



VIEWPOINT

Newsflash

A new month and the 58th issue of Viewpoint from FP.

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July feels like much more of a distant past than the mere two and a half weeks that have passed since the end of the month. This is probably because events in August have once again disregarded the northern hemisphere's summer holiday period, with parts of the United Kingdom witnessing riots and looting and the United States' credit rating being cut by Standard & Poor's. Add to this the ongoing struggle in Europe to come up with a long term and sustainable solution to the debt woes of Club Med, and it is clear that investment analysts cannot afford to turn their backs on the market for one minute. Or perhaps that is exactly what we should have been doing, given that the economic outlook and most recent indicators are arguably not that different from what they were a year ago.

In July (and, in truth, during the first couple of weeks of August as well) we have been grappling with the question of whether the current market environment and economic outlook merely point to a soft patch, or a more prolonged slowdown. A year ago, when the MSCI World fell by around 14% peak to trough from the end of April to early July, we were convinced that markets were oversold and that more bad news than good was being priced in. In the end, the Bellwether Global Equity index had recovered to its April 2011 levels by October, and ended the year on a high. This time around we are not so sure that there are enough positive developments ahead to gild a similarly bullish outcome for risk assets. Monetary policy could barely be any looser in the United States and the

United Kingdom, with the European Central Bank no doubt rueing its decision to increase rates in July. Governments in the developed world are certainly not planning to spend more, so the chances of any economic booster shot from the public purse can be discounted in the years ahead. Given the current high levels of government debt to GDP in most developed countries, it is also improbable that tax rates will be reduced by any great amount. As much as 25% of the homeowners in the United States are still in negative equity territory, and whilst they could simply return their keys to the bank, it means that there is still a large debt overhang weighing on the combined private and banking sectors. In most of Europe (including the UK) a similar situation exists, and in this instance households cannot escape the burden by returning the asset to the lender. Unemployment is still high in North America and large parts of Europe, and has not shown significant improvement when compared to previous post recession recoveries. In short, economic growth is unlikely to be driven by the state or households, meaning that the emphasis is on the corporate sector, which, of these three fundamental cogs of the economic machine, looks to be in the strongest position following the 2007-09 financial crisis. Profit margins are at record highs, but it is not inconceivable that they will remain elevated for longer given the hurdles that new entrants face in the current economic environment. More recently we have noticed a rise in downwards earning revisions compared to a year previous, which perhaps points to more than a mere bump in this already feeble recovery. Under "normal" circumstances (as if any recovery can be considered normal) one would expect a fairly strong bounce in production given the 7% GDP output gap (in the United States) at the end of the recession in 2009. Based on historical trends this would have translated into consecutive years of above 6% annualised GDP growth, whereas the actual recovery has yielded less than half of this.

Outside of the corporate sector's strength, and perhaps the continued growth being witnessed in Asia, there is not much evidence to suggest that global developed economies are likely to suddenly find their footing and start growing out of their bleak fiscal predicament.

Current market sentiment, which is certainly far from exuberant for the reasons explained above, was not helped by the deliberations in Washington, as both Republicans and Democrats exhibited far greater capacity for narcissism than rationalism in eventually agreeing to increase the US Federal Government's debt ceiling early in August. These events do not fill us with confidence about Congress' ability to successfully tackle a much more important issue – cutting their fiscal deficit and containing (not to mention reducing) their ballooning public debt.

On the other side of the Atlantic, European policymakers did not cover themselves in glory either, as they persisted with kicking the proverbial debt can down the road, instead of picking it up and disposing of it once and for all. It is quite understandable that the German electorate is not keen to fund Greek, Portuguese and Spanish bailouts, unless there is a clear commitment on the part of these countries to reign-in their frivolous government spending and to collect (if not raise) taxes.

Outside of the US and Europe attention remains focused on China, and whether the economy is gliding towards a soft landing or a bumpy set down. Data from the world's second largest economy presented a mixed picture during July. China's manufacturing PMI fell to a level just above par of 50, the fourth consecutive monthly decline. Manufacturers face tightening monetary and credit conditions, alongside rising labour costs and power shortages during the summer peak season. The extent of credit creation, given its links to inflation via a quantitative theory of money, continues to trouble policy makers. Moody's cast doubt over the completeness of data from China's National Audit Office on the country's problem loans. Further aspersions were cast on corporate governance standards at a number of Chinese companies, who are believed to have side-stepped listing requirements on foreign exchanges via so-called reverse takeovers; the most high profile of which during July was Chinese timber company Sino Forest. Despite these headwinds, China's second quarter GDP growth exceeded expectations, at an annualised rate of 9.5% versus consensus of 9.3%.



