# EUROPE: A DESTINATION FOR INCOME



**POSITIVELY DIFFERENT**

GUINNESS GLOBAL INVESTORS

# THE EUROPEAN INCOME LANDSCAPE

**Risk & Performance**

The Guinness European Equity Income Fund is an equity fund. Investors should be willing and able to assume the risks of equity investing. The value of an investment and the income from it can fall as well as rise as a result of market and currency movement, and you may not get back the amount originally invested. Details on the risk factors are included in the Fund's documentation, available on our website (guinnessgi.com/literature). Shareholders should note that all or part of the fees and expenses will be charged to the capital of the Fund. This will have the effect of lowering the capital value of your investment.

| ◀ Lower risk | | | Risk & reward | | | Higher risk ▶ |
|---|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | 6 | 7 |

Typically lower rewards — Typically higher rewards

The risk and reward indicator shows where the Fund ranks in terms of its potential risk and return. The higher the rank the greater the potential reward but the greater the risk of losing money. The Fund has been classed as 6 because its volatility has been measured as above average to high. This is based on how investments have performed in the past and you should note that the Fund may perform differently in the future and its rank may change.

The Fund is actively managed with the MSCI Europe ex UK Index used as a comparator benchmark only.

The European Equity Income Fund designed to provide investors with exposure to high quality dividend-paying companies in the Europe ex UK region.

Past performance does not predict future returns.

# INTRODUCTION:

The UK has historically been a popular market for dividend investing. Over the last 10 years to 2021, the MSCI UK Index dividend yield has averaged 4.2%, providing investors with a high level of dividend income. By contrast, the MSCI Europe ex UK region dividend yield has averaged 3.2%, with the difference explained by Europe ex UK's greater exposure to higher-return and higher-quality sectors and lower exposure to the commodity-based and regulated industries which the Guinness European Equity Income Fund tends to avoid. Figure 1 underscores the point, showing Energy, Materials, Telecoms, Real Estate and Utilities accounting for 19.6% of total sector exposure (ex banks) in Europe ex UK vs. 31.4% for the UK, 26.1% for MSCI Asia Pacific ex Japan and 21.2% for MSCI USA.

**Figure 1: MSCI Ragional Sector Weights % (July 2022)**

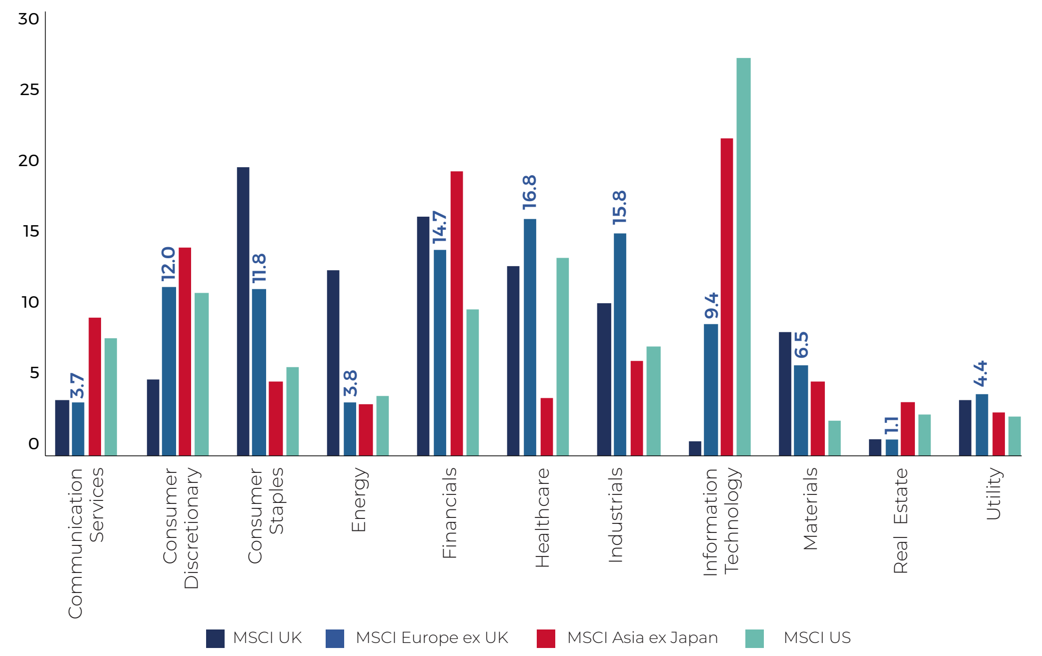


*Figure 1. Source: Bloomberg*

| | MSCI UK | MSCI Europe ex UK | MSCI Asia ex Japan | MSCI USA |
|---|---|---|---|---|
| % Highly Cyclical or Regulated ex Banks | 13.4 | 19.6 | 26.1 | 21.2 |

The MSCI Europe ex UK region contributes a significant portion of global dividends and one which has remained broadly constant for the last 10 years, averaging 19% of total global dividends paid since 2011 and 18.1% in 2021. The slightly lower 2021 number is accounted for primarily by the lag in the restoration of (primarily bank) dividend payments by regulators following the coronavirus pandemic.

**Figure 2:** **MSCI Ragional Income Contribution in 2021 (USD)**

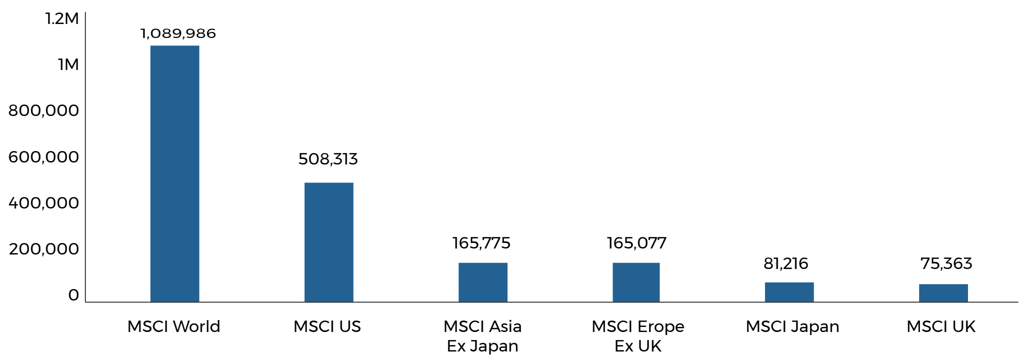


*Figure 2. Source: Bloomberg*

# THE CASE FOR DIVIDEND INVESTING

There are three main reasons why dividends form an integral part of an investment strategy. First, reinvested dividends account for a significant component of total returns. Secondly, dividend payments play an important role in company capital allocation decisions. Thirdly, a reliable and well supported dividend stream reduces the downside risk to the share price.

## Total Returns

The reinvested dividend component of total shareholder return (the other being price appreciation) is often the most significant component over time. Figures 5 to 7 display the total returns – separated into returns from reinvested dividends and price appreciation – that an investor would have received from an investment made in 2004 in Europe ex UK, the UK, and MSCI All Company World Index (ACWI) respectively. It is important to note that it is the discipline of reinvesting the dividends – investors increasing their capital invested in a company, in order to benefit from future price appreciation – that leads to this powerful compounding effect. Figure 3 highlights the outperformance of dividend paying S&P 500 stocks over time.

