Aggressive Dividend Investing With The High Income Equity Fund

20 June 2015
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The Miller Howard High Income Equity Fund is an aggressive approach to dividend investing offering a substantial discount to NAV.

Dividend Investing Is More Than Collecting Distributions

Dividend investing is more than just sitting back and collecting distributions. There are multiple approaches to capturing yield, some seeking to avoid risk, others embracing it. The folks at Miller Howard Investments know this and have spent the last 24+ years focusing on those strategies. They have created a number of proprietary funds and indices based on strategies developed over the course of the companies existence. The High Income Equity Fund is the most recent, and most aggressive, of their offerings. It is a closed end fund with a 10 year duration that offers investors not only a steady income through monthly distributions but a safety net for those who fear a value trap.

The funds term structure is not unique but it is rare, a CEF with a preset term limit. At the end of the term all shareholders are guaranteed a disbursement of NAV on top of dividend payments accrued over the ten year period. The intention is to provide a guaranteed return on investment to ensure investors are not stuck with an asset that persistently trades at a discount to NAV. According to Steve Chun, Director of Client Services at Miller/

Howard Investments,"*This term provision directly addresses what many consider the biggest risk of investing in CEFs - the risk of holding a fund in a persistent discount, … If you look at dividend equity CEFs, you will find that most have traded at a significant discount over the past 10 years. So what looked like good value became a value trap for investors who did not see the discount gap close much during the past 10-years."*

Dividend yield in this issue is nearly 8.5% at current market prices near $16.25. Annual return is $1.39 per share paid out in monthly installments. The fund is able to sustain this payout through its aggressive approach and quarterly rebalancing. The fund is targeting undervalued companies with steady income and dividend payments along with high probabilities for increases to both. The goal is to capture income as well as capital appreciation with a medium to long term outlook. Holders of the fund today will get 100% return on principal through dividend distributions even before the term limit is up, then add in the NAV and you have the opportunity to make at least 100% ROI in under 10 years.

The portfolios is well diversified by sector but does have a noticeable bias toward high yielding assets such as REITs and MLP's. The MLP aspect of the portfolio gives it a healthy number of micro-cap stocks and helps to boost energy exposure to to over 20%. After that REITs are the largest holding at just under 20% with the top four sectors making up more than 56% of portfolio value. When you drill down you will find that while the fund is only minimally exposed to the healthcare sector, only 3.5%, actual exposure is much higher as many of the REITs are focused on healthcare related properties.

