



# why dividends will drive returns



February 2009

**Tineke Frikkee**, manager of the flagship Newton Higher Income Fund, explains that the provision of dividend income is as important as growing it over time.

It's difficult to overstate the long-term value of a strong and rising level of yield to a portfolio. There's no shortage of research to demonstrate just how greatly long-run returns are influenced by the reinvestment of dividends. And the longer the investment horizon, the more important dividend income becomes. This is because the reinvestment of what may initially appear modest dividend amounts soon grows to become a dominant part of the total return.

Not surprisingly, dividends account for an even larger proportion of total returns when the capital return from equities turns negative. Indeed, those stocks that are able to offer a consistent and rising level of dividend tend to strongly outperform during such periods partly as a result of investor demand. This has historically seen

funds which invest for equity income outperforming those which invest purely for growth during periods of declining market sentiment. As **figure 1** clearly shows, the importance of income as part of a total return has been most evident during periods when capital returns turn negative.

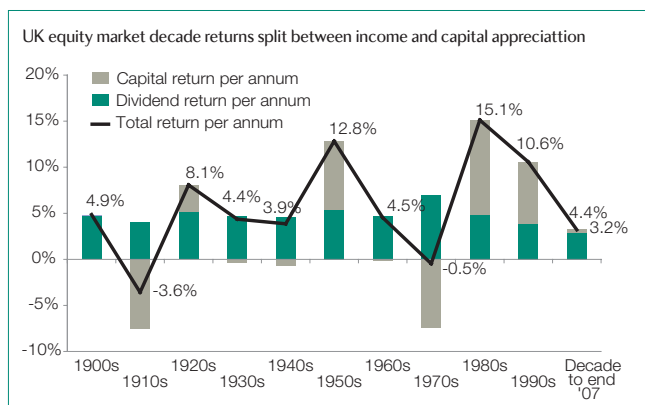
With global markets still suffering the after effects of the biggest correction for almost 80 years, there's probably never been a period when the investment fundamentals have so greatly favoured investing for dividend income over other, more growth oriented approaches. Early signs of this can be seen from the fact that the IMA Equity Income sector has outperformed the IMA All Companies sector by some margin in every month from July 2008 through to December 2008<sup>1</sup>.

## vital signs

A healthy and growing dividend not only contributes to total returns over time, but also provides a vital clue as to the growth prospects of a company, its cash flow generation and the strength of its balance sheet. Recent research by Citigroup<sup>2</sup> shows a strong correlation between the performance of share prices and dividend changes during the last five market downturns in the UK. According to the findings, stocks that provided above-average dividend growth tended to outperform those with below-average dividend growth.

The study also highlighted how in previous cyclical downturns, dividend growth has proved far more resilient than earnings growth. During the last five UK eco-

**figure 1**  
contribution from dividends to returns



Source: Dimson, Marsh and Stauton (ABN Amro.LBS), Global Investment Returns Yearbook 2008, February 2008 and Triumph of the Optimists, Princeton University Press, 2002.

conomic downturns dividend growth averaged 3% a year, while earnings fell almost 20%.

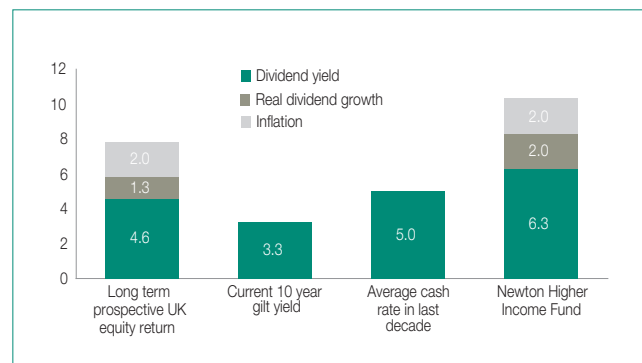
Because of what it says about a company's health, the bottom line is that most company boards are extremely reluctant to cut dividends, even in challenging times. In the UK, which for many years was by far the most generous market in terms of dividend payments, companies have shown a preference to continue paying their dividends in such conditions by raising their pay-out ratios. Once earnings start to rise again, their boards start rebuilding dividend cover by reducing their pay-out ratio to their target cross-cycle level. This fact can be something of a double-edged sword, as stocks with the greatest earnings uncertainties and the most stretched balance sheets also have the greatest risk of cutting their dividends. This means that to successfully invest in high yielding equities requires detailed research and careful stock selection.

### revision risk

Against an average dividend growth of 3% across the last five down cycles in the UK, current estimates for 2009 dividend growth of 6-7% appear too high. We expect dividend growth in the UK market over the next 12 months to be below inflation as more companies, deprived of capital, cut their dividends. Our analysis shows that banks, consumer-exposed house builders, pubs and some retailers are most at risk.

Consensus earnings growth forecast for 2009 and 2010 is still suggesting 20% growth for the next two years. Going back to the early 1970s, on average earnings have fallen by 19% during the last five UK bear markets. Accordingly, these figures imply that most companies are likely to distribute some level of dividends but that consensus earnings forecasts are too high.

**figure 2**  
UK equity market total return expectations for the next 3-5 years



Source: Reuters, Newton as at 4 December 2008.

### modest expectations

The next three to five years should see UK equities generate an annual dividend return of around 8% (see figure 2). This is based on a dividend yield of 4.6%<sup>3</sup>, 1.25% real dividend growth (20-year average excluding inflation) and the Bank of England's inflation target of 2%. This return would compare relatively well to the 3.3% currently offered by the yield of a 10-year UK government bond or the 5.0% average cash level seen over the last decade.

## leading the field

The Newton Higher Income Fund is among a handful of funds that can boast of having grown its dividend in real terms for more than a decade. The Fund has increased its level of dividend payments at a rate of 10% compound annual growth rate (CAGR) over the last 13 years.

The Fund continues to achieve a consistent first quartile ranking for income distribution over one, three, five and ten years in the IMA UK Equity Income sector.

### sector restructuring bodes well

Looking ahead, we expect the Fund to assume a more dominant position in its sector as the IMA UK Equity Income sector is restructured to comprise only those funds which meet the sector's income requirement. Around a third of the sector's

previous constituents recently moved out of the sector as the IMA begins to strictly police the requirements for funds to generate a yield which is 110% of the yield on the FTSE All Share Index.

### Newton Higher Income Fund

Net yield	6.3%			
Performance	1 year	3 years	5 years	10 years
Quartile	1	1	1	1
Rank	9/91	13/82	16/74	6/59

Source: Lipper as at 31/12/2008. Rank refers to the IMA UK Equity Income sector. Fund performance calculated as total return including reinvested income net of UK tax and annual charges, but excluding initial charge. The impact of the initial charge, which may be up to 4%, can be material on the performance of your investment. Performance figures including the initial charge are available upon request. Current yields are not a guide to future yields.

The Newton Higher Income Fund is available through Skandia's Life and Pensions fund ranges and the Selestia Investment Solutions platform.

<sup>1</sup>Source: Lipper as at 31 December 2008.

<sup>2</sup>Source: Citigroup 2 October 2008.

<sup>3</sup>FTSE All Share as at 30 November 2008.

Past performance is not a guide to future performance. The Skandia fund will not mirror the performance of the underlying fund because of Skandia fund charges, taxation adjustments (if appropriate) and the Skandia investment process.

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