**Figure 3** - **Annualised total return of rising and falling dividend stocks**
(S&P 500 categorised by dividend history, average annual total return in USD, 1972-2019)

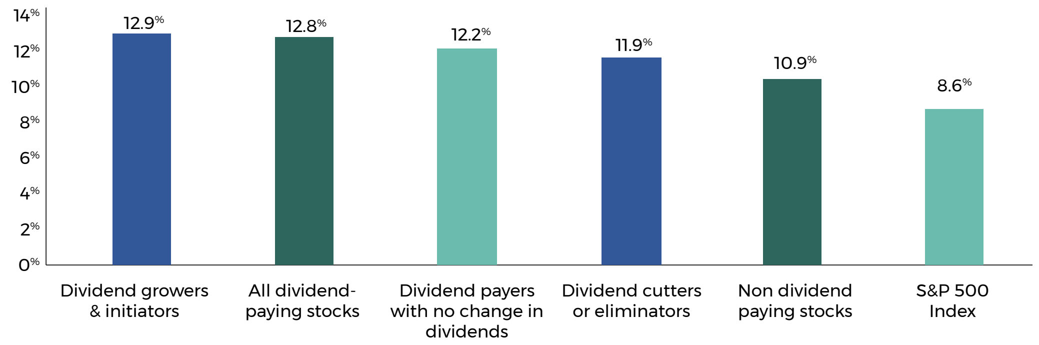


*Figure 3. Source: Ned Davis Research, 31.12.2019*

## Capital Allocation

In our view, a company's commitment to a dividend policy provides tangible evidence of disciplined capital allocation. Management must decide how much capital is required by the business to operate and grow and how much to return to shareholders. A disciplined approach to reinvestment tends to reflect a more selective approach to re-investment, making sustained profitability more likely. As an example, Figure 4 shows Nestlé's strong track record for capital allocation, with a gradually growing portion of dividends/sales against stable capex/sales and R&D/sales over time, alongside a continuous interplay between bolt-on acquisitions, debt repaid and shares repurchased. A dividend policy stands as very visible evidence of this discipline because dividend payments are typically regularised, particularly in Europe, and changes to the policy are immediately apparent. In this context, while share buybacks also represent a return to shareholders and may in some cases be more tax-efficient, they are irregular and do not place the weight of a commitment onto management.

**Figure 4** - **Nestle Capital Allocation % Sales**

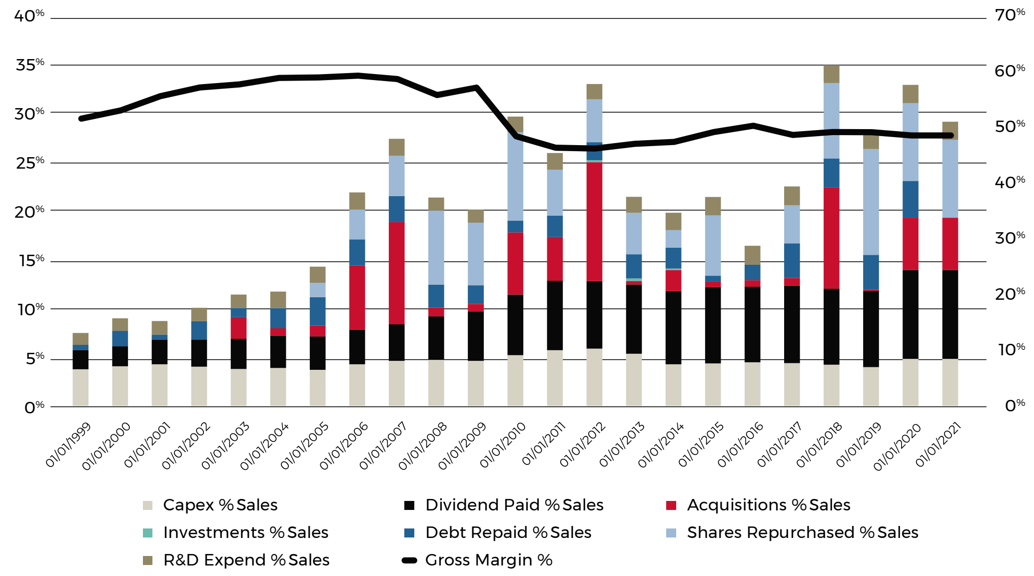


*Figure 4. Source: Bloomberg*

## Downside Protection

The downside protection dividends offer comes not from the size of the payment but from an assessment of its sustainability. A profitable business that re-invests to grow profits and cash flows but generates more cash than it requires to fund that re-investment provides a solid base. Those businesses with long track records of paying and growing the dividend, supported by the requisite cash flow growth and a strong balance sheet, can engender confidence from investors that they will continue to do so and therefore offer investors downside protection, assuming a fair valuation.

The relatively high contribution of dividend to total return in Europe ex UK can be seen in total regional returns over time (2004 – 2020), separated into returns from reinvested dividends and price appreciation. This contrasts with the UK, where total returns have predominantly come from dividends, and the MSCI All Company World Index (ACWI), where the bulk of returns has come from price.

