

BAILLIE GIFFORD

Investing for Income

Piers Lawson

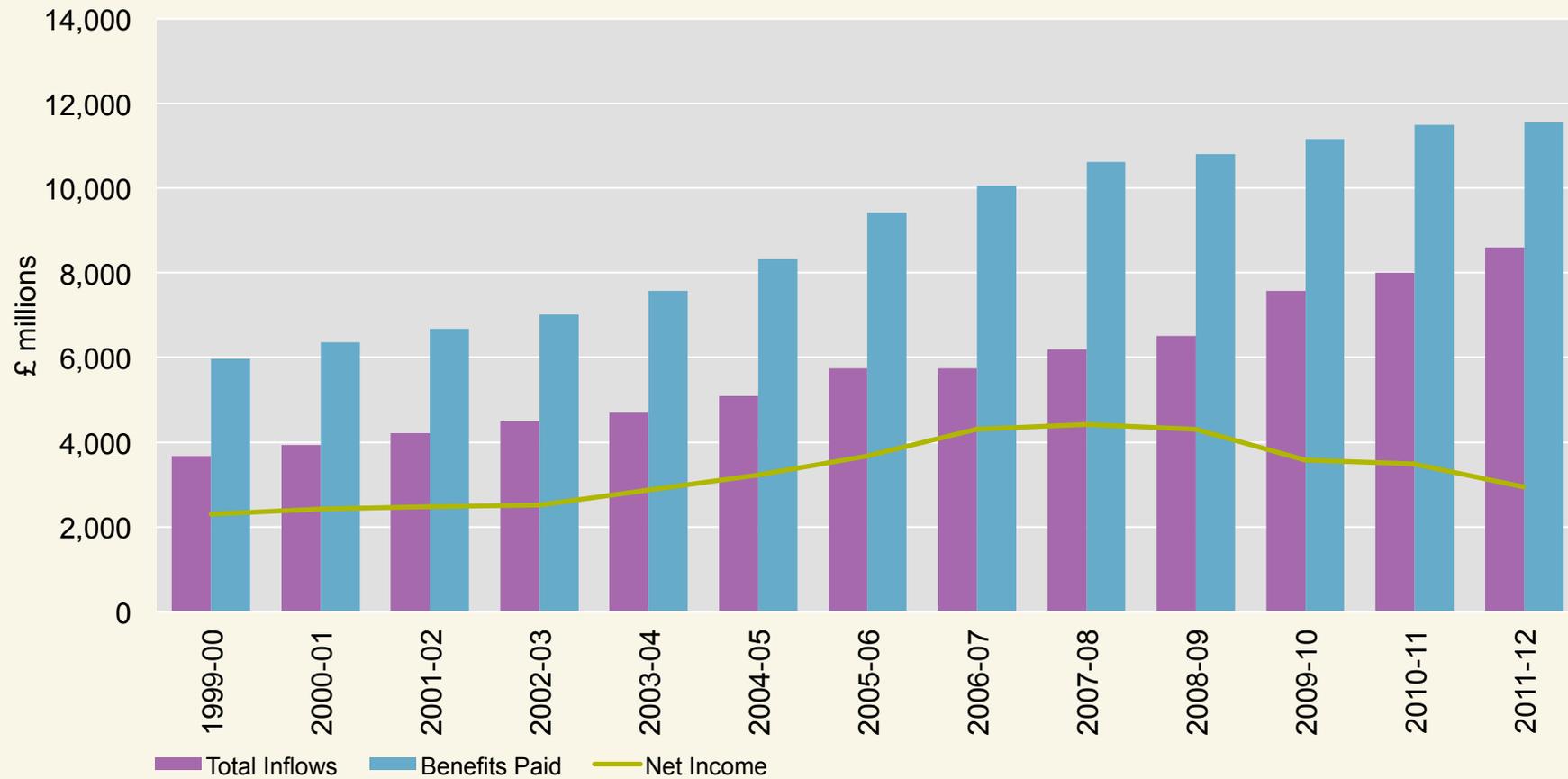
Ken Barker

Dominic Neary

September 2013



The LGPS Maturity is Accelerating



Source: Local Government Financial Statistics No.20 2010 and No.23 2013.

