Which alternative trusts could outperform equities?

We look at what returns are likely from equity markets in the coming decade and identify which alternatives could offer similar or greater returns for lower levels of risk...

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Secular stagnation refers to the economic theory that growth will be persistently low for some time to come, due to an imbalance between savings and investment. If capital is saved rather than invested productive capacity lies idle, while the drag on consumption reduces demand in the economy. As a result GDP growth is reduced. **As we have previously discussed**, there is no historical evidence that GDP growth has a direct impact on stock market growth – in contradiction of the theorised linkage via earnings. However, in a world of secular stagnation in which there is a glut of savings, corporate earnings will be muted as demand for companies' wares remains sluggish, which should negatively impact stock market growth. High rates of savings would also push equity valuations higher than they would otherwise be and thereby reduce future returns.

Investors can respond to this situation in a number of ways. One is to try to find active strategies, which either seek to harness certain factors likely to boost returns or to generate high stock-specific alpha. In the first case this could mean looking to harness the small cap premium or to the emerging markets which should see greater earnings growth over the long run. It could also mean looking to the tech sector, where earnings are dependent more on secular changes within the economy than the growth rate of the economy. In the second case this would mean looking for highly active stock pickers who run concentrated portfolios and aim to pick the winning companies which can steal market share from competitors. We believe the investment trust universe is the perfect place to find such strategies, as the structure allows managers to focus on managing their strategy and not inflows and outflows, while being able to take exposure to relatively illiquid assets and harvest the premium for doing so.

Another way of responding is to look for alternative assets which offer comparable or superior returns to the equity market as a whole. In our view, when we look at likely equity returns over the next ten years, some alternatives look compelling. In the below we sketch a rough idea of likely equity returns over the next decade and then introduce some trusts we think have the potential to generate similar returns from more predictable cash flows and potentially less volatile NAVs.

The outlook for equity markets return over the next decade

Looking historically, the equity risk premium (ERP) is the return we received for investing in equities instead of in safe assets. Equity returns can therefore be broken down into the risk-free rate and the ERP. One way of forecasting what we will receive from investing in equities in the future is to forecast the ERP and forecast the risk-free rate.

Clearly one factor which will lower future expected returns from equities is the collapse in the risk-free rate. The US ten-year treasury bond yields just 0.7%, down from 1.9% at the start of the year. The average pre-GFC was 4.7% over ten years, and it has been on a downward trend ever since. The UK 10 year gilt has followed the same path, with the current yield just 0.3%, down from 0.79% at the start of the year and a ten year average pre-GFC of 4.8%.

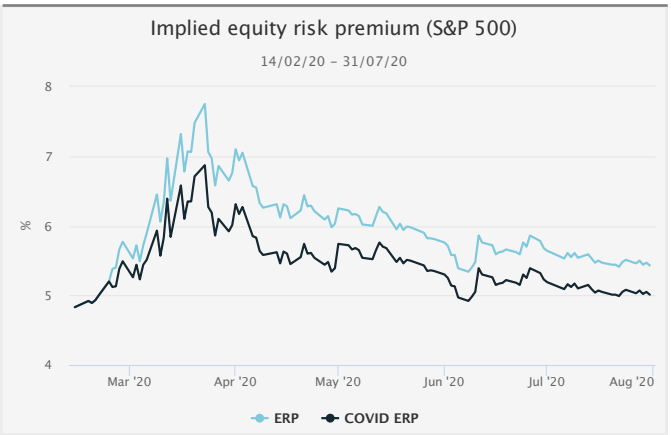
That leaves the ERP. We can very easily calculate what the ERP has been in the past by subtracting the risk-free rate from realized equity returns. A simple approach to forecasting returns would be to take the average ERP in the past and add it to our expected risk-free rate to construct a forecast equity return.

However, this method is problematic, as Aswath Damodaran – professor of finance at the Stern School of Business at NYU – explained in his paper Equity Risk Premiums (ERP): Determinants, Estimation and Implications (last updated in March 2020). The key problem is the fact the average changes radically over different time frames, so the number obtained is extremely sensitive to this one decision.

