C | A

CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENTARY

TAKING STOCK OF U.K. DIVIDENDS

February 2008

Eric Winig
Kijana Mack

Taking Stock of U.K. Dividends

We have often commented on the high dividend yields (DYs) available in the U.K. market (at least relative to those of most other global equity markets) as a feature likely to give investors a bit of protection in the event of a market downturn. Indeed, *ceteris paribus*, equities with higher DYs automatically provide a greater margin of safety than those with lower DYs. However, given that *absolute* DYs are not particularly high in the United Kingdom—they fall somewhere between 3.3% and 3.7% depending on which index is used—we thought it worth exploring the extent to which dividends should be expected to hold up should the U.K. economy slip into recession. This issue is of particular concern to U.K. charities that rely on income, rather than investment returns, for endowment spending. Our conclusion is that, while U.K. dividends seem likely to hold up reasonably well in coming years, investors should also be cautious of placing too much faith in the defensive characteristics of the U.K. market based on its DY alone. Put simply, *caveat emptor!*

The Power of Dividends

It is little wonder U.K. investors put such stock in dividends. Since MSCI data began in 1970, re-invested dividends have accounted for nearly three-quarters of total returns for U.K. investors, more than in any other major market. Put a different way, on a price return basis, £100 invested in the MSCI U.K. Index in 1970 would have grown to £1,752 as of January 31, 2008; the same investment with dividends re-invested would have totaled £6,233. Further, as noted above, the U.K. market continues to have one of the highest DYs in the world, even if absolute levels are not particularly high.

Nevertheless, U.K. DYs have fallen sharply in each of the three U.K. recessions since our data began in 1964, with the 1974–76 plunge—from 11.7% in December 1974 to 5.0% in January 1976—being especially steep (Table A). Still, this does not tell the entire story. To begin with, in inflation-adjusted market value terms, dividends were already falling well before the recession began in 1974. Indeed, dividends fell steadily from the mid-1960s through the mid-1970s, and did not begin a sustained rise until the early 1980s (Table B). Further, the main factor that pushed DYs up in late 1974 and then down sharply was not a change in *dividends*, but rather dramatic swings in *equity prices*, which fell by more than half in 1974, then rallied 158% through January 1976. The other recessionary periods are similarly inconclusive, with dividends peaking on a cyclical basis in the middle of the 1980 recession, and moving within a narrow range during the early 1990s recession.

The bottom line is that historical data (what little of it we have) provide us with *no* evidence that recessions have, in and of themselves, caused real dividend payments to rise or fall.

This Is Not Your Father's DY

More important, of course, is the degree to which current dividends are sustainable, particularly given the low level of absolute DYs. Indeed, there is a world of difference between DYs of 12% (or even

6%) and those in the mid-3% range. While investors buying into markets with double-digit DYs have a built-in margin of safety (assuming a large portion of dividends have not been based on one-off gains unlikely to be repeated), for investors today there is far less room for error.

On this score, current DYs appear a bit more compelling. Payout ratios, for example, have plunged to all-time lows in recent years (Table C), an indication companies have been conservative with dividend increases amid surging profit growth. While much of this surplus cash has been returned to investors through share buybacks and the like, companies appear to have room to maintain current dividend payments *even if* profit growth turns down. As Merrill Lynch recently quipped about the U.K. corporate sector, "Even management know[s] the current profits expansion won't last—so they've kept their dividend commitment to a minimum."

On a more granular level, any discussion of dividends must deal with the health (or lack thereof) of the financial sector, which contributed more than 30% of total U.K. dividends in 2007 (Table D). Indeed, financials and energy combined made up nearly half of total dividend payments for the year; thus, a stumble in either sector could drive yields sharply lower. Analysts, who on the whole are notoriously overoptimistic, do not foresee many problems. Goldman Sachs, for example, expects dividends for banks and financial services firms to rise by 8.1% and 16.1%, respectively, in 2008, despite projected income growth of -3.1% for banks and 6.2% for financial services. For the U.K. market as a whole, Goldman expects dividends to grow by 8.1% in 2008, and 8.8% in 2009. Such optimism is not confined to the United Kingdom—consensus estimates for the broad European financial sector (including the United Kingdom) call for DYs to rise from 4.8% in 2007 to 5.3% in 2008 and 2009, and for earnings per share, which *fell* 17.3% in 2007, to rise 17.1% in 2008 and 11.2% in 2009. Overall, European DYs are forecast to rise from 3.6% in 2007 to 3.9% in 2008, and 4.2% in 2009.

