Investors benefit from growing dividend culture

With stock markets stagnant and interest rates and bond yields low, investors are increasingly turning to a growing number of dividend-paying shares for both income and total returns

The market has seen a structural shift away from rewarding capital growth potential towards favouring companies that pay dividends. This is more than just a quest for income: dividend-paying companies have generally been seen as higher-quality and dividends as a more tangible source of return. In the UK market, dividend payouts are now at their highest absolute level ever, but can this strength endure in the face of declining economic prospects across the globe?

It has been repeated so often that it is now a cliché, but in the current environment income is scarce: the yields on high-quality government bonds continue to compress against all expectations, corporate bonds are facing a liquidity squeeze, with the ultimate outcome unclear, and cash rates are negligible. It is unsurprising that in this environment investors are increasingly looking to dividend-paying stocks, where the income is higher and there is still potential for capital growth.

Peter Toogood, investment services director at Morningstar OBSR, explains: "Every year that goes by with low interest rates, the yield available on equities becomes more valuable. As a result, equity income has been in a stealth bull market. Areas such as tobacco and classic defensives have done extremely well."

According to EPFR Global, a financial data provider, dividend equity funds globally absorbed a net US$858m in the last week in July, the same week in which outflows from all equity funds exceeded US$10bn. Global equity income has been the top-selling IMA equity sector of the year in the UK. Even traditional growth investors are looking to dividends as a key driver of total returns as share prices remain stagnant.

Comparing different sources of income

Has this gone too far? On a yield basis, equity income funds still look attractive compared with other sources of income. In the UK, ten-year gilts currently pay just 1.44%. Higher yields are available on emerging-market debt, but the sector has seen significant institutional fund flows over the past two years, and consequently spreads have moved lower. US dollar-denominated Brazilian debt now pays just 1.11% over US Treasuries. The other option is to move into peripheral euro zone debt, where the income is potentially higher but the risks are all too apparent.

Corporate debt is another option. The FINRA/Bloomberg Investment Grade US Corporate Bond Index shows that the average yield on corporate bonds is 5%. However, indices are increasingly skewed by the high yield available on financial bonds, while blue-chip corporates such as Nestlé pay a tiny spread over benchmark interest rates for their borrowing.

Nestlé is a salient example of the decision that investors face. The latest corporate bonds, issued by the company in June, had a duration of five years, were US dollar-denominated, →

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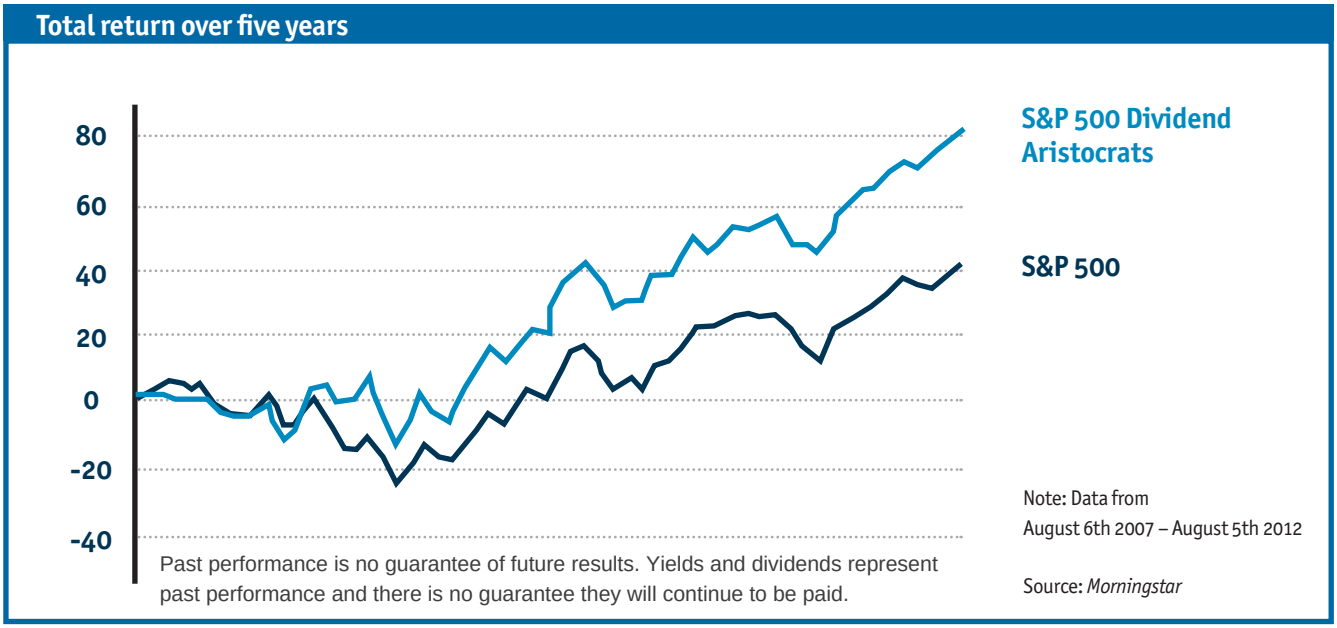

paid a coupon of 1.375% and redeemed at par. In contrast, the shares have a yield of 3.21% and offer the potential for long-term capital growth as well.

"Across all regions in developed markets, the spread between equities' dividend yield over government bond yields is close to record highs," according to the latest Morgan Stanley dividend report. " We do not think this metric is a good market timing indicator (for example, it told you to sell equities through much of the 1980s and 1990s); however, it does illustrate their relative attractiveness to income-oriented investors in particular, and with record low government bonds, we suspect this will remain in investors' minds for some time."

