Standard Life
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Dividend signals

- The trend in dividend payments can help with the timing of investment decisions
- Forecasts of dividends are pricing in a very pessimistic outlook
- Valuation signals relative to cash suggest equities can outperform in the years ahead
- Dividends are an important component of total equity returns

Global Perspective

STANDARD LIFE INVESTMENTS

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Dividend Signals

Dividends are an important signalling mechanism for equities. Our Focus on Change analysis suggests the dividend swaps market is pricing in too pessimistic an outlook for dividends and therefore equity markets.

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The importance of dividends

Dividend payments are important. A basic premise of finance theory is that the price of a share equals the future sum of discounted cash flows. The difficulty for an investor is in determining what those future flows will be, bearing in mind the volatility of a company's earnings within the broader economic cycle. There is a risk, especially during recessions, that such cash flows may differ materially from investor expectations. In addition, the discount rate may rise or fall too far, further impacting on growth expectations and hence the value of a share.

Investor enthusiasm towards dividends varies across countries. The UK has a history of dividend payments. One reason is the nature and sector composition of its companies; typically they are more defensive and cash generative. A second reason is UK investors have traditionally relied on dividends as a source of income; hence managers have felt obliged to pay out a large proportion of earnings in this form. Tax changes in 1997, however, forced investors to forego 20% of dividends, which has lessened the appetite for dividends since then. Conversely, in the US the different treatment of income and capital tax gains has discouraged companies from paying high dividends. Share buybacks have been relatively more popular. In continental Europe dividends are typically paid annually, and historically there has been lower recognition of dividends as a source of income. Investors have usually preferred income to come from bonds.

The trend in dividend payments can be an important tool to help the timing of investment decisions. For example, managers often slash dividends as a last resort when the company is in peril. By this point the equity market may be already pricing in maximum stress and thus the lows in equity prices are seen.

In this article we assess the recent history of dividend payments and their outlook, considering the deep recession and moderate recovery in the economy but also the sizeable efforts by companies to restore profitability through cost cutting. We examine the historic relationship with equities and its use as an investment signalling tool. Our analysis suggests the market pricing of future dividend payments is too pessimistic, which suggests some upside for dividends. The key question for investors is how much of this has already been priced into the stock market.

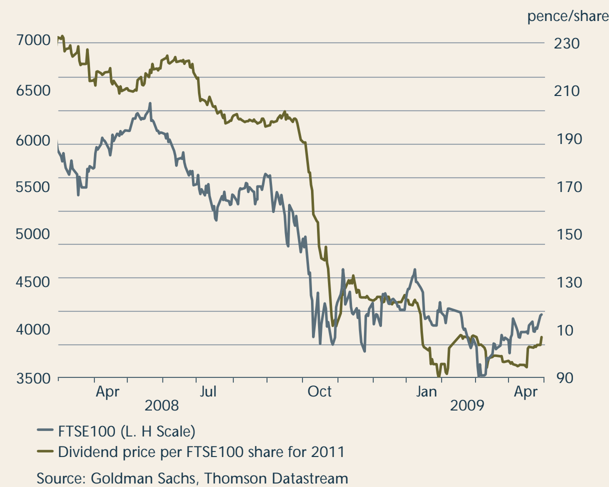
Dividends pricing a regime change

The recent falls in the equity market have reflected one of the severest earnings recessions on record, which impacted noticeably on the amount of dividends paid out by companies. From the peak in cash payments in 2008 there has so far been a 15% decline. Analysts are pencilling in further cuts of 10-20% in cash dividends in the next two years - a severe outcome by historical standards. It is possible to compare these forecasts with the dividend swaps market, whereby investors exchange future fixed and floating streams of dividend payments. The swaps market has priced in even more savage cuts. For example, the market price of either UK FTSE100 or European EuroStoxx50 dividends suggests at least a halving: 2009 is priced for 15-30% of dividend cuts, with another 40% in 2010. For the US S&P500 dividends the swaps market has priced in annual declines of 20-25%, a cumulative 40% fall in 2009-10.

The outlook for dividends is an important driver for investors. Firstly, the daily pricing of dividends on the swaps market has typically been strongly correlated with equity markets. Since 2000 dividends have been 84% correlated with the FTSE100, and 63% correlated with the EuroStoxx50 index. Chart 1 illustrates how 2011 FTSE100 dividend prices, for example, have tracked the FTSE100 index in the recent equity downturn.

Secondly, the length of time over which dividends are cut is important. Table 1 demonstrates that in previous episodes where dividends were cut in consecutive years then equity markets generally fell leading into, during and after these periods. It should be noted that most of these periods were before 1940, when corporate governance was less prevalent and a full recognition of dividends as a management signalling tool was not fully established. Many of these periods were around wars and the 1930s Depression when the corporate sector faced unprecedented stresses.