**Figure 5** - MSCI Europe ex UK returns from dividend and price 2004 – 2020, in USD.

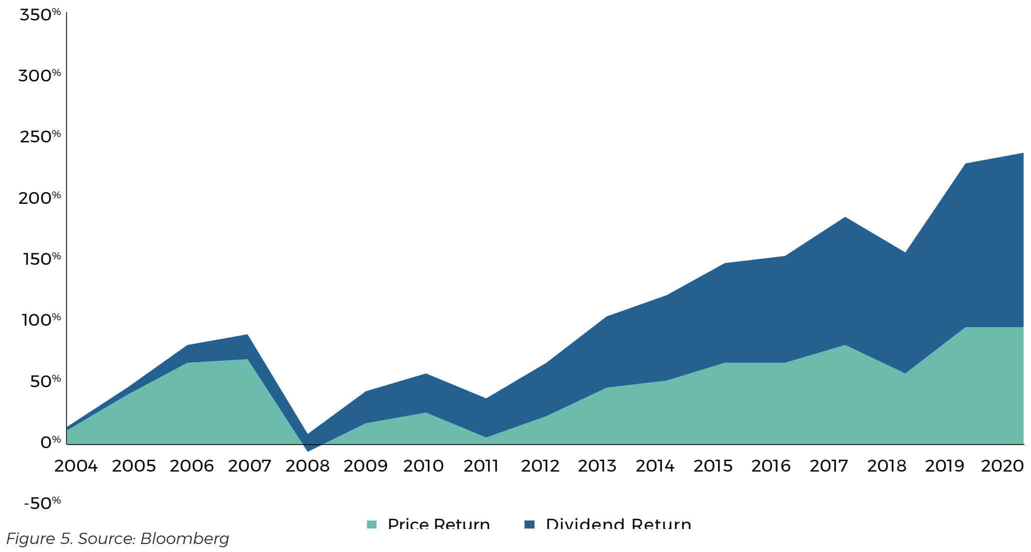


*Figure 5. Source: Bloomberg*

**Figure 6** - MSCI UK returns from dividend and price 2004 – 2020, in USD.

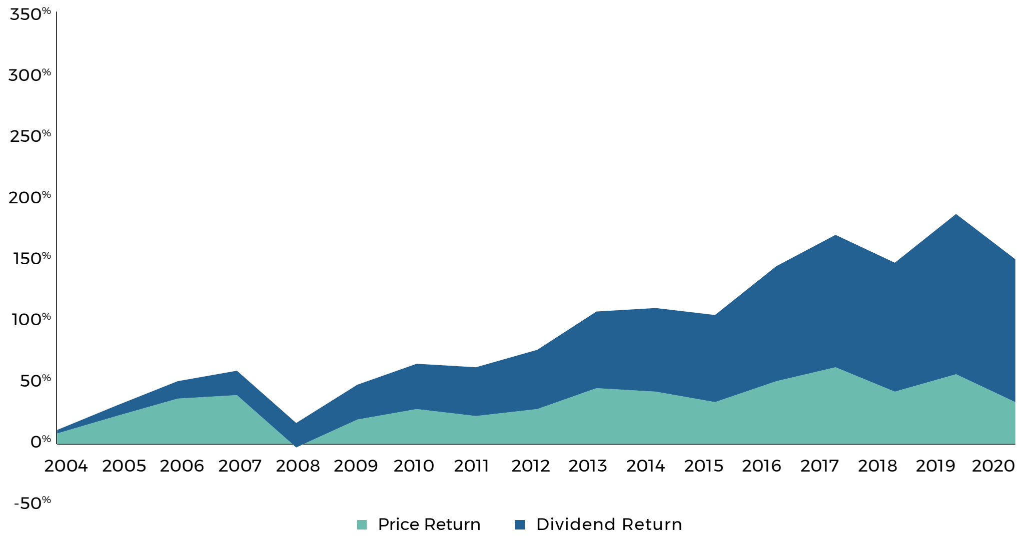


*Figure 6. Source: Bloomberg*



**Figure 7** - MSCI World returns from dividend and price 2004 – 2020, in USD.

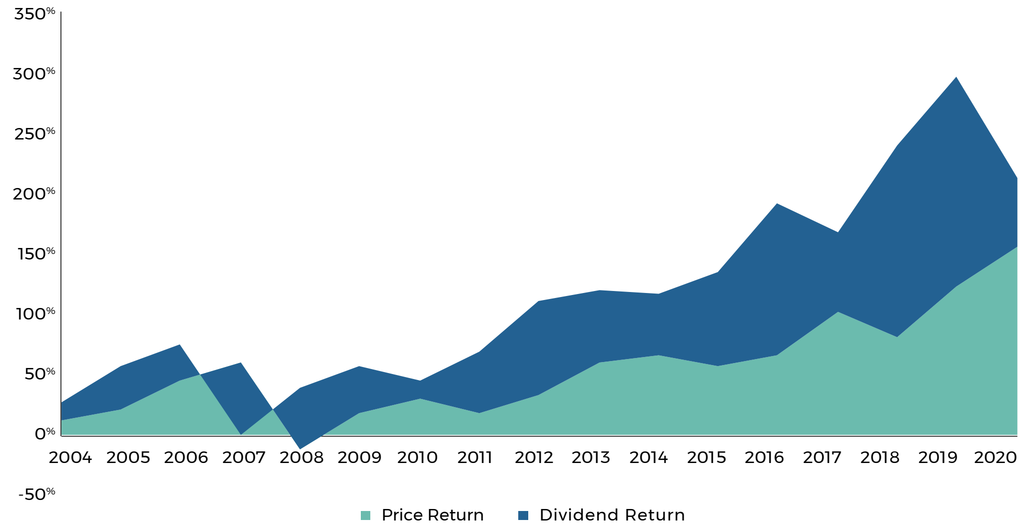


*Figure 7. Source: Bloomberg*

**Figure 8** - MSCI regional returns from dividend and price 2004 – 2020, in USD.

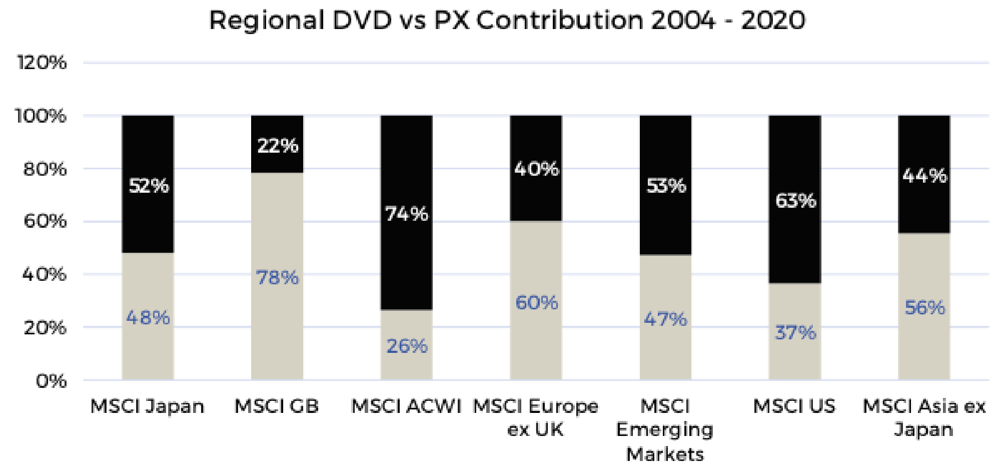


*Figure 8. Source: Bloomberg*

# EUROPE IN CONTEXT

Although steeped in history, Europe is politically speaking a young region. The tide is turning, however, as recent events from Trump and Brexit to coronavirus and Russia's tragic invasion of Ukraine create a strong impetus towards more cohesive and agile decision making, underscored by the current move away from unanimity voting towards majority voting. Historic growing pains have also often distracted investors from the region's core strengths. The Eurozone, led by Germany and its Northern European neighbours, is a leading global exporter and in normal times boasts a healthy current account balance. Its globally leading industries range from Consumer Staples and luxury products to Financials (ex banks), industrial technology, materials science and areas of healthcare.

**Figure 9 - Current account balance % GDP Eurozone, US and China (1999 – 2021).**

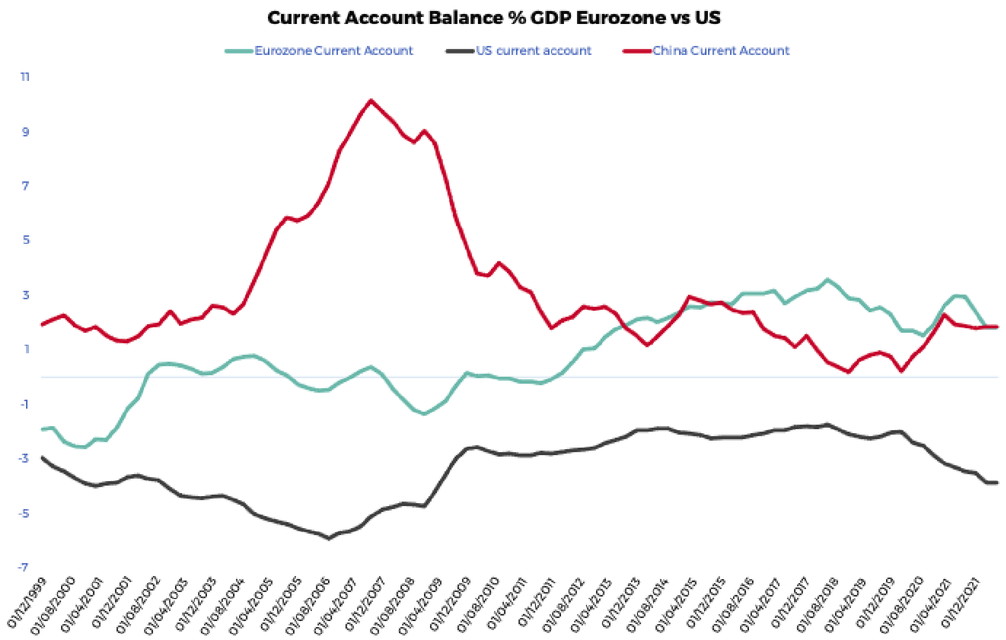


*Figure 9. Source: Bloomberg*

### Europe as a source of income: yields and dividend growth

The Europe ex UK region offers investors a premium level of dividend income vs other main regions (and asset classes such as bonds), yielding significantly more in aggregate than the MSCI All Country World Index (ACWI) and MSCI USA Index, as shown in figure 11. This is primarily due to the region's longstanding progressive dividend culture which contrasts with the US, where share buybacks comprise a far higher portion of capital returned to investors. The intersection of higher yields and globally leading quality across a range of sectors makes Europe a primary destination for income investors.



