

## **Blake Hutchins (Troy) – The Sweet Spot for UK Equity Income**

**Tom Yeowart:** Blake welcome to the podcast. Thank you very much for coming on again. So last time we spoke, which was coming up to two years ago, you're parting bit of advice was to be deliberate and optimistic. So, a lot has happened over the last two years with the pandemic, with volatility in markets. So, I was just wondering how that advice has guided you?

**Blake Hutchins:** Hi Tom. Hi George. Good to be back, couple years on and it has been a really challenging two years, but actually it's been a challenging three years, I would say. Pretty unprecedented: pandemic, reopening, rerating, inflation, derating, and then throw in for UK investors last year, what was this incredible period around that mini budget which had big consequences specifically for UK assets. So, it's been a really challenging environment for all investors.

I think on the deliberate point. It definitely stood us in good stead. Having a plan is so important. What are we trying to do? Invest in great quality businesses that can deliver resilient total return and a sustainable income growth. Having that as your guiding compass amongst all that change, I think has been really important. It also enables you to know where to look for new ideas. We've been very clear as to what we're trying to do, which is a continuation of what we've always done.

Optimism. That's definitely something I've got but in periods last year of 2022 in particular, it's difficult and that's one of the beauties and challenges of investing. At the beginning of last year when some of our favourite companies whose share prices were falling pretty fast. I'm thinking about companies like Diploma, down 40% at one point, despite having had two profit upgrades and grew its earnings and dividends, 26%. When I think about Experian, really solid business, we're pretty sure that they're going to trade well through a more difficult economic environment. And yet the share price is telling you something different and you are asking yourself, am I missing something here? Are these companies about to hit a speed bump. Is there profit growth and their cash flow generation going to be different than what I'm expecting? So, there are times when you question yourself, but ultimately, I've always said this, if you own good businesses, you can remain optimistic about them.

**George Viney:** The environment today for income investing is really quite different compared to when we first spoke to you, Blake, in that interest rates have shot up. Base rates in the UK, 4%. So, the hurdle rate for dividend yield,

but also discount rate for dividend growth is very different. So how do you think about that balancing act?

**Blake Hutchins:** I think if you look over 10 years+ the gap between bond yields and equity dividend yields, or even cash yields, short dated government bonds and even what you can start to get in the bank now. Its gone the wrong way for the first time in over a decade, which is a material change. When we were last speaking, we were probably talking, bond yields in the ones, and now we're talking in the threes to fours. And so, I think it is materially different.

A couple of points that I would make. One, I think that with higher inflation, the importance of income and income growth specifically, is probably going to come back to the fore. I think we had over a decade where capital growth really drove the stock market, particularly in the US but also in the UK. So, I think that's the bullish case for equity income investing, more appreciation of dividends, dividend growth as part of a sensible total return. Because we're probably not going to be in an environment where it's all about capital growth anymore with a high discount rate. I think the headwind we have is that there is now an alternative which is probably where your question is getting at.

And so, when I think about equity income investing, what have we got in our locker to compete against the alternatives, that option that investors now have, for the first time in a long time, of investing in bonds? Well, there's two things that really are important to me. One, we've got to make sure that the income that we generate is sustainable because when you can get guaranteed four, there's no point us having dividends that aren't sustainable, that can't actually be realised, that's not doing anyone any good. And so, I still think the adage of not chasing for high yield, not overly stretching, is really, really important.

It's not just about competing with bonds for the highest yield. Making sure that dividend is sustainable through investing in good quality companies is the first thing that I'm really thinking about, and I think we're in great shape in that regard. The second point is, what do equities have in their favour over bonds? It's the opposite of being a fixed income. It's the fact that we have growth as part of our total return. If you think about in the next 10 years, you buy a bond. Compounds at let's say four, you turn a £100 into what? 140, if you just clip the income, 150 maybe if you reinvest those dividends, but equities on average give you a better total return than that.