Turning to markets, global equities fell by 1.8% during July, with all major regions suffering losses in local currency terms, other than Asia Pacific excluding Japan which rose by 0.6%. The deteriorating outlook in Europe prompted falls of 4.2%. Government bonds rallied, with the JP Morgan Global index gaining 2.4% in US Dollar terms. US treasuries moved ahead in spite of the political impasse, up by 1.9%. Convertible bonds appeared as areas of weakness, as the company risk premium

rose. In property securities, the global aggregate index posted gains of 0.7% in US Dollar terms, led by the US and Asia. European securities including the UK and Australia suffered losses. Excluding the euro, most major currencies traded higher against the dollar, with the yen in particular gaining by over 4%. Commodities made ground despite the deteriorating outlook for some production inputs, whilst gold again reached new highs in the face of stresses affecting fiat currencies.

Asset Class Performances

Asset Class/Region	Index	To 29 July 2011		
		Currency	Month	Year to date
Equities				
United States	S&P 500 NR	USD	-2.1	3.5
United Kingdom	FTSE All Share TR	GBP	-2.2	0.7
Continental Europe	MSCI Europe ex UK NR	EUR	-4.2	-1.8
Japan	Topix TR	JPY	-0.9	-5.2
Asia Pacific (ex Japan)	MSCI AC Asia Pacific (ex Japan) TR	USD	0.6	3.6
Global	MSCI World NR	USD	-1.8	3.4
Global emerging markets	MSCI World Emerging Markets TR	USD	-0.4	0.4
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	1.9	4.2
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	4.1	10.1
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	2.5	5.8
US High yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	1.2	6.2
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	3.5	5.3
UK Corporate (investment grade)	Merrill Lynch Sterling Non Gilts TR	GBP	2.6	5.6
Euro Government Bonds	Citigroup EMU GBI TR	EUR	0.2	0.1
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	1.2	2.7
Euro High yield	Merrill Lynch Euro High Yield 3% constrained TR	EUR	-0.5	4.3
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.3	0.9
Australian Government	JP Morgan Australia GBI TR	AUD	2.2	6.7
Global Government bonds	JP Morgan Global GBI	USD	2.4	6.3
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	1.8	6.3
Global Convertible bonds	UBS Global Convertible Bond	USD	-1.9	2.8

Asset Class/Region	Index	To 29 July 2011		
		Currency	Month	Year to date
Property				
US Property securities	MSCI US REIT TR	USD	1.5	11.4
UK Property securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	-3.0	12.9
Europe ex UK Property securities	FTSE EPRA/NAREIT Developed Europe ex UK TR	EUR	-3.0	4.2
Australian property securities	FTSE EPRA/NAREIT Australia TR	AUD	1.4	-3.7
Asia Property securities	FTSE EPRA/NAREIT Developed Asia TR	USD	-4.2	3.0
Global Property securities	FTSE EPRA/NAREIT Developed CR	USD	0.7	6.9
Currencies				
Euro		USD	-0.9	7.1
Sterling		USD	2.3	4.8
Yen		USD	4.6	5.1
Australian Dollar		USD	2.6	7.2
Rand		USD	1.0	-1.4
Commodities				
Commodities	RICI TR	USD	2.3	3.5
Agricultural Commodities	RICI Agriculture TR	USD	1.8	-5.0
Oil	Brent Crude Index (ICE) CR	USD	6.5	26.3
Gold	Gold index	USD	8.2	15.4
Commodities			Current rate	Change at meeting
United States	9 August 2011	USD	0.25%	-
United Kingdom	4 August 2011	GBP	0.50%	-
Eurozone	4 August 2011	EUR	1.50%	-
Japan	4 August 2011	JPY	0.10%	-
South Africa	2 August 2011	AUD	4.75%	-
Australia	31 July 2011	ZAR	5.50%	-

Focus: New opportunities – divining dividends in Asia

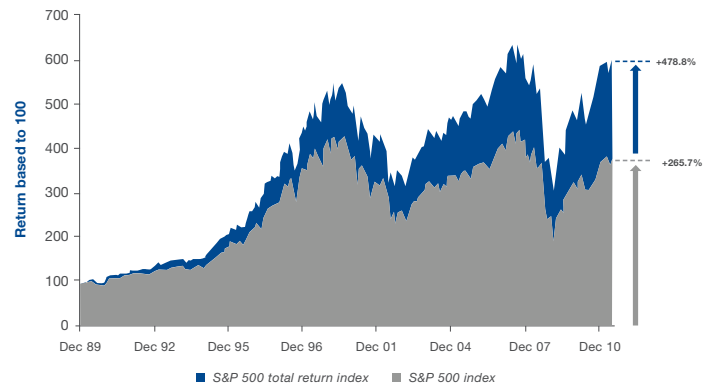
Equity investors earn two sources of return, namely capital gains and distributed earnings in the form of dividends. Yet investors have tended to focus on the former, especially in the high growth markets of Asia, ignoring the fact that capital gains are inherently more volatile and less reliable than dividend income, and the gain needs to be realised before it is a return to the investor.

