

The Search for Income

Adrian Frost - Artemis Income and High Income fund manager

How is a dividend decision arrived at?

It is tempting to think of the dividend decision to be just about the profit and loss account, how much cash you have at the end of the year and how much you can afford to pay out to investors. It is largely that, but there are other factors that come into play. For example, the economy, capital structure, pension funds, management and structural threat.

The capital structure of the company defines how much of the cash flow is legally going to go to people who have lent you money. We have to remember that the dividend is a discretionary decision. Some dividend decisions are formulaic, some more finger in the air.

Many companies in the UK have large, mature pension schemes. The companies actually owe money to these pension schemes, which will take away some of the cash flow.

The management decide how to spend the cash flow. They don't always decide to reward shareholders. Instead they may be looking for acquisitions to make the company bigger.

The one that strikes that most fear is structural threat. Structural threat means is there a competitor out there that is completely subsuming or overwhelming the company that you are hoping to get your dividends for? Is there a technological change that is declaring this company redundant? Quite often there is obstinate failure of management to recognise the fate that awaits them.

What has caused the fall in dividends in market?

When we look back at the fall in dividends it is as much about capital structure as economics.

Companies had a pretty awful shock, in that they had a lack of access to borrowing or they couldn't go to bond markets and actually get funds. Where they could, the funds were horrendously expensive, sometimes double what they last paid. The companies response was, we can't get money externally therefore we must do everything we can internally to actually generate cash to put the company back on a sound footing. This was a worrying period for dividends.

What is the outlook for dividends?

From here, we are quite optimistic about dividend growth. The worst is past, the cutters have cut. At the same time, these companies are gradually getting access to borrowing. Their businesses are generally

not in bad shape and they are actually starting to generate cash. So the next question is what should they do with it? That brings companies back onto the dividend list.

Cutters will 'trumpet' dividend increases. There will be wonderful statements by companies saying they have increased dividends by 30%, but it wasn't much in the first place.

'Chuggers' will continue to chug. There are a raft of companies in the UK that are well financed, are not terribly economically sensitive that have good yields. For example Glaxo, increased its dividend by 7%, market reaction was complete indifference.

There are still risks. If some of the negative economic scenarios play out, then some companies may have to cut again but we are at a pretty low basis already. Choice is a problem in the UK. The feature of the UK market is that the source of dividends is pretty concentrated. There is also currency risk, as a lot of the dividend paying companies have currency sensitivity, typically dollar to sterling.

The challenge in the search for income

A significant factor in the UK is the concentration of income. Effectively in the UK 38% of the market value, the top 6 stocks, contribute 52% of market income. If you owned a tracker fund, half the dividend would be coming from just 6 companies in a stock market that has 350-400 companies. Within that Oils provide 25% of market income. There is the risk of what happens to the oil price. This is fine for now, but it is a risk that one has to bear in mind.

Contrast that with the European market. Where the income comes from is much more diverse. The top 6 stocks represent 18% of market income.

Only 30% of top 300 UK stocks yield more than 110% of market i.e. 4%.

The current strategy

We are currently seeing an equity recovery which has been led by recovery situations with very little yield. There are however, a raft of companies paying dividends who are absolutely and relatively cheap, so we are buying more of them.

We are not dividend chasers at any cost. Utilities are an area that we have sold, as we see better opportunities elsewhere.

Generally our stocks are not the shiniest in town; generally they have got one or two problems, which is why they present themselves with quite a decent yield. We are finding the quality of company we can buy, is much higher than it was historically. Almost investing above our station, but we don't mind that.

To get over the challenge of UK concentration, we are using our powers to invest overseas. We can put up to 20% of the fund overseas. We have about 14% in Europe. So we are accessing that greater diversity of where we can get our income from. And we have had up to 6% of the fund in bonds.

The search for income

There are reasons to be positive about dividends from here. The caveats are the sensitivity to sterling/dollar rate and sensitivity to the oil price. We see good prospects for dividends and good value. We are heading back towards a more balanced source of income.