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Income is not what it used to be

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An old joke goes: nostalgia is not what it used to be. Neither, it seems, is investing in equities for income.

If you consult anyone in fund marketing about the name of a fund they will tell you to put “income” in the name.

Investors are desperate for income, with zero interest rates in most of the developed world setting a clear barrier to finding high yields. In a world in which Italian 10 year government bond yields went below 1.5 per cent per annum, you know that the search for yield has become extreme.

Yet increasing numbers of so-called “income” funds are dropping out of the Investment Association’s UK Income Sector classification because they can’t make the three-year 110 per cent of All Share Yield benchmark. Both the Invesco Perpetual High Income and Invesco Perpetual Income funds have been moved to the UK All Companies sector, as has St James’s Place UK High Income and most recently the Schroders Income Fund.

It remains to be seen whether they retain “income” in their name even though they no longer qualify for the sector. If you thought they couldn’t do that, you were wrong. Even more surprising is the fact that you can launch a fund with “income” in the name and have three years in the sector to gather assets before having to prove that the fund can achieve the yield benchmark or leave the sector, at which point you can still call it an income fund. Surely this is questionable, given the label seems able to mesmerise investors.

I would in any case question the whole importance attached to yield. Several factors seem to have led to some confusion among investors, who can perhaps be excused when faced with funds with “income” in their name that are not in the sector.

Investors have learnt that dividends are an important contributor to equity performance over the long term. But as with many concepts in finance, it is necessary to understand the concept fully and I doubt that many do.

Investors often quote evidence such as that from Jack Bogle, the father of index funds and one of my investment heroes, about the importance of dividends.
He said: “An investment of $10,000 in the S&P 500 Index at its 1926 inception with all dividends reinvested would by the end of September 2007 have grown to approximately $33.1m (10.4 per cent compounded). If dividends had not been reinvested, the value of that investment would have been just over $1.2m (6.1 per cent compounded) — an amazing gap of $32m.

“Over the past 81 years, then, reinvested dividend income accounted for approximately 95 per cent of the compound long-term return earned by the companies in the S&P 500.”

There you have it — dividends are more important than share price appreciation. Right? Sadly it’s not as simple as that. Note that Mr Bogle uses the word “reinvestment” no less than three times. It is this reinvestment and the return on it that accounted for almost all of stocks’ long-term total return.

You do not achieve this result if you invest in equities and take the dividend and spend it. The critical feature that Mr Bogle alighted upon is the benefit from reinvesting the dividends in equities. While this does make a dramatic difference to the outcome, it does not prove that income funds or high yielding equities are likely to deliver a superior return

You would have had a better result than in Mr Bogle’s example if you had invested dividends not in the whole index, but in companies that delivered a return superior to the index; and/or if instead of paying a dividend the companies had simply retained all the earnings and reinvested them, assuming they could deploy the additional cash at an adequate rate of return.

This is illustrated by the performance of Warren Buffett’s Berkshire Hathaway, which has never paid a dividend during the 50 years he has run it. Mr Buffett correctly concluded that if the rate of return he could obtain by reinvesting funds at Berkshire was higher than the rate of return on the S&P 500 Index, it would produce a better performance for investors if he retained all the earnings and reinvested them.

You might think you could get the same result if Berkshire paid a dividend and you reinvested it. Not if you pay income tax on your investment income, as you would only have the amount of the dividend net of tax to reinvest.

So it is not the dividend that is important, or even just the reinvestment of the dividend, but rather it is the rate of return on reinvestment of the dividend that drives the return.

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This is the first of a two-part series on investing for income