How Should Schemes React?

Diversification

Investing for income

- Providing diversification benefits
- Generating regular income to meet benefits

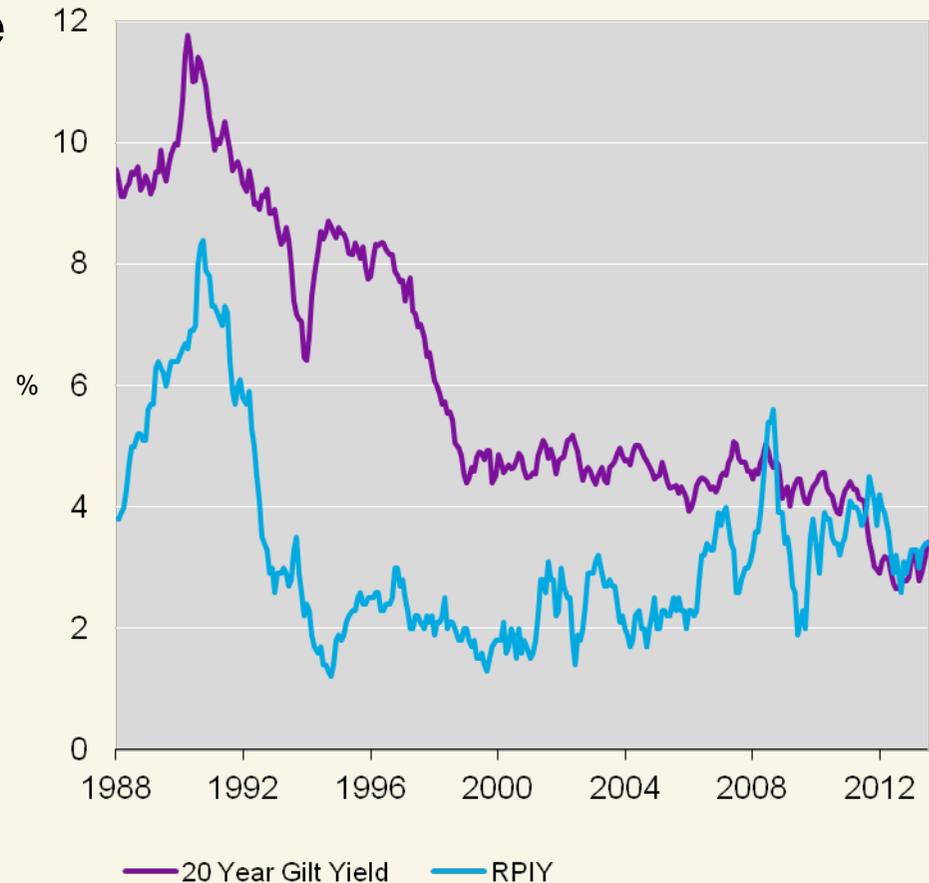
Meeting the challenge of cash flow negativity

Bond Yields and Inflation

Bonds can provide steady income in most market conditions

Inflation is the usual risk – remember the 1970s!

QE is the new danger – artificially depressed yields



Source: Haver Analytics

Real Long-term Growth

Income investors require real growth over the long term

In normal inflationary environments equities have produced positive real returns:

- **Earnings and dividends**
 - Revenues in many sectors linked to inflation
 - Efficiency improvements enhance profit growth
- **Capital**
 - Balance sheet assets
 - Reinvestment of earnings

