Liontrust Income Fund

Q1 2022 review

Fund managers: Robin Geffen, James O'Connor and Clare Pleydell-Bouverie

The Liontrust Income Fund returned 2.1% in the first quarter of 2022, outperforming both the FTSE All Share Index and the IA UK Equity Income sector, which returned 0.5% and -0.1% respectively. This placed the Fund in the second quartile for Q1 and moved the Fund up to first quartile on a rolling 6 month and 1 year basis.

The past couple of years have been incredibly dynamic on many fronts, and the first quarter of 2022 proved no exception. Economic growth in the UK, and indeed around the world, faced new headwinds stemming from a Covid resurgence (the "Omicron hit") and the Russian invasion of Ukraine. These added to economic uncertainty, sent commodities prices soaring, exacerbated existing supply chain issues and increased inflationary pressures − further intensifying an ongoing cost of living crisis in the UK as real incomes continue to fall.

UK inflation (CPI) hit 6.2% in February − a 30 year high − and is forecast to hit 9% in late 2022. In response, the Bank of England has hiked interest rates 3 times in quick succession since December 2021 (twice in the quarter), each by 25 basis points, taking the UK market back up to the pre-Covid base rate of 0.75%. GDP growth in February, meanwhile, was slightly below expectations at 0.1%. However, the weakness was concentrated in the NHS test and trace and vaccination estimates and growth in services was robust. The level of GDP in the UK is now 1.5% above its pre-pandemic level, with services activity 2.1% above, representing an improvement from the end of 2021 when the UK economy was 0.1% below its pre-pandemic peak.

In the UK government's spring budget, support was mostly geared towards the consumer through features such as a 5p per litre fuel subsidy, helping to offset surging fuel costs (Brent oil prices climbed above $120 per barrel in March on Russia sanction concerns). The government also announced a 'super deduction in capital allowances for company investment in plant and machinery' to help incentivize long-term investment.

Against this turbulent backdrop, the UK market managed to outperform other global markets over this period. The FTSE 100 Index gained 1.8% in Q1 and strongly outperformed the FTSE 250 Index (down 10.6%). This disparity was largely attributable to the sector composition of the FTSE 100, which has relatively high exposure to energy, commodities and financial stocks (sectors which benefit from rising rates and inflation hedging) and defensive sectors such as healthcare and utilities (safe havens for investors concerned about the Ukraine crisis). The larger-cap FTSE 100 stocks also benefited from international exposure and economies of scale because they have been better able to manage inflation through cost controls and superior insight and influence over supply-chains. Rallies in stock-specific constituents further bolstered the FTSE 100 over the quarter, including former laggards

Pearson and LSE, and BAE Systems, which benefited from increased European defence spend prospects.

Nonetheless, despite this top-end rally, UK stocks remain cheap relative to peers with the FTSE 100 trading on an 11.2-times forward earnings multiple at the end of Q1 (compared to 13-times for the Euro STOXX 50 and 20-times for the growth-heavy S&P 500). The FTSE 100 remains the cheapest global developed market relative to its own 10-year history.

From an income perspective, the UK has continued its 2021 trend of companies reinstating dividends that had been cancelled or suspended throughout 2020. Total UK dividends have now returned to over of 80% pre-Covid levels (on an underlying basis) and can grow from a more sustainable basis, as indicated by a notably improved dividend coverage ratio for the FTSE All Share (2.65-times as of the beginning of the year).

On a sector basis, industrials and materials were the 2 greatest contributors to Fund performance in the quarter. Whilst the Fund remains marginally underweight in industrials, it benefited from an overweight position in BAE Systems, which gained over 30% in the quarter as the Ukraine crisis spurred an increase in defence budgets across Europe. Meanwhile, in the materials space, the Fund benefited from overweight positions in diversified miners Anglo American and Rio Tinto (boosted by increased commodities prices and inflation hedging) as well as copper miner Antofagasta, which had the additional benefit of an improved regulatory outlook in Chile.

On the flipside, our overweight exposure to technology was our key Q1 detractor on a sector basis. This was largely attributable to one position in particular – Halma – which was one of the biggest stock-specific detractors in the Fund, falling as rising inflation and subsequent interest rates saw investors rotate out of traditional growth stocks. Our US tech positions, whilst still a marginal headwind overall, fared notably better, with Visa an overall positive contributor to the Fund over the period. The Fund also faced performance headwinds from our homebuilder stocks, Persimmon and Berkeley Group. In spite of their strong order books and record house prices, these companies fell on the back of industry-wide regulatory concerns regarding cladding as well as the roll-off of government support in the form of help-to-buy schemes.

Owing to the rotation out of growth stocks as interest rates (and expectations for rates) increased in the period, our 'Steady Eddies' underperformed our more value-orientated 'Hidden Fruits' and cyclically-driven 'Economic recovery' stocks.

Given ongoing supply chain issues and soaring commodities prices, the inflation outlook looks set to worsen before it gets better and is currently expected to hit 9% by late 2022. Given this inflation backdrop, we continue to focus on companies that can pass on costs and mitigate input costs through economies of scale and greater efficiencies.

In response to this inflation outlook, the Bank of England (BOE) is expected to continue with its program of hiking interest rates, with the market currently pricing in slightly over 5 rate hikes for the year. However, given the geo-political uncertainty that has been evident since the start of the year and the Ukraine crisis, the BOE is cognizant of the need to rein in inflation while supporting economic growth. Notably, the language used by the BOE in its announcements has changed in recent weeks, with the speed of interest rate hikes appearing to slow slightly.

In a rising rate environment in which returns are less driven by multiple expansion, dividends are becoming a growing contributor to shareholder returns. The UK's status as a superior hunting ground for dividends (which are projected to continue their steady growth trend) thus looks set to boost its attractiveness to investors feeling the squeeze from rising rates across global markets.

Against a backdrop of market uncertainty, we continue to believe that picking 'dependable income stocks' and our 3-silo portfolio structure will help our Fund to mitigate market downturns whilst participating in the upturns. Through our focus on picking dependable stocks, the Liontrust Income Fund has been able to grow distributions by 5% over the past 3 years despite market turbulence and a slew of dividend cuts. The Fund's dividend distribution for the first quarter was 15% higher versus the Q1 2020 dividend. We are optimistic for the year ahead given the strength of corporate cash levels in the UK.

Discrete years' performance (%), to previous quarter-end:**

	Mar-22	Mar-21	Mar-20	Mar-19	Mar-18
Liontrust Income C Acc	14.1%	27.9%	-18.4%	8.8%	1.9%
FTSE All Share	13.0%	26.7%	-18.5%	6.4%	1.2%
IA UK Equity Income	10.8%	32.6%	-20.6%	3.6%	0.3%
Quartile	1	3	2	1	2

***Source: FE Analytics as at 31.03.22**

****Source: FE Analytics as at 31.03.22. Quartiles generated on 05.04.22**

For a comprehensive list of common financial words and terms, see our glossary at: https://www.liontrust.co.uk/benefits-of-investing/guide-financial-words-terms

Key Risks

Past performance is not a guide to future performance. The value of an investment and the income generated from it can fall as well as rise and is not guaranteed. You may get back less than you originally invested.

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

Investment in the Fund involves foreign currencies and may be subject to fluctuations in value due to movements in exchange rates. The value of fixed income securities will fall if the issuer is unable to repay its debt or has its credit rating reduced. Generally, the higher the perceived credit risk of the issuer, the higher the rate of interest. Bond markets may be subject to reduced liquidity. The Fund may invest in emerging markets/soft currencies or in financial derivative instruments, both of which may have the effect of increasing volatility.

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