An x y and Zee Equity Income Update

Dividend Income and Growth in the UK

Generating an after-tax return in today's low-yield environment is incredibly difficult. Given we know that dividends make up the bulk of long-term equity returns, that compounding those previous dividends plays a huge part in generating returns, and that dividend payments are only sustained by companies that are economically able to sustain them, it is perhaps more important to avoid companies that might cut payments rather than owning stocks with a lower but progressive yield. Total returns should be the bottom line for any investment strategy as, at the end of the day, an investor needs both. We therefore decompose total returns into dividend components and capital return components for companies in the UK over the last 10 years.

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Whilst the balance between a requirement for yield and capital preservation has been paramount, the underlying environment remains challenging with ultra-low interest rates and ultra-low bond yields posing a considerable problem for income-seeking investors. Whilst the UK equity income sector saw over £6 billion[1] of inflows last year and was the best selling net retail sector, average yields have fallen. That said, returns from UK equity income over the last 10 years have been in excess of 100%.[2]

Average Equity Income Yields, Last Five Years (%)

	2009	2010	2011	2012	2013	2014
UK Equity Income	5.08	4.57	5.00	4.77	4.11	4.31
Global Equity Income	4.59	3.81	4.31	3.78	3.94	3.73

Source: Morningstar, Note data as at end November 2014

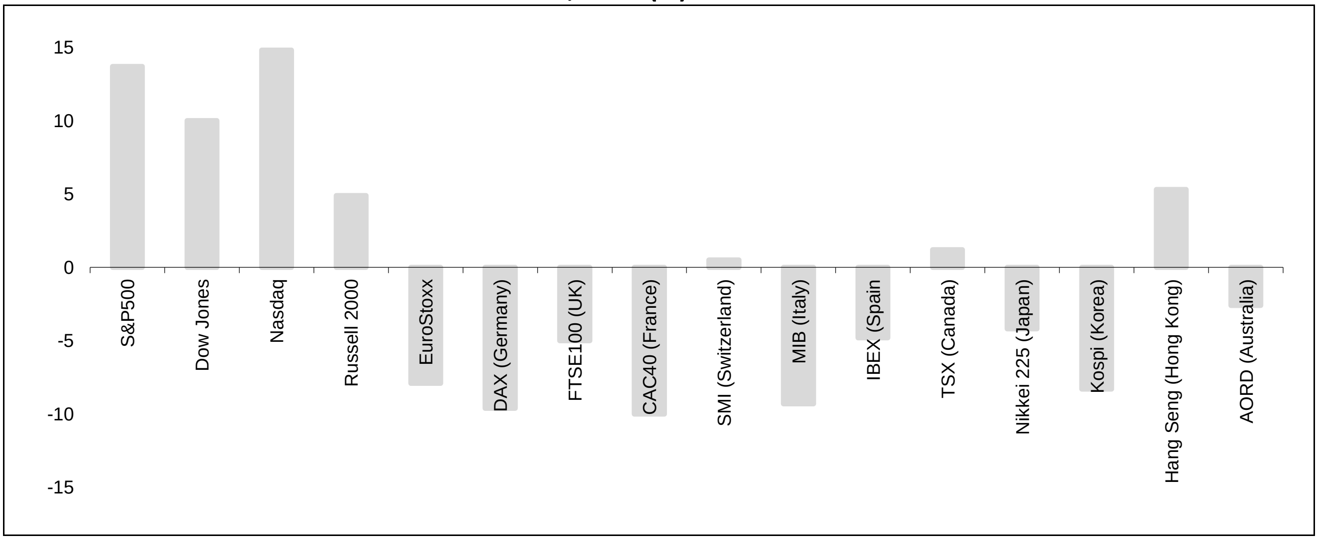
Concerns about rising inflation has rather quickly turned into worries about deflation. We know that rising inflation feeds through to higher dividend growth but is bad for equity prices overall. However, deflation is simply bad all-round and will affect wider macro-economics in terms of lower profits, shrinking employment and incomes. Investors are effectively stuck between a rock and a hard place, with the ability to find solid yielding stocks with prospective dividend growth at attractive valuations becoming even more limited. That said, we note that four out of the five top performing funds in the UK during 2014 were income funds. Not bad when the FTSE All Share declined by 2.1% on an absolute performance basis and 4.9% on a relative performance basis.

Top Performing Funds in the UK, 2014 (%)

Fund	Outperformance Against FTSE All Share
CF Milton UK Value Opportunities	10.35%
Majedie UK Income	10.29%
Troy Trojan Income	9.95%
Invesco Perpetual Strategic Income	9.89%
Invesco Perpetual High Income	9.65%

Source: Financial Times

Total Return Performance for Selected Indices, 2014 (%)