Dividends, however, are ‘birds-in-the-hand’, providing investors with some security of returns. While dividends follow the trend of earnings, both up and down, companies are very reluctant to cut their dividend and will usually only do so in extreme circumstances. Thus dividends are generally much more stable than earnings and more reliable than returns from price movements alone.

In bull markets, when confidence is high, investors have tended to ignore tangibles such as cash generation and distributed earnings; when sentiment is poor, no amount of ‘massaging the bottom line’ can disguise the fact that cash is king. The supposed ‘irrelevance’ of dividends ignores the fact that management often make poor decisions with regards to investing retained earnings. In contrast, paying out dividends imposes a strict discipline on management and increases the focus on cash generation. This same fact means that companies with high payout ratios are not necessarily low growth ones; research, in fact, suggests the opposite (e.g. Arnott & Asness 2003)¹.

Nonetheless, investors tend to be drawn to the fastest growing companies and the most exciting investment stories in search of capital growth. This belies the fact that if you had bought the broad basket of stocks represented by the S&P 500 in 1990, nearly half of your total return over the subsequent 20 years would have come from reinvested dividends (see Chart 1). Whilst the price index, which does not account for dividends, rose by 265.7% over the period, the total return including reinvested dividends equalled 478.8%.

Chart 1 – US stock market returns



Source: Bloomberg LLP. Daily returns between January 1990 and July 2011.

The rationale for any successful investment is always predicated on the investment environment. Currently investors are faced with volatile but essentially sideways moving markets as Western governments, businesses and consumers simultaneously attempt to reduce the excessive and unsustainable levels of debt built up over the last decade or more. Given that deleveraging results in reduced spending and low levels of growth, and is a multiyear process, economic growth in the Western world is likely to remain very subdued for some years. Returns from equity markets are therefore likely to remain low and range bound for some time to come, which increases the importance of income from dividends.

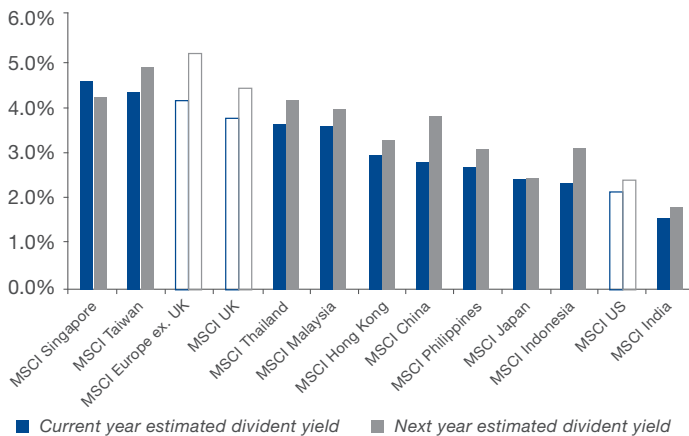
Current dividend yields in equity markets look compelling. With cash and government bonds offering very low yields and corporate debt sometimes yielding less than the same company’s equity, we expect investors to increasingly turn to equities for their income needs, whilst receiving a participatory stake in any future growth at the same time. For example, investment grade bonds issued by Colgate-Palmolive and Astrazeneca (both maturing in 2015) offer yields to maturity of 1.0% and 2.1% respectively, whereas the two companies’ common shares offer dividend yields of 2.7% and 7.0%². Furthermore current equity valuations are not demanding and dividends do not appear vulnerable given the strong balance sheets presented across much of the corporate sector.

Source: Momentum Global Investment Management / Bloomberg. July 2011

One would expect income stocks to perform relatively better than other stocks when equity markets are falling, as investors' preferences shift in favour of more visible returns and steady income streams. Indeed, looking at a suitably diversified portfolio of UK stocks demonstrating stable earnings and high dividend yields, we find some evidence of this trend³. Owning an equally-weighted portfolio of income stocks post the bursting of the dot-com bubble (August 2000 to March 2003) would have left one's investment essentially flat in nominal terms, compared to the FTSE 350 Index, including dividends, which fell by close to 40%. Over the last decade the average UK equity income manager has captured 71.1% of the upside of the broad market, and 90.1% of the downside, leading to a net return of 79.3% versus 59.3% for the market portfolio⁴. Whilst income stocks may be considered 'dull' in the good times, their capacity to compound value results in their outperforming over the long run.