So, if we can deliver yield plus growth, that's going to be our defence against bonds, that's going to be our defence against inflation. That's going to be our defence in terms of other alternatives. So, back to making sure that dividends

are sustainable and make sure that you have that component of growth is going to be more important than ever. It's not just all about yield. Because let's just say a 7% total return compounded for 10 years, that's doubling over your money. So, we're talking about turning a £100 into £200, which is a really, really big plus for equity income over fixed income investing.

**Tom Yeowart:** There's quite a strong correlation between yield and dividend growth, so the lower yielding companies have stronger dividend growth and vice versa. So, I'm just interested how you are striking the balance within the portfolio. Can you tell us a bit more about where you are on this sort of yield perspective and then also what that translates to in terms of sustainable dividend growth?

**Blake Hutchins:** So, we've done a bit of a study on this actually, and I'm probably going to write about it in my next newsletter. And it shows starting dividend yield and then forward dividend growth. And it basically shows that the lower the starting dividend yield, the better the prospective growth. The higher the dividend yield, the riskier the dividend growth. And in fact, it's usually negative.

But there's a real sweet spot, and our sweet spot in terms of dividend yield reflects this, which is dividend yields around 2-4%. Dividend yields around 2-3 over time have grown, I think it's eight on average. Dividend yields between 3-4% have grown 5% on average. Anything above 4% dividend yields have on average gone flat to backwards. And obviously the higher you go the worse the dividend growth.

So, if we can find stocks that are yielding 2-4%, but have prospects for that 4-9% dividend growth, which makes me believe that we can deliver high single digit total return, maybe even double digit total return. And that's a really good combination. And that's a difference between our approach to equity income investing and some of our peers is, we start with that resilient total return, seeing those two components between a good starting dividend yield and dividend growth. So, when you look at the portfolios today, they have about a 3.2% dividend yield, around twice covered by earnings. So, we have an earnings yield of about 6% across the portfolio. And we believe that we can deliver mid-single-digit dividend growth on a compound basis from that.

So that's how we're thinking about it and it's about the companies that we own that can deliver that. And I think we take a lot of comfort that our companies have done that for a very, very long time. When I look across the portfolio there's a lot of companies that have this almost dividend hero status. Croda, you

could say only a 2% dividend yield, but grown its dividend every year in the last 30. Bunzl, 2.3% dividend yield, grown its dividend every year for the past 30. Diageo, I think 25 years of consecutive dividend growth, P&G, 65 years of consecutive dividend growth. Medtronic, 50 plus years of consecutive dividend growth. So, we think that that yield will get paid, and we also think that that dividend growth, we've got history on our side to show that our companies can deliver that.

**George Viney:** Blake, I think I know the answer to this question, but I'm going to ask it anyway. None of the businesses you mentioned just then are either banks or commodity businesses. Banks do well in rising interest rate environments, at least maybe in the early phases when they can collect higher yields on their loans and investment portfolios. And clearly, you've seen commodity businesses generate higher income because the commodities that they mine or drill are at higher prices. Is there any scope for them in this new regime, or is it continue to be the case that they are not part of our investment universe?

**Blake Hutchins:** Not owning those companies has been a pretty material headwind to our performance over the past 12 months. The problem with those sectors is they're incredibly macro in nature. And so, the short answer to your question is no, we're not going to invest in banks, oils, miners. And the reason for that is because they still don't have the characteristics that we look for. Historically, and I believe going forward, they're going to find it difficult to sustain high returns on capital. They're price takers in many cases, rather than price setters. They generally consume capital as they grow, and it's easy to forget that a lot of these businesses will have to reinvest into higher prices and maybe the returns that we're getting today from a lot of these companies won't be sustained in the future.

But that doesn't mean that we can't have access to many other businesses that have some of the same drivers or even operate in the same industries. A lot of work we've been doing over the past three years is getting to know our industrial companies. It's one of the great areas of the UK market, which doesn't get as much attention as it should. Thinking about these specialty chemicals, industrials, engineering businesses that absolutely serve oil and gas industries, which serve the mining industries, have been fantastic businesses. So, it's almost that old picks and shovels argument. Companies like Diploma or Victrex, Intertek, Rotork, Smiths Group. These are businesses that will benefit from more activity in mining and in oil.

