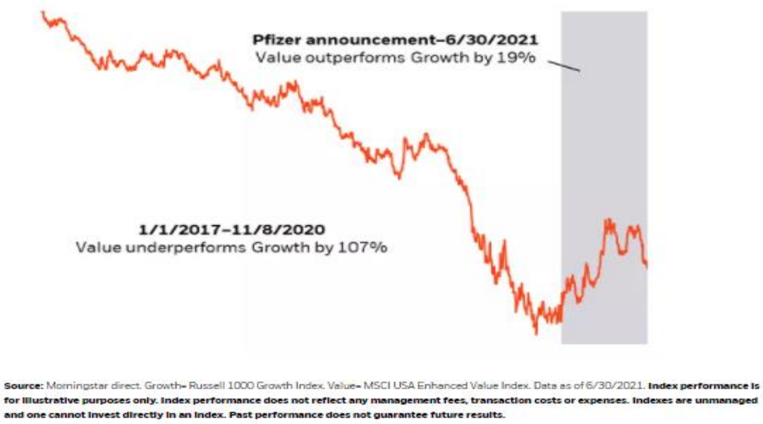


Source: MSCI Factors in Focus: Are Your Equity Styles Ahead of the Curve?, January 2022

Inflation rotation: room to run

Value-biased equities have been out of fashion since the financial crisis with performance lagging Growth or Momentum factor equities. But they are making a comeback because of their cash generative ability and shorter equity duration characteristics which mean they have greater potential to outperform during an inflationary regime. Value has outperformed growth since vaccine day (9th November 2020) in a so-called "great rotation". However, it still has room to run, in our view, owing to the extent of prior underperformance.

Fig.16 Value vs Growth relative performance 2017-2021



Source: BlackRock, "Turning the Lights Back on With Value and Quality", August 2021

For these reasons, our tactical outlook is overweight Value & Quality factors. Value factor exposure can be isolated and accessed cost-efficiently using index funds and ETFs.

Summary

We believe it's important to adapt portfolios for inflation by refocusing equity allocation to income/value, alternatives to provide a return underpin from equity income as well as a value bias that should outperform mainstream index exposure during a rising interest rate/inflation regime..

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