

C A M B R I D G E A S S O C I A T E S L L C

EUROPEAN MARKET COMMENTARY

CHARACTERISTICS OF HIGH-YIELD U.K. EQUITIES

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Characteristics of High-Yield U.K. Equities

Although the anachronistic provision that requires U.K. charities to spend income only may soon be repealed, many charities are still unable to invest on the basis of total return. For those charities that must operate under income-only policies, U.K. equities, with their relatively high dividend yields (DYs), have served as a refuge.

U.K. equities offer an attractive DY of about 3.0% and prospects for future dividend growth are strong, as dividends grew 7.5% in 2004 and 14.2% in 2005, compared to a post-1924 average annual growth rate of 5.7%. However, DYs of 3.0% are not sufficient to meet many of these charities' needs, so high-income strategies are often employed to earn above-market average yields. We examined the implicit bets institutions may be making today by concentrating their U.K. equity portfolios in shares with relatively high DYs.

To do so, we sorted the shares of the FTSE All-Share into four quartiles from low (or no) DYs in the first quartile to the highest DYs in the fourth quartile and examined the differences in market capitalization, valuation multiples, economic group exposure, and trailing performance over the last five years (Tables A through F). The following summarizes the key differences between high dividend-yielding shares and the broad market based on 31 December 2005 data:

- While the FTSE All-Share sports a DY of 3.0%, 199 companies (29.1%), representing 47.0% of market capitalization, have DYs greater than that of the index. DYs in the top quartile of stocks ranged from a low of 3.2% to a high of 7.9% (Table A).
- As might be expected, there is a positive relationship between market capitalization and DY. The median market cap of the both third and fourth DY quartiles was £0.5 billion, compared to £0.2 billion and £0.4 billion for the first and second DY quartiles, respectively, and £0.4 billion for the index as a whole. While all DY quartiles include small-cap shares, the largest companies are in the top half of the DY distribution (Table B).
- Relative to the FTSE All-Share Index as a whole, high DY stocks are also less expensive on the basis of price-earnings ratios (P/E). The highest quartile of dividend payers had the lowest median P/E (15.5), while companies that pay low or no dividends had the highest median P/E (32.9). However, there were a few shares with astronomical P/Es that inflated the *average* P/E among the highest dividend payers (Table C).
- The median price-book ratio (P/B) was not significantly different for high-dividend payers, low-dividend payers, and the index as a whole. Among quartiles, the median P/B ratio ranged from 2.1 for the first DY quartile to 2.4 for the second DY quartile. However, excluding outliers, the half of the index consisting of high-dividend payers included fewer shares with P/B ratios above 8.0 than did shares paying a lower DY (Table C).
- There are some material divergences between the economic group weightings of the highest dividend-paying quartile of shares and those of the FTSE All-Share Index. The most significant difference is the 41.2% allocation to financials among the highest dividend-yielding shares, which represents a 13.7 percentage point (pp) overweight relative to the broad index. Utility and non-

cyclical services were also more heavily represented in the highest DY quartile, but by a much narrower margin, 3.8 pps and 3.5 pps, respectively. High DY share underweights are distributed more evenly across economic groups. The largest underweights are in resources, 6.7 pps, non-cyclical consumer goods, 5.1 pps, and cyclical services, 4.8 pps (Table D).