Damodaran prefers to back out an equity risk premium implied by valuations at the end of each calendar year. His work on the S&P 500 demonstrates that this approach generates a correlation of 0.77 with the implied premium at the end of the next year, a correlation of 0.44 with the actual return from equities over the following five years and 0.55 over the next ten years. These results are robust at the 0.05 significance level (displaying T-stats above 2). This is considerably better than using the historical implied premium (negatively correlated with outcomes) and other simplistic approaches such as fund manager surveys or looking at earnings yields and dividend yields, all of which show positive correlation but much lower. Damodoran backs out the ERP using a discounted cash flow model, the details of which are in his paper. At the end of 2019, he calculated an implied ERP of 5.2% for the S&P 500, in nominal terms. You can find the paper and many downloadable spreadsheets showing his various calculations at **his website**.

The coronavirus crash has caused significant disruption to business and huge volatility in markets – how has this affected the picture? The ten year US Treasury rate has fallen from 1.9% at the start of the year to 0.7%. This is another leg down in a secular bear market for rates which has reduced expected returns from equities. The effect on the ERP is more nuanced. Assuming a 25% drop in earnings, 80% of which is recovered by 2024, Damodaran calculates that the ERP spiked dramatically as the market crashed and then drifted back down close to where it started by the end of July – 5.03%.

Fig.1: Implied ERP



Source: Damodaran.com

With the US ten year yield, serving as our risk-free rate, at 0.7%, this implies nominal returns of 6.1% p.a. from US equities. This compares to the long-run average of 10.1% between 1970 and 2020. Returns are therefore likely to be much lower in the US than in the past according to this model. The ten-year breakeven inflation rate in the US (the difference between the rate on nominal and inflation-linked bonds) is 1.8%, implying real returns of just 4.3% from investing in US equities, over the next decade. The US equity markets make up 58% of global stock markets, so would be the core of a globally diversified investor's portfolio.

Damodaran's papers elucidate the academic basis for the models used by various practitioners. The expected nominal return of 6.1% from US equities generated via his method is close to the 5.8% nominal forecast by BlackRock in their latest capital market assumptions report (published in August). JPMorgan estimated a ten-year implied return of 6.1% on 17 April 2020, after the initial recovery from the coronavirus crash.

And for alternatives?

In the light of these historically low expected returns there are a number of alternative investment trusts which investors may find interesting. All the trusts below seem to have the potential to generate total returns close to our forecast for equities over the next ten years. They may also have more predictable cash flows and less volatile NAVs, though of course none of this can be guaranteed and they are not without risk. The vast majority of the return will, in all cases, come from the income generated, and we think given the cloudy outlook for equities, locking in the yields on offer could be an alternative way to generate returns close to those from equities over the next decade and could provide valuable diversification without lowering the expected portfolio return significantly.

Of course, a falling risk-free rate is a headwind for all asset classes, and so returns in future investments may not match up to those made in the past, and this has to be borne in mind. Furthermore, there are risks with these trusts such as specific industry risk, liquidity risk and so on which allow them to offer considerable returns. Usefully, many alternatives have the advantage of offering fully or partly inflation-linked yields, which offers some protection if inflation does rise from its currently low levels to those levels implied by long-term breakevens over the course of ten years. Investors also have to consider the reinvestment risk in each case. The assets these trusts have limited

lives. Some trusts (such as UKW) reinvest part of the income they earn in new assets in order to maintain their return profile. Others (such as HICL) need to raise capital periodically, either by selling more expensive assets to reinvest, or raising fresh equity, and reinvest the proceeds to deliver an extended income stream.

US Solar Fund (USF) is not yet fully invested, but targets a 7.5% annualised return on its investments including a 5.5% dividend on the IPO price. The managers aim to be fully invested by the end of 2020 and covering its target dividend by Q1 2021. USF builds or buys solar plants and agrees long-term power price purchase agreements with counterparties which should allow it to lock in income at agreed rates, with the intention being for a weighted average of 15.5 years. The agreements would commit the purchaser to buy all energy output from the relevant plant, with USF behind multiple other sources of power generation in the event demand was not sufficient. The fixed contracts mean USF does not have exposure to power prices, which is helpful in the current post-COVID environment that has seen falling prices. However the long-term contracts mean that USF would not be able to increase prices in the event of an inflation shock. Investors would also have to take dollar risk, as the US-listed portfolio is not hedged back into sterling.