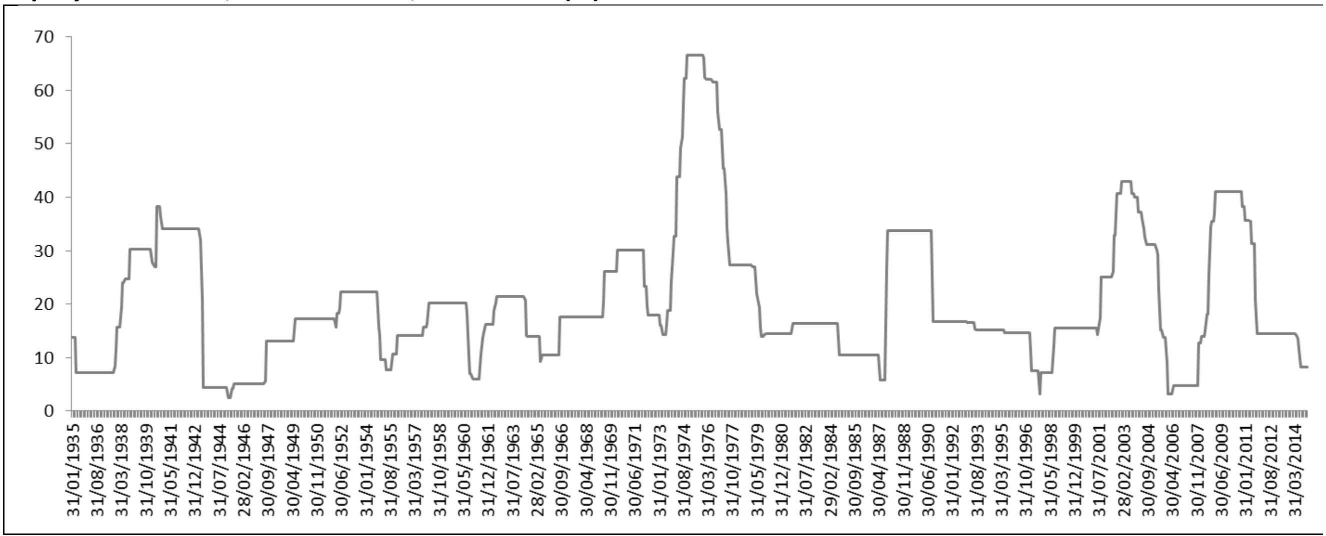
Source: TRD

[1] Source: The Investment Association, December 2014, http://www.theinvestmentassociation.org/investment-industry-information/fund-statistics/

[2] Total investment return, net of charges (other than the initial investment charge) for a basic rate tax payer, including reinvestment of all dividends.

So faced with miserly returns, the choice in 2015 may be whether to invest in the first place or not. Central bankers have made it difficult to hold cash, bonds are beyond expensive (with some corporate bonds, such as Nestle's four-year Euro-denominated bond, negative yielding), and whilst many favour equities on the basis that there's no alternative offering any sensible yield, some cannot stomach the risk. By focussing on higher and solid dividend yielding stocks, any investor will outperform the market on a total return basis but will have to suffer long periods of capital return losses as a result of their buy-and-hold strategy. Indeed, one should always remember that the downside risk of owning an equity is huge. The average peak-to-trough drawdown of holding equities in the UK over a three year rolling period since 1935 is around 20%, but in a crisis this increases markedly, and compares to around just 7% for bonds.

Equity Drawdown, FTSE All Share, Since 1935 (%)



Source: TRD

On a relative basis, with lower betas and more cautious characteristics, equity income stocks *should* outperform during periods of weak equity market performance. In addition, buying stocks with sound balance sheets (not loaded up with debt) *should* help weather any storm. Indeed, as a measure of the appetite for equity income, investors in the US have ploughed US$90bn into dividend funds over the last three years.[3] As an aside, an interesting paper, "Juicing the Dividend Yield: Mutual Funds and the Demand for Dividends"[4] found that *"Some mutual funds purchase stocks before dividend payments to artificially increase their dividends, called "juicing". Funds paid more than twice the dividends implied by their holdings. Juicing is associated with larger inflows . . . [but is] costly to investors through higher turnover and increased taxes"*. In other words, be careful when picking a fund in which to invest!

[3] EPFR Global, http://www.epfr.com/

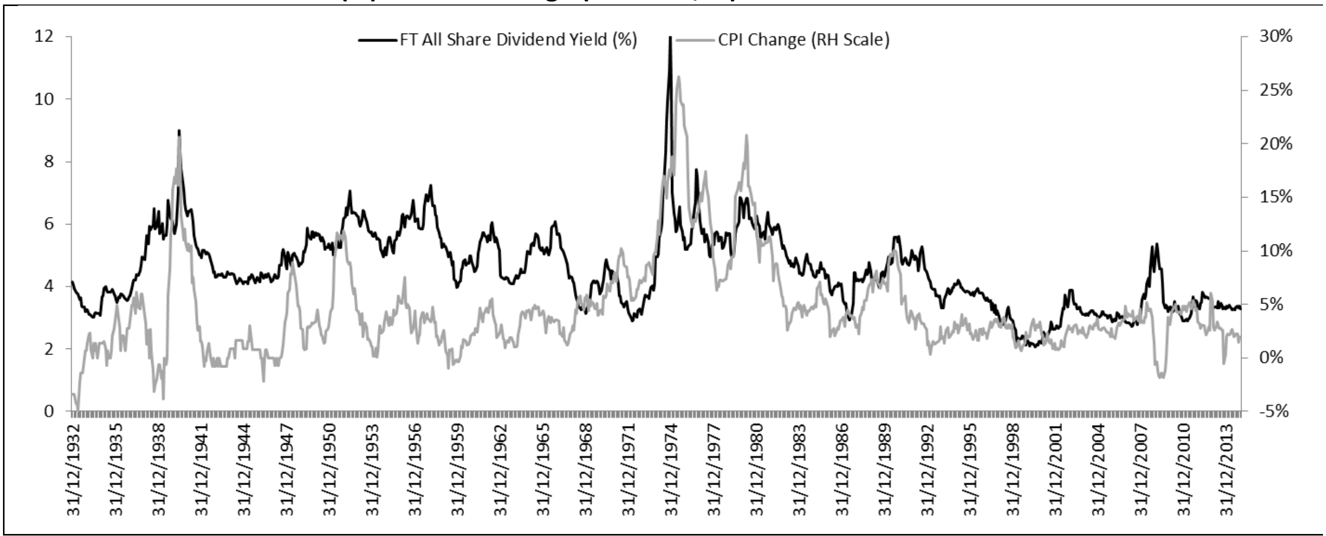
[4] Juicing the Dividend Yield: Mutual Funds and the Demand for Dividends, Harris, Hartzmark & Solomon, October 2014, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2510484

Inflation and Income Returns

Many academic studies have examined the historical returns of equities and their relationship to bond yields, thus deriving the equity risk premium. Ibbotson and Chen's seminal study[5] decomposed equity returns into supply factors, which we discuss in more detail below. According to the study, the bulk of historical returns are due to dividend payments and nominal earnings growth (i.e. real earnings plus inflation) but how has inflation influenced dividend growth over the longer term and how have dividend-paying stocks performed during periods of deflation?

