

The power of dividends

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Expectation is an important concept – not just in investing but in all decision-making. At SWIP, we use fundamental research as a means both of selecting stocks and forming our views on the market. No matter the environment, we aim to provide our clients with total return: the rise in the value of a stock plus the yield from its dividends. Despite the turmoil in equity markets, we find that dividend-paying European companies can continue to generate returns and provide investment opportunities.

Europe's sovereign debt crisis may be putting equity markets through the ringer, but such a turbulent environment provides a compelling opportunity for investing in companies that have the ability to increase their earnings – and dividends. Clearly, there are risks attached to investing in any stock market, but for those who can, SWIP's European equity dividend-plus strategy offers investors access to our high-conviction selection of stocks, with the aim of offering attractive dividend yields, capital growth and diversification.

There are many reasons to invest in dividend-paying and dividend-growing companies in Europe. The most obvious reason is that stock dividends can provide a steady stream of income. In the wake of the financial market turmoil that began in late 2007 that crippled the banks, and the Macondo oil spill that crippled BP, UK investors have started to recognise the attraction of high-yielding continental European stocks. They have also recognised that looking further afield for high-yielding investments can spread the risk of their equity income investments.

Until relatively recently, European companies tended to demonstrate management strength by increasing earnings and retaining excess capital. On the latter, the mindset has changed. Now, chief executives and financial officers are aware of the need to improve the management of their capital to the benefit of shareholders. Typically, this is achieved by reinvesting the capital in new projects, increasing the level of dividends, buying back shares – or a combination of the three.

With the economic and investment environment still unclear, how important are dividends to an investment strategy? Our sense at SWIP is that investors in Europe and elsewhere are re-evaluating the role of equity income investing in their asset allocation plans. We believe that many investors are starting to place a higher importance on dividends, especially given the attractive dividend yields that are available relative to other types of assets. Equity dividend-plus investing, which concentrates on the income from dividends as well as the rise in a stock's value, is something that can help to smooth the overall level of returns. In other words, it can allow investors to share in the success of a rising market while reducing the risks when markets fall.

Our experience at SWIP has been that shares in companies with disciplined dividend policies have, historically, been less volatile and susceptible to sharp falls in their share price than “growth” stocks with a less disciplined dividend policy. This suggests that a portfolio that includes consistent and growing dividend-paying companies will provide a smoother overall level of return.

Conventional wisdom has assumed that high-dividend-paying companies are past the stage of growth that typically requires them to reinvest their profits. In other words, a high dividend means companies do not see any opportunities to reinvest cash and prefer to pay it to their stakeholders. While this is true for some firms, in Europe it’s becoming more of an exception. The mindset towards dividends has been changing: shareholders have been partaking in more of any excess cash – though not at the expense of the company’s re-investment for growth.

While dividends are not guaranteed, a record of consistent and rising dividend payments can be a good indication of sound capital management as well as a company’s confidence in its strategy. Equally, a commitment to returning spare cash to shareholders through dividends can represent a valuable management discipline, one that obliges a company to think carefully about how to run its balance sheet the most efficiently. This, in turn, can lead to better subsequent returns on investment.

At SWIP, we apply the same research and investment methods during a downturn as when markets are rising. Rigorous analysis of balance sheets and cash flows as well as regular contact with senior management are the foundations of our research process. We scrutinise each stock from the roots up, building five-year financial models for every company we invest in. This investment approach has worked in the past; it should continue to do so in future.

SUMMARY:

- Many investors are starting to place a higher importance on dividends, especially given the attractive dividend yields that are available relative to other types of assets.
- UK investors have started to recognise the attraction of high-yielding continental European stocks, to spread the risk of their equity income investments.
- Dividends can supply a steady stream of income, helping to smooth out returns when markets are volatile.
- A record of consistent and rising dividend payments can be a good indication of sound capital management as well as a company's confidence in its strategy.

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