While we have no particular insight into future dividend growth for the U.K. financial sector (or any other sector, for that matter), we would take these estimates with a grain of salt. We tend to agree with Ben Inker of Boston money manager GMO, who recently penned an analysis on U.S. financials that is certainly applicable to non-U.S. financial firms as well. In his words:

> *[T]he uncertainties around the ultimate value of much of the US financial system are so large that it may very well be advisable to substantially underweight or avoid financial stocks—not because we know the stocks to be overvalued, but because the magnitude of the unknowns is such that we mere mortal analysts cannot hope to know what the true values of the companies are.*

However, even under a worst-case scenario for financials, dividends are unlikely to fall too far. Merrill Lynch, for example, estimates that in the event that European financials cut their dividends by 50%, the overall DY would fall only from 3.7% to 3.1%. (While the analysis was done on all of Europe, it is applicable to the United Kingdom given that the financial sector makes up a similar percentage of the U.K. and total European markets.) Of course, assuming everything else stays the same, this still represents a roughly 20% fall in the value of dividends paid. Indeed, an alternative interpretation of Merrill's analysis is that DYs are already so low they cannot fall much further!

Conclusion

All else being equal, equities that pay a higher dividend provide investors with a higher margin of safety than those with lower DYs. Thus, the fact that the U.K. market has a DY among the highest in the world is a point in its favor, particularly in the current low-return environment. (As noted earlier, this is of particular interest to U.K. charities that rely exclusively on income to meet spending needs.) Further, given that companies have kept dividend increases in check during the recent explosion in profit growth, a steep fall in dividend payments seems unlikely. On the other hand, absolute yields remain relatively meager, while more than one-third of 2007 dividends came from the ailing financial sector.

In sum, while we continue to believe U.K. equities provide a higher margin of safety than equity markets with lower DYs, the gap is not particularly wide. Finally, investors should note that in the event of a global market downturn, "relatively high" U.K. DYs are likely to prove as ephemeral as the ubiquitously inedible "relative performance."

Table A

FTSE ALL-SHARE COMPOSITE DIVIDEND YIELD

31 December 1964 – 31 January 2008

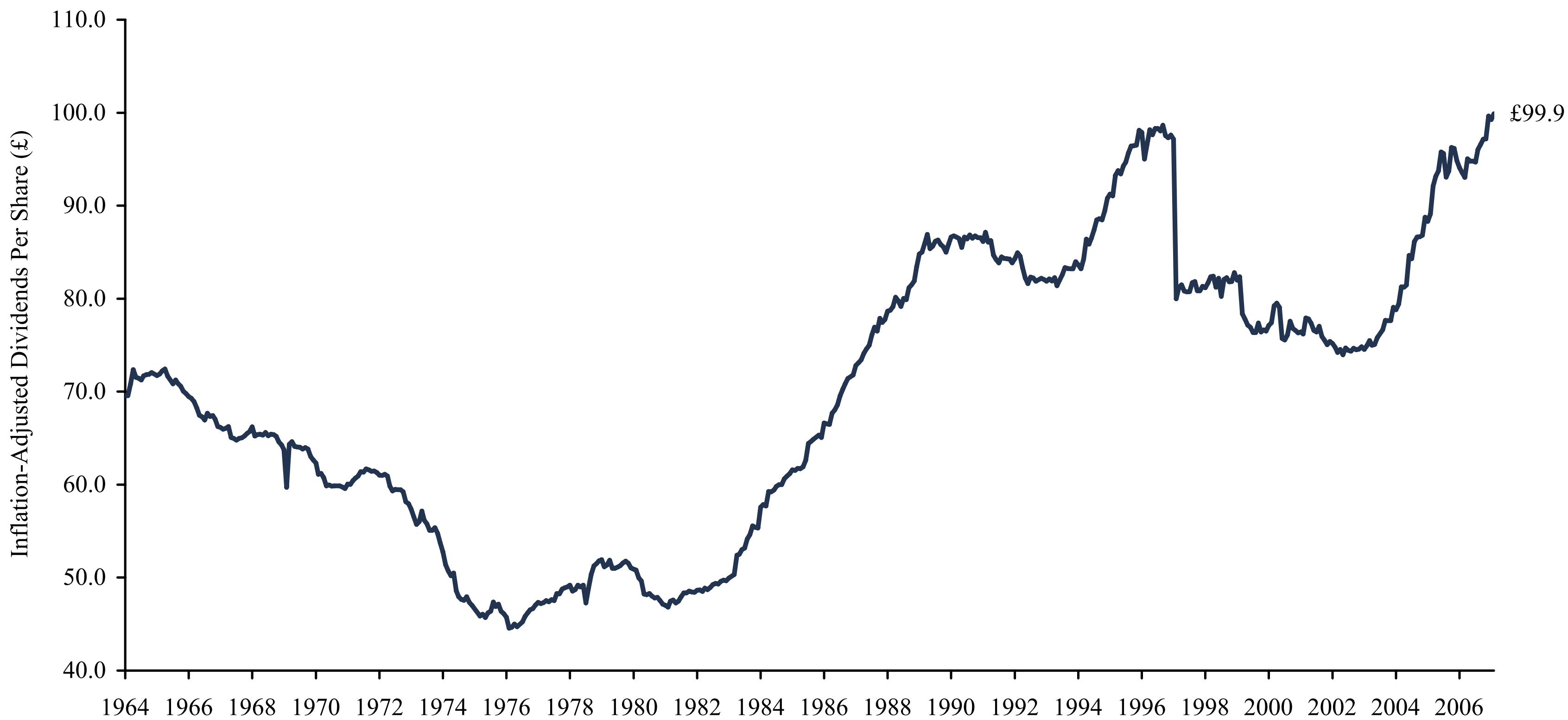
Source: Thomson Datastream.