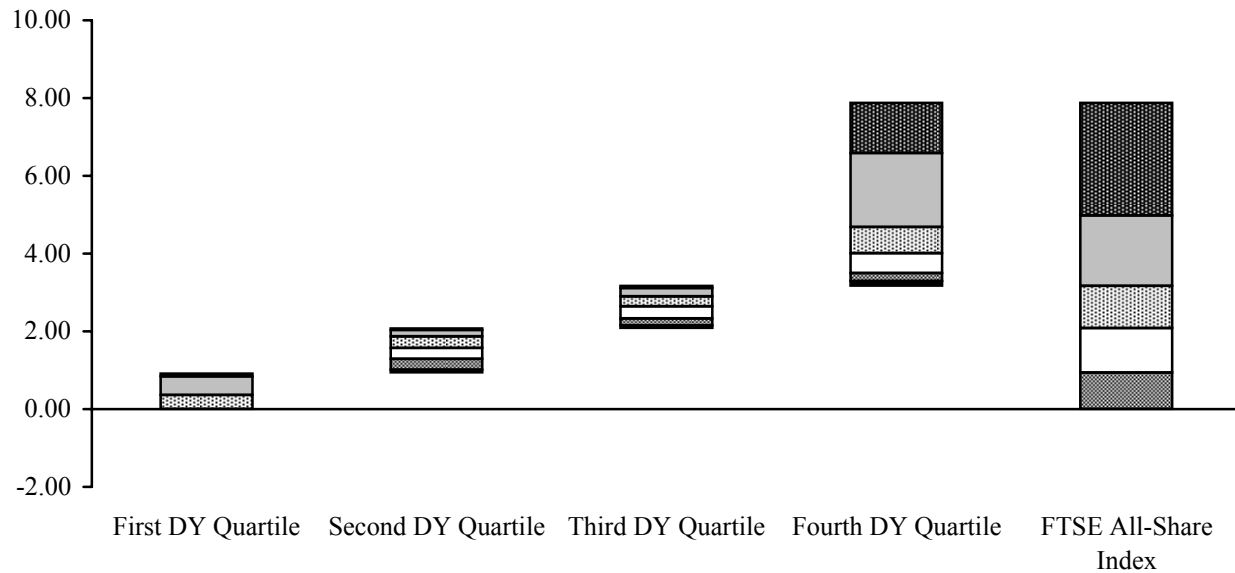
- While we would expect the performance of high dividend-yielding shares to move in cycles relative to the broad market, the relative performance over the last one-, three-, and five-year periods has not been encouraging. The return distribution of the top quartile of dividend-yielding shares had a similar downside, but a markedly lower upside than the broad market and the other three DY quartiles in general (Table E).
- However, the risk profile was slightly lower for the highest dividend payers. The standard deviation distribution of the fourth DY quartile was the narrowest among all quartiles, ranging from 4.6 to 14.8, excluding outliers, compared to a range of 4.7 to 19.2 for the FTSE All-Share Index in aggregate. The distribution of shares' betas was not meaningfully different across DY quartiles (Table F).

Investors in search of income should be aware that the pool of higher-dividend shares from which they may invest are likely to have different characteristics than the broad market. These differences could result in significant biases that would tend to favor large-cap shares, value shares, and financials, and tend to underweight resources. Investors should be aware of these differences and actively monitor and manage tracking error relative to the broad market. The experience of the last five years clearly demonstrates that returns can differ markedly.

