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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

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

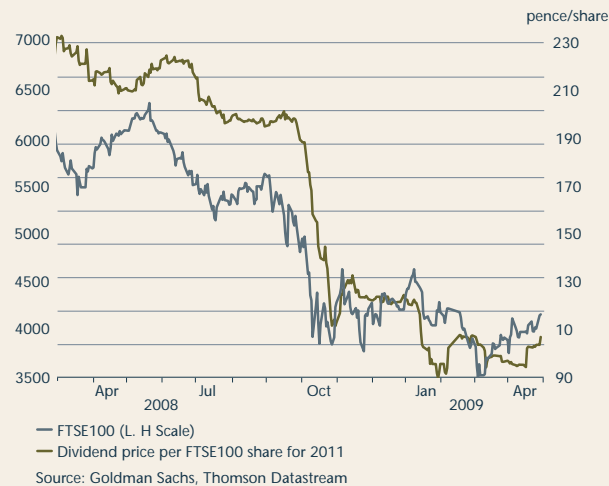


Table 1
UK stock market performance around two years of consecutive cuts in dividends

Rank	Years	Equity performance around dividend cut 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 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.

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House View

Standard Life Investments recommended asset allocation for Canadian balanced mandates.

	Positive	Negative	Our View
Canadian Equities	<ul style="list-style-type: none"> Earnings will respond to lower loan losses and higher commodity prices once the economy expands. 	<ul style="list-style-type: none"> The market is ahead of likely earnings in 2009 and 2010. Commodity prices are likely to consolidate and loan losses in financials will continue at high levels this year and into next. 	<p>Portfolio continues to feature high-quality companies. But with sluggish global growth and high valuations on current earnings we remain</p> <p>UNDERWEIGHT</p>
US Equities	<ul style="list-style-type: none"> We expect the US market to be more stable through the current bottoming in the long-term cycle. 	<ul style="list-style-type: none"> Earnings will remain under pressure throughout 2009. The market is currently discounting much higher EPS in 2009 and 2010 than is likely. 	<p>We maintained our positions in US equities within balanced funds, reflecting the valuation, the appeal of the dollar vs. the loonie and the relatively defensive nature of the market. We are selectively adding to the cyclical nature of the portfolio, especially in financial and consumer related stocks. We remain underweight equity assets overall.</p> <p>OVERWEIGHT</p>
EAFE Equities	<ul style="list-style-type: none"> We have benefited from strong stock picking in early cycle parts of the market and sectors we believed to be excellent value. 	<ul style="list-style-type: none"> International stocks have suffered severe PE compression, but EAFE typically carries more cyclical risk than the US and Europe will likely lag the US in any recovery. Companies face pressure from global recession. 	<p>We remain</p> <p>UNDERWEIGHT</p>
Real Estate	<ul style="list-style-type: none"> Capitalization rates are now attractive for long-term investors. Real estate typically produces positive returns even in a difficult period. Vacancy rates are low in Canada. 	<ul style="list-style-type: none"> Capitalization rates have risen sharply at year end. We expect a challenging environment in 2009, but excellent long-term prospects. 	<p>Benefit from cash flow and stability over the cycle.</p> <p>NEUTRAL</p>
Canadian Bonds	<ul style="list-style-type: none"> Inflation is low in Canada and economy is slowing under US weakness and soaring loonie. Credit spreads in Canada begun to narrow and corporate and provincial bonds are extremely attractive. 	<ul style="list-style-type: none"> Long-term yields at under 3% are not attractive on a multi-year view, especially compared to equities. 	<p>We have reduced bonds in favour of cash, so as to be able to invest in equities when we believe they reflect current earnings environment. Our bond exposure is still one of the highest allocations among Canadian managers. Within the portfolio, we hold longer-dated corporate bonds, and benefit from record spreads.</p> <p>OVERWEIGHT</p>
Cash	<ul style="list-style-type: none"> Holding for flexibility at this stage. 	<ul style="list-style-type: none"> Not attractive as a long-term asset given low yields. 	<p>We have added to cash reserves from bonds to add back to equities eventually.</p> <p>OVERWEIGHT</p>

The terms Overweight, Neutral and Underweight express Standard Life Investments' view of a Canadian Balanced Portfolio against a given benchmark.

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