Without getting into too heavily involved in an inflation versus deflation argument, with both government and consumer indebtedness so high, a return to healthy levels of inflation would be more than welcome. Just four years ago, inflation rates in the UK were becoming a concern but recently published CPI data for December 2014 shows a fall to just 0.5% which has started the "lowflation" debate. Below we show the dividend yield for the UK market and change in inflation since 1932. No surprises to see a strong correlation and big spikes in 1940 and 1974.

FT All Share Dividend Yield (%) and CPI Change (RH Scale, %)

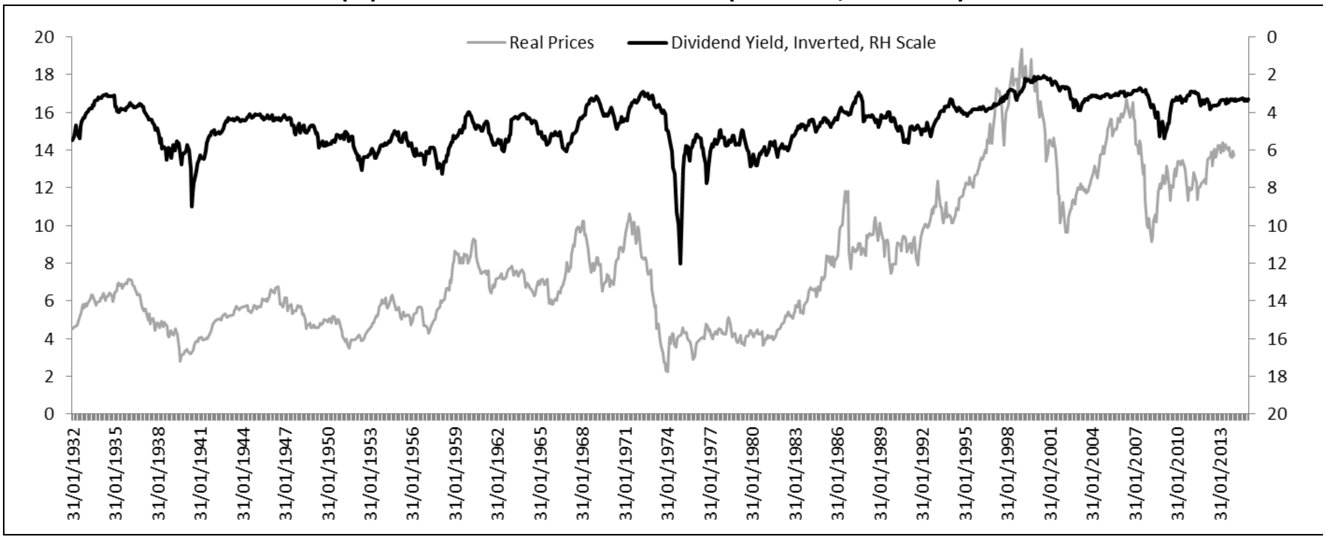


Source: TRD

[5] Long-Run Stock Returns: Participating in the Real Economy, Ibbotson & Chen, April 2006, http://dx.doi.org/10.2469/faj.v59.n1.2505

But the spikes in the dividend yield cannot wholly be explained by share price falls, indicating that some stocks do relatively well during periods of high inflation and overall equity market weakness.

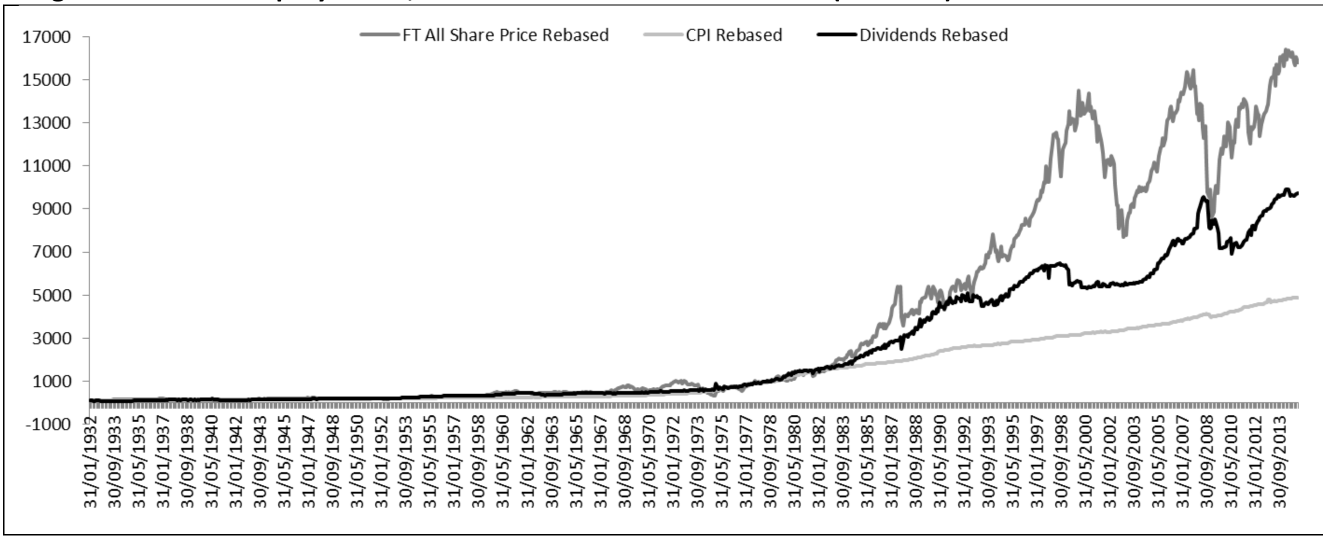
FT All Share Dividend Yield (%) and FT All Share Real Prices (Inverted, RH Scale)



