
UK Equity Income Funds Struggling to Retain Assets

Poor performance is driving investors away

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Key Takeaways

- ▶ GBP 15.3 billion flowed out of the UK equity income Morningstar Category between January 2016 and April 2019. Funds in the category held GBP 64 billion as of April 2019, coming down from the peak of GBP 75 billion in May 2018.
- ▶ Poor performance led to investors falling out of favour with the category. The category was bettered by all other UK equity categories and comparable benchmarks in the period January 2016 to April 2019.
- ▶ Some of the better-performing funds managed to buck the trend by acquiring assets, including Troy Trojan Income and Man GLG UK Income.

Introduction

Having recently seen a fund suspend dealing due to large outflows, we wanted to look more closely at the UK equity income category and explore why these funds have experienced such high outflows in recent years. The category is one of the largest for UK-domiciled funds and is home to many of the UK's most high-profile managers and funds. Even though these funds are rarely sold outside of the UK, they have attracted a very large volume of assets over the years. Funds in this category held aggregate assets of GBP 64 billion as of April 2019, down from a peak of GBP 75 billion in May 2018. Poor performance as a driver of outflows, funds that have grown or shrunk the most, and what made these funds appealing in the first place will all be looked at in greater detail.

The Good: UK Equity Income Funds' Appeal

Some UK equity income funds have been around for over 40 years, albeit in slightly different iterations. Their longevity shows that they play a key role in many investor portfolios. Investors have typically viewed the UK equity income fund sector as a staid, steady one, featuring funds that invest in large, sturdy, and dependable dividend-paying companies, making such funds suitable for core allocations to UK equities within portfolios.

Whilst funds in this category usually only invest in UK companies, less than one third of aggregate revenue from FTSE All Share companies is generated in the UK. A recent [report](#) by Morningstar shows that even though the average fund in this category had a higher-than-benchmark exposure to the domestic UK market, 59% of revenue still came from abroad as of March 2019. Therefore, whilst this does imply higher currency risk for investors, it effectively means that, in theory, these funds are more regionally diverse; higher diversification usually means lower risk for investors.

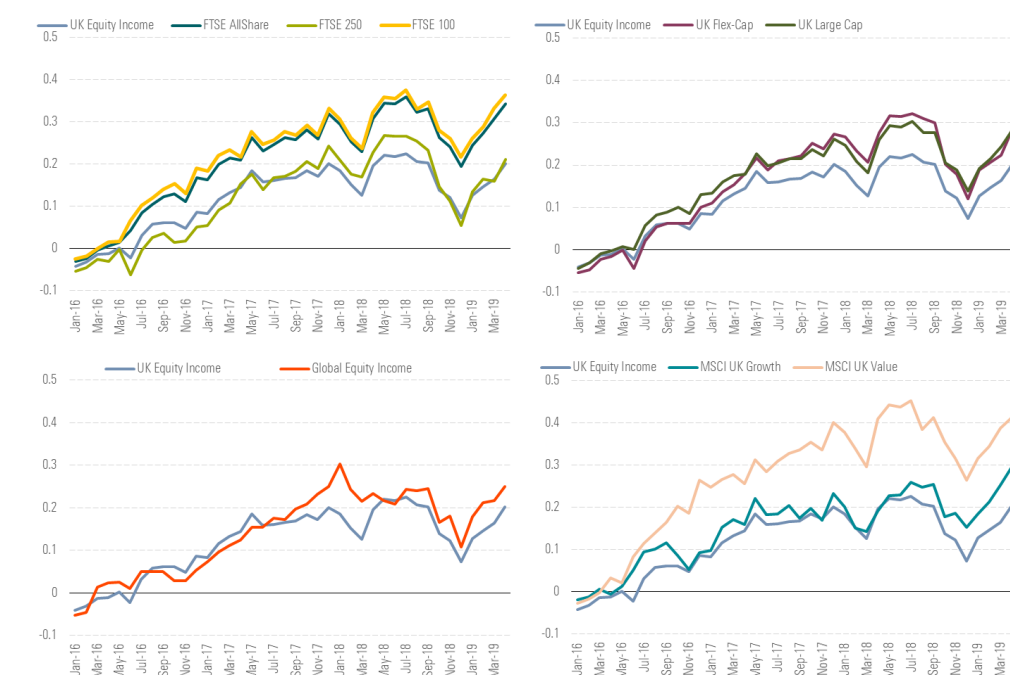
In the era of historically low interest rates, equity income funds have also represented an attractive option for investors seeking income-generating assets. Since the financial crisis, bond yields have been historically low and cash savings accounts have offered similarly low interest rates. As an alternative, investors may have turned to these income funds, which have yielded between 3% and 4% over the last

decade. Compare that with long-dated UK Gilt yields that have come down from a 2010 average of 4.3% to a 2018 average of 1.8%.

The Bad: Performance

The performance of these funds has been especially poor in recent years. Regardless of possible benefits, if returns are poor, investors will go elsewhere, which could explain why UK equity income funds have lost such large volumes of assets. Exhibit 1 shows four charts that compare the category against several different benchmarks or other categories. Panel 1 shows that the FTSE AllShare, the benchmark most often used by UK equity income funds, has performed considerably better than the UK equity income category. The FTSE 250's performance has also been poor over this period, and could mean that higher exposure to mid-caps has driven the category's underperformance. As an alternative, those investors wanting exposure to the UK could have bought a passive product or invested in a UK flex-cap or UK large-cap fund, as they have also performed better on average (panel 2).