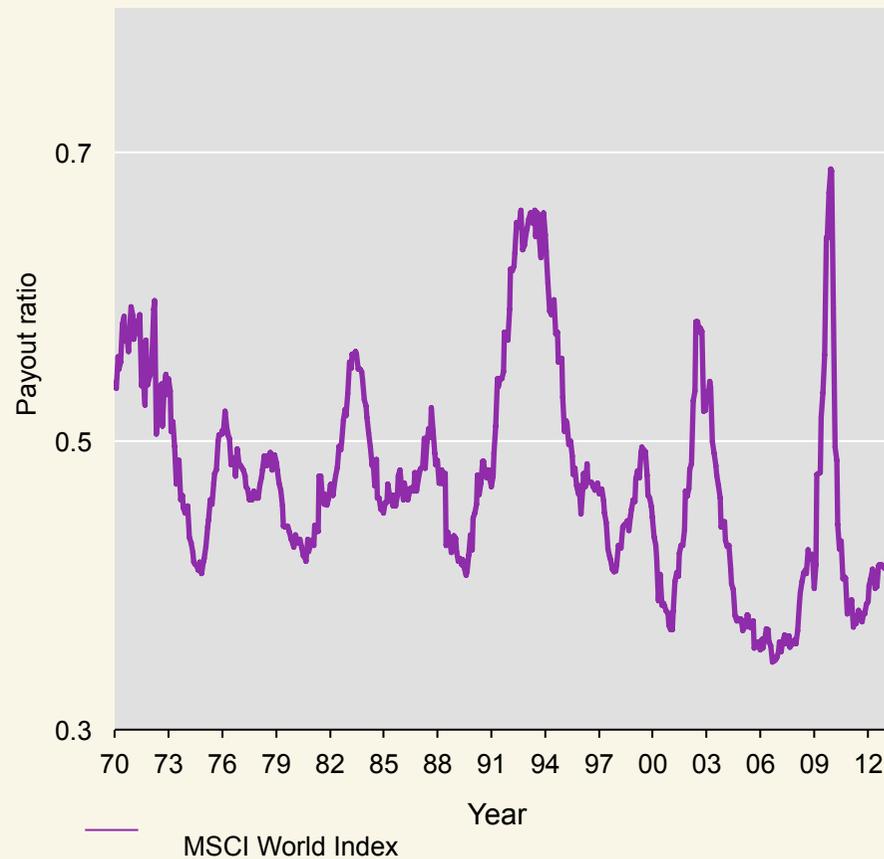
Timing

Cash-rich balance sheets

Low payout ratios relative to history

Increasing focus on shareholder returns via dividends

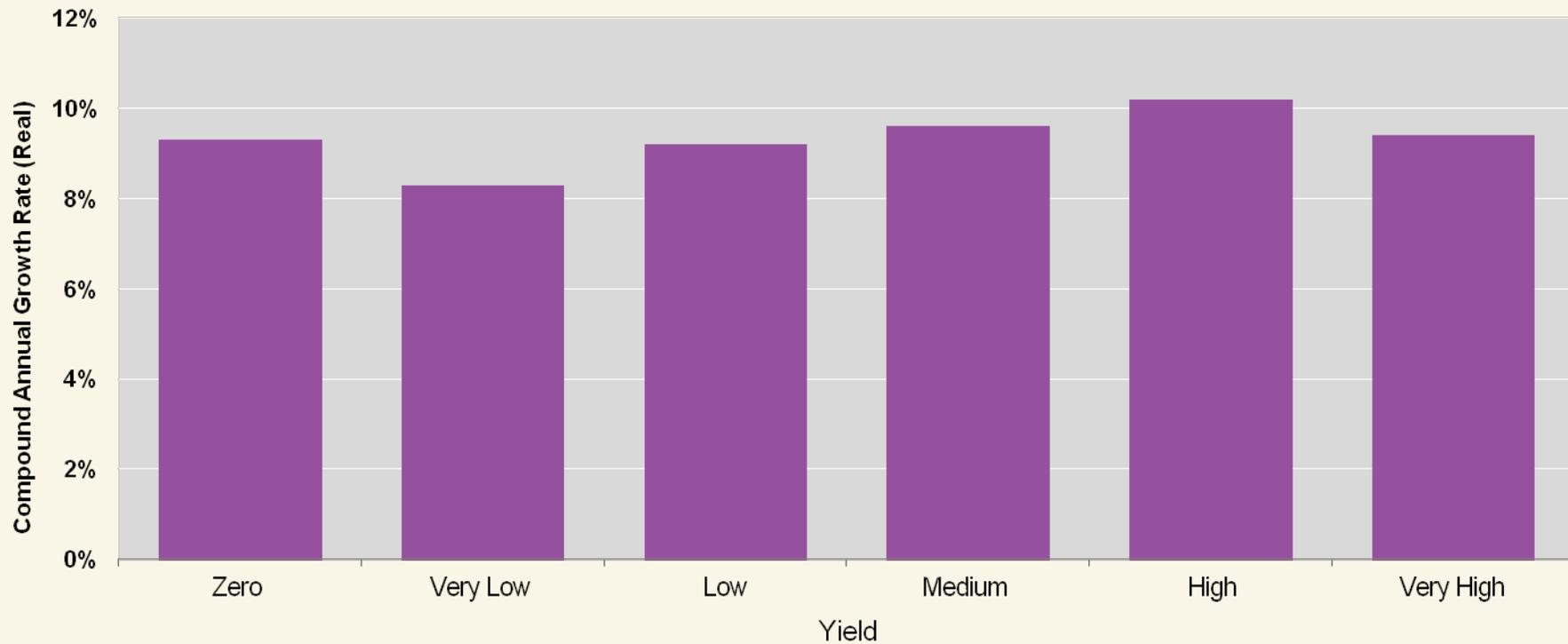