**Figure 10 - S&P 500 dividends per share and earnings per share year-on-year growth**

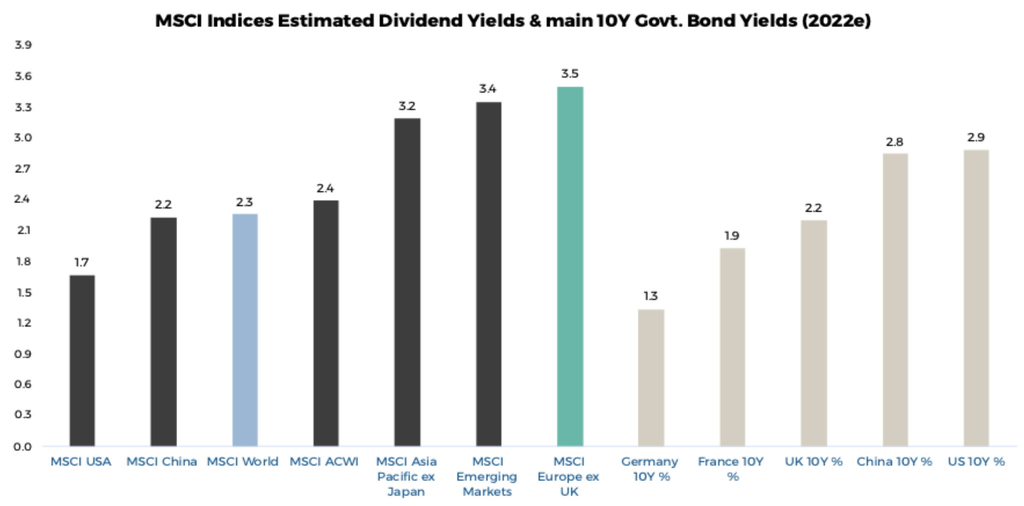


*Figure 10. Source: Bloomberg*

**Figure 11 - Dividend Yield current vs Buyback Yield 2021, MSCI US vs MSCI Europe ex UK.**

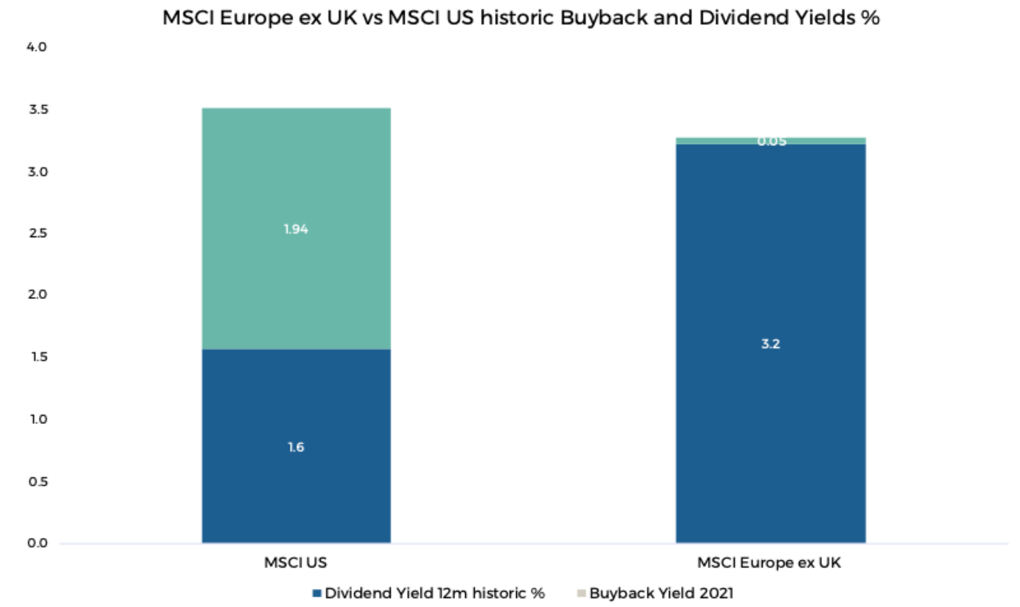


*Figure 11. Source: Bloomberg*

Europe ex UK dividend returns have done well in a global context over the last 10 years despite the Euro crisis, which primarily affected Eurozone banking sector returns. Over the 15 years up to the pandemic (2004-2019), the MSCI Europe ex UK region generated a respectable 7.2% dividend compound annual growth rate (CAGR). This level was far above the 4% CAGR seen in the UK over the same period, though just below the 8% generated by MSCI US.

**Figure 12** - **15Y dividend growth MSCI Europe ex UK (green) vs. MSCI World (LHS) and MSCI UK (RHS) 2004 – 2019.**


*Figure 12. Source: Bloomberg*

For the sake of transparency, moving the 15-year timeframe to 2006-2021, to include a base of comparison just before the financial crisis of 2008 and to include the 2020 pandemic, when many European companies were precluded from paying dividends by regulators and companies had a lower buyback buffer vs US peers due to Europe's progressive dividend culture, results in a 2.4% dividend CAGR for MSCI Europe ex UK, 4.1% for MSCI World and 0.3% for MSCI UK.

### The quality of the European dividend landscape is often overlooked

A regional breakdown of the European dividend landscape serves to better illuminate the opportunity. There are stark differences between north and south and between sectors. Higher-return countries which we aggregate as 'High-IP Europe', namely Scandinavia, the Netherlands and Switzerland, returned a 10-year dividend CAGR to 2019 of 8% vs 4% for MSCI Europe ex UK and a 2% CAGR for the rest of Europe (see single country breakdown below).

**Figure 13** - **Scandinavia (8% 10-year dividend CAGR), High-IP Europe (8%), MSCI Europe ex UK (4%) and Rest of Europe (2%). High-IP Europe: Scandinavia, Netherlands & Switzerland.**