Source: TRD

The chart below shows long run returns in the UK split into price, dividend and inflation components. We can see that from 1932 until around 1985, equities only just managed to keep track with inflation. In other words, ignoring reinvested dividends, real dividend growth was zero due in large part to the rapid rise of inflation in the 1970s.

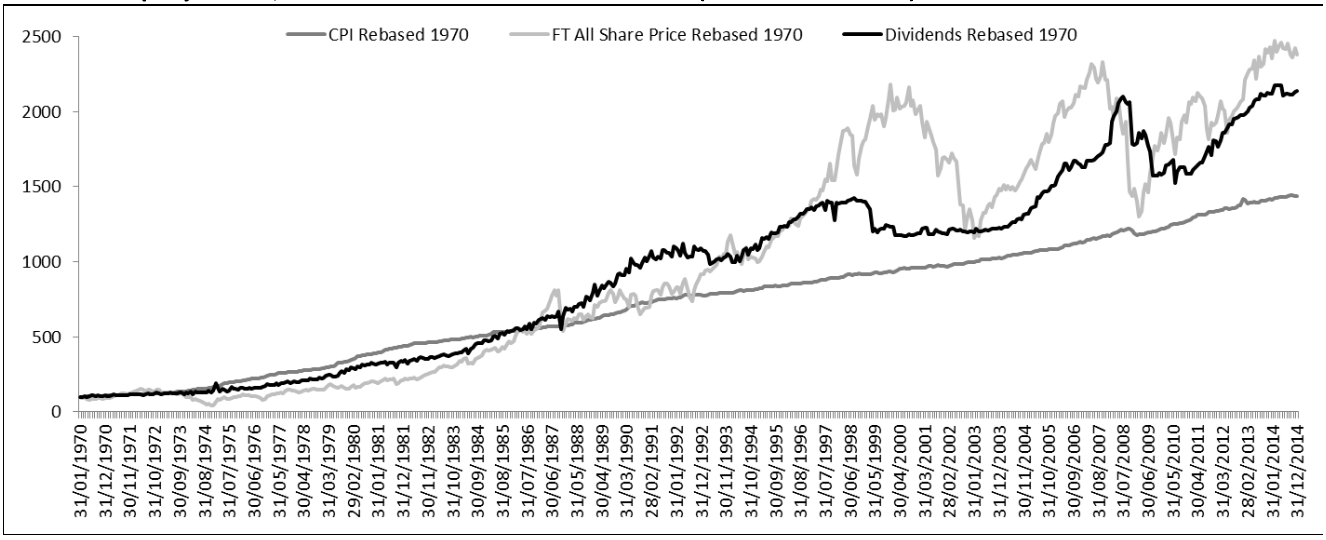
Long Term Nominal Equity Prices, Dividends and Inflation in the UK (Rebased)



Source: TRD

If we chart the same data but rebasing to 1970, we can more clearly see that when inflation was brought under control, real dividend growth was achieved and equity prices subsequently rose.

Nominal Equity Prices, Dividends and Inflation in the UK (Rebased to 1970)

