

14th February 2022

UK value/income bias delivers performance in uncertain times

- Value bias has made UK equities more attractive recently
- Within UK equities, strategies with an income-bias has outperformed
- “Smart-Beta” means a rules-based approach for constructing an index

Value/Income bias for inflation protection

In our [2022 outlook](#), we explained why inflation will remain hotter for longer and will settle above pre-pandemic levels. Within equities, we outlined our rationale for being overweight Value-factor equities with an Income bias to shorten equity duration. This built on [our May 2021 view on UK equity income providing a helpful inflation hedge](#).

The rapidity and severity of market movements against the prospect of faster-than-expected inflation and greater-than-expected interest rate tightening have only served to reinforce these views, as reflected by performance.

Whereas world equities have struggled year to date, UK equities have been a relative bright spot. Within UK equity index exposures, indices that focus on dividends (with an inherent value bias), over size (market cap) have delivered best results.

Our [Smart-Beta UK Dividend Index](#) [ticker ELSUKI Index] has delivered positive returns YTD ahead of more mainstream UK equity indices, driving the absolute and relative returns of the [VT Munro Smart-Beta UK Fund](#), which is benchmarked to this index¹.

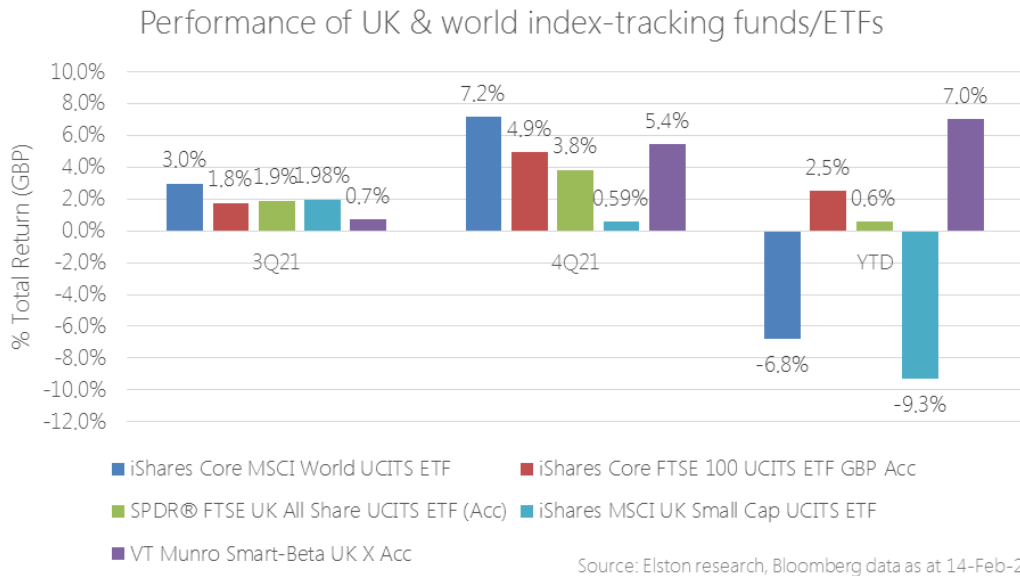
In low dispersion markets, where markets move tightly in the same direction, asset selection across equity markets, and security selection within equity markets makes little overall difference. Rising tides can float all boats.

In high dispersion markets (like the start to 2022), where markets move widely in different directions, asset selection across equity markets, and security selection within equity markets makes a material difference.

That dispersion is on show year-to-date as illustrated in Fig.1., below.

¹ Note & Commercial Interest Disclosure: Elston Indices is the benchmark administrator for the Freedom Smart-Beta UK Dividend Index, to be renamed the Elston Smart-Beta UK Dividend Index with effect from 1st March 2022. The VT Munro Smart-Beta UK Fund is benchmarked to this index.

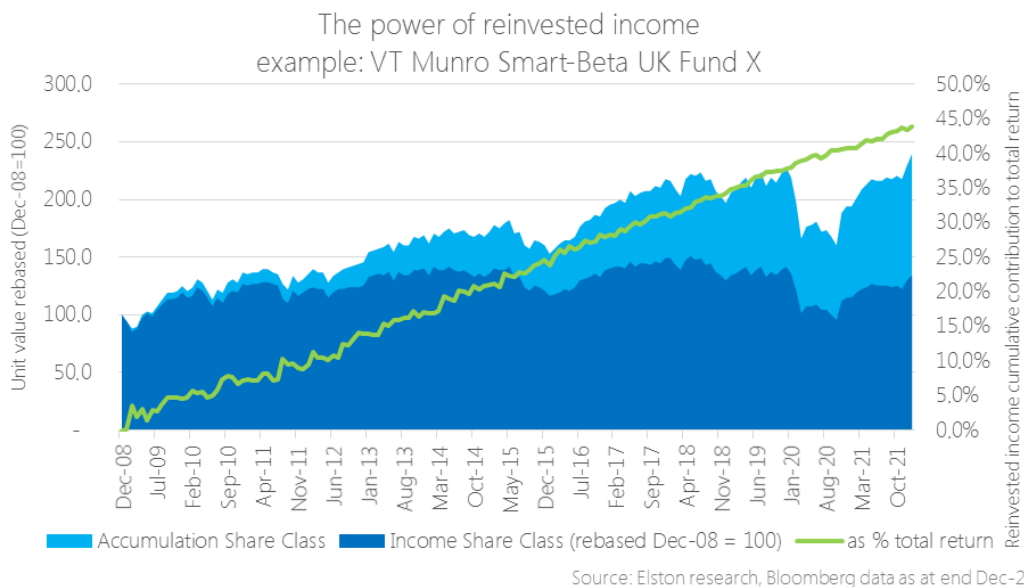
Fig.1. Dispersion to the fore!



