

“Searching out income in the UK equity market”

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Chris Murphy, Fund Manager at Aviva, discusses the UK equity market.



Given the current low interest rates available from savings accounts and government bonds, UK equities offer investors a combination of potential capital appreciation and an attractive yield, whilst also being something of a hedge against inflation. UK equity income funds can be one route to access this mix of returns from capital and income as most funds aim to deliver above average yields relative to the FTSE All Share Index. The yield on UK equities is largely driven by the dividends paid by companies within the All Share. Given the impact of the credit crunch and subsequent recession on UK companies, where are the opportunities for searching out income?

Recent history of dividends

Over the last few years we have seen two major trends in the UK equity market:

- Firstly, the number of companies cutting their dividend has increased sharply since mid-2008. This is largely explained by the tumultuous events of the credit crunch and the need for many companies to retain cash in order to shore up their balance sheet and plug holes in their cashflow – all of which could be seen as a negative for a company’s outlook. However, if we look at historical evidence, companies that take swift and decisive action to cut dividends in the face of significant issues facing the business tend to outperform over the following 6-24 months. This can often be seen as a sign of strong management.

- Secondly, the concentration of yield in the market has become extreme. Only a few sectors such as Oil & Gas, Telecommunications and Pharmaceuticals dominate the market and this has resulted in a handful of mega-cap stocks accounting for around half the overall yield of the FTSE All Share Index. Largely due to the sharp falls in the

market experienced in 2008 and early 2009, there was a short period when yields were artificially inflated, but we have since seen the overall yield on the market fall below 3.5%. This is more in line with the longer-term average of the past decade. Looking forward, quality dividend payers are likely to be scarce and will, therefore, command a premium. Dividend growth is likely to remain muted over the next few years, with continued low payouts from key sectors such as banks and mining, combined with risks to other areas of the market such as the oil majors.

So where will dividends come from?

The intrinsic value of any stock is a function of future expected payments to investors. As such, earnings and cash flow should be the most important considerations when selecting stocks for any portfolio. After all, cash flow is used to fund research & development, investment, mergers & acquisitions and, of course, dividend payments.

This is why you need to look beyond simple valuation metrics when looking for higher yielding companies as it is very easy to overpay for what you perceive to be a safe dividend yield. Re-investment into any business is fundamental for future cash flow and profitability which is why you should look to companies who have a balance between paying cash to shareholders and re-investing cash to fund for future growth.

When constructing an income portfolio, managers look for a broad mix of opportunities for example across sectors and market capitalisation. It is not as simple as owning the biggest payers in the market in order to meet your required yield target. One way of looking at stocks for income generation, is to break down investment candidates into three distinct categories: cash flow recovery, cash compounders and future cash flow.

- Cash flow recovery - businesses that are experiencing operating difficulties, whether for economic reasons or because they have been mismanaged or suffered severe competition are often ignored by income funds given they pay out little or zero dividends. However, these companies have huge scope to improve their returns and release cashflow to shareholders offering an attractive combination of potential capital and dividend growth. When looking for these companies it is important to look at a range of historic valuation multiples, including EV/Sales. GKN is such an example, being a market leader in automotive and aerospace components offering attractive recovery potential given exposure to industries hit by the economic downturn over the past few years.
- Cash compounders - a focus on dividend quality and sustainability naturally leads towards an allocation to stocks that are often perceived as 'boring'. These companies often have high barriers to entry, and generate high returns and stable cashflows. Companies within this category tend to consistently pay out distributions to investors and would tend to sit in sectors such as pharmaceuticals, telecommunications, utilities and food retailers. When looking at these types of companies it is important to look back over the historical long-term trend of returns, dividend yield and cash flow yield in order to give you confidence around the dividend sustainability and growth. Bunzl is an example of a cash compounder, paying an above market 4% yield and it has grown its dividend consistently. Unilever is another example where a strong range of top quality brands and effective cost cutting are supporting robust cash flow generation and better than market yield.
- Future cash flow - companies with a lower dividend policy but that are experiencing strong growth should also be considered attractive investment opportunities in a diversified portfolio, as this should support future cashflow growth and in turn strong dividend growth. Examples of structural growth opportunities that would fit into this category are currently to be found within the support services sector.

Companies with overseas earnings could also be an interesting prospect in the search for income over the next few years. It is likely to be a tough time for the UK economy with the consumer facing many headwinds through 2010 in the form of higher interest and mortgage rates, increased taxes and high levels of unemployment. However, it is worth considering that the UK equity market is no longer dominated by the domestic economy with almost two thirds of UK companies' earnings derived from overseas markets – and these currently have a better overall growth outlook. Companies that can deliver strong franchises with an international earnings profile could provide a more reliable source of income growth through 2010.

In summary, the search for income is not a fruitless one in the UK equity market – you just need to look beyond traditional sectors and past simple valuation metrics to unearth worthwhile opportunities.

For further information about our UK equity range, please visit our website www.avivainvestors.co.uk

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