Declining NAV Provides Discount To Share Price

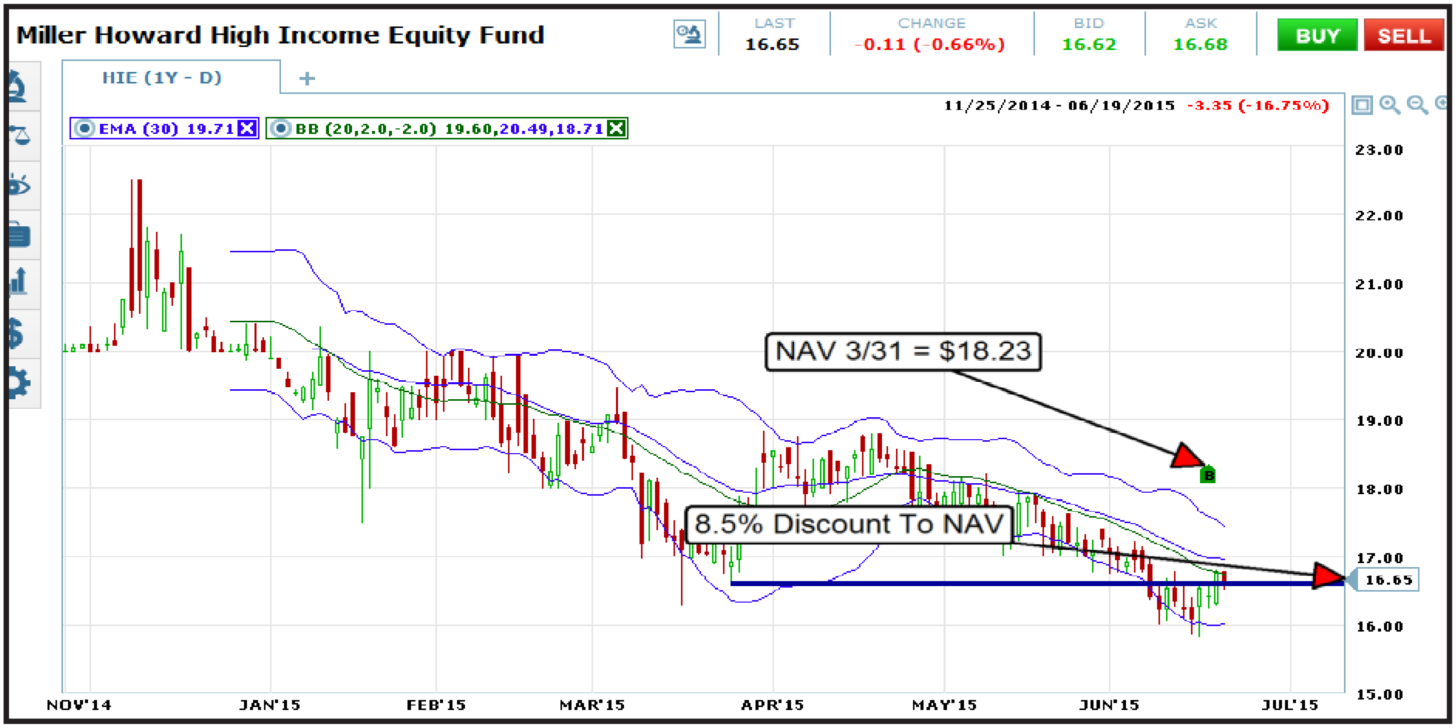
Net asset value is a big concern with this and any other high yield fund. The HIE portfolio value has been in steady decline since its inception back in 2014. At last check-up, March 31st 2015, NAV had declined by 4.3% to and it is likely we will see another decline this quarter, although its depth is questionable. One reason for losses to NAV is the fall in oil prices and their affect on oil stocks. The good news is that oil prices have

SECTOR ALLOCATIONS [5] as of March 31, 2015

REITs	19.2%
MLPs	12.9%
Financials	12.8%
Energy	11.3%
Industrials	10.1%
Utilities	7.8%
Consumer Discretionary	6.4%
Telecom	4.8%
Technology	4.5%
Health Care	3.5%
Cash	3.2%
Consumer Staples	2.5%
Materials	1.0%

TOP 5 HOLDINGS [5] as of March 31, 2015

Holding	Sector
Kinder Morgan Inc	Energy
Williams Cos Inc	Energy
Ares Capital Corp	Financials
Blackstone Group LP	Financials
Pattern Energy Group Inc	Utilities



bottomed since the first quarter and will likely result in better than expected earnings for the sector. When broken down like this the loss of value looks to be temporary and providing attractive entry points for long term investors.

Share prices have fallen along with NAV but the market has gotten too far ahead of it. At current share prices HIE is trading at close to a 10% discount to NAV and well below its average since inception. Bill Jameson, market analysts at KeyStock, says "NAV discounts offer some of the best advantages for those looking to invest in closed end funds... These discounts essentially enable investors to buy a pool of assets at sale prices and then to collect the gains as these discounts eventually close." Of course, you have to consider that NAV may continue to decline but for that you also have to believe the entire market is going to be lower in the future than it is now. Considering we are in a long term secular bull market driven by underlying demographic factors it is more likely the market will be much higher in the coming years, not lower.

Oil is not the only reason to expect another decline in NAV although it may be the last. This is because of poor earnings expectations, not so much for the HIE but for the market in general. S&P 500 earnings growth is expected to be negative for the coming reporting season and has the entire market under pressure. The good news is that this quarter, fiscal 2nd 2015, is most likely to be much better than expected and a trough in the earnings cycle that will lead to rising values throughout the market, not just the HIE portfolio. According to expectations from FactSet and Moody's expanding margins and steady economic recovery are leading to expectations of robust growth for the broader market into the end of this year and next year. Current expectations for full year earnings growth are in the range of 2-3% and expand to over 12% for 2016.