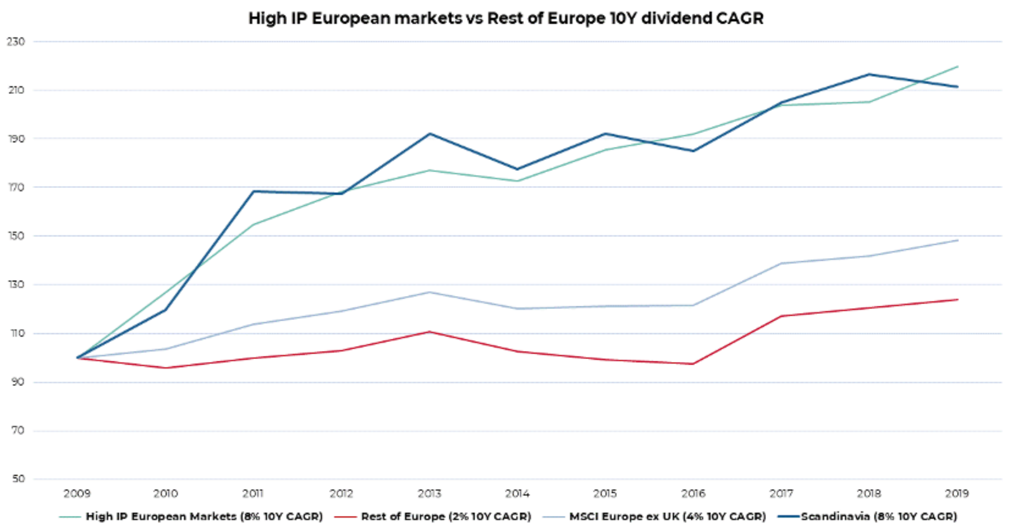


*Figure 13. Source: Bloomberg*



Scandinavian and High-IP European markets' contribution to total Europe ex UK dividends over four five-year periods (2006 – 2021) highlights continuous income market share gains by these high-quality and innovative northern European markets vs Rest of Europe, rising from 13% and 32% of total European dividends paid in 2006 to 17% and 43% respectively in 2021. We classify High-IP European markets as Scandinavia plus the Netherlands and Switzerland, where companies like Roche and Novartis add considerably to the total dividend share vs Scandinavia alone. Naturally countries such as Germany and France also hold many high-quality companies, but the dividend growth is offset by their larger banking, commodity and regulated sectors.

**Figure 14** - **High-IP European markets contribution to European dividend 2006 (32%) – 2021 (43%).**

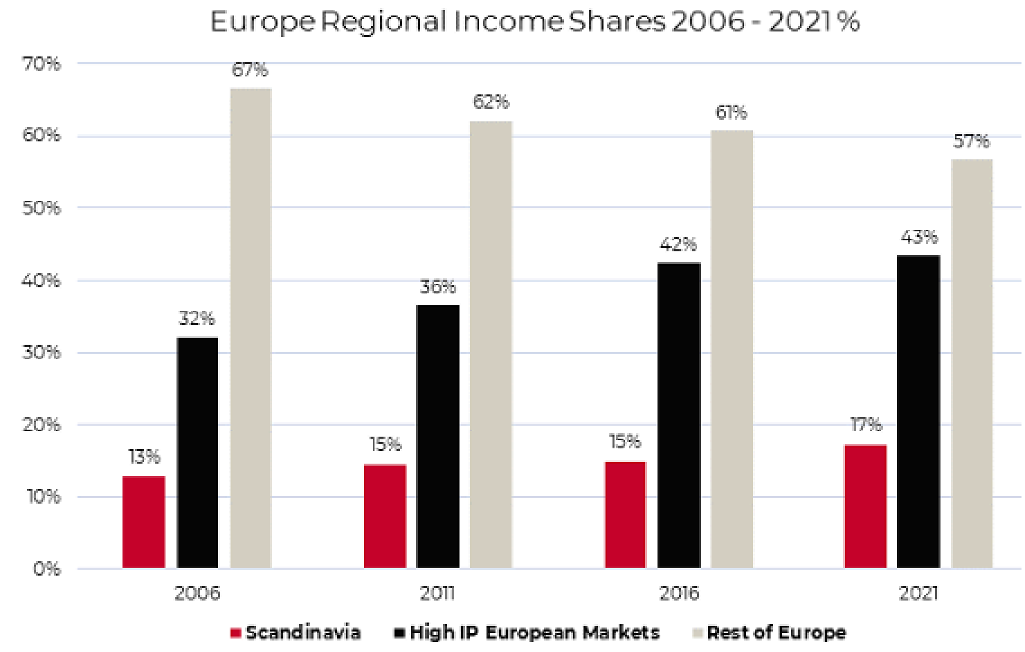


*Figure 14. Source: Bloomberg*

What is driving Northern European income market share gains vs the rest of Europe? At root, it is arguably the twin drivers of high levels of innovation and good governance, the latter expressed in the Scandinavian region's focus on active founder-led business models alongside strong protections for minorities, and the former seen in UNESCO Institute for Statistics data showing world-class levels of R&D expenditure as a portion of GDP and researchers per million inhabitants.

**Figure 15** - **UNESCO Institute for Statistics global country R&D Expenditure % GDP (X axis) vs. Researchers per million inhabitants (Y axis).**

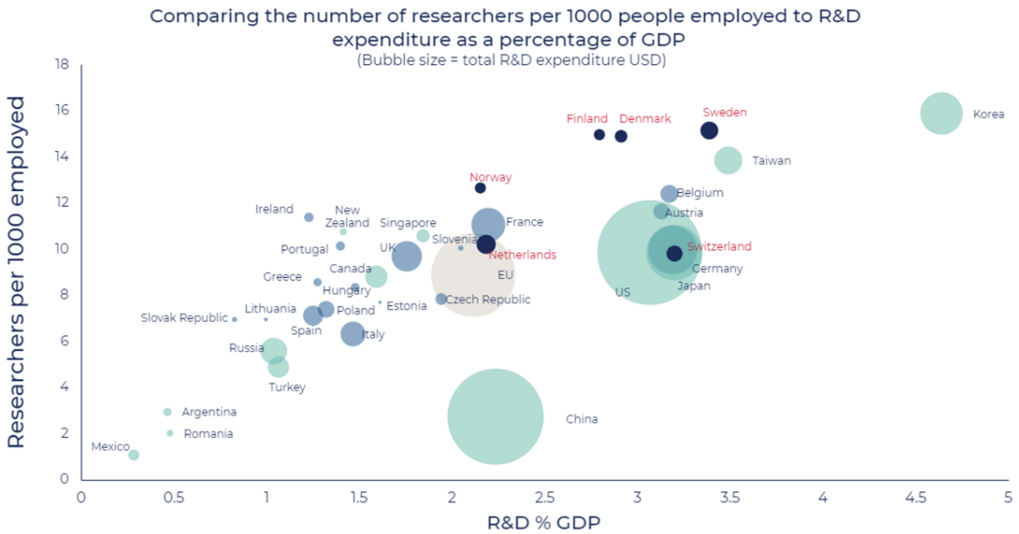


*Figure 15. Source: http://uis.unesco.org/apps/visualisations/research-and-development-spending/*

## Dividend total return by region and country

Total returns (from both dividends and price) of 405% from these six high-quality and innovative Northern European markets from 2004 to 2020 broadly match up to total returns seen in MSCI USA and Asia Pacific ex Japan and are not far off twice MSCI Europe ex UK total returns of 230% seen over the same period. The 10-year dividend CAGR reveals a very similar picture, with High-IP Europe returning an 8% CAGR vs 4.5% for MSCI Europe ex UK.