Table A

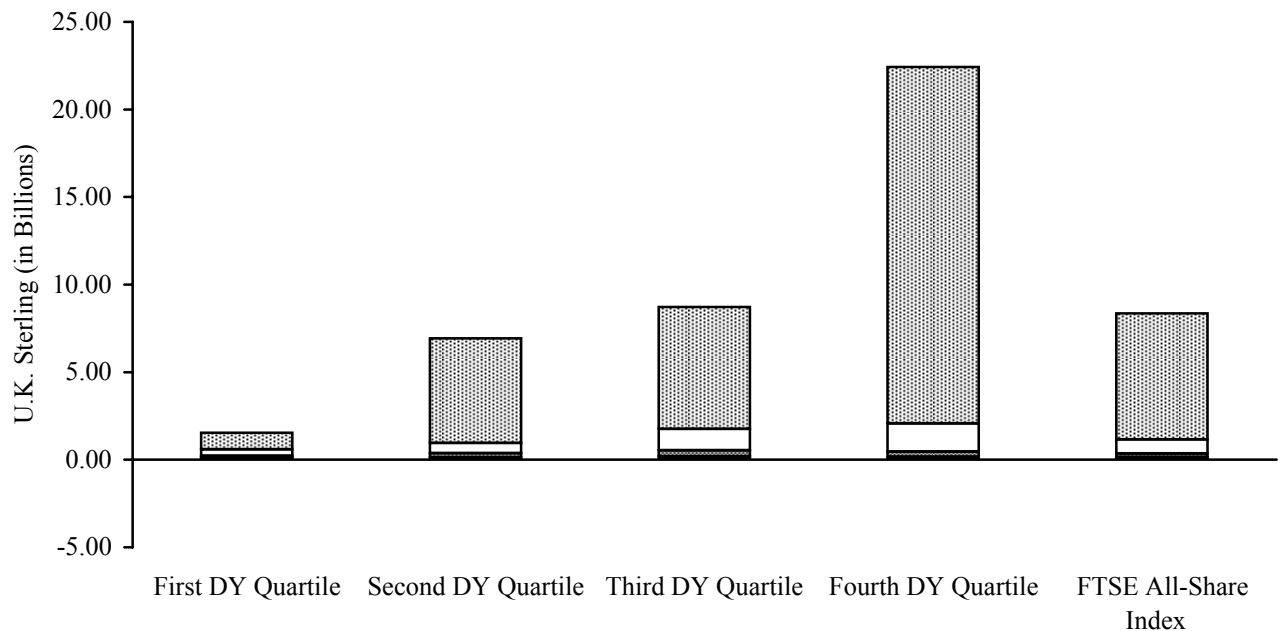
DISTRIBUTIONS OF FTSE ALL-SHARE INTO DIVIDEND YIELD QUARTILES

31 December 2005



	First Quartile	Second Quartile	Third Quartile	Fourth Quartile	FTSE All-Share Index
High	0.91	2.07	3.17	7.88	7.88
5th Percentile	0.84	2.03	3.12	6.59	4.98
25th Percentile	0.36	1.87	2.90	4.68	3.17
Median	0.00	1.57	2.64	4.01	2.08
75th Percentile	0.00	1.29	2.33	3.50	0.94
95th Percentile	0.00	1.02	2.15	3.30	0.00
Low	0.00	0.94	2.08	3.17	0.00
Mean	0.19	1.55	2.61	4.31	2.17
FTSE All-Share Index					2.95

Sources: Factset and FTSE International Limited.

Table B**MARKET CAPITALIZATION DISTRIBUTION OF FTSE ALL-SHARE
DIVIDEND YIELD QUARTILES****31 December 2005****Market Capitalization
in U.K. Sterling (billions)**

	<u>First DY Quartile</u>	<u>Second DY Quartile</u>	<u>Third DY Quartile</u>	<u>Fourth DY Quartile</u>	<u>FTSE All-Share Index</u>
High	20.34	44.83	127.96	105.11	127.96
5th Percentile	1.54	6.92	8.71	22.42	8.35
25th Percentile	0.59	0.96	1.75	2.06	1.15
Median	0.22	0.36	0.54	0.47	0.35
75th Percentile	0.12	0.14	0.19	0.17	0.15
95th Percentile	0.07	0.07	0.09	0.08	0.08
Low	0.03	0.03	0.06	0.04	0.03
Mean	0.57	1.73	3.02	4.61	2.49
FTSE All-Share Index					1,698.5

