UK Equity Income: an alternative approach

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The search for yield remains a primary preoccupation for many UK investors. We have seen investors start to position their UK equity portfolios more defensively and UK Equity Income strategies are in focus. We believe that WisdomTree's approach to equity income strategies potentially provides the best of all worlds, adopting a fundamental approach that draws on some of the best features of active and passive management, whilst providing investors all the accessibility of the Exchange traded fund (ETF) wrapper, which is particularly relevant in the context of a recent high profile mutual fund trade suspension in the UK Equity Income space.

Why is equity income in focus?

As we enter the latter part of the economic cycle many investors are reticent about dramatically lowering their equity allocations and giving up potential upside but are also wary of market risks both at home and globally. Against this backdrop investors are considering the benefits of allocating to UK equity income strategies that focus on holding high yielding dividend paying companies. By focussing on high yielding companies, investors can position the equity portion of their portfolios more defensively whilst securing a strong income stream.

What makes the WisdomTree Strategy unique?

Traditionally, investors in the UK have favoured actively managed mutual funds to obtain their equity income exposure but we feel that adopting a transparent, rules-based approach underpinned by fundamentals is an alternative way of accessing high yielding dividend payers in the UK in a measured and cost-effective manner.

WisdomTree's UK equity income strategy provides access to a portfolio of the highest dividend yielding UK companies and is designed to capture the high-yield premium whilst managing valuation risk. Rather than adopting a traditional yield-weighted approach, we weight our portfolio by cash dividends paid and rebalance annually to relative value. This approach not only helps magnify the impact dividends have on performance but also tilts the portfolio to large capitalisation dividend paying companies providing a more defensive exposure.

In some respects, we adopt many of the screens and style tilts applied by traditional active managers but in choosing to launch this strategy, over three years ago, as a rule-based, index-tracking UCITS ETF – we are also able to provide investors with a cost-effective and diversified exposure, hallmarks of a passive index-tracking approach, which can be blended with or used as a core alternative to active equity income strategies.

Why should investors consider using ETFs?

The recent suspensions that have plagued certain high-profile mutual funds have raised some interesting questions in respect of fund transparency, portfolio concentration risks and underlying liquidity across the broader asset management industry.

One of the advantages of the ETF wrapper is its relative transparency when compared to traditional mutual funds that implement swing pricing. Above all else, the liquidity of an ETF is primarily determined by the underlying market that it is providing exposure to. As such, investors are clearly able to assess liquidity risks with any given investment in an ETF. Of course, it is beneficial that most ETF assets are tracking very liquid markets but even in instances where products track less liquid underlyings, investors have all the tools at their disposal to conduct the necessary due diligence. Additionally, ETFs are priced in a competitive and transparent manner. In the primary market, ETF providers will create or redeem securities with authorised participants and market makers will compete to price these securities accordingly. If large outflows are experienced, ETF providers cannot actively penalise investors in the NAV of the fund, which can occur with swing pricing. Furthermore, investors benefit from the additional layer of liquidity provided by secondary market trading, which provides both price transparency and accessibility on an intraday basis, two features that should not be overlooked in potentially volatile markets.

Investors should always consider the levels of risk, including concentration and liquidity, that active managers are taking in the pursuit of alpha. For those acutely aware of the due diligence challenges this may pose, a fundamentally driven, rules-based approach within a transparent ETF wrapper should not be discounted as a core alternative or complement to active equity income mutual funds.

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