**Figure 16** - **MSCI regional returns from Dividend and Price. High-IP Europe and Europe ex UK in light blue (dividend) and orange (price).**

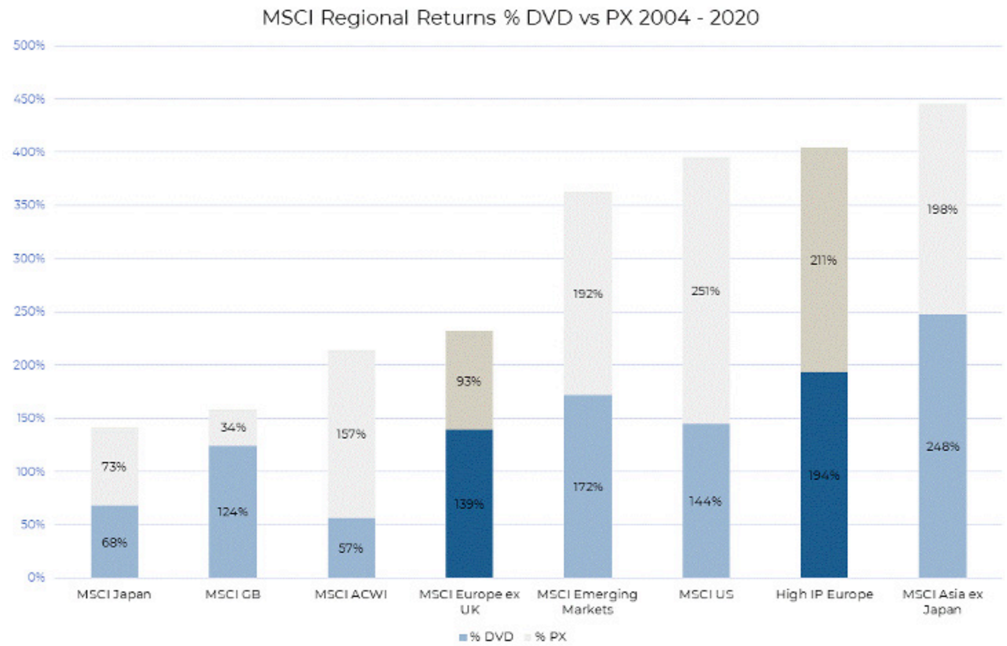


*Figure 16. Source: Bloomerang*



Investors should also consider the ebb and flow of returns from price and dividends, the latter tending to grow in importance in periods of low growth and over long timeframes. Dr Ian Mortimer and Matthew Page's updated April 2020 white paper **Why Dividends (Still) Matter** highlights that since 1940 dividends have accounted for 94% of S&P500 Index total returns, with the proportion of total return accounted for by dividends working in a countercyclical fashion. The 1940s and the 1970s both saw dividends account for over 70% of total returns vs 45% in 1950 and 25% and 26% respectively in the 1990s and 2010s. If inflation and rising oil prices are defining features of low-growth decades, the importance of dividends to total return may once again be on the rise. Dividends are much less volatile than earnings, providing a cushion to shareholder returns in volatile and slow growth periods. **Looking at the last five recessions from the early 1970s to the financial crisis in 2008, the average fall in S&P500 dividends per share was -8% vs. -42% for earnings per share**. Dividend-paying stocks' good track record for providing a hedge against inflation, as dividends tend to grow alongside or at a higher rate than inflation, only adds to the attraction of the asset class. And if share prices do fall, then the quality dividend investor is in the opportune position of being able to reinvest their income by buying more shares at attractive prices. For more detail, see **Why Dividends (Still) Matter,** published on our website.

**Figure 17** - **UMSCI regional 10Y dividend CAGR. High-IP Europe and Europe ex UK in light blue.**

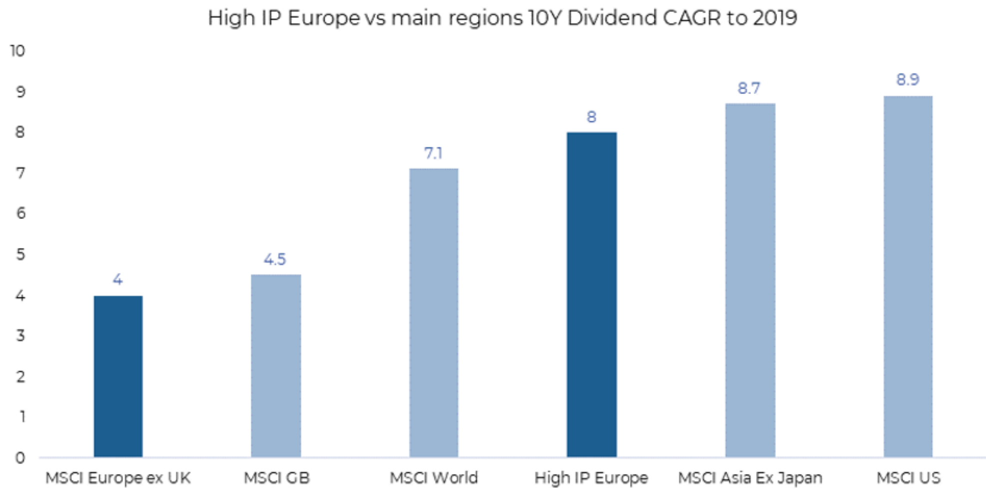


*Figure 17. Source: Bloomerang*

Breaking down Europe ex UK by country (alongside yield and payout ratio) reveals very strong 10-year dividend growth from Denmark (19% CAGR), followed by Norway (11%), Netherlands (10%), Ireland (9%) and Switzerland, Sweden and Belgium (all 8%). Denmark's dividend growth is boosted by the size and success of Novo Nordisk relative to its market, and Norway is helped by the cyclical effect of a weak oil price coming out of 2009. At the other end of the spectrum, French and German headline dividend CAGR of 3% is held back by higher proportions of cyclical and regulated sectors, including chemicals and banks, obscuring many high-quality and innovative companies including those held in the Guinness European Equity Income Fund. Similarly, Finnish dividend growth rates are flattened by the country's high exposure to forestry and the paper and packaging industries. At the weakest end, Spain and Portugal report negative 10-year dividend growth over the 2009 to 2019, weighed down by high exposure to banks (over the Euro crisis) and other unreliable cyclical and regulated areas of the market such as Utilities.

**Figure 18 - MSCI Europe 10Y dividend CAGR by country (light blue), dividend yield estimated (dark blue) and payout ratio (orange dot).**

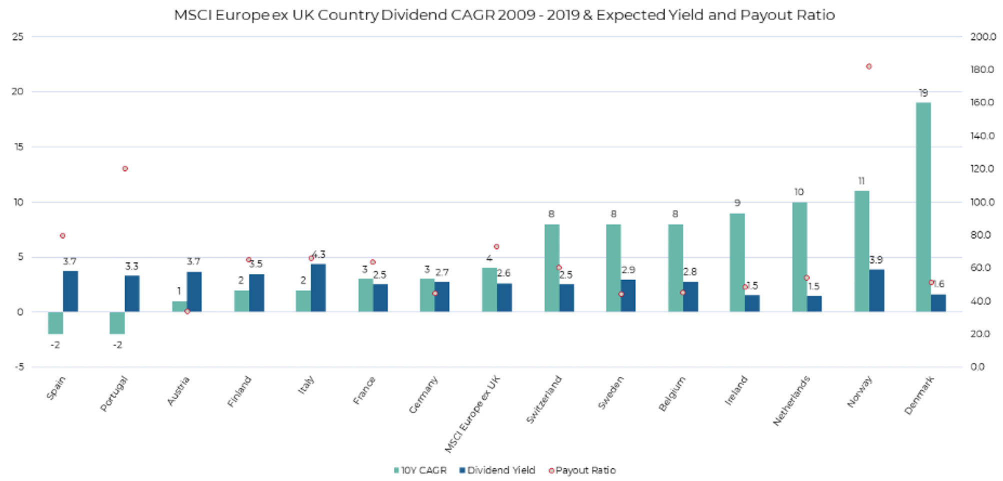


*Figure 18 Source: Bloomerang*

### Dividend quality differs significantly between sectors and markets

By sector, the Guinness European Equity Income Fund is primarily focused on quality sectors including Industrials, Healthcare, Financials, Consumer Staples and Discretionary. In these sectors we find more companies with the persistent high return on capital necessary to generate consistent dividend growth, and the balance sheet strength to weather all markets and emerge from downturns stronger. As shown by Figure 19, the MSCI Europe ex UK Health Care, Consumer Staples and Discretionary sectors generated the highest 10-year dividend CAGRs to 2019 at 9%, 7.6% and 7.4% respectively, followed by Financials, Materials and Industrials at 7.2%, 7% and 6.5% respectively. The Financials sector dividend CAGR benefits from the cycle and is negative if taken to 2020 or 2021. However, the Fund's overweight position in Financials spans quality, higher-return segments including exchanges, asset managers and insurers. The Europe ex UK Materials sector is interesting in that it contains many more high-quality sustainably focused businesses (such as the enzyme companies) than the sector tends to hold in other regions and countries, notably the UK with its high exposure to mining companies. Naturally, payout ratios and dividend yields tend to be lower across sectors characterised by higher levels of dividend growth.