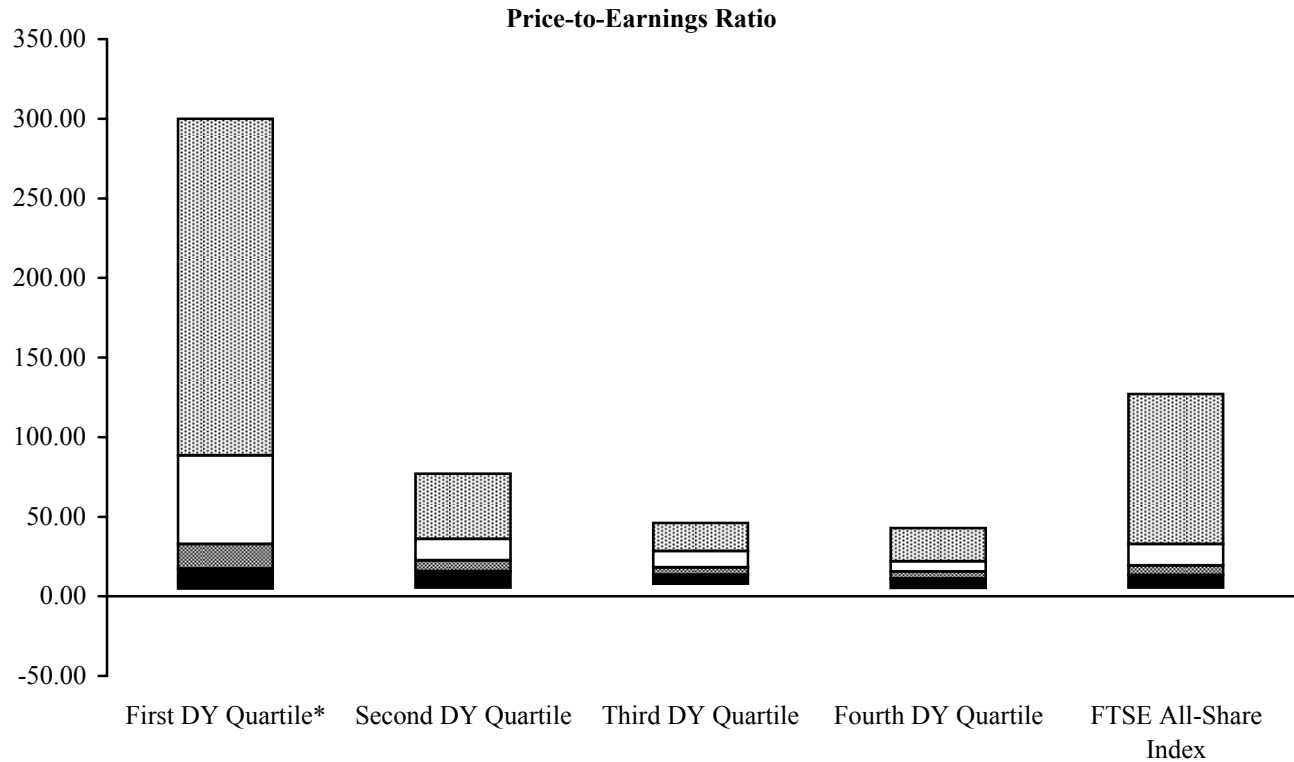
Sources: Factset and FTSE International Limited.

Note: The first dividend yield quartile includes shares with the lowest dividend yields (or no dividend yields), while the fourth quartile includes shares with the highest dividend yields.

Table C

VALUATION DISTRIBUTION OF FTSE ALL-SHARE DIVIDEND YIELD QUARTILES

31 December 2005



Price-to-Earnings Ratio

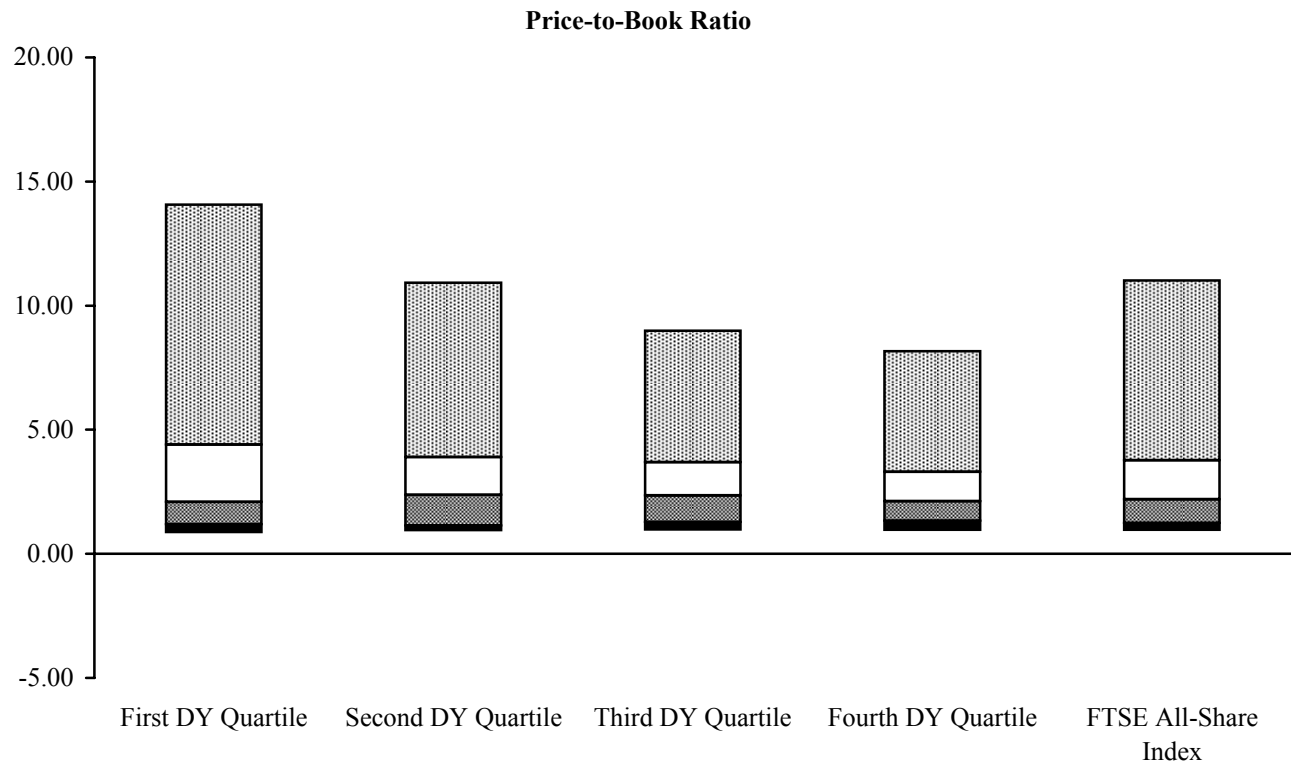
	<u>First DY Quartile</u>	<u>Second DY Quartile</u>	<u>Third DY Quartile</u>	<u>Fourth DY Quartile</u>	<u>FTSE All-Share Index</u>
5th Percentile	449.16	77.03	46.02	42.92	127.12
25th Percentile	88.45	36.06	28.41	21.95	32.80
Median	32.89	22.49	18.21	15.48	19.39
75th Percentile	17.26	15.79	13.55	11.07	13.22
95th Percentile	4.64	5.20	7.73	5.02	5.20
Mean	103.59	34.31	24.80	51.89	49.59