Exhibit 1 UK Equity Income Category versus Various Categories and Indexes



Source: Morningstar Direct. Data as of 30/04/2019. Clockwise starting in top left, UK Equity Income category: (1) versus FTSE AllShare & MSCI World; (2) versus UK Flex-Cap & UK Large-Cap categories; (3) versus MSCI UK Growth & MSCI UK Value, and; (4) versus Global Equity Income category.

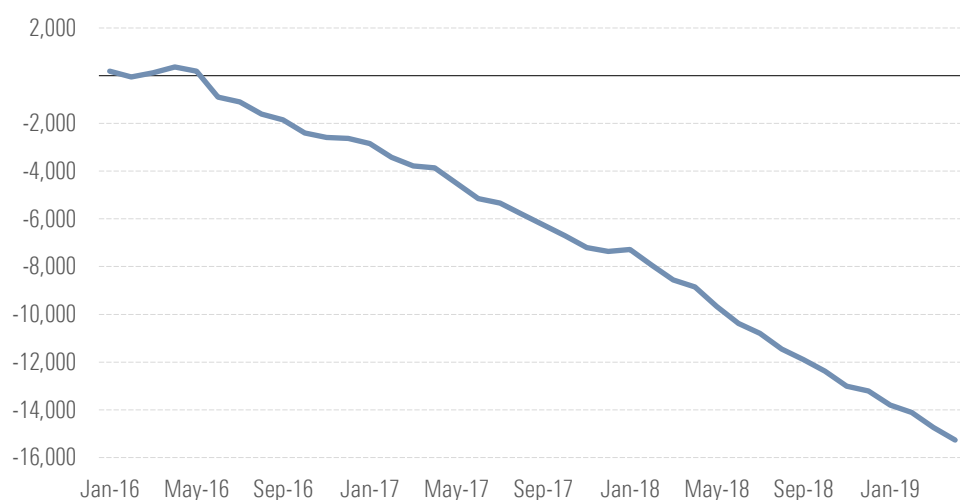
As UK equity income funds tend to have more of a value tilt, we can compare their returns against a value benchmark. Versus the MSCI UK Value Index, the UK equity income category average has underperformed since the start of 2016. Whilst value has outperformed growth since the start of 2016 (primarily due to the very strong performance of the mining sector in 2016), the UK equity income category average still finishes behind the MSCI UK Growth Index. If it is income that investors are searching for, there are alternatives to just investing in the UK market. Panel 4 shows that the global equity income category has outperformed the UK equity income category since the start of 2016. However, it is worth noting that the yields available on global equity income funds have generally not been as high as in the UK.

The UK equity income category has underperformed when compared with all alternatives shown above, and therefore it is no surprise that investors have been withdrawing in significant volumes from many of these funds.

The Ugly: Flows

In the period from January 2016 to the end of April 2019, GBP 15.3 billion was withdrawn from UK equity income funds. After April 2016 there was only one month that had a net inflow into the category, and that was a relatively modest GBP 80 million.

Exhibit 2 UK Equity Income Category Cumulative Net Flows (GBP Millions)



Source: Morningstar Direct. Data as of 30/04/2019.

The biggest outflow was from the range of Invesco UK equity income funds. These contributed to half of the total outflow, with GBP 7.5 billion being withdrawn from Invesco's equity income suite. The best-performing fund from this range, Invesco Income & Growth UK, had the smallest outflow of GBP 124 million. LF Woodford Equity Income, managed by Neil Woodord, also suffered greatly; GBP 3 billion flowed out from the beginning of 2016 to the end of April 2019. Considering that performance has been particularly poor for this fund over the past few years, the large outflows come as no surprise. Low liquidity levels as a result of a high allocation to smaller-cap and unquoted companies meant that the sheer size of outflows had become such an issue that dealing was recently suspended.

Clearly, most outflows from the category came from a few of the largest funds. Exhibit 3 shows that, on average, those funds that were in the smallest fund size quartile at the start of 2016 had inflows, and the rest had outflows. The largest quartile for fund size contributed to over 90% of the outflows from this category. However, as a percentage of beginning assets, their outflows (18%) were similar to those of the third quartile (17%). Furthermore, even if you exclude the top and bottom 10% of funds, in flow terms, the total net outflow is still GBP 4.7 billion, proving that the problem is not exclusive to the largest funds.

Exhibit 3 Flows by Fund Size Quartiles

Quartile	Beginning Fund Size Quartile Upper Limit	Number of Funds	Total Flow (GBP millions)	Average Flow (GBP millions)	Flow as % of Beginning Assets
1st Quartile	97	20	878	44	133%
2nd Quartile	250	20	-15	-1	4%
3rd Quartile	960	20	-1,954	-98	-17%
4th Quartile	12,405	20	-14,175	-709	-18%
All		80	-15,266	-191	

Source: Morningstar Direct. Data as of 30/04/2019.

It is not doom and gloom for all funds; there were some notable exceptions that managed to acquire significant assets. JOHCM UK Equity Income and Franklin UK Equity Income, which both carry Morningstar Analyst Ratings of Silver, have seen net inflows of around GBP 450 million each since the beginning of 2016.

The fund that grew the most was Man GLG UK Income, managed by Henry Dixon. The Bronze-rated fund is one of the best performing funds in this category, having outperformed the category average by 5.5% annualised since the beginning of 2016. It has not had a single monthly net outflow since February 2016 and has seen net inflows of GBP 850 million since then. Not far behind is Silver-rated Troy Trojan Income, managed by Francis Brooke, with GBP 829 million in net inflows since the beginning of 2016.

Active UK equity fund managers have a difficult time recently, especially with political turbulence such as Brexit, but some have managed to shine through, producing strong returns and attracting investor interest. They demonstrate that, with improved returns, the category may manage to attract back some of the investors it has lost. ■■

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