**Figure 19 - MSCI Europe ex UK 10Y sector dividend CAGR to 2019 (blue) and estimated dividend yield (orange).**

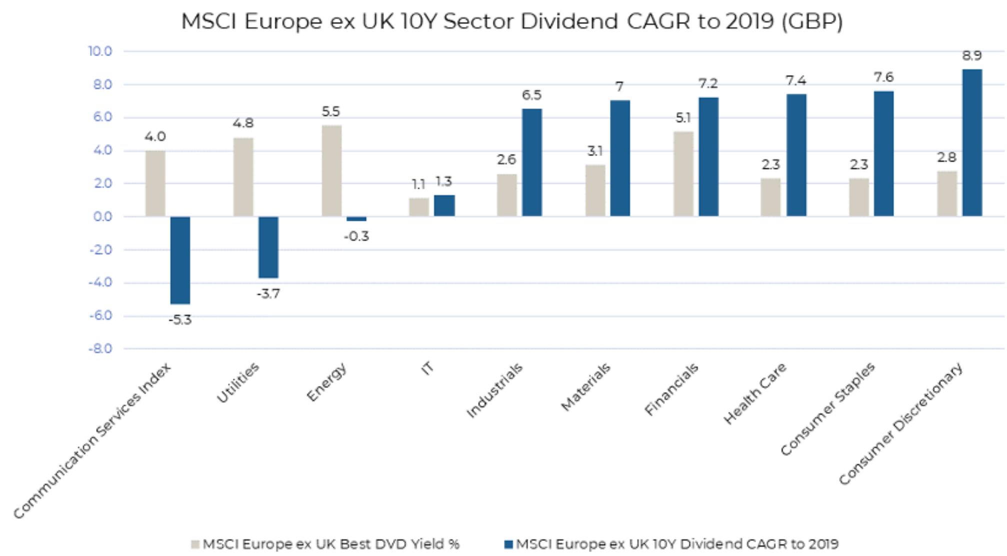


*Figure 19 Source: Bloomerang*

**It is across these higher-quality sectors and northern European countries, characterised by attractive dividend growth, where we find many of Europe's unique and world-class companies that more than match up to their US and global counterparts in terms of business quality and growth potential.** Europe is notable for its global leadership in areas including industrial technology, luxury goods, fast-moving consumer goods (FMCGs), salmon farming, parts of healthcare and materials science, and more broadly, sustainability. The latter is fast becoming a tailwind for sustainably focused European leaders which are finding themselves in a position to supply what the world increasingly wants.

*For the income investor this is the sweet spot, in our view, where investors can achieve a significant yield premium over MSCI US or MSCI World without giving up on business quality or dividend growth potential.*

Figure 20 shows MSCI Europe ex UK sector dividend yields against MSCI US. In a recent review of the Guinness European Equity Income Fund holdings vs their closest US counterparts we found investors achieved a near 70% uplift in dividend yield without giving up on quality.

**Figure 20** - **MSCI Europe ex UK and MSCI US estimated dividend yield by sector (June 2022, Europe ex UK higher dividend growth sectors in blue).**

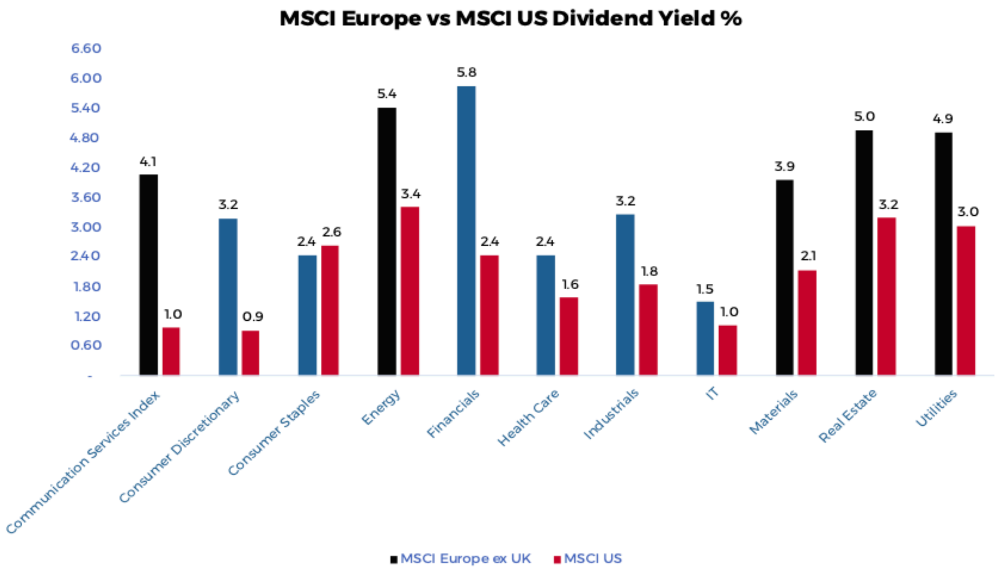


*Figure 20 Source: Bloomerang*

A glance at MSCI Europe ex UK sector dividend contributions (shown by year 2005-2021 in figure 21 and by percentage 2019-2021 in figure 22) highlights the importance of a balanced portfolio. In 2020, sharp dividend drawdowns in Financial and Consumer Discretionary sectors (banks and autos) over the coronavirus crisis are visible against robust contributions from Consumer Staples and Healthcare, the latter the only sector in the Europe ex UK region to grow its dividend payout in 2020.