* A value of 300 is graphed for the 5th percentile of P/E ratios in the first quartile to eliminate the skewness. There were eight companies with P/E values greater than 300 in this quartile.

Table C (continued)

VALUATION DISTRIBUTION OF FTSE ALL-SHARE DIVIDEND YIELD QUARTILES

31 December 2005



	Price-to-Book Ratio				
	First DY Quartile	Second DY Quartile	Third DY Quartile	Fourth DY Quartile	FTSE All-Share Index
5th Percentile	14.06	10.92	9.00	8.17	11.01
25th Percentile	4.40	3.90	3.70	3.31	3.77
Median	2.09	2.37	2.35	2.11	2.20
75th Percentile	1.19	1.14	1.28	1.33	1.24
95th Percentile	0.87	0.94	0.98	0.95	0.95
Mean	4.91	4.00	3.07	6.05	4.49

Sources: Factset and FTSE International Limited.

Note: The first dividend yield quartile includes shares with the lowest dividend yields (or no dividend yields), while the fourth quartile includes shares with the highest dividend yields.

Table D
ECONOMIC GROUP DISTRIBUTION OF FTSE ALL-SHARE DIVIDEND YIELD QUARTILES

31 December 2005

	FTSE All-Share Index	Weights (%)			
		First Quartile	Second Quartile	Third Quartile	Fourth Quartile
Resources	22.19	34.05	20.59	31.14	15.46
Basic Industries	3.38	4.52	2.79	6.00	1.74
General Industrials	2.85	4.32	4.39	4.62	0.94
Cyclical Consumer Goods	0.38	0.12	0.00	0.67	0.36
Non-Cyclical Consumer Goods	16.42	7.83	26.40	20.13	11.32
Cyclical Services	13.12	15.60	21.23	15.31	8.35
Non-Cyclical Services	9.16	2.56	7.80	5.92	12.62
Utilities	3.99	3.01	1.21	0.00	7.76
Financials	27.42	18.09	14.14	15.83	41.15
Information Technology	1.09	9.90	1.45	0.39	0.32
	100.00	100.00	100.00	100.00	100.00

Sources: Factset and FTSE International Limited.

Notes: Percentages may not add to 100% due to rounding. The first dividend yield quartile includes shares with the lowest dividend yields (or no dividend yields), while the fourth quartile includes shares with the highest dividend yields.