There are two approaches to equity income investing. One is taking the higher dividend yield today and being attracted to that, which is fine. Or the other approach is to take a lower starting dividend yield with much more security and certainty of growth or progression of that dividend. And I often think about commodity businesses in the former camp and some of our businesses in the latter camp. We've got this great example of Anglo American versus RELX. If you think back in 2007, the setup was pretty similar to what we have today in markets. RELX had a 2.5% dividend yield in 2007. It still has a 2.5% dividend yield today, but in that time, you've had basically, I think it's 8% compound average free cash flow and dividend growth. To the extent that over that time, for a £100 invested in RELX in 2007, you've now received back about £70 of that original £100 in dividends alone. And you've also made a fantastic total shareholder return, about 12% compound. By contrast, Anglo American started in 2007 with a dividend yield, I think it was about 4-4.5%. But being an investor in Anglo's has been a very volatile journey. Some years the dividend's high, some years the dividend's low. Some years it doesn't even pay an income.

Over that period of time, despite that lower starting dividend yield from RELX they've distributed much more dividends to end investors and taken them on a much better and smoother ride. And really, I suppose that's the poster child for what we are trying to do. An attractive starting yield is of course, important. But what we are trying to achieve over time is growth in dividends, year in, year out, in pounds and pence so that for a £100 invested in the fund today, if we can give you £3.30 back as a dividend, because we have a 3.3% dividend yield. If we can turn that £3.30 into £4 into £4.50 into £5, and on and on, that's what we're really trying to do, and we do that by investing in companies that themselves can do that.

**Tom Yeowart:** Blake, you have obviously just talked about why you are sticking to your principles and being deliberate with your philosophy and the types of businesses you invest in, and also that some of them do benefit from this new regime we're entering. But more holistically do you think there are other ways we need to adapt as investors, as we shift into what is a very different regime to the one we've been used to over the last decade or more?

**Blake Hutchins:** I think it's much less benign. Much less benign. And I think one of the things that we've been talking about is this time of incumbency actually. For a long time when your cost of capital is zero, when the cost of debt is zero or very close to zero, I think it's disproportionately benefited two types of companies, one, I call them the zombie companies that really don't have a right to compete anymore, that have been kept alive by banks or funds that have just been funding an incredibly low cost of debt and equity. And I think that's

going to be a really difficult place to be. The second one is high growth companies. And there will always be high growth winners. Of course, there will be. Innovation doesn't sleep. There's still so much digitization and benefits from technology that are going to come through over the coming decades, but I can't help but think with cost of capital being zero, a lot of businesses that have not made cash flow or have no prospects of making cash flow for many, many years are going to find it very, very difficult to fund themselves.

And so, this time of the incumbent, what I'm picturing here are big companies, have big moats around their businesses, are highly cash generative, pay a dividend funded from cash flow, have strong balance sheets. Actually, it could be their decade, because I don't think we are going back to the zero bound anytime soon. And when I think about some of the businesses that we own, that's exactly what they are. Think about Next, to use an example that's quite close to home. For the past 10 years, there's been loads of digital start-ups snapping at their heels. We love talking about some of the capital allocation that Lord Wolfson, Simon Wolfson, CEO of Next has been able to do over the past many decades. And last year he did a great one where he bought Made.com's brands and IP for £3m. Now, just a year before that, Made.com was floated and had a market value of £800 million. And he took those brands and IP out of receivership and he's trying to build something on a long-term view. He's transitioning into being a retail platform. And that's what I'm talking about really, this time of the incumbent. Next, strong balance sheet, not the most glamorous company in the world, but it's a survivor. And it's a self-funding business, and that's what I love about our equity income stocks. They self-fund. It's a really, really important concept where these companies can generate enough cash, not just to pay a dividend, but actually to reinvest back into themselves. They don't rely on capital markets for funding, and I think that's going to be a good time for these businesses.

**Tom Yeowart:** We've spoken a bit about inflation in a general context, but thinking about the potential of persistently higher inflation, especially in the UK, I'd love to hear you talk about how that impacts your businesses and why you think your businesses, relative to the broader market, are better positioned to deal with persistently higher inflation?