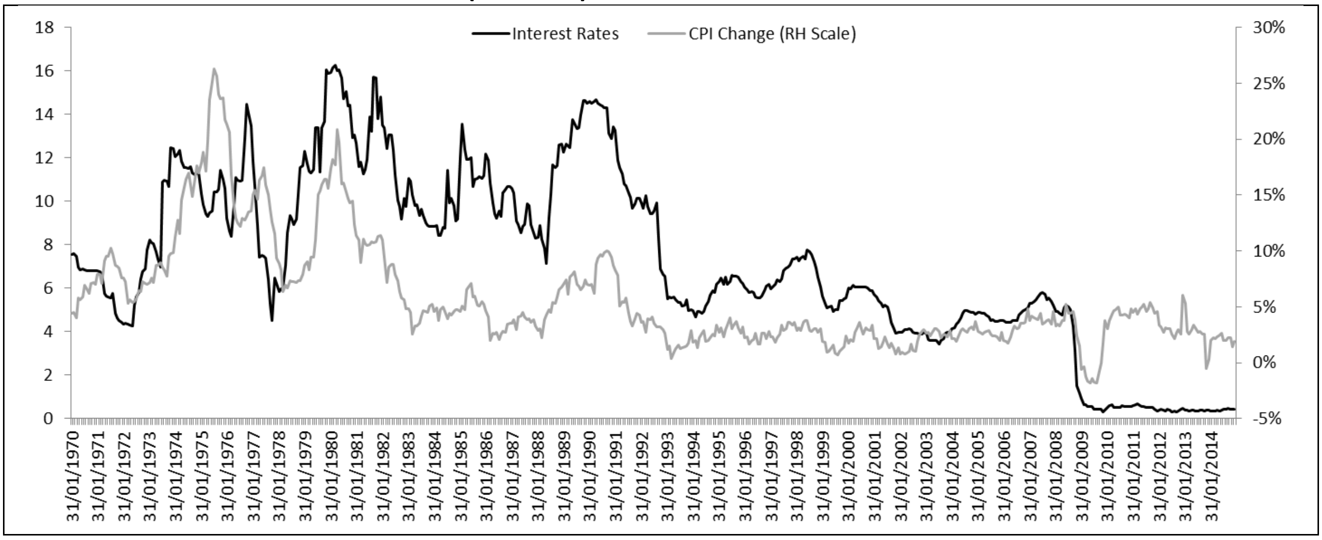


Source: TRD

Interest Rates and Inflation

With interest rates on the floor, what are the prospects of an increase? Data today suggests that the UK will not see an interest rate rise for at least another 12 months, but who knows? Whilst the General Election is imminent, any monetary policy change will not likely happen before the end of the year.

Interest Rates in the UK and Inflation (RH Scale)



Source: TRD

Decomposition of Returns

Determining the relationship between equity returns and income stocks in relation to changes in inflation is not easy. Ibbotson and Chen's study[6] mentioned above decomposed historical equity returns into supply factors using six different methods:-

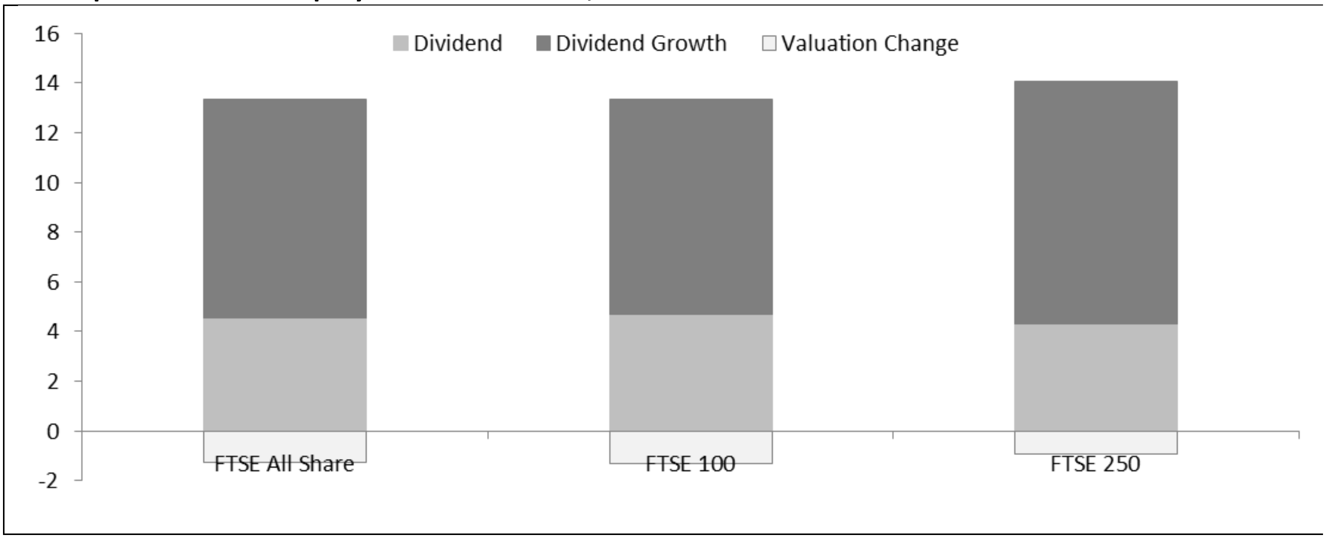
1. Building Blocks = Real Risk Free Rate + Inflation + Equity Risk Premium;
2. Capital Gain and Income = Inflation + Real Capital Gains + Real Dividends;
3. Earnings = Inflation + Real EPS Growth + Change in P/E + Real Dividends;
4. **Dividends = Inflation + Real EPS Growth + Change in Payout Ratio + Real Dividends;**
5. Return on Book Equity = Inflation + Growth in Real Book Value + Growth in Real ROE + Change in P/E + Real Dividends; and
6. GDP per Capital = Inflation + Real Growth in GDP per Capita + Increase in Equity Markets Relative + Real Dividends.

The study concluded, first, that the growth in corporate productivity measured by earnings is in line with the growth of overall economic productivity. **Second, that PE increases account for only a small portion of the total return of equity as the bulk of the return is attributable to dividend payments and nominal earnings growth (including inflation and real earnings growth).** Third, the increase in the equity market relative to economic productivity can be more than fully attributed to the increase in P/E. **Fourth, a secular decline has occurred in the dividend yield and payout ratio, rendering dividend growth alone a poor measure of corporate profitability and future growth.**

Decomposition of Returns for the UK Market

So what we know, but which is often forgotten or completely ignored, is that compounding returns (dividend yield, dividend growth, inflation) provides the bulk of equity returns over the long term. We are able to decompose total returns into their dividend and capital return components where the dividend component is the annualised difference between the total and capital return. Assuming that dividend growth is positive, one would expect the higher the dividend yield of the market, the greater long term return.