NextEnergy Solar (NESF) has a more mature portfolio, having launched in 2014. It yields 6.7% at the current share price (which is on a premium of 7.3% to NAV). NESF invests in UK solar assets, and has successfully grown its dividend in line with RPI since it was fully invested in the 2016 financial year. In April, NESF reported that the company's assets had not been affected by the pandemic and it successfully paid a final dividend in line with expectations in May. In the annual report, the board also raised its dividend target for 2021 to 7.05p a share, 2.62% above the 2020 payout and in line with RPI over the year to March (financial year end). However, the board did warn that the dividend would be considered under review given the uncertainty unleashed by COVID-19 regarding demand and, therefore, power prices. They also note that power prices and RPI have become less and less correlated. NESF estimates that the average remaining life of its assets are just under 26 years, with the lowest longevity of a single asset around 16 years.

Greencoat UK Wind (UKW) also has a track record of growing its dividend in line with inflation, and is the only one with a stated intention of continuing to do so. Launched in 2013, UKW has growth to £2.3bn in total assets, which is likely to grow substantially following the placing programme announced last week. UKW invests solely in wind farms and yields 5%, despite the share price trading on a 5% premium to NAV. Fifty percent of the cash flows used to pay the dividend are directly index-linked and 50% linked to growth in the power price; consequently, as with NESF, any fall in correlation between power prices and inflation could cause RPI dividend growth to become harder to maintain. UKW estimates an asset life of 30 years as their base case. A rough and ready calculation, using the weighted mid-point of the age ranges they give for the assets in their annual report, gives an estimated average remaining life of 22.5 years. Only 18% of the assets have an age of over ten years, meaning they have less than 20 years' life remaining on current assumptions.

HICL Infrastructure (HICL) offers a dividend yield of 4.9% on the current share price, which is on a 14.2% premium to NAV. As much as 72% of HICL's infrastructure investments are in availability-based assets, on which the trust receives payment as long as the asset is available for use. This income is therefore more resilient than the 20% in demand-based assets which, like toll roads, generate an income depending on how often they are used. There is also an allocation to regulated assets, the income of which depends upon regulatory decisions. The latter two classes of assets give HICL some exposure to the economic cycle, which could hurt it in the short term, but overall it offers a portfolio of assets with long-dated income streams. The manager expects that income to have some correlation to inflation, and currently estimates the pass-through to be about 80% - in other words, if inflation were to rise by 1%, the income generated on the portfolio might rise by 0.8%. The weighted average asset life was 27.8 years as of the annual report in March.

The Renewables Infrastructure Group (TRIG) invests largely in wind and solar assets, with exposure also to one battery storage asset. Most of the portfolio is invested in the UK, with some exposure to continental Europe. The shares are yielding 5% despite being on a 20% premium to NAV. TRIG has a progressive dividend target, and although income on the portfolio is not inflation-linked, dividend growth has been 1.8% annualised since launch, which compares to average YoY RPI of 2.4%. Importantly in the current environment, TRIG's short term exposure to power prices is limited. TRIG fixes the electricity price it receives into the future which, together with the subsidies earned by certain assets, means that the managers estimate 74% of TRIG's revenues are fixed through to 31 December 2024. During 2019 the company extended the assumed economic lives of its assets to 29 years for wind assets and 30 years for solar assets. As such, the portfolio has a weighted average remaining life estimated at 23 years, although the average subsidised life of those assets earning subsidies is 12 years.

Neuberger Berman Global Floating Rate Income (NBLS) The proposed new strategy was approved by shareholders this Tuesday (08/09/20). We published a full note explaining the new approach here. NBLS is transforming itself into what we see as a true strategic bond fund, using the liquidity advantage of the investment trust sector to access privately arranged loans as well as investing across

conventional fixed and floating rate debt and in CLOs. The board will set a targeted dividend at the start of each year depending on where rates and spreads are, but the current dummy portfolio is generating a gross yield of 6.6%. As a generally short-dated fund but with exposure to plenty of floating rate debt too, NBLS should not be too affected by rising risk-free rates if they occur, but should benefit from increasing yields on offer in the market. The return potential will depend on credit spreads and the liquidity premium for investing in the more esoteric fixed income markets for the most part.

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