MSCI World Index Payout Ratios



Source: MSCI, Socgen.

Total Returns: Irrelevant for the Income Investor

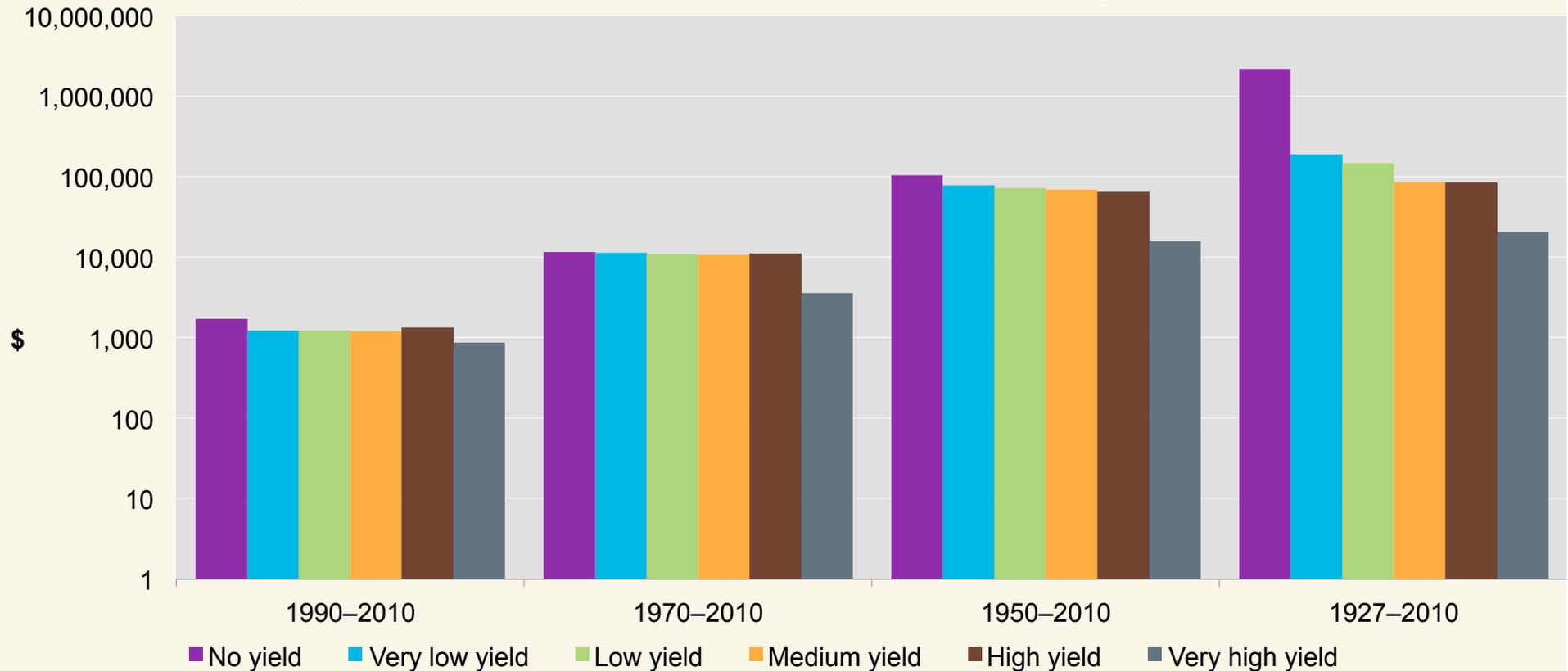
US Equities Annualised Real Growth Rates with Income Reinvested 1927 – 2010