**Blake Hutchins:** One thing to say is that move from low inflation to high inflation, we had a really difficult 2022 and for me, when I thought about this and I thought about it a lot, that move from low inflation to high inflation has not hurt our company's profits and cash flows overly. Our companies continue to operate well, grow their cash flow, grow their dividends. It has really impacted their rating. I'm generalizing here, this is not for the whole portfolio,

but there are a few stocks with which, the derating that happened as we move from bond yields being very low to a more normal number was really, really painful.

Now, from here, I would argue that whether we're a bit higher or a bit lower in the UK in terms of interest rates, I think we're there or thereabouts. I think we've had a bit of a dry run last year during that mini budget debacle of what 5%+ rates look like in the UK and it's not a pretty picture. The UK is quite interest rate sensitive compared to the US. I don't think we have the strength in the economy that we have in the US. We don't have these 30-year mortgages that the US have. And so, we don't expect bond yields to really gap up again. And so, I think your question about more persistently sticky inflation is the right one, rather than thinking about 2022 happening again. And I think in that environment, that's where we feel pretty good about our companies. If you just look historically, Troy's portfolios have tended to do pretty well in more difficult environments. And I think the persistence of inflation will test consumers, will test businesses, as will higher interest rates as well. And so, because our companies tend to have pricing power, because they tend to be quite defensive. A third of the portfolio in consumer staples, 10% in healthcare, about 20% in pretty resilient recurring digital type businesses. We think that our companies will continue to grow their profits, grow their dividends, and very importantly, pay their dividends, through what is likely to be a more difficult economic environment.

**George Viney:** And having taken a lot of pain as you described in 2022, where do you see the valuations for the UK market broadly, but particularly your favoured sort of companies?

**Blake Hutchins:** I think it's a difficult one when you're comparing the UK market to other markets just because of the skew of the FTSE100 really. But that being said, I don't think it's controversial to say that there's more value in the UK in terms of headline multiples than there is internationally. The UK looks good value. And we can go into the reasons for that, but I'm not too fussed about the reasons for it. You read a lot about it in the press, I'm sure a lot of our listeners have. I can't do anything about that. I get excited because it enables me to have access to good companies at slightly cheaper valuations.

How that valuation discount unwinds. I don't know. Will it unwind? I don't know. But it means we get better value; we get higher dividend yields as a result for good businesses. The one thing I would say, George, is that markets move so fast now and so comments on valuation can get dated pretty quick, but I would say that, particularly around what was happening middle to end of last

year around the mini budget, there was real revulsion towards UK companies, more UK-orientated businesses, and you saw that with the mid 250 down at one point last year, I think was down over 30%.

And some of our businesses got hit very hard. Next, I think was trading at 9x earnings at one-point last year. Domino's Pizza 11x earnings, had never traded on a higher dividend yield. So, some of our more UK orientated businesses were definitely where the value was at the back end of last year.

Thankfully the turnaround's been pretty swift. They've been quite strong year to date, and whilst they're still cheap I don't think the UK domestic discount is quite as high as it was last year. And so that takes me to wanting to own some of those, absolutely. And Next and Domino's Pizza are good examples. Admiral is another good example of some of our UK domestics. But then what really excites me, and if you look at the portfolios, what we have our biggest weighting to are some of these world-class multinational businesses that are listed in the UK but are really international type companies. So, when I think about the likes of RELX, just posted really fantastic numbers. It's still only 21x earnings. I personally believe a business that has grown its free cash flow per share, 8-10% compound now for the past 15, 20 years, if that was listed in the US or another market, it would be trading at a materially higher valuation. I look at Diageo, it's now on 19x earnings. It's the market leader in the US spirits industry. I think that's very good value. I look at Unilever at the top of the portfolio. Really interesting turnaround, I think that may happen under the new chief exec, Hein Schumacher, 17x earnings. Bunzl, the value-added distributor, again market leader in what it does, 16-17x earnings, and I could go on, but I think those UK multinational businesses are definitely trading at a few P/E points lower than they do internationally and that's exciting for me.