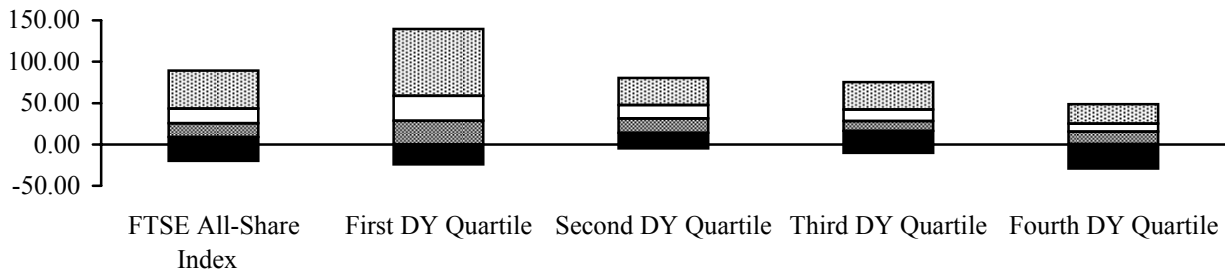
Table E

RETURN DISTRIBUTION OF FTSE ALL-SHARE DIVIDEND YIELD QUARTILES

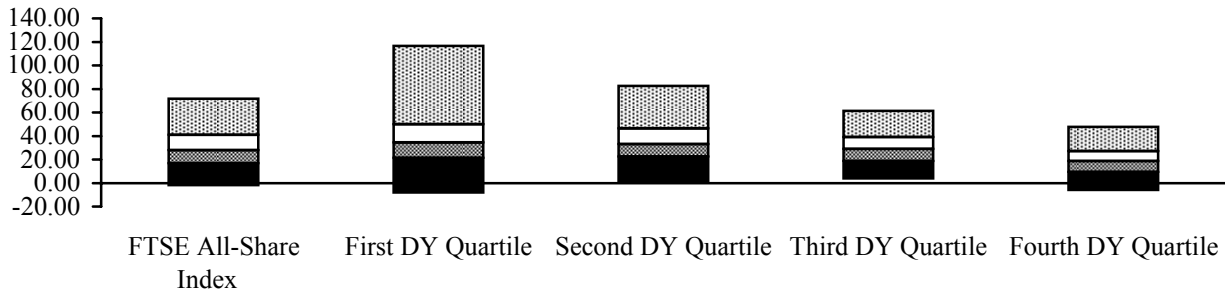
Distribution from 5th to 95th Percentile Returns

31 December 2005

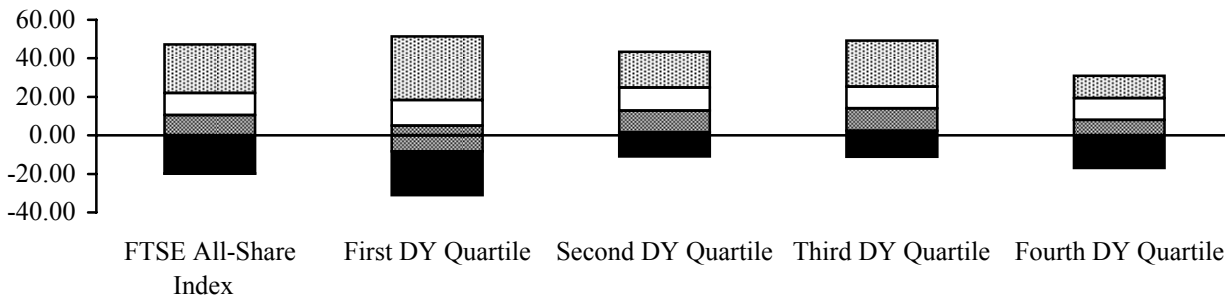
One-Year Returns



Three-Year AACRs



Five-Year AACRs



Sources: Factset, FTSE International Limited, and Thomson Datastream.