Source: Socgen and Professor Kenneth French, Dartmouth University, USA.

When dividends are not reinvested

Total Value of Capital and Received Dividends on \$100 Invested in US Equities



Source: Socgen and Professor Kenneth French, Dartmouth University, USA.

Recommendation: Invest across all yields, balancing income generation with real growth potential

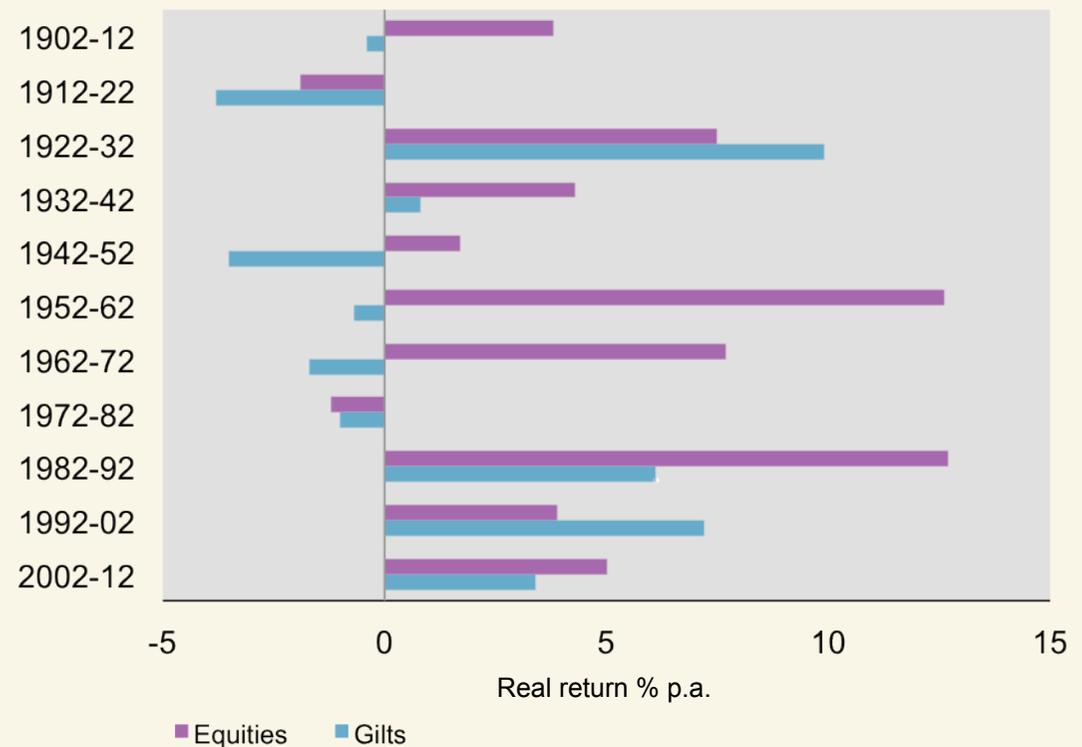
Risk and Income

Higher equity weighting increases volatility

Permanent loss of capital is true risk

Bonds arguably riskier on this measure

UK Market Return After Inflation



Source: Barclays Equity Gilt Study 2013

Equity versus gilts and cash

	Holding period (years)					
	2	3	4	5	10	18
Outperform cash	75	77	79	81	94	95
Underperform cash	37	34	31	28	10	1
Total number of years	112	111	110	109	104	96
Probability of equity outperformance	67%	69%	72%	74%	90%	99%
Outperform gilts	76	82	83	80	82	84
Underperform gilts	36	29	27	29	22	12
Total number of years	112	111	110	109	104	96
Probability of equity outperformance	68%	74%	75%	73%	79%	88%

