investment WEEK
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FUND MANAGER'S COMMENT |

The boring, ugly and unfashionable

Last year was rewarding for UK equity income managers, who consolidated gains made the year before and partly made up for the disappointments of the previous two years.

The rise of the FTSE All-Share from its low point in March 2003 has helped to diminish pessimism. We measure this pessimism – or over-reaction – by its dividend yield, and whether this will provide adequate compensation for its uninspiring prospects.

We grade stocks as ugly, boring and unfashionable. To qualify for the first category a stock must yield 2% over the long-dated gilt. If government bonds yield about 4.5%, ugly stocks must offer 6.5% or more. These ugly stocks are those other investors have fallen out of love with, whose prospects for recovery are, in the market's opinion, severely limited.

"To get the best out of these kinds of uninspiring stocks one must take a five-year view"

Jeremy Lang, Joint Investment Director, Liontrust Asset Management.

The other two grades are less extreme. Boring stocks provide a dividend yield of more than 2% over inflation – at least 4.5% a year. Unfashionable stocks are good companies the market views as average. They must be able to grow their dividends faster than inflation.

To get the best out of these kinds of stocks one must take a five-year view in the expectation that over this period the over-reaction will die down and the reasons investors loathe these stocks will begin to fade. In the meantime the equity income fund manager can sit back, reap the dividend and wait for sentiment to change.

Over the past two years all three stock categories have been rewarding for investors. However this period has not been without its bumpy moments. In 2003 the ugly stocks rose by 40% as a group. But within this category half cut their dividend. Likewise 2004 was another good year – as a whole these stocks rose 18%, despite the fact that 30% reduced their dividends.

Similarly the boring stocks have provided a reliable total return over the past two years. In 2003 they grew by 27%, even though a quarter of them were unable to raise their dividends faster than inflation. This disappointing dividend growth was a feature of these stocks again last year, although as a group they rose by 17%.

The final category of holdings, the unfashionable stocks, grew by 40% in 2003 and 15% in 2004. In 2004 their dividend growth averaged 5%.

Two months into 2005 there is much less pessimism. The number of ugly stocks on extremely high yields is down to single figures. This tells us that optimism is beginning to build again. When this happens it is best to move away from the extremes of the market and to be content to search for opportunities in stocks that others find dull or uninteresting.

We believe most returns are likely to come from the boring and unfashionable stocks. We are entering a period where one has to be careful when looking for value. It is important to be mean about the price one is prepared to pay and not be duped into buying just because stocks look relatively cheap.

BULL POINTS

Gains in 2003 and 2004 made up for losses.

Opportunities among dull and uninteresting stocks.

Much less pessimism and optimism beginning to build.

BEAR POINTS

Be careful when looking for value.

Be mean about the price you pay for stocks.

Don't be duped into buying stocks just because they look cheap.