INVESTMENT INSIGHTS

February 2012

The search for income: A global dividend strategy

Introduction

- In this new low growth, low yield environment, there are opportunities to generate a sustainable yield from an equity portfolio.
- The safety of the dividend is of paramount importance. Investors can achieve a much higher predictability of excess returns within a high yield equity portfolio.
- Combining an attractive dividend yield and dividend growth leads to successful total returns. Many investors have chased dividend yield but have forgotten the importance of the dividend growth component.
- Cashflow research is a critical skill that helps investors avoid companies with optically high dividend yields that may not be sustainable.
- Diversifying your income stream is key to delivering a sustainable yield in a world heavily impacted by macro events.

A low growth, low yield environment means a generation faces poor returns

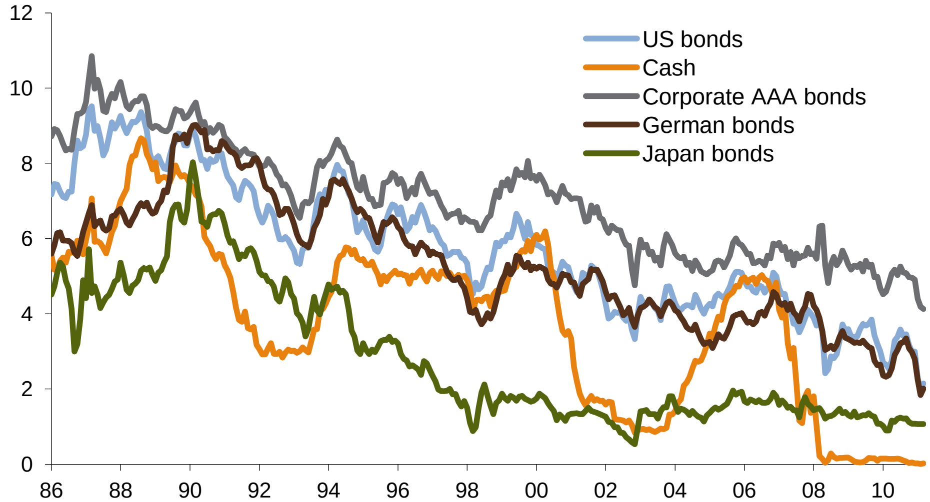
We have entered a low yield, low growth environment where generating income streams has become a challenge for both institutional and retail investors. Yield has become much harder to come by from traditional fixed income strategies and as a result a number of investors are struggling to meet liabilities. Prospects for slower growth and the focus of many developed market governments on cutting high budget deficits are pushing central banks to keep monetary policies easier for longer.

In its most recent statement the US Federal Reserve suggested that its Fed funds rate would remain at near zero levels until late 2014. It also announced operation twist' to buy longer-dated Treasuries at the expense of short-dated bonds in an effort to push down longer-term yields. Combine this with more quantitative easing in the UK, the complexity of the yield environment in Japan and the recent turmoil in Europe, and investors face a new fiscal world order and a tough period when searching for yield.

*'Professional investors' corresponds to professional clients as defined within the European Union Directive 2004/39/EU on Markets in Financial Instruments (MiFID).

Exhibit 1 – Ten-year government bond yields, corporate bond yields and cash

A long march to ever lower yields (%)



Source: Datastream, as at December 2011.

As bond yields have dropped dramatically, the pension funding gap for US corporates has almost doubled over the last 12 months. From a moderate surplus at the end of 2007, pension plan assets at S&P 500 companies now cover about 74% of estimated liabilities, a deficit of USD 477 billion (see **Exhibit 2**). That's a USD 228 billion fall from the USD 249 billion in underfunding (84% funded) as of the 2011 year end. Falling yields have also lowered the discount rate used to calculate the value of promises to past and present employees resulting in some companies having to make much greater contributions to offset the funding shortfall.