Source: Barclays Equity Gilt Study 2013

Go Global

Diversification

- Diversified sources of income
- Reduce risk to capital

Opportunity

- Select the best opportunities from around the world
- Own a company for its prospects, not domicile

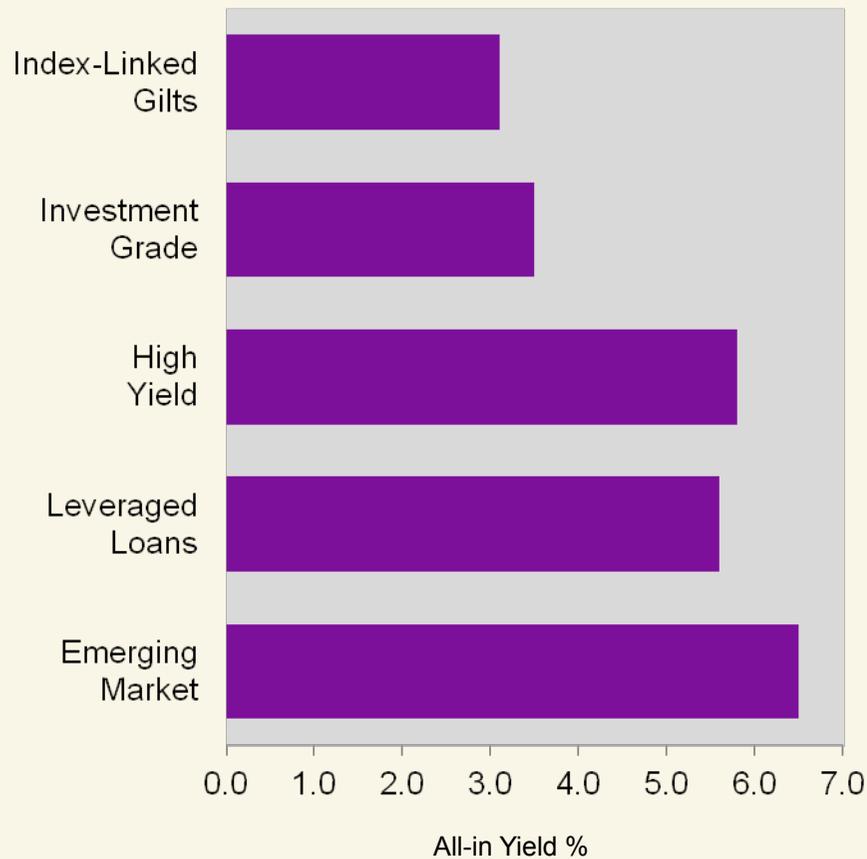


Active Management

Bottom-up stock selection for quality and growth

- Select stocks for total return potential
- Stability and growth in earnings, dividends and capital
- Avoid apparently high-yielding value traps

Sources of Income From Bonds



Pros

Cons

Inflation-proof

Miserable yield

Modest premium to gilts

Track gilts

Better yield

Cyclical

Libor base

Hard to access

Better fundamentals

Volatile in short term

Source: FT, Merrill Lynch, JP Morgan & Baillie Gifford & Co. As at 31st July 2013

Investing for Income

Summary

- Gilt yields close to historic lows
- Scope for diversification into other Fixed Income assets
- Equities can offer long-term growth in capital and income

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