**George Viney:** And versus their own history, they're trading at discounts as well?

**Blake Hutchins:** When I look across the portfolio at those stocks that are trading at a discount to their own history, a material discount, it remains those UK domestic stocks, Domino's Pizza, Next Admiral, trading at low to mid-teens earnings are still at a discount to their history. But I would caveat that with, the outlook for the UK economy is pretty difficult. I talked about the interest rate sensitivity of the UK economy. I think it's going to be difficult for the consumer on a medium-term view. And one of our colleagues likes to say, you don't get good prices with good news. And I don't think there is going to be that much good news for the UK consumer over the next few years, but valuations are reflective of that.



**Tom Yeowart:** You made an oblique reference to the fact that the UK market attracts quite a lot of noise, whether it's Brexit or the mini budget debacle. The market itself in aggregate hasn't performed particularly well over the last decade. The currency has clearly weakened. But can you talk about what proportion of your portfolio is actually exposed to the UK domestic economy?

**Blake Hutchins:** So, we have about 80-85% of the fund is listed in the UK but as you rightly say, that's quite misleading in that only about 20% of the revenues of the fund come from the UK. Some of our big multinational businesses have quite established businesses in the UK. So IHG, Intercontinental Hotel Group, 50%+ of its profits come from the US but the UK is still a big market for it. Experian, Diageo, likewise. But the majority of that 20% of our revenues that comes from the UK would be from businesses like Next, like Admiral, like some of the savings' platforms that we have, like Domino's Pizza. So, when we go for UK domestic stocks, we tend to like to go for market leaders, businesses that we think have a demonstrable competitive advantage within the UK market. And then on a longer-term view, I still think that access to the US market is really attractive. When you think about a business-like Compass Group, the world's biggest catering company. Again, over half of their profits come from the US and they've got an amazing runway for growth in the US market. Huge benefits from the fact there aren't cultural differences. The fact that it's a very dynamic economy, the fact that there aren't language barriers to deal with. It's much more business friendly environment than say, across Europe. And it's a growing population as well.

**Tom Yeowart:** How would you say the portfolio has changed since we last spoke to you?

**Blake Hutchins:** So, within the industrial bucket that we have, we've bought Bunzl about this time last year. Now, for those who don't know Bunzl, it's a FTSE100 company approaching 10 billion or so market cap. And so, it's not a big business in the grand scheme of things. It's got plenty of runway for growth. It's a global leader in what it does, which is value added distribution. It does a lot of the everyday not for resale items that a lot of their customers need. So, bags, coffee stirrers, protective equipment and the rest. They've got an amazing opportunity in terms of continuing to consolidate their markets. And so, if you look over time, half of its growth has come from organic growth, and then about half through acquisitions. And the beauty is they make these acquisitions at incredibly low multiples. On average, maybe 7 or 8x EBIT. And there's a long opportunity through this consistent cash generation and reinvestment, both organically and inorganically, for Bunzl to continue its amazing track record of dividend growth, which is over 30 years.

Elsewhere, we've also added to some of our data businesses. So, the middle of last year we became investors in London Stock Exchange Group. London Stock Exchange Group is one of the premium data businesses in the world. If you believe in the continued financialization of markets, their incredibly valuable and rich data is only becoming more and more important. Incredibly cash generative business, high margins, very, very well covered dividend. So that's another one that we've bought in the past year.

**Tom Yeowart:** We've seen quite a rally in some of the more domestic or more cyclical names in the UK but actually some of the Staples's names have derated and I think you've been using that opportunity to increase your staples exposure, but perhaps you could just talk a bit about that?

**Blake Hutchins:** So, we were pretty impressed last year with how the consumer staples companies have fared. Pretty unprecedented inflation that they have been suffering through their cost of goods sold line, and therefore they've had to price quite aggressively. And at the moment elasticities seem to be holding up pretty well. That's going to be tested in 2023 and beyond because we're not done in terms of inflation or price rises. So, prices are going to continue to go up collectively from these companies. But as inflation starts to roll over and price rises start to come through there's a real opportunity for these businesses to repair their margins and taking a step back, they're very, very resilient businesses. And as you said, in recent months there has been much more risk on to markets both UK domestics, but you've also seen that in various assets, you know, bitcoin's back up from its lows, US technology companies are faring much better.