- **Poor performers this year:** the rotation from growth to value means that funds tracking world equity markets are down -6.8% and funds tracking UK small caps are down -9.3% YTD in GBP terms.
- **Strong performers this year:** the UK has been a bright spot within equity markets owing to its value bias. Funds tracking FTSE All Share +0.6%, the FTSE 100 are +2.5%, whilst the fund tracking our Smart-Beta UK Dividend Index are +7.0% YTD in GBP terms.

When looking at longer-term performance, the contribution to dividends to total returns is material. For example, looking at the VT Munro Smart-Beta UK Fund as an example, approximately 44% of Total Returns are explained by reinvested income.

Fig.2. The power of reinvested income



What kind of companies are in the index

Our Smart-Beta UK Dividend Index's top holdings represent the largest dividend payers by quantum. Which tends to bring in a *de facto* bias towards Value-style companies, which are typically beneficiaries of rising inflation (energy, materials sectors) and rising interest rates (financial sectors).

Fig.3. Top 10 holdings compared

Top 10	Dividend-weighted	Top 10	Market-cap-weighted
Rio Tinto plc	8.48%	Shell plc	5.94%
British American Tobacco plc	6.08%	Astrazeneca plc	5.46%
Shell plc	6.07%	HSBC Holdings plc	4.41%
HSBC Holdings plc	5.01%	Unilever plc	3.96%
Glencore plc	3.63%	Diageo plc	3.50%
Unilever plc	3.57%	GlaxoSmithKline plc	3.32%
Astrazeneca plc	3.17%	BP plc	3.05%
BP plc	3.13%	British American Tobacco plc	2.96%
Anglo American plc	2.76%	Rio Tinto plc	2.31%
GlaxoSmithKline plc	2.75%	Glencore plc	2.08%
Top 10 as %	44.65%	Top 10 as %	36.99%

Source: Elston research, manager data

Source (Market-cap-weighted): SPDR FTSE UK All Share UCITS ETF Acc Fund Factsheet, as at end January 2022

Source (Dividend-weighted): VT Munro Smart-Beta UK X Acc fund factsheet, as at end January 2022

This is a function of the index construction methodology, that is anchored in the traditional value-based investment approach that dividends underpin equity returns. We explore the details of this methodology below.

Index rules drive performance outcomes

There's no such thing as passive. Everything around portfolio construction and implementation requires active choices.

When creating an equity allocation, the decision as whether, and to what extent, to include a UK home-equity bias is an active choice. Whilst a global-bias has delivered better results since the financial crisis (and the rise of tech), this quarter, the defensive tech-free nature of UK equities has delivered far better results for investors.

To implement a UK equity allocation using index funds (including index-tracking ETFs) also requires an active choice. Should you select an index funds that holds the largest 100 companies, all listed companies, small cap companies or something that uses something a bit different?

For the something a bit different, enter "Smart Beta". Beta is just the fancy Greek term for index investing. A fund with a Beta of 1 to its index, moves in line with its index.

Traditional Beta refers to market capitalisation weighted indices which is the most common form of weighting securities within an index. The advantage of this approach is that it's widespread and

familiar. The disadvantage of this approach is that it is pro-cyclical – the big get bigger within an index, until they don't. In fact, most of the criticisms levelled at “passive” investing, are actually directed at traditional capitalisation-weighted indices.

So-called “Smart” Beta refers to any alternative (non-market-capitalisation) weighting scheme to create an index. For example, an equal weighted approach, a minimum volatility approach, a style-factor overlay, or a dividend-weighted approach. These are all different ways of constructing indices to isolate or emphasise particular characteristics that investors may want exposure to.

In the case of our Smart-Beta UK Dividend Index, the methodology is to weight companies by their forward-looking dividend contribution to aggregate UK dividends. The bigger the dividends paid in absolute terms, and therefore as a proportion of overall dividends, the bigger the weighting of that security in the index. By being forward-looking, and rebalancing monthly, it means that if analysts upgrade their dividend forecasts for a company, its weight in the index will also increase, other things being equal. In this way, changes in a company's prospects owing to information today (for example a rise in oil or commodity prices) are captured pre-emptively, rather than after the results.

Summary

Benjamin Graham was seen as the “father of value investing”. In his book, [The Intelligent Investor](#), he outlines the importance of dividends to underpin equity returns. In a market environment where so much is uncertain, the underpin of robust and growing dividends provide an anchor to share price valuations. The nearer-term, more certain nature of those dividends also makes a company's share price less inversely sensitive to increases in interest rates: a concept known as “shorter equity duration”. This makes this type of equity strategy an appropriate part of the solutions matrix when [adapting portfolios for inflation](#).

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