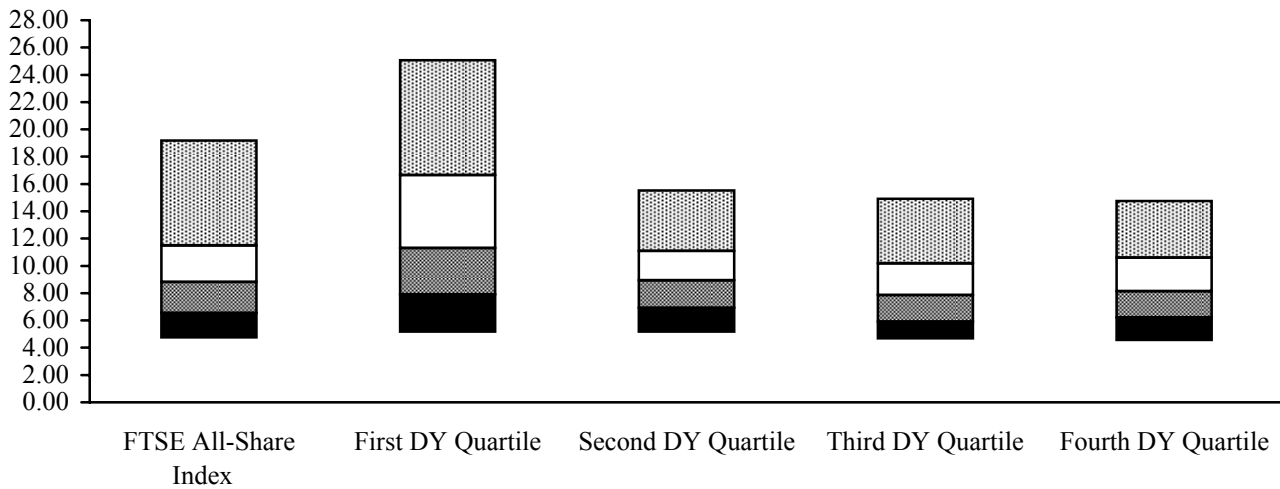
Notes: The first dividend yield quartile includes shares with the lowest dividend yields (or no dividend yields), while the fourth quartile includes shares with the highest dividend yields. All returns are total returns denominated in U.K. sterling.

Table F

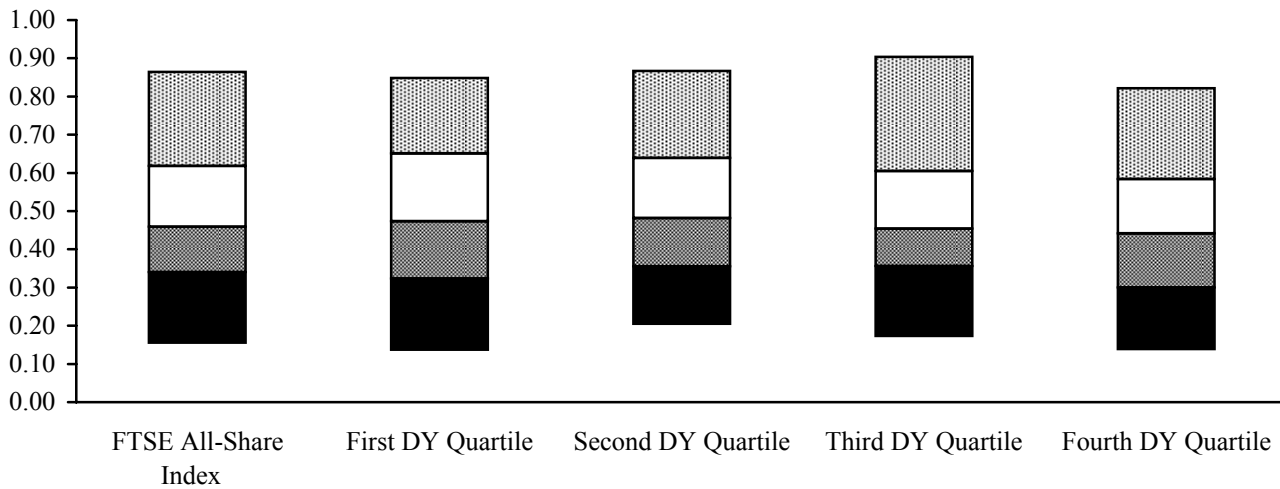
RISK DISTRIBUTION OF FTSE ALL-SHARE DIVIDEND YIELD QUANTILES

Trailing 60-Months Ending 31 December 2005

Standard Deviation



Beta



Sources: Factset and FTSE International Limited.

Note: The first dividend yield quartile includes shares with the lowest dividend yields (or no dividend yields), while the fourth quartile includes shares with the highest dividend yields.