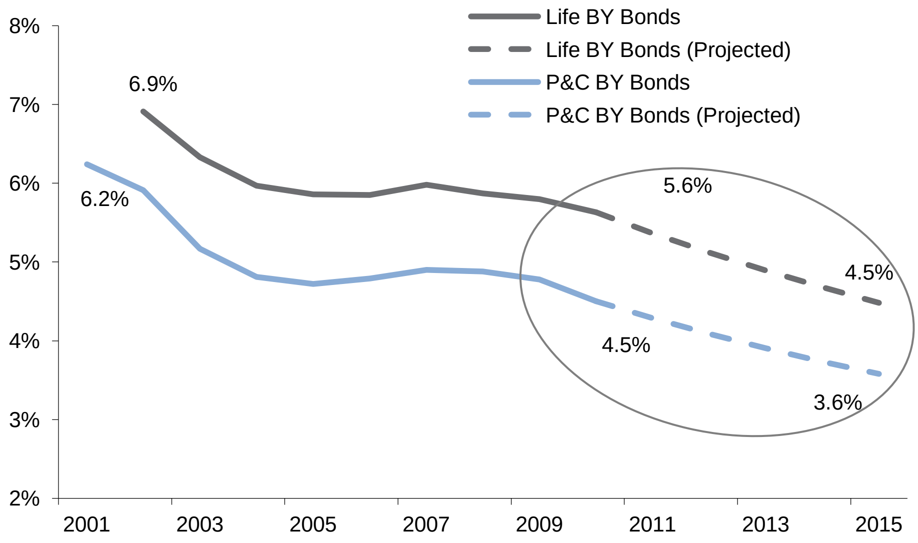
Exhibit 2 – S&P 500 pension underfunding hits USD 477 billion

S&P 500: Pension Plan funding gap has doubled

% Funded

Note: 2011E includes actual funded status for January to June fiscal year end companies.
Source: Company data, Credit Suisse estimates

Exhibit 3 – Historical and projected book yields on bonds for the insurance industry



Assumptions: Reinvestment yield for Life is 3%. Reinvestment yield for P&C is 2.75%. Assets grow by 5% per year, in line with 10 year trend. Book yield at 31 December 2010 is equal across all maturities. Distribution of bond maturities for Life and P&C industries is taken from SNL as of 31 December 2010. Note: Data is for US Insurance industry only.

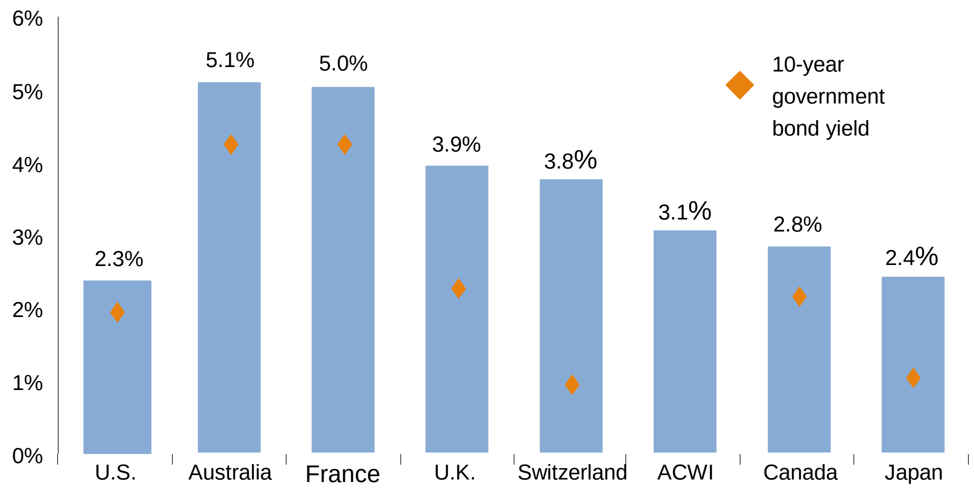
Coupled with an ageing population there is also a growing mismatch between pension return assumptions and what is realistic given where yields are today. Overall asset return expectations in the US are around 8% for corporate and state pensions. Assuming a traditional asset allocation this is very optimistic as it would require equities to return 12% net of fees.

Projected book yields for the insurance industry also make pretty grim reading (see **Exhibit 3**). Bond yields are expected to fall 110 basis points (bps) for life insurers and 90bps for property & casualty insurers over the next five years, if the current low rate environment persists.

For investors who are worried about income in an uncertain environment of low growth and low yield the potential yield reduction is daunting. However, we believe there are additional sources of stable investment income that can help mitigate this widening gap. We would advocate a low risk equity approach with a focus on companies that can maintain, and even potentially grow, their dividend.