The discipline of dividend paying

The discipline of paying a dividend is often considered a sign of a well-run company, with good cash flow, good corporate governance and a positive outlook for the future. If a company prioritises tangible returns to shareholders, it will often not spend money on speculative and value-destroying deals. There is also a natural valuation discipline to dividend investing. As yield is expressed as a percentage of the stockmarket capitalisation, if the share price rises, the yield falls. This means that those investors who seek out higher-dividend companies tend to buy at lower valuations. Also, these stable, quality companies tend to perform better over the long term. The S&P Dividend Aristocrats Index, which measures the performance of large-cap, blue-chip companies within the S&P 500 that have followed a policy of increasing dividends every year for at least 25 consecutive years, is up 6.5% over three years, outperforming the broader S&P 500, which is down 5.2% over the same period. The S&P Dividend Aristocrats Index saw significantly smaller drawdowns during the market panic of 2008, which contributed to higher overall returns and lower volatility, as seen in the chart below. This outperformance of dividend stocks has been seen globally and has been particularly marked in emerging markets.

Increasing sources of dividends

As markets increasingly value dividends, the sources of dividends are shifting and diversifying. And because companies are rewarded for paying higher dividends by the market, new companies are encouraged to pay dividends and existing dividend-payers are encouraged to move their payouts higher. This means that the choice for dividend investors is increasingly diverse, both in terms of geographical region and sector.

The UK market has historically been the best source of high-dividend companies, along with some US blue-chips. But this is changing, with companies from many other countries increasing their dividend yield over the past five years, as seen in the table (1) overleaf. For example, in Japan, where companies have traditionally been reluctant to pay dividends, the yield on the FTSE Japan Large Cap has moved from 1.2% to 2.7%.

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Traditionally, dividend investors have had to limit themselves to sectors such as oil and gas, pharmaceuticals and utilities. However, a number of high-profile technology companies have now started to pay a dividend, notably Cisco and Apple. The yield on the global technology sector has increased from 0.9% to 1.4%, but there has also been a substantial hike in yields in other sectors, as shown in the table (2) below.

Current concerns

The latest figures from Capita show absolute dividend payouts at record levels. Second-quarter dividend payouts surged by 18% to £22.6 billion the highest for the period on record. This has, not unsurprisingly, led to concerns over pricing.

Because of the natural valuation discipline of income stocks, it is difficult for them to be in a "bubble" as such. However, overvaluation can be a problem if dividends are not being covered by a company's cash flow. At the moment, companies generally have large cash balances, and payout ratios (the proportion of net income a firm pays in dividends) have dropped. In other words, dividend rises have not kept pace with profits, leaving plenty of scope for further increases, or at least maintaining payments at current levels. Nevertheless, it is important to look at dividend cover and the source of dividends, rather than simply selecting high-dividend stocks.

Mr Toogood says: "Investors are desperate for income and they want safety. This trend is likely to continue unless quantitative easing finally starts to work and there is a significant turnaround in the economic cycle."

In the US the sector faces other short-term issues. There is concern over the expiration of favourable dividend tax treatment in the US. This has been well flagged and as such is likely to have already been factored into the price of shares. When the tax concession was originally introduced in 2003, it had little impact on the preferences of companies to pay out dividends. It seems unlikely that it will have a significant impact in the opposite direction when and if it is allowed to expire.

Ultimately, the current spotlight on income-paying stocks is a return to the status quo; the focus on capital growth seen in the 1980s and 1990s is likely to be viewed as a historical anomaly as previously investors often bought equities for their yield. This trend is supported by the fact that dividend investors now have greater scope as more companies, from different sectors and countries, have begun to pay dividends—dividend culture is spreading around the world. Also, markets are increasingly valuing, and rewarding, the tangibility of dividends over the nebulous charms of capital growth. It is a reversion to history and a boon for investors seeking income in the current low-yield environment.

Past performance is no guarantee of future results. Yields and dividends represent past performance and there is no guarantee they will continue to be paid.

1

Countries/regions	Dividend yield (%)	
	July 31 2012	August 10 2007
FTSE All World Asia excl. Japan	3.2	2.4
FTSE Latin Americas All Cap	3.2	2.2
FTSE Japan Large Cap	2.7	1.2
FTSE North America Large Cap	2.3	1.9
FTSE UK All Cap	3.7	3.1
FTSE Developed Europe Large Cap	4.1	3.2

Source: Financial Times.

2

Sectors	Dividend yield (%)	
	July 31 2012	August 10 2007
Basic materials	3	2.1
Industrials	2.7	1.8
Consumer goods	2.6	2.1
Healthcare	2.6	1.8
Consumer services	2.1	1.6
Telcos	5.2	3.3

Source: Financial Times.

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The FTSE All-World Asia Pacific excluding Japan Index is a free float market capitalization weighted index of Large and Mid cap stocks from both developed and emerging markets in the Asia Pacific region, excluding Japan. The FTSE Latin Americas All Cap Index is a free float market capitalization weighted index of equities in Latin America countries investable by non-nationals. The FTSE Japan Large Cap Index is a free float market capitalization weighted index of equities reflecting the top 68-72% of Japanese companies by market cap. The FTSE North America Large Cap is a free float market capitalization weighted index reflecting the top 68-72% of US companies by market capitalization. The FTSE Developed Europe Large Cap is a free float market capitalization weighted index reflecting the top 68-72% of developed European companies by market capitalization. The FTSE UK All Cap is a free float market capitalization weighted index reflecting the entire universe of UK listed companies.

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