And I just think when you see some of these very steady, resilient businesses that are continuing to churn out good growth and good dividend growth that have been derated, I'm starting to find them much more attractive. So, as I said, Diageo is now trading sub 20x earnings, the lowest P/E it's traded on for five years+. Similarly, Unilever, I think there's some real positive change happening within that business, 16-17x earnings. Looks pretty good value to me when I'm seeing plenty of stocks trading at 20-25x+. So, for me right now, given markets have rallied quite strongly and where valuations are, adding a bit of incremental capital to these businesses doesn't seem like the worst thing to do.

**George Viney:** To what extent has the pandemic in a way been helpful in resetting dividends for the broader market and for certain companies that were over distributing. And does that mean that dividends are on a much surer footing now as we arguably go into a tougher economic environment for earnings and dividend cover?

**Blake Hutchins:** I think that's definitely the case. Heading into the pandemic, dividend cover was too tight across most of the UK market. A lot of companies were over distributing. They took this big opportunity to really reset their dividends and they have much more sensible dividend policies now.

It was a real turning point for the mining sector, for example, where they moved away from progressive dividends come what may to paying out dividends as a percentage of their profit after tax. And the thing is, their profit after tax in any given year can literally be anything. I mean, it can be a negative number, it could be a super high number. And so having a progressive dividend policy when you have such a volatile business doesn't make a lot of sense to me. So, when I look across the market, dividend cover is actually pretty healthy for the UK market.

And I think that that is one of the big positives about equity income investing in the UK now. It gave itself a bit of a tarnished name because of that lack of cover, because of over distributions, but that's not the case now. I think a lot of lessons have been learned for the time being. Let's see how long it lasts, but I'm much more optimistic about that.

In terms of us in the portfolio, dividend cover is really, really healthy. I tend to think about the portfolio in three factors. One being quality, the other being growth, and the other being yield. And so, when I think about our portfolio in terms of quality, we have about a 20% return on invested capital, 20% operating margins on average across the portfolio. That's about double that of the average of the UK market. Second, when we think about prospective growth, again, for the UK market, it could be any number really, it really does depend on whether metal prices, oil prices are high, whether the banks are making money or losing money. But for us, our businesses are pretty predictable. You can use history as a bit of a guide, and we think that there's good mid-single-digit, maybe even high-single-digit free cash flow and dividend growth embedded in the portfolio. So high quality, good growth embedded in the portfolio. And then in terms of yield we look at earnings yield and dividend yield. So, earnings yield is 6%. Dividend yield is about 3.3%.

And there's two points to be made here. The first, that the 3.2 is about half the six, which means that our dividends are well covered, which is very, very important, but it also means that our companies are retaining around a half to a third of their earnings to reinvest back into their business. And why wouldn't they reinvest back into their business when we've already said they're making 20% return on invested capital. So, I think from the UK market, the backdrop is actually pretty good. And certainly, when I look at the portfolio and I look at

that lens of high-quality businesses that can grow, that have good attractive yields that are well covered, that's why I feel really good about the portfolio and the backdrop for UK equity income.

**Tom Yeowart:** Blake, you've obviously been on the show before, so I'm not going to ask the same closing question. But if we fast forward 20 years, what do you hope to have achieved?

**Blake Hutchins:** I think you can measure it in terms of very specific outcome, and it comes back to yield on cost. And what I want to be able to do is grow the fund's dividend in a really resilient and consistent way over the next 20 years. If we can deliver 4-7% compound dividend growth over the next 20 years from a starting dividend yield of 3.3%, I think our investors and, and we will be very, very happy. And so, over the next 20 years, what do I want to deliver? Resilient compounding total returns with a growing income stream to our investors.

**Tom Yeowart:** Blake, thank you very much for coming on.