Picking out the next big growth company is what many hope for but few achieve. **Newton Investment Management’s** global income manager Nick Clay highlights why an income manager thinks differently and how that may suit investors in the current climate.

Returns have been eroded by the ongoing spate of asset support conducted by central banks since the financial crisis, Clay states. He describes the idea of the global economy weaning itself off measures such as quantitative easing as “ridiculous,” with central bankers willing to step in the moment something goes wrong. Investors also expect it. The result of these actions has been to push up valuations of assets. “There is a cost to that support and that is lower returns and increased volatility.”

As a result, Clay believes investors need to think carefully. “One thing you can do is to try and trade that volatility—but good luck. These days unexpected events, like snap elections, make it difficult to build a repeatable process around such an approach.” Instead, he believes the nature of sustainable income over time, the power of compounding dividends, can provide a resilient and significant impact to one’s total return which, in the long run, leads to greater asymmetry in returns. “Stability of returns is important to clients and in a world of risk and high valuations, it is ever more important.”

**FEAR OF MISSING OUT**

However, many growth-oriented managers are still seeking the big story—the next Internet or electronic firm to break out from the competition. “They have a fear of missing out (FOMO). But the ability to pick one particular fish out of the sea is difficult.

“I see investing more like Michelangelo, who famously, when asked about his art, said it’s what you take away that matters. We take a similar view: take away the statistically unattractive stocks. That’s what the discipline of income does—it narrows down the bucket and forces us to be patient.”

To create sustainable income over time, a company needs to generate sustainable cash flow and return on investment, allocating capital efficiently, Clay says. He cites a large U.S. software company and a Norwegian conglomerate as two good examples of income plays. The software company, Clay believes, wasted a lot of money trying to compete with other firms before it stopped and started returning cash to investors, resulting in better capital allocation discipline and, consequently, returns. The conglomerate had an aluminum business Clay describes as a leach: “They sold it, reinvested in their brands’ business and, are now beginning to reap the rewards.” Some of its brands, such as herring paste, are esoteric but possess pricing power unlike an aluminum business, he notes.
WORLD WONDERS

Calling dividends the eighth wonder of the world, Clay says capital may go up and down like a yo-yo, but compounding returns can provide ballast. “Capital growth will be so much harder to come by over the next 10 years, given starting valuations today,” Clay believes.

With respect to his global income strategy, Clay says he remains confident in the sustainability of dividend growth. While noting that dividend growth in general has fallen off since the financial crisis, he says more recently it has had a boost from currency plays, such as lower sterling.

Clay favors neither so-called “hopeful recovery” stocks, such as miners and banks, nor the oil and gas sector or direct positioning in emerging markets. Instead, he prefers what he calls boring stocks—consumer goods and health care. “Demand for items like whisky and shampoo are unlikely to be dependent on economic recovery.”

Noting the increased indebtedness of the U.S., rising valuations and what he feels is a growing threat of a slowdown, Clay says he no longer favors the region while taking a more positive view on areas like the UK and Switzerland versus the comparative index (the FTSE World).

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INDEX DEFINITIONS

The FTSE World Index is an unmanaged, free float-adjusted market capitalization-weighted index that is designed to measure the performance of 90% of the world’s investable stocks issued by large- and mid-cap companies in developed and advanced emerging markets. Investors cannot invest directly in any index.

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