Decomposition of Real Equity Returns in the UK, Since 1985

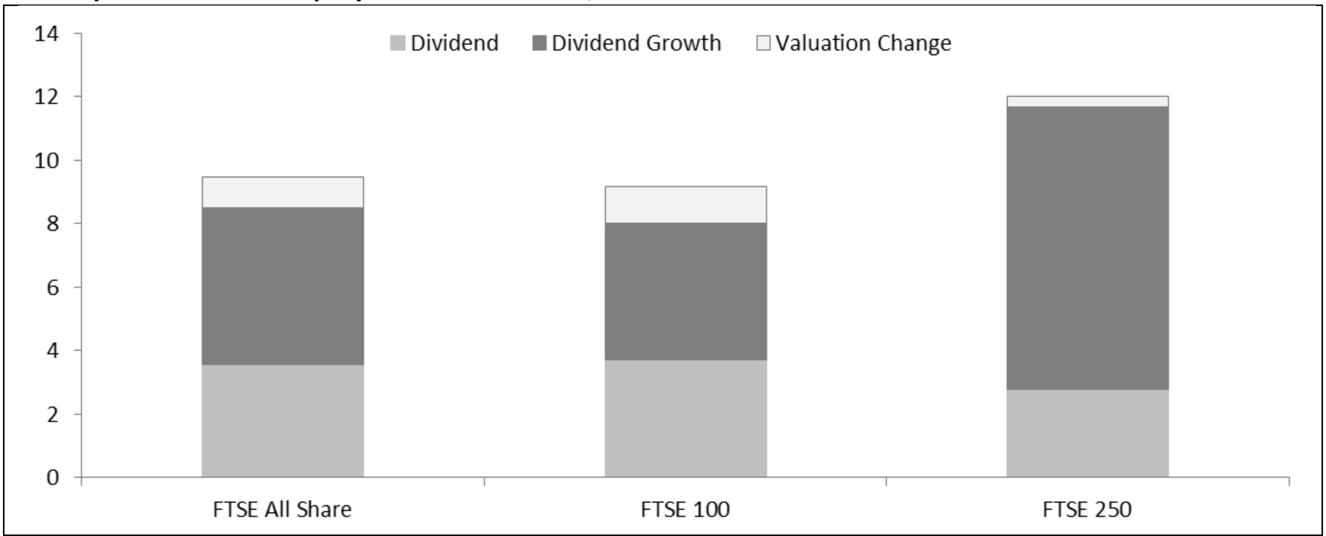


Source: TRD

[6] Long-Run Stock Returns: Participating in the Real Economy, Ibbotson & Chen, April 2006, http://dx.doi.org/10.2469/faj.v59.n1.2505

The capital return component can be split into dividend growth and the difference between the starting and ending valuation (i.e. multiple expansion). If dividend growth and price returns are the same, then the starting and ending dividend yield will be equal. We can then split the dividend growth component into real dividend growth and inflation. It makes sense to split inflation from the growth component as in a higher inflationary environment dividend growth will be higher in nominal quantities (in other words, dividend growth and inflation are essentially the same). Total return should be the bottom line for any investment strategy, whether the fund is focused on capital gains or income, as an investor needs both. On a real return basis, it is the level of dividend yield first purchased that ultimately determines long-term returns.

Decomposition of Real Equity Returns in the UK, Last 10 Years

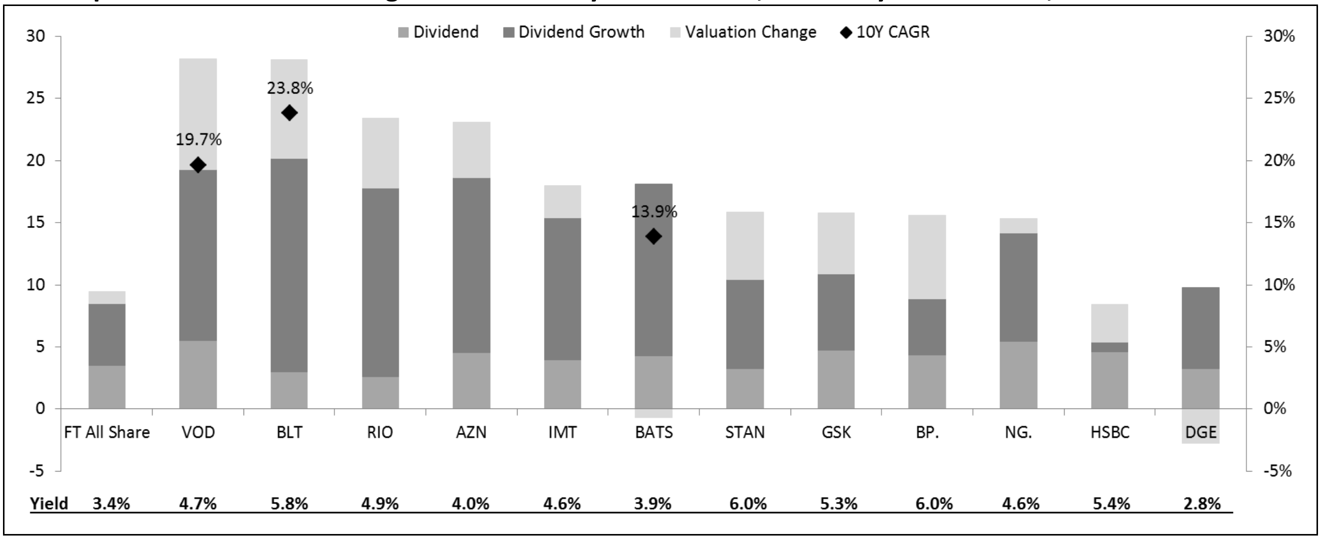


Source: TRD

Decomposition of Returns by Company

By replicating the above exercise we are able to decompose returns for individual dividend paying companies. We started with the most important dividend payers in the UK market (by total dividend contribution) and found that whilst HSBC is the largest payer, it's returns have been rather lacklustre over the last 10 years. In contrast, Vodafone's returns have been quite impressive. Of the 12 companies in the chart below, just three (Vodafone, BHP Billiton and British American Tobacco) have increased (not just maintained, but increased) dividend payments each year for the last 10 years. We want safe dividends and whilst BHP Billiton didn't cut payments during the financial crisis, given where commodities prices are today, the risk is that they may have to. We'd favour the defensive tobacco and pharmaceuticals stocks.