Across equity markets there is clear valuation support when comparing dividend yields to bond yields. Dividend yields are now higher than their respective bond yields across most major developed markets (see **Exhibit 4**). For the last 30 years dividend yields have traded below bond yields to reflect the potential of dividend growth.

Exhibit 4 – Equity yields versus bond yields
Equity dividend yields, world markets by capitalisation

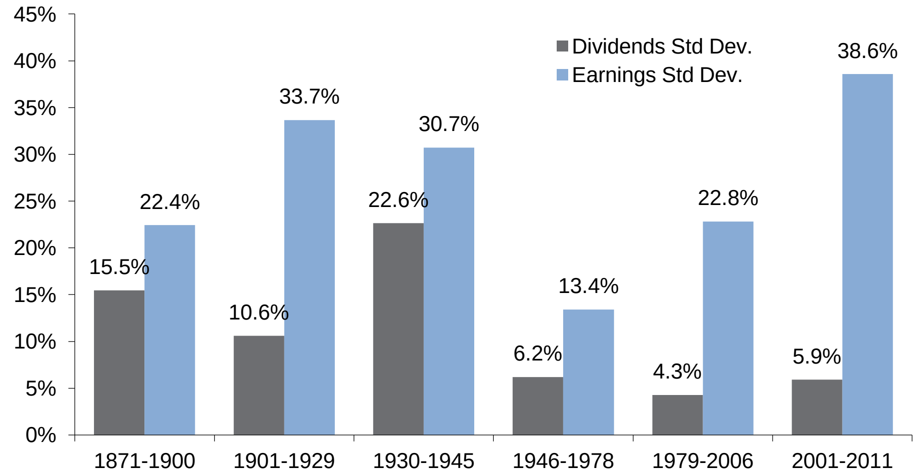


Source: FactSet, MSCI, J.P. Morgan Asset Management. Yields shown are that of the appropriate MSCI index. Data as at December 2011

The safety of the dividend is of paramount importance

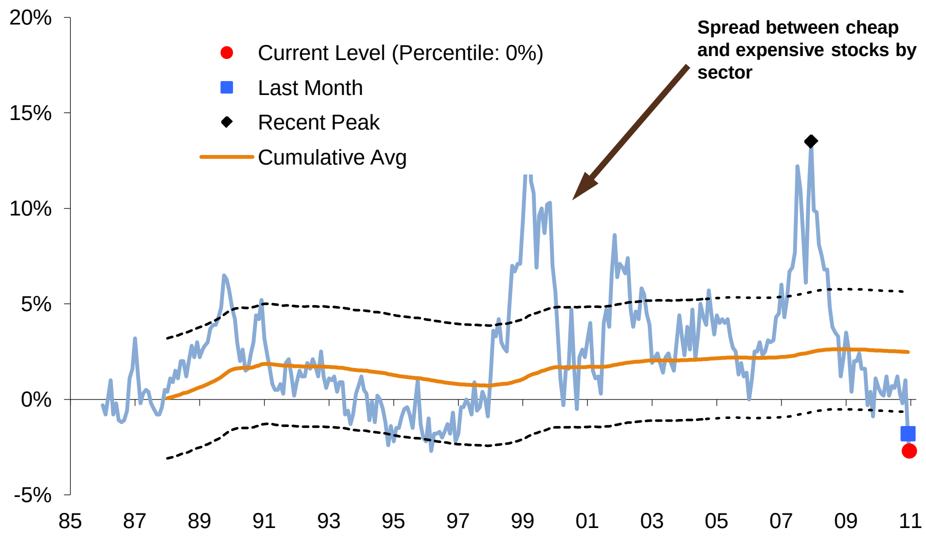
The stability of the dividend as a part of the total return from equities remains the key strength of income investing. Within a high yield equity portfolio, the safety of the dividend is therefore of paramount importance. In our view, increasing levels of equity volatility in recent years has only served to highlight the importance of this principle.

Exhibit 5 – Dividend strategies are less volatile than other equity strategies
Dividends are much less volatile than earnings



Source: IBES, Datastream, European Equities, Credit Suisse.

Exhibit 6 – DDR dividend yield spread
Overall dividend yield valuation spreads are no longer attractive



Q15 DDR spread by BarraDivYield. Source: J.P. Morgan, US equities as at December 2011. Spread based on the discounted cash flow and dividend projections from our proprietary company analysis.