**Figure 20** - **MSCI Europe ex UK and MSCI US estimated dividend yield by sector (June 2022, Europe ex UK higher dividend growth sectors in blue).**

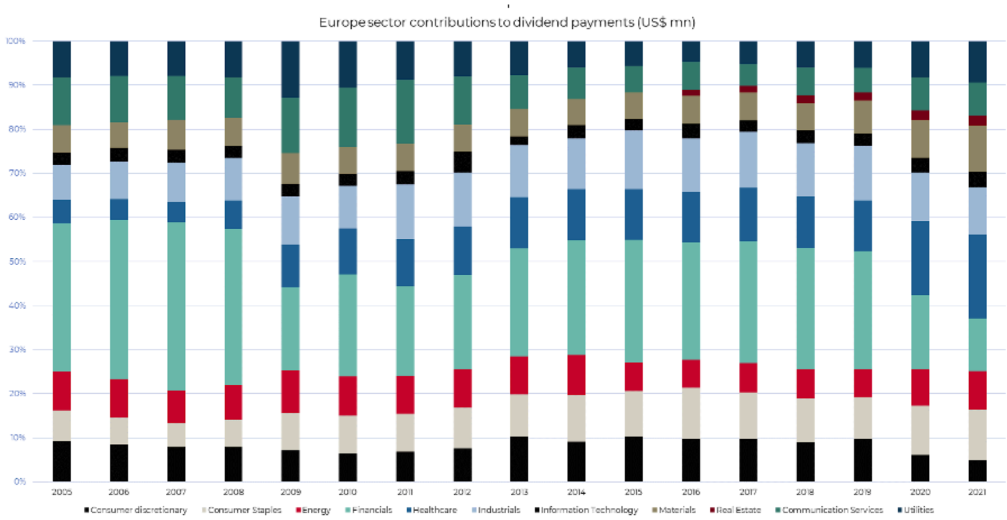


*Figure 21 Source: Bloomerang*



**Figure 22** - **MSCI Europe ex UK sector dividend contributions 2019-2021.**

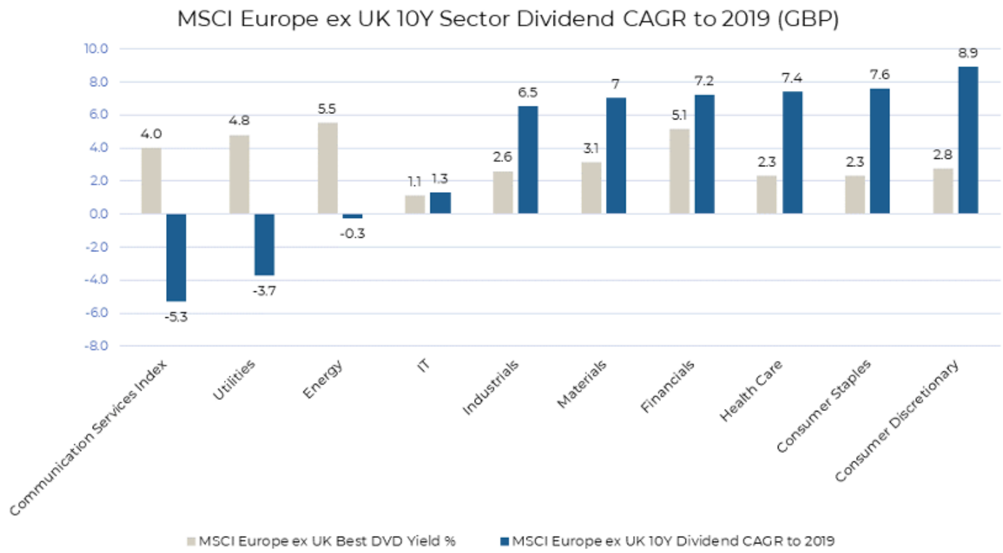


*Figure 22 Source: Bloomerang*

## CONCLUSION

**Figure 23** - **Fund (RHS) vs MSCI US (LHS) and MSCI Europe ex UK (middle) 2022e PE, ROE and Dividend Yield (gross, approximately inline with Index net of WHT).**

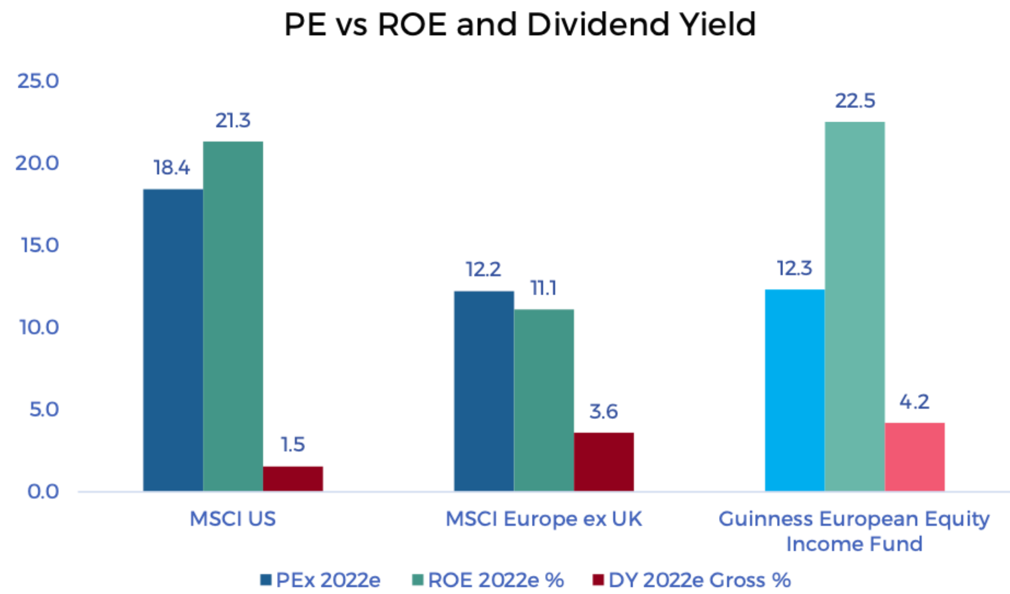


*Figure 23 Source: Bloomberg, as of June 2022.*

The Guinness European Equity Income Fund offers investors the best of Europe ex UK in the form of a concentrated (30-stock) equally weighted portfolio. It is characterised by exceptional quality, with portfolio debt/equity of less than half the MSCI Europe ex UK Index alongside returns of more than double the market (and approximately in line with MSCI US Index ROE), for a price to earnings multiple approximately in line with MSCI Europe ex UK (but at a significant discount to the MSCI US). It offers a dividend yield approximately in line with the index at 3.3% (at 31 July 2022) after withholding tax and a significant premium over MSCI US dividend yield of 1.6%. (Historic yield reflects the distributions declared over the past 12 months expressed as a percentage of the mid-market price, as at the date shown. It does not include any preliminary charges. Investors may be subject to tax on the distribution.)

**Figure 24** - **Guinness European Equity Income portfolio statistics vs iShares MSCI Europe ex UK ETF at 30 August 2022.**

| | | Guinness European Income Fund | iShares MSCI Europe ex UK ETF | Guinness Delta vs. MSCI Europe |
|---|---|---|---|---|
| **Quality** | Debt / equity % | 77.7 | 198 | -120.3 |
| | Net debt / Equity % | 42.1 | 47.6 | -5.5 |
| | ROE % | 23.5 | 11.7 | 11.8 |
| **Value** | PE (2023e) | 12.5 | 12.7 | -0.2 |
| | FCF Yield % | 6.6 | 6.3 | 0.3 |
| **Dividend** | Dividend Yield % (LTM) vs Index gros | 3.3 | 3.4 | -0.1 |
| | Weighted average payout ratio % | 54 | 73 | -19 |
| **Conviction** | Number of stocks | 30 | 344 | -314 |
| | Active share | 82 | NA | |

*Figure 21 Source: Bloomerang*

Our disciplined portfolio of companies focusing on quality and dividend growth makes the most, we believe, of Europe as a destination for income.

**Nick Edwards, August 2022**

Portfolio Manager, Guinness European Equity Income Fund

Nick joined Guinness in 2018 and is portfolio manager of the Guinness European Equity Income Fund. Prior to joining Guinness, Nick worked from 2001 for Mirabaud, where he focused on European equities and global environmental equities. Latterly he worked as a member of Mirabaud's Strategy Team with a focus on the capital cycle, capital allocation, quality and incentives. Nick holds a Master's degree in Finance from London Business School and an MA from the University of Edinburgh.