Steve Chun had this to say about HIE and its role in a dividend portfolio "A constructive approach to investing in HIE would be to see it as a consistent stream of income for the 10-year term generated by a basket of high-yield equities. The investor needs to consider where they think equities will be trading 10 years from now - higher or lower than today," .

Outlook For Top Holdings By Sector And Company

The energy sector will no doubt have the biggest impact on the HIE in the coming quarters. The price of oil has been volatile, caused by global supply/demand imbalances, and exposure to the sector is high. However, there are many positives when considering it in terms of future performance. Kinder Morgan and Williams Companies Inc are the two largest holdings in the energy sector. Both are pipeline/carriers and have some insulation from volatility in oil prices. Together they pay a combined $4.32 per share annually. Kinder Morgan is viewed by many to be deeply undervalued at current prices and supported by insider buying and a brand new $100 million repurchase program. Williams Companies, also undervalued, has recently completed the merger of a formerly spun-off subsidiary and substantially increased its dividend.

Yes, the 2nd quarter is expected to be quite bad for the energy sector, another -61% decline in earnings, but it is highly likely earnings will be better than expected as I outlined before. Looking at just the energy sector growth is expected to return by the end of 2015 and outlook for next year is robust. This is because oil prices are largely expected average 10% higher next year. 2016 earnings growth is expected to expand to 35% from -50% and since the sector is already undervalued, most estimates are based on $50 oil, this creates an environment for enhanced returns and dividend growth. With the outlook so rosy and the sector undervalued I would not be surprised to see Miller Howard add exposure to the portfolio in coming quarters.

The REIT's will also have a huge impact on HIE's performance going forward. Not only is it another 20% of exposure, it is a sector that is expected to do quite well over the next few years and is prime for increased income and dividend payments. Miller Howard targets the typical shopping malls and apartment buildings you find in other REIT based funds but also includes more targeted assets such as healthcare and assisted living. The combination of real estate shortage, expanding economy and aging population have combined to create upward pressures on rent for everything. According to data from Moody's the rate of absorption

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of office space is at long term highs and expanding while at the same time plans for hiring remain strong. In terms of rising rents all you have to do is search on Google to find dozens of articles outlining why rents are on the rise from coast to coast.

The financial sector is the third largest by portfolio weight and yet another sector with a healthy outlook. Financials make up 12.8% of the fund and as a sector are one of only four with analysts revising their estimates upward. At last look the sector was expected to grow earnings by 9.8% in 2016 following a 15.6% increase in 2015. Estimates for both years have risen, to 10.0% for 2016 and 16.1% for 2015, revealing underlying momentum in the sector. This momentum is due to ongoing improvements in the economy, steady improvement in labor markets, growth in consumer spending and the upcoming FOMC rate hikes. In terms of interest rate hikes this sector is expected to benefit in the form of increasing revenue, increasing margins and increasing earnings into the next several years.

Top holdings in this sector and among the top five for the portfolio are Ares Capital and Blackstone Group. Both are high yielding financial management companies, Ares a BDC. Together they pay a combined $4.18 per share and are among the top performing assets in the financial arena. Blackstone alone has been reporting steady increases in revenue, earnings and assets that are expected to lead to dividend increase. Ares is seen by many as the best choice among the high yielding BDC's, both companies are undervalued relative to oil prices and forward earnings.

The Bottom Line

The bottom line is this; the High Income Equity Fund is a decent choice for high yield investors at worst and an opportunity for serious capital appreciation along with a healthy dividend distribution at best. On top of that is the safety net provided by the funds term limit, a feature you will not find in most high yield investments. In the near term NAV and share prices may be affected by poor outlook for 2nd quarter earnings but any weakness should be viewed as a buying opportunity. The portfolio is well positioned to take advantage of economic trends and should see a bottom in NAV declines in the near future. Longer term, earnings growth in the energy, financial and real estate sectors will be amplified by expanding economic growth and result in rising asset values as well as share prices for the HIE. With all this in mind today's 8.5% discount to NAV looks pretty inviting and could be the catalyst to spark a rise in share price as value investors scoop up the yield.