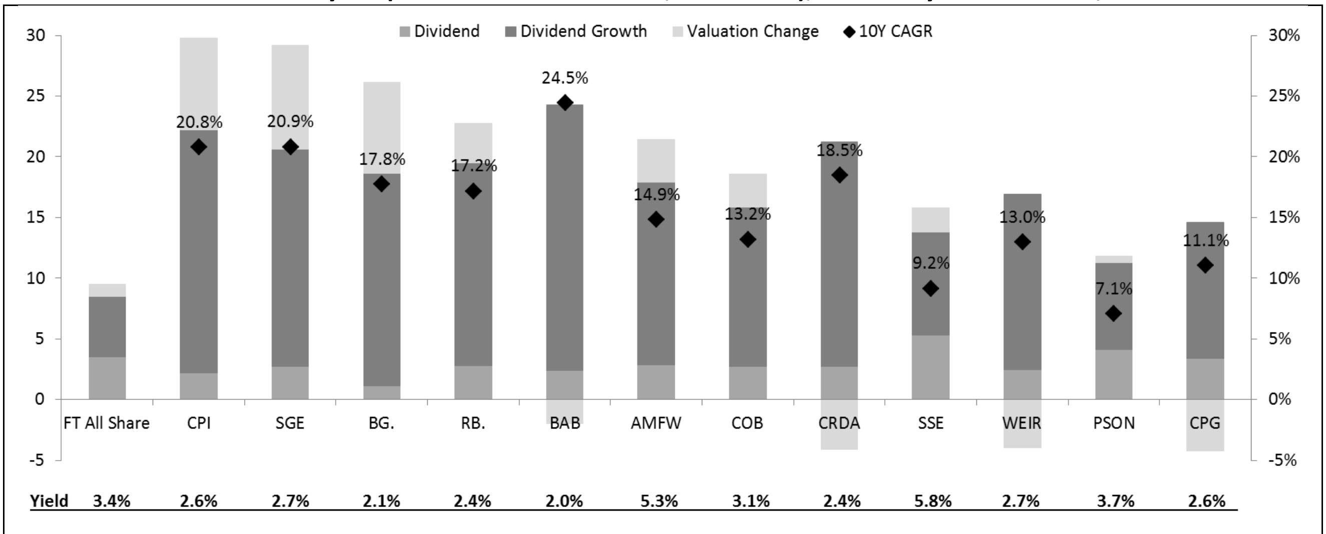
Decomposition of Returns - Largest Dividend Payers in the UK, Sorted by Total Return, Last 10 Years



Source: TRD, Note that the yield is Yr1E prospective divdend yield.

If we take a look at the other companies which have increased dividends every year for the last 10 years, we see that, apart from Amec and SSE, prospective yields are really rather low. However, SSE's dividends have not been covered by free cash flow generation for years and are currently being serviced by new debt. Amec's exposure to the Oil and Mining sectors means that its share price has been hit by the oil price rout.

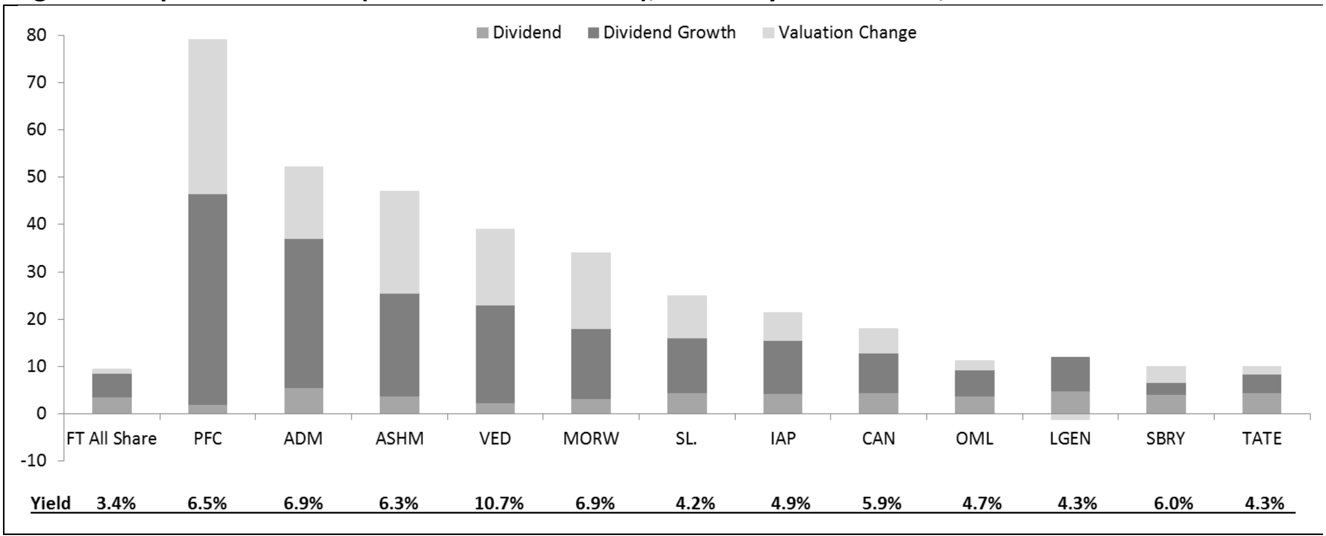
10 Year CAGR Dividend Payers (Not Mentioned Above, >2% Yield), Sorted by Total Return, Last 10 Years



Source: TRD, Note that 10 Year CAGR includes only those stocks which have INCREASED (not just maintained) their annual dividend payments each and every year over the last 10 years. The yield is Yr1E prospective divdend yield.

