A repeat of 2011?

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After a good start to 2012 UK equities have started to drift lower as investor concerns regarding the state of the Spanish and other European sovereign debt markets have re-emerged and as leading economic indicators have started to lose momentum. Despite these issues, year-to-date, cyclical sectors such as chemicals, electronics and paper have still outperformed while defensive sectors – food retailers, mobile telecoms and pharmaceuticals have lagged the market.

2012 appears to be shaping up to be a repeat of 2011 with cyclicals outperforming defensives in the early months before European worries drag down markets and “safe assets” become preferred. With a raft of elections in Europe this year to add to market uncertainty investors are rightly debating the best positioning for the months ahead.

In an environment of low economic growth, slower and more volatile business cycles and the additional problems of historic over leverage in government and consumer areas, stocks which can produce consistent, reliable and attractive yields and dividend growth should continue to outperform over the medium term. Interestingly even with the strong start to the year, UK Income Funds have delivered good returns year-to-date with an average return of over 6% against the FTSE All-Share up just over 4%. Indeed over the last 25 years, higher yield equities within the FTSE 350 have on average outperformed the index and in a more difficult economic/market environment we would expect an income approach to continue to prosper.

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The FTSE All-Share is trading on circa 10x price to earnings but with attractive real income characteristics. The market is currently yielding 4.0%* prospectively as dividend growth is expected to be around 7% in 2012 but with the potential for additional returns of capital via special dividends the outlook is positive. While income investors traditionally have sought out more defensive stocks, following the travails of 2011 there remain, selectively, great income opportunities among more cyclical/value stocks. While these are not currently in vogue they offer an attractively valued option on improving market sentiment with superior dividend growth prospects. If progress can be made in addressing some of the structural problems in Europe and growth continues, this area has the potential for exciting returns given time.

Performance data source: Bloomberg unless stated otherwise. *Source: Cazenove Capital at 30/04/12

Past performance is not a guide to future performance. The value of an investment and the income from it may go down as well as up and an investor may not get back the amount originally invested.

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