Chart 1
The FTSE100 and dividends are closely correlated



Source: Goldman Sachs, Thomson Datastream

Table 1
UK stock market performance around two years of consecutive cuts in dividends

			Equity performance around dividend cut years			
Rank	Years	2yr Dividend drop	-1Yr	Dividend cut Yr 1	Dividend cut Yr 2	+Yr1
10	1913-14	-16%	-1%	-7%	-8%	-4%
9	1912-13	-19%	0%	-1%	-7%	-8%
8	1901-02	-20%	-4%	-5%	-1%	-6%
7	1931-32	-21%	-1%	-7%	-19%	-20%
6	1903-04	-22%	-5%	-6%	3%	6%
5	1907-08	-25%	0%	-14%	8%	5%
4	1930-31	-28%	-7%	-19%	-20%	6%
3	1914-15	-38%	-7%	-8%	-4%	1%
2	1918-19	-49%	-10%	-11%	2%	-13%
1	2009-10#	-53%	-31%	-4.3%*	?	?
	Average	-29%	-7%	-6%	-5%	-4%

* YTD to May 1st 2009
# Forecast dividends priced into SWAP market for FTSE100 index

Source: Barclays, Standard Life Investments

The dividend outlook

Investors need to consider a number of questions: first why is such pessimism priced into the market, and secondly how likely is such an outturn? One reason is very technical: an important driver of the price of dividends in the swaps market has been investment banks writing large amounts of option contracts while risk aversion has been high. By definition this increases the supply of dividends, and thus reduces their price, in the swaps market.

It is certainly the case that companies could cut their dividends further. In this downturn investors have been willing to forego dividends for the sake of the longer term survival of a company. Investor attitudes may be changing, as they pay less attention to current dividends while anticipating some future upturn. Nevertheless, on balance investors will still want a soundly based estimate of how much further dividends could fall. Our approach to answering this question has been to stress test an extreme scenario for each of the various sectors within the UK stock market. A key assumption is that the UK experiences a lengthy recession but not an elongated corporate depression. We analysed a combination of a 45% fall in dividends paid by the total financial sector, including various banks completely waiving dividends, while across the cyclical sectors the average fall reached 43%, with defensives taking a 19% hit.

The stress test concluded that for the UK market dividends will not fall more than 35% in total in 2009-11. These would still be the severest cuts in dividends on record, bar 1918-19 at the end of WWI (see table 1) when the UK economy was effectively bankrupt. It would suggest the price of FTSE100 dividends falls from 233 pence per share at the end of 2008 to 150p by December 2011. In contrast, the market currently suggests a dividend price of 115p on that date. To put this figure into perspective, it would represent only the following firms: GlaxoSmithKline, Vodafone, Royal Dutch Shell, BP and HSBC paying their current dividends each year, with the rest of the stock market foregoing dividends for three consecutive years. This is clearly an extreme outcome.

The cuts in dividend expectations also reflect the changed mix of companies paying dividends. The financial sector has seen large cuts in dividends, so it will probably only account for 20%, rather than 40% previously, of all UK and European dividends paid out. This means that defensive sectors, where dividends should be more stable, will be responsible for 60% of the payout and cyclicals the remaining 20% in the years ahead.

Investment implications

It is possible to consider dividend flows as a separate asset class in their own right. Investors can examine future dividend prices and decide whether or not they are correctly priced, whether they concur or disagree with our opinion that even after severely stress-testing the dividend outlook this asset class is priced too cheaply. We believe buying dividends as an asset class offers a 10-12% per annum return in the medium term, suitable for example to include in an absolute return portfolio.

When looking at the equity signalling function of dividends over the last 100 years, the current level of dividend yields over cash are in the 10th decile of cheapness in the UK and France and the 30th percentile in the US. This valuation signal has historically suggested equities were been able to outperform cash by typically 5-10% a year in the UK and US, and up to 25% in France, over a number of years. More recently in the UK after similar dividend signals in 1973/74 and 2003 equities outperformed cash by 20% per year over 2 years. Such analysis supports the Heavy positions in UK and US equities in the House View portfolio.

Lastly, investors should remember the importance of dividends as a contributor to total long term equity returns. Looking back over the last 10, 20 and 30 years suggests dividends typically have accounted for a large proportion of total equity returns. As investors have had to endure two equity bear markets in the last 10 years, it is hardly surprising that dividends have accounted for more than 100% of total returns in the UK, US and Japan, and some 90% in continental Europe. Even over the last 30 years, the figures are 72% in the UK, 61% in both Europe and the US and just 44% in the low yielding Japanese equity market.