Although equities involve more risk and near-term volatility, high dividend products, where the dividend is well covered by cashflow, lead to much higher predictability of excess returns. Companies tend to protect dividend payouts in equity markets as company managements are cautious in committing to higher payouts in an upturn and are correspondingly eager to minimise dividend cuts in a downturn, hence why dividends typically fall much less than earnings.

The average peak-to-trough earnings fall in past cycles has been around 40% compared to dividend volatility of 5% (see **Exhibit 5**). High dividend payers also tend to be larger, more stable companies with undervalued stock prices and solid balance sheets. Dividend payouts have been historically quite stable, even in periods of earnings volatility.

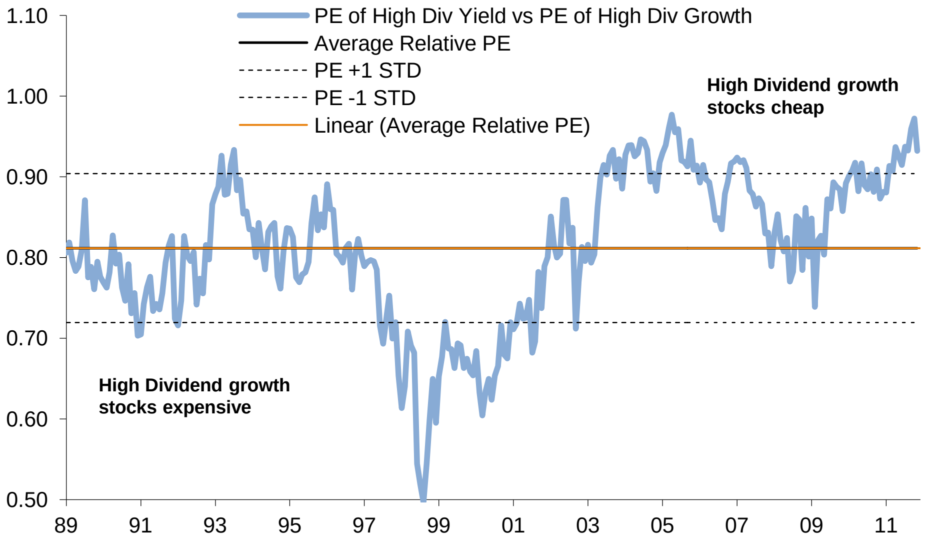
High dividend companies: Are they too fashionable and expensive?

Combining an attractive dividend yield and dividend growth leads to superior total returns. Many investors have chased dividend yield but have forgotten the importance of the growth component.

Amid economic uncertainty high dividend strategies have become very popular with equity investors. As discussed above, you cannot argue with the rationale for this type of approach – low interest rates, low government bond yields, favourable demographics, low growth opportunities favouring a return of capital to shareholders, and cash rich companies with historically low and potentially rising payouts. High dividend yielding companies have been resistant to increases in stock-specific volatility and risk.

Exhibit 7 – Valuation of high dividend growth relative to high dividend yield

High dividend growth is attractive on a valuation basis and high dividend yield on its own is expensive



Source: BofA Merrill Lynch Global Quantitative Strategy, December 2011.

The consequence of a heightened preference for dividend payers and a constrained supply of dividends has meant valuations within these high yield areas have become expensive relative to their historic average. High dividend yields now trade at a premium to the rest of the market in terms of their dividend discount rate (DDR), and look more expensive than at any point over the last 25 years. This leaves very little margin for error. **Exhibit 6** shows the spread between high and low dividend yield stocks, revealing the exceptional narrowing of dividend yield spreads in 2011 and the fact that high dividend yielders in some regions are no longer attractive on a valuation basis.