Which got us wondering what returns look like for the highest prospective yielders in the UK market but this chart seems the most uninteresting of the three, consisting of some highly risky names. Petrofac's dividend is quite obviously at risk; Admiral has been tapping bond markets to pay dividends; Ashmore, as an emerging market investor, has seen its share price suffer; Vedanta is in the Mining sector; and William Morrison has been hit hard by competition from discount supermarkets.

Highest Prospective Yielders (Not Mentioned Above), Sorted by Total Return, Last 10 Years



Source: TRD, Note that the yield is Yr1E prospective divdend yield.

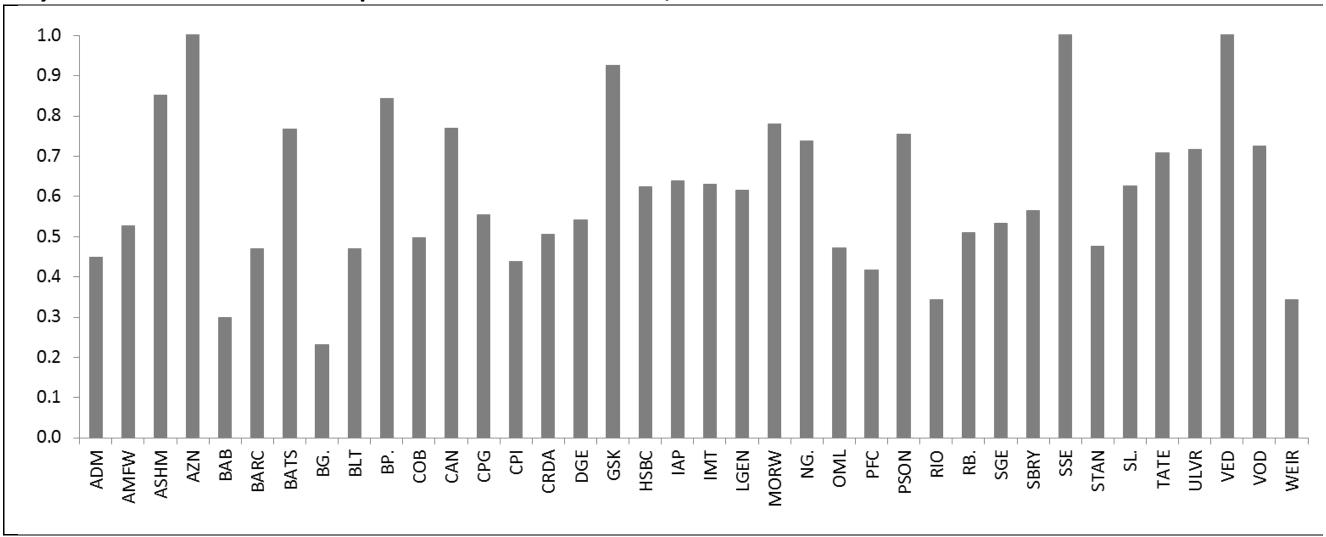
Payout Ratios

Ibbotson & Chen's study includes the change in the dividend payout ratio when computing returns. However, one of the core conclusions of the study was that "a secular decline has occurred in the dividend yield and payout ratio". Indeed, financial theory states that *rapidly growing companies* are better off deploying capital themselves and therefore, repayment via a dividend, is inefficient. Some CEO's of major corporations seem to think they know better[7] but we continue to believe that a firm commitment to paying dividends (rather than a flaky one of buying back shares) should help safeguard shareholders from over-inflated boardroom egos.

Higher dividend payout ratios also suggest optimism about future profits growth and a study entitled, "Surprise! Higher Dividends = Higher Earnings Growth"[8] showed that *"future earnings growth is fastest when current payout ratios are high . . . [which] contradicts the views of many who believe that substantial reinvestment of retained earnings will fuel faster future earnings growth."* Remember, on a real return basis, it is the level of dividend yield purchased that ultimately determines long-term returns but, quite obviously, if payout ratios rise to unsustainable levels (by whichever measure you use), then the dividend will likely be cut. It is perhaps more important to avoid companies that might cut payments rather than owning stocks with a lower but progressive yield.

[7] Berkshire Hathaway Annual Letter, 2012, http://www.berkshirehathaway.com/letters/2011ltr.pdf
[8] "Surprise! Higher Dividends = Higher Earnings Growth", Arnott & Asness, 2003, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=390143

Payout Ratios for Those Companies Mentioned Above, Latest Data



Source: TRD, Ratio = DPS/EPS, Note: AZN 3.4x, SSE 2.3x, VED 13.2x

Conclusion

Generating an *after-tax* return in today's environment is incredibly difficult. Given that we know that dividends make up the bulk of long-term equity returns, that compounding those precious dividends plays a huge part in generating returns, and that dividend payments are only sustained by companies that are economically able to sustain them, avoiding companies that cut dividends payments is perhaps more important than owning stocks with a lower but progressive (and compounding) yield. But, as with many things, the near-impossible short-term constraints imposed on many funds – coupled with an overall lack of patience in general – means that long-term income investing may never be considered quite exciting enough.

As ever, I'd very much welcome any comments, suggestions or constructive criticisms regarding anything included in this note. If you would like any further explanation of commentary contained within this document or any additional data, please let me know. Lastly, if you would like to reproduce any part of this document, please contact me before doing so. Many thanks. Zee.