May 09

House View

This page sets out our House View as it applies to a UK based balanced fund. Details of how the House View applies to other UK-based funds and funds based in other parts of the world can be obtained from your Standard Life Investments representative.

	Positive	Negative	Our View
US Equities	• Further policy measures such as quantitative easing will offset the sharp economic downturn • Valuations are attractive, especially for some financials and cyclicals	• Squeeze on corporate margins is forcing major cuts in employment and investment • Continued uncertainty about extent of downturn in the housing sector	Market supported by improving valuations and easier monetary and fiscal policy despite credit concerns STAY HEAVY
European Ex-UK Equities	• Management responding to pressures on margins through cost cutting and more M&A activity • Parts of the region did not experience as large a credit boom as other countries	• Exports coming under pressure as euro appreciates and global trade slows sharply • Growing concern about lack of policy response in Europe versus other regions	The region is vulnerable to a continued slowdown in world trade growth and weaker earnings STAY LIGHT
UK Equities	• More aggressive monetary and fiscal support appearing • Valuations such as dividend yields provide underpinning for the market	• Oil and resource companies vulnerable to sharp falls in commodity prices • Concerns remain about extent of consumer and housing bad debts as unemployment rises	Although financials and retailers are under pressure, the market is supported by favourable valuations STAY HEAVY
Japanese Equities	• Japan's financial sector is in a stronger position than in some other countries • Increasing dividends plus share buybacks are helpful for investors	• Companies facing much weaker export demand from the US and Europe • Domestic economic data suggests economy has entered a severe recession	Policy response looks to be more limited than in other countries. Move into sustained deflation is hitting margins STAY LIGHT
Pacific Basin Ex-Japan Equities	• Infrastructure spending remains a primary driver of many economies • More governments taking action to support domestic activity	• Earnings at risk from the marked slowdown in OECD demand • Dangers of global capital flows moving back towards developed markets	Valuations have become less attractive while the region is vulnerable to further shocks STAY VERY LIGHT
Global Emerging Market Equities	• Current-account surpluses protect some countries from credit concerns • More central banks able to ease monetary policy as inflation pressures ease	• Vulnerable to a prolonged global recession affecting commodity prices • General investor risk-aversion is still a negative	Continued capital outflows from emerging markets as part of the global credit crisis STAY VERY LIGHT
International Bonds			STAY HEAVY
US	• Quantitative easing by the US authorities should cap Treasury yields	• Vulnerable to increased supply as the fiscal position deteriorates rapidly	STAY HEAVY within international bonds as Treasuries benefit from quantitative easing
Euro-zone	• Slow response by the monetary authorities to the financial and economic crisis	• Extent of likely debt issuance from easier fiscal policy	STAY HEAVY within international bonds on expectations of further ECB interest rate cuts
Japan	• Return of deflation and the lack of policy-levers to stimulate economic growth	• Valuations starting to look stretched	STAY NEUTRAL within international bonds on concerns about effective Bank of Japan action
UK Bonds			Within UK bonds:
Gilts	• Interest rates are close to zero, anchoring short-dated gilt yields while the authorities have begun quantitative easing to affect longer dated yields • Defensive characteristics of index-linked debt increasingly recognised	• Continued concerns about the extent of the rise in the public sector deficit • Uncertainty about the details of quantitative easing worrying some investors	STAY HEAVY in conventional gilts STAY NEUTRAL in index-linked debt
Corporate	• Strong retail and institutional investor demand for extra yield	• Downturn in corporate cash flows will lead to higher corporate bond defaults	STAY VERY HEAVY corporate bonds Corporate bond valuations are increasingly attractive although individual issues still require careful examination
Property			
UK	• Property income yields relative to gilt yields have risen to highs last seen in the 1930s. Increasing number of property investors emerging to buy back into the asset class.	• Rental values are falling as occupational demand for property mirrors weaker economic environment	We favour well located properties with tenants of good financial strength with a sector bias towards dominant retail locations STAY LIGHT
Global	• Continued, albeit lower, economic growth in a number of overseas markets will support property returns	• Credit constraints have spread to most international property markets, impacting negatively on the availability of capital for property investment	We prefer selective European markets such as Central & Eastern European logistics, based on infrastructure improvements, and Nordic retail, where consumption is expect to be more robust
Cash	• Cash is an attractive alternative when corporate earnings and dividends are under considerable pressure	• Cash yields close to zero are encouraging some investors to seek higher-yielding assets	Official interest rates are at the lowest level on record STAY LIGHT

The terms, Very Heavy, Heavy, Light, Very Light and Neutral express Standard Life Investments' view of a balanced portfolio against a given benchmark.

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