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European equities – the best option for resilient income

With bond markets offering little in the way of income, the continent's highest quality equities offer an attractive and defensive yield

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Investors seeking income (and a safe haven), particularly in Europe, have traditionally bought government bonds. It is easy to see why. Go back to the beginning of 2002 and 10-year German Bunds yielded more than 5%. Not bad with inflation below 3%, particularly when you consider those same Bunds were backed by a AAA issuer.

The 2008/09 global financial crisis changed all that. Investors in Italian, Greek or Spanish government bonds saw yields spike and capital values plummet, amid concerns about mounting government debt and threats of default; conversely, German Bund yields fell sharply as investors flew to safety.

Fast-forward a decade to the middle of another crisis and, after huge central bank stimulus, many European government bonds are yielding precious little, and some are below zero. Investors wanting income need to look elsewhere.

And that means Europe's equities, which offer a far higher and more reliable source of income than bonds. Over the past decade equities have delivered consistent yields of between 3% and 4% as bond yields have fallen and their volatility has risen. With a current yield of close to 4.5%,[1] European equities look attractive – even if some dividends are likely to be cut in a recession. They are particularly attractive compared to US and Asian equity yields.

One reason dividend yields are so attractive in Europe is that companies have been able to improve their operating margins through operational efficiencies. This has strengthened cash flow and balance sheets, and increased payout ratios, to the benefit of shareholders.

High-quality companies fit for all weathers

But what about periods of heightened equity market volatility, such as now? How can investors ensure they capture both a respectable yield (while minimising risks of capital loss) and long-term capital appreciation when the recovery comes?

Strategies investing in the highest quality companies in Europe are well-placed to deliver an attractive income yield and guard against capital loss. There is no doubt their shares have fallen heavily, as have financial markets everywhere, but companies with robust balance sheets, healthy returns on capital, plus sustainable and visible cashflows underpinned by long-term structural growth, are best placed to weather the economic downturn and benefit from the upturn.

When investing we seek companies with pricing power, giving further downside protection. We avoid high-yielding, low-quality, distressed companies which are vulnerable in a downturn. Typical holdings include pharmaceuticals company GlaxoSmithKline, insurer Tryg and Vodafone.

Since my greater involvement with European income strategies, I have increased weightings to higher quality stocks and especially companies that score more highly against environmental, social and governance (ESG) criteria. ESG forms an extra layer of analysis which helps us assess the quality of a business, and we have a global 12-strong team[2] dedicated to responsible investing and ESG analysis.

Targeting a high yield, plus capital growth

We aim to deliver a yield at least 10% higher than that of the MSCI Europe index benchmark. We achieve this by focusing on bottom-up stock selection rather than by targeting specific sector weightings: strong business models where scale and technology will deliver a competitive advantage. By contrast, we avoid areas where technological disruption, increased competition and low interest rates are proving challenging.

This bottom-up investment approach means we are less concerned by short-term market considerations and more with understanding individual companies. Our strategies hold from 30-50 stocks compared to 438 constituents of the MSCI Europe index, so they will not mirror the performance of wider European equity markets.

To help underpin long-term capital growth, we use a barbell approach combining higher yielding stocks with our highest conviction, often lower yielding, growth stocks. The combination is designed to deliver respectable long-term capital performance, as well as above-average income.

With Europe's bond markets offering little in the way of yield, and hardly likely to do so for the foreseeable future, the highest quality companies have stepped in to offer a much-needed source of income. While their stock prices may have fallen with the rest of the financial markets, and some dividends may be under threat, the best of them are in a good position to guard against recession and grow in a recovery.

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[1] Columbia Threadneedle Investments/Bloomberg data, 2020.
[2] As at April 2020.

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