Note: Shaded areas represent periods of recession in the United Kingdom.

Table B

FTSE ALL-SHARE INFLATION-ADJUSTED DIVIDENDS PER SHARE

31 December 1964 – 31 January 2008



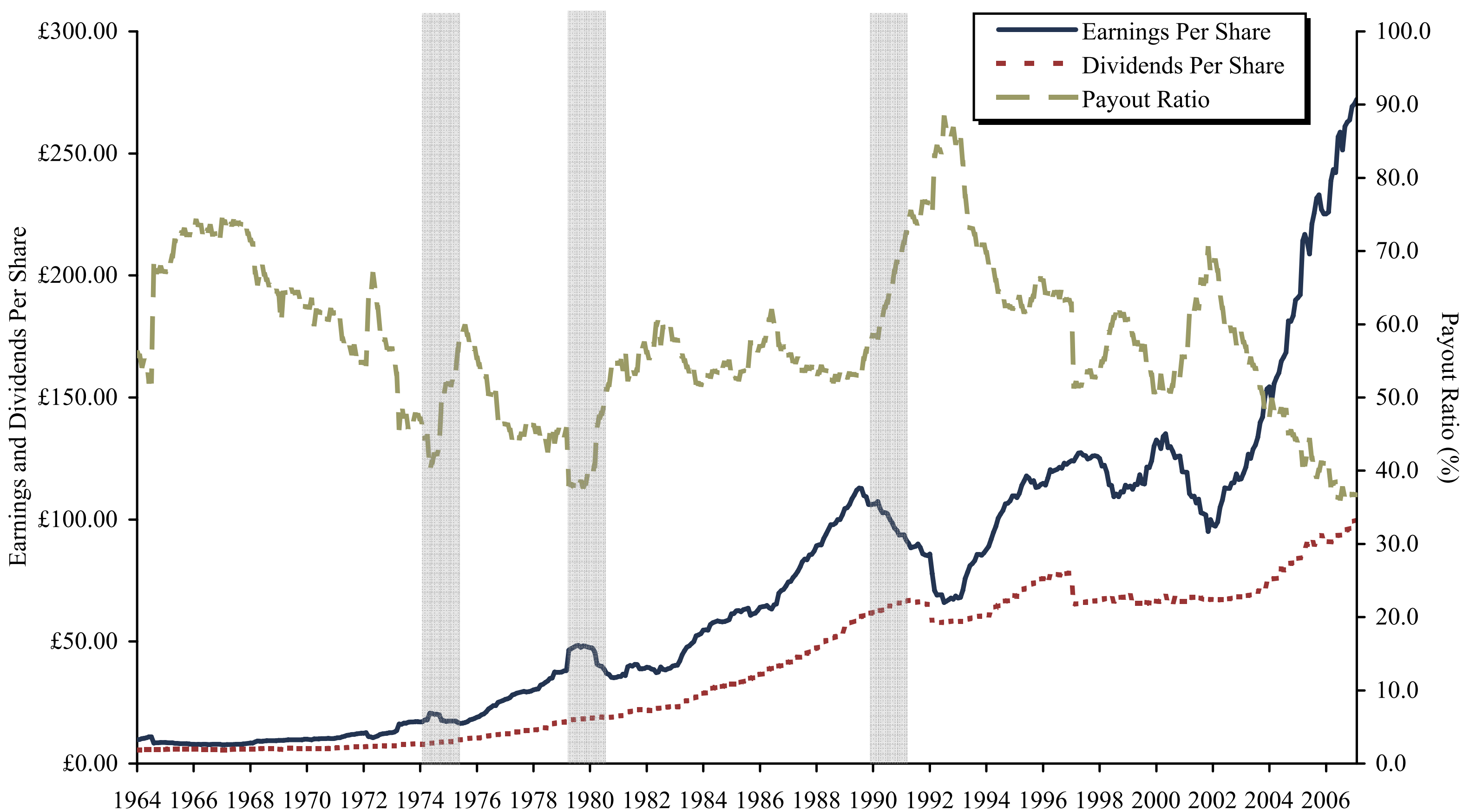
Source: Thomson Datastream.