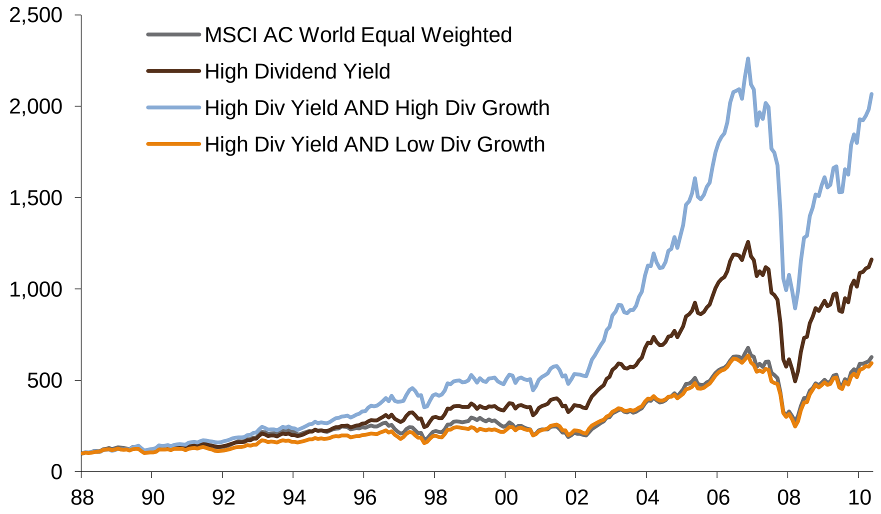
Companies with strong projected dividend growth are cheap on a valuation basis

Given the current market environment and where bond yields are trading today we believe exposure to a high dividend strategy is still desirable. However a strategy with an emphasis on free cashflow and rising payouts, provides a superior risk reward than just investing in a strategy with optically high dividend yields.

The risk associated with the uncertainty of a longer term cashflow stream and future dividend growth has meant a wide valuation gap has emerged between high dividend companies and companies with the ability to increase their dividend (see **Exhibit 7**). While investors are willing to pay a premium for the certainty of short term dividend payments there is strong valuation support in companies with robust profitability, low payout ratios and where there could be a favourable rerating as they boost their dividend.

Exhibit 8 – High dividend yield combined with high dividend growth significantly outperforms high dividend yield

Why invest in companies that grow their dividends



Source: BofA Merrill Lynch Global Quantitative Strategy, MSCI, Worldscope, as at 30 April 2011.

- USD 10,000 in high yielding stocks in 1988 would be worth USD 116,203.
- USD 10,000 in high yielding stocks with high dividend growth would be worth USD 206,669.

Combining an attractive dividend yield and dividend growth leads to successful total returns

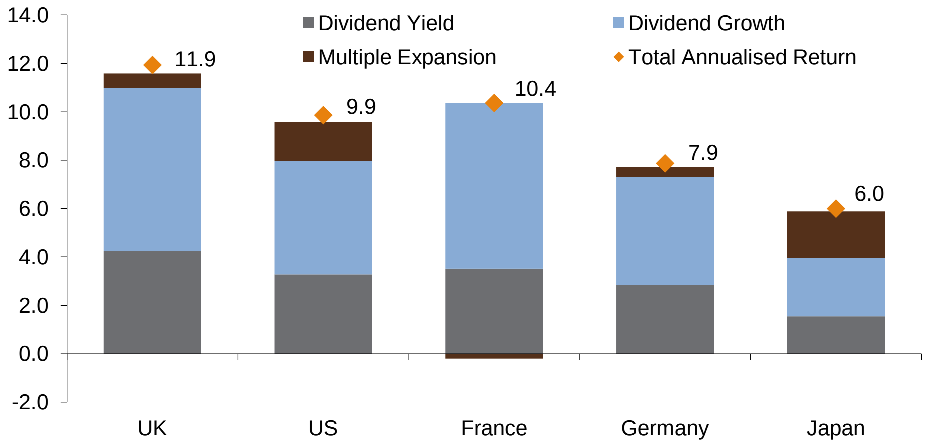
Investors should not simply search for companies with a high dividend yield, but instead target high dividend companies with high dividend growth. Over the long term a strategy that invests for dividend growth would be expected to significantly outperform a strategy that just invests in stocks with the highest dividend.

One of the problems with high dividend yield stocks is their yield can be high simply because share prices have fallen. Combining dividend yield with dividend growth reduces the chance of selecting high dividend yield stocks that may cut dividend payments. **Exhibit 8** shows the cumulative relative performance of stocks based on the various combinations of high and low dividend yield and high and low dividend growth.

Investors have forgotten the importance of the dividend growth component

Over the longer term, dividend yield and dividend growth have contributed the majority of the total return on equity investments (see **Exhibit 9**). Dividend growth has made up the most significant part of this return. However, as discussed above, equity investors have been rewarded through the safety of the dividend yield alone and the dividend growth component has become the forgotten part of the total return equation. We believe this is set to change.