Asia has traditionally been considered a growth market; investors have sought and proven willing to pay a high premium for those companies with the highest rates of growth. The Asian financial crisis led to a change in investor attitudes however, prompting companies to look to improve corporate governance standards, including returning earnings to shareholders. As such there is a growing opportunity set for income-orientated investors in the region. Asia's largest markets currently offer comparable dividend yields to the UK, the US and Continental Europe, as seen in Chart 2 below.

Chart 2 – Stock market dividend yields

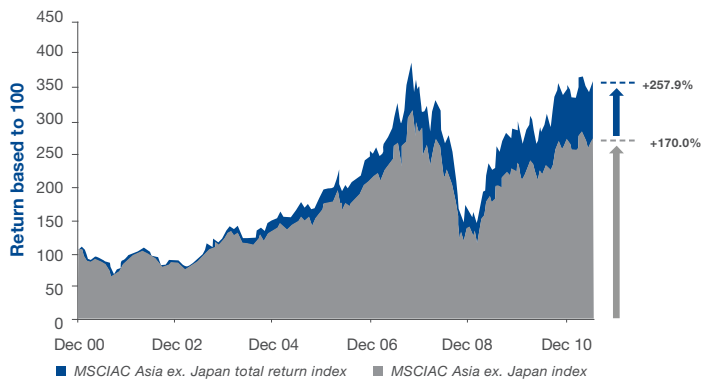


Source: Bloomberg LLP.

Source: Momentum Global Investment Management / Bloomberg. July 2011

Indeed, as with the US stock market, a quarter of the return to equity investors in Asia excluding Japan since 2001 has come from reinvested dividends, with the price index up by 170.0% compared to the total return index's gain of 257.9% (see Chart 3).

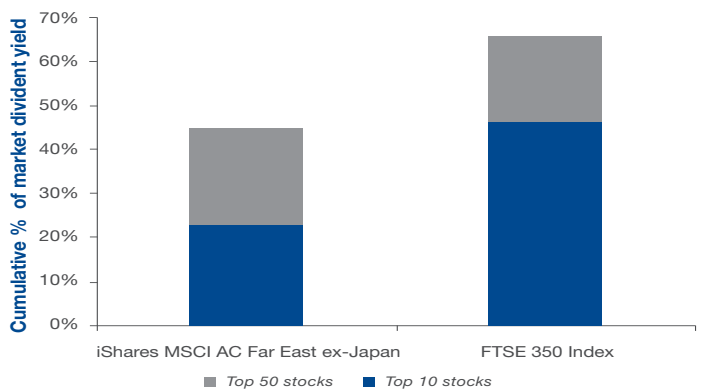
Chart 3 – All country Asia (excluding Japan) stock market returns



Source: Bloomberg LLP. Daily returns between January 2000 and July 2011.

Asian companies currently offer similar dividend yields to companies in more traditional 'income markets', whilst boasting higher coverage ratios and greater potential for dividend growth. The distribution of dividends across listed companies is also around a third less concentrated than in, for example, the UK when constructing a 50 stock portfolio of the highest yielding stocks based on index weights (see Chart 4). As such, the income component of one's portfolio is less dependent on the fortunes of a single company or, as is often the case, a few high yielding sectors – from which we infer diversification benefit – whilst the price paid for income stocks is less likely to be bid higher by an excess of demand over supply.

Chart 4 – Concentration of index dividend yields



Source: Bloomberg LLP.



Faced with serious macro headwinds to the global growth story, and with yields on traditional income investments such as cash and government bonds at historically very low levels, now may be the time to focus on equities as the income asset class. Further, the well-documented rise of Asian economies is proceeding hand-in-hand with a change in investor attitudes towards the region. With the appearance of a growing number of mature companies – global multinationals which are highly cash generative and have established footprints in Western markets – we expect to see investors increasingly looking to Asia for their income needs.

¹ *Arnott, R. & Asness, C. (2003). Surprise! Higher Dividends = Higher Earnings Growth. Financial Analysts Journal. 59 (1) p. 70-87.*

² *Bloomberg LLP.*

Colgate-Palmolive Co.; Maturity, 01/11/2015; Bid Yield to Maturity, 0.97%; Dividend Yield, 2.69%.

AstraZeneca PLC; Maturity, 15/01/2015; Bid Yield to Maturity, 2.09%; Dividend Yield, 7.00%.

³ *Style Research online. Simulated returns do not account for trading and other implementation costs. Performance based on an equally weighted portfolio of stocks demonstrating a combination of high sustainability of growth, high dividend yield and low beta, selected from the largest 350 companies in the UK universe by market capitalisation. Portfolio rebalanced quarterly.*

⁴ *Lipper Hindsight UK equity income universe.*

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