Notes: U.K. inflation data represent the Retail Price Index from 1964 through November 2003 and the U.K. CPI from December 2003 onward. The sharp drop in 1997 is due in part to a tax reform measure that eliminated imputation credits for tax-free investors.

Table C

FTSE ALL-SHARE PAYOUT RATIO

31 December 1964 – 31 December 2007



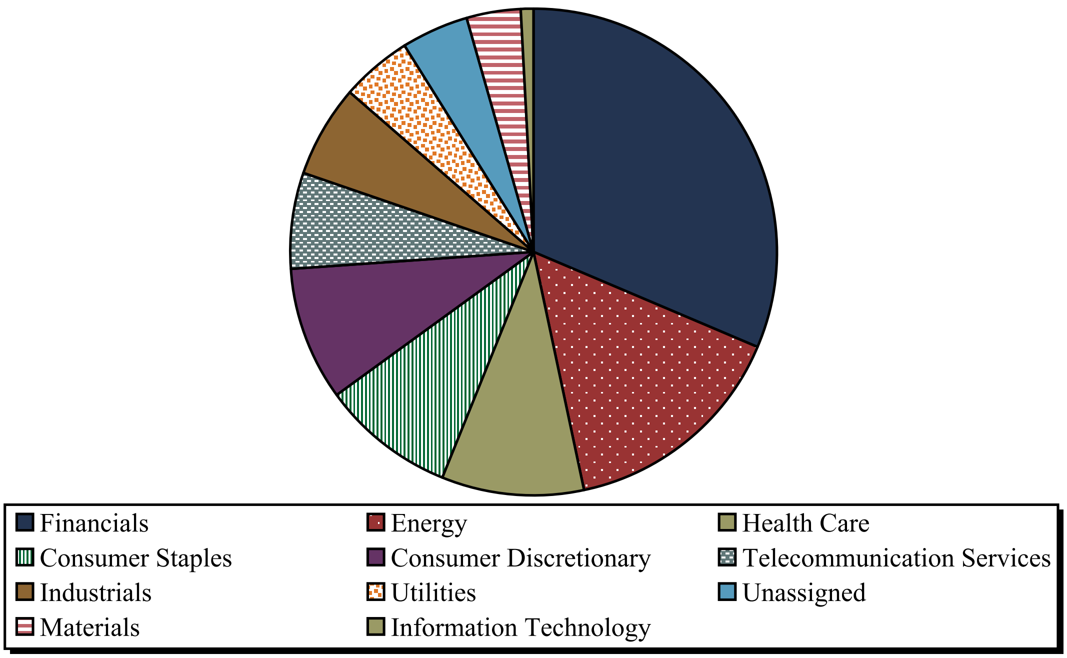
Source: Thomson Datastream.

Note: Shaded areas represent periods of recession in the United Kingdom.

Table D

FTSE ALL-SHARE DIVIDEND YIELD CONTRIBUTION PERCENTAGE BY SECTOR

As of 31 December 2007



Sector	Index Weight	Dividend Yield (%)	Dividend Payout (£ million)	Contribution Percentage
Financials	22.6	3.7	12,394.7	31.4
Energy	17.2	3.3	5,976.6	15.1
Health Care	6.5	4.1	3,738.8	9.5
Consumer Staples	12.3	2.8	3,546.0	9.0
Consumer Discretionary	7.7	3.0	3,446.4	8.7
Telecommunication Services	7.1	3.6	2,595.6	6.6
Industrials	7.0	2.7	2,335.5	5.9
Utilities	4.2	3.7	1,862.6	4.7
Unassigned	4.1	2.1	1,831.8	4.6
Materials	10.0	1.6	1,377.0	3.5
Information Technology	1.2	2.2	345.0	0.9

Sources: Bloomberg L.P., Cambridge Associates LLC, and FactSet Research Systems.

Notes: Data reflect the dividend yield for the trailing 12 months ended December 31, 2007. Contribution percentage is based on sector weights as of December 31, 2006. Unassigned sector includes companies that are not classified in any particular sector.