Exhibit 9 – Dividend growth makes up a significant part of share price returns
Decomposition of nominal equity market returns by country, 1970-2011



Real returns	UK	US	France	Germany	Japan
Dividend yield	4.3	3.3	3.5	2.8	1.6
Dividend growth	6.7	4.7	6.8	4.4	2.4
Multiple expansion	0.6	1.6	-0.2	0.4	1.9
Total annualised return	11.9	9.9	10.4	7.9	6.0

Source: SG Quantitative research as at 31 December 2011.

Over the past three years many companies have focused on repairing balance sheets and are now in a strong position to return cash back to shareholders once again. Due to the severity of the global economic downturn, companies have chosen to preserve a higher proportion of capital and dividend payout ratios have remained at low levels as dividend cuts in 2008 were much more severe than previous downturns. Cash generation has been exceptional and there is now a very large amount of cash sitting on company balance sheets (over USD 1 trillion in US equities alone). We estimate that European non-financials have EUR 700 billion in net cash on balance sheets and forecast net gearing is the lowest in 20 years.

Against a backdrop of sharply higher volatility in financial markets and elevated sovereign uncertainty, company management have been conservative with their use of their excess cash. But provided that macroeconomic concerns do not derail the recovery, companies globally (many with significant international exposure) are now well placed to put surplus cash back to work. Over the next few quarters we believe dividends will be supported by the relative strength of corporate balance sheets and that dividend growth will again become the key driver of share price returns. A number of companies have already begun raising dividends again and we believe 2012 looks set to be a continuation of this trend.

Over the next three years, our analysts expect that dividend growth of around 10% within the portfolio could be possible. This is in stark contrast to other asset classes, where income and growth prospects remain under pressure.

Cashflow is critical to identifying companies with high and rising dividends

To be able to maintain and grow an income stream, shareholders need to look beyond just investing in companies with a high dividend yield. Simply screening for the safety of dividend yield could mean your portfolio is susceptible to a number of potential dividend cuts. Cashflow analysis is key to understanding how companies will deploy their excess cash and can therefore help investors avoid companies that may cut their dividend. Sustainability of cashflows and the strength of balance sheets are the backbone for the long-term viability of a company. The strength of a company's future cashflows is central to its share price performance and its ability to maintain and grow an attractive dividend.

A growing number of companies, particularly in Europe, have optically high dividend yields that are not supported by strong and improving cashflow. Telefonica recently downgraded its 2012 and 2013 dividend payout, while a number of European financials have suspended their dividends altogether. These announcements have refocused investor attention on the security of optically high dividend yields.

These so-called 'value traps', or companies with deteriorating cashflow, are the stocks that investors need to try and avoid. We believe a forward looking approach is essential in achieving a stable and growing income for investors. Identifying companies with strong and improving cashflows helps us to avoid companies that cut their dividend and leads to a sustainable and growing dividend for investors.

Diversifying your income stream is key to delivering a sustainable yield

We believe investors should maintain an unconstrained and more diversified approach to income investing by sourcing dividends anywhere in the world in a range of sectors and regions. The focus is on delivering attractive returns by investing in companies with strong and growing dividend payments.

Strong income opportunities can currently be found in both defensive and cyclical sectors. The dividend stocks we like across defensive sectors exhibit strong balance sheet qualities with high dividend yields. Across more cyclical sectors we look for opportunities where dividend growth is particularly compelling as profitability improves. In a world that is heavily impacted by macro/political/regulatory events, we believe it is important to diversify the portfolio across sectors and regions to generate a stable income for investors.

Summary

With this low yield, low growth environment now having a profound effect on the ability of institutions and retail investors to maintain an attractive income from traditional fixed income strategies, market dynamics have created opportunities to generate a sustainable yield across other asset classes. An equity strategy focusing on dividend growth may not be an obvious product for many clients, but we believe focusing on a defensive equity fund with sustainable levels of income is an attractive solution for clients seeking income. There is clear valuation support when you compare dividend yields to bond yields, while within equities a number of companies have high levels of cash and balance sheets are in good shape to increase dividends.

The demand for income has caused valuations across many high dividend yielding sectors to become expensive relative to history. However, there is strong valuation support for companies where dividend growth will be the key driver of share price returns. A focus on higher dividend yielding stocks, which are supported by strong dividend growth, should lead to outperformance versus global equities in the longer run as markets move to more normalised levels.