

an evolving income environment

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Chris White assesses the impact of the financial crisis on UK equity income investing and gives details of where he believes the opportunities now lie.



It has been a difficult year for UK equity income funds. While markets have made a significant comeback since the spring, we are still not in a normal environment. Amid the extremely challenging economic conditions in which companies have had to continue to do business, many firms have been hoarding cash as they struggle to survive. Value has also been diluted as more companies have sought to raise money through rights issues as banks have been unwilling to continue to finance highly leveraged business models.

Under these circumstances it is not surprising that large dividend cuts have been a key feature of the market over the past year. The taboo of cutting dividends has been broken and, with trading conditions remaining tough, some companies have given greater priority to rebuilding their balance sheets over distributing profits to shareholders. Nevertheless, there are also companies – such as Barclays and Rio Tinto – that are keen to resume paying dividends as soon as they can.

dividend prospects

(£bn)	2007 (peak)	2009 (trough)	Change (%)
Banks	20.0 (31%)	6.6 (13%)	-67%
\$ Dividend	26.0 (41%)	35.0 (67%)	+33%
Other	18.0 (28%)	10.0 (20%)	-45%
Total	64.0 (100%)	51.6 (100%)	-18%

Source: Citigroup, Threadneedle March 2009.

impact of the financial crisis

Since the turn of the market many of the poorest quality companies, offering little or

no dividend income, have enjoyed some of the biggest market gains. The reason for this is the extreme risk aversion, post the collapse of Lehman Brothers which gripped the market in 2008 and early 2009, priced in company failures on a massive scale. Firms seen as likely to fail saw their shares fall to incredibly low valuations as a result. As investors began to realise that Armageddon was not at hand, and that most companies would survive, they began to appreciate just how cheap these stocks were and a buying spree ensued.

Growing optimism about an economic recovery has favoured more cyclical businesses seen as likely to benefit from a return to growth. As confidence has grown market performance has broadened out. However, higher quality, better managed and more defensive companies have lagged the rally. A resulting benefit for equity income investors is that some of the UK's top companies with the best dividend yields are now also looking more attractively valued, and look well-positioned to attract renewed interest in the market.

assessing the current environment

One of the major developments in the market has been a polarisation among companies in terms of dividend yield, with a shrinking pool of UK yields as a dwindling number of firms yield more than 110% of the FTSE All-Share Index yield. Only 98 companies in the UK now exceed that yield level. This small group of businesses in turn is dominated by the very largest companies in terms of capitalisation. They are high quality blue chip businesses that

have the ability to generate income even in challenging market conditions. Indeed, the top ten stocks in the UK account for 40% of the market capitalisation and 55% of the total income produced by the market. A key benefit of owning these large, high quality, defensive companies which looking forward offer high dividend yields, can be deduced from considering the actual likelihood of strong economic growth in the coming years, and for many observers that prospect is not good.

Low inflation has long been considered a desirable goal – and in earlier years it was a profitable one as well, as equity markets also benefited from the lower bond yields that resulted. In the wake of the deep downturn in global growth, however, subdued inflation is now more associated with overcapacity in the economy and expectations that a return to buoyant economic growth could take years to return. With such a backdrop, the prospects for the kind of double digit annual gains seen in equity markets in the first half of the decade look far away. In an environment of low inflation and low growth a good investment strategy is to focus on yield and those companies able to provide it. Also worth noting is that with gilt yields likely to stay in the 3.5-4.0% range, equities look historically attractive at this level relative to both bonds and cash.

outlook

Despite the likelihood of below-trend growth over the medium term, there are positive developments for investors as well. Even at very muted levels of growth, companies can structure themselves to deliver attractive returns to shareholders, and there is evidence of management teams

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taking sensible action in this regard. Although we will see further dividend cuts going forward, they are declining and should tail off further – and fears of complete financial meltdown have likewise receded. With the market believing in recovery there is scope to make money in the months to come.

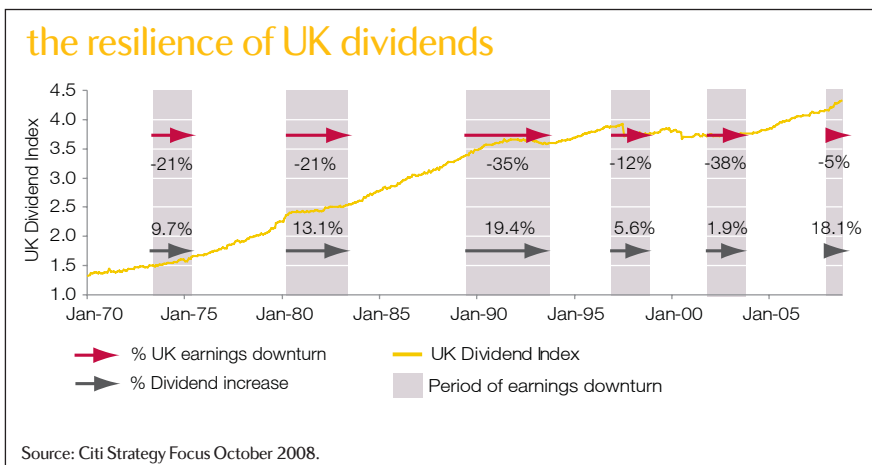
With the economic background remaining difficult, increasingly the view is that the worst is behind us. Subdued demand for consumer goods, excess capacity in many industries and minimal wage growth suggest that inflation is not going to be an issue in

the short to medium term. However, the amount of stimulus that has already been unleashed means that inflationary pressure is likely to build at some point. Once prices start to rise, inflation readings may move quickly and the authorities may be sluggish in their response for fear of choking off growth. We believe that the market will start to focus on this risk in late 2010. Until then, we do not see inflation as a major issue and fiscal policy is likely to tighten, especially after the next general election. Meanwhile, the financial system has survived its recent stresses and companies are adjusting their costs bases to match reduced demand.

This creates the scope for experienced and skilled managers to make money for investors.

It is clear that a solid core of defensive large cap names representing the established themes of dividend sustainability and the ‘strong getting stronger’ are essential to any successful UK equity income portfolio. However, in this evolving environment those seeking to achieve the best returns will also need to explore new themes, such as refinancing and cyclical recovery. There should be a focus on those companies offering sound business models with strong management teams. Sector themes are now less clear-cut overall and we believe that stock selection will be the key performance driver. ●

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