BROOKS MACDONALD

Equity Income Investing

In this session we look specifically at equity income investing, and particularly at companies that pay out dividends, which are a form of equity market income.

What is a dividend?

A dividend is a distribution of money to shareholders. The shareholders participate in the fate of the company, and have exposure to the profit and loss of the company. A dividend is typically a proportion of the earnings generated by that company in any given year, and depending on the type of company you are looking at, it might be a very small proportion if it is a growing company, or it might be quite a high proportion if it is a more mature company. Mature companies are more likely to give back earnings to investors through dividends, while earlier-stage companies are more likely to use their earnings to reinvest in future growth opportunities.

The dividend will normally be proposed by the company's board, and this proposal will go to shareholders to vote. This is part of the shareholders' voting rights. Dividends can be paid regularly, for example quarterly, semi-annual or annual, or companies can also pay a 'special' dividend, which is a one-off payment typically when a company has undertaken a large transaction. A good example of this would be where a very well-established company might sell off a set of its assets or a particular division or part of the company, and choose to pay a special dividend to return a proportion of the money earned from the strategic disposal of assets to shareholders, in return for investing in the company over time.

Larger, established companies tend to pay dividends, but there are specific sectors where companies are also more likely to pay out dividends, such as basic materials, energy, healthcare and utilities. Companies in these sectors tend to pay higher dividends because their cashflows tend to be less variable, and the companies in these areas are relatively well-established.

Looking at the UK market, dividends tend typically to be higher than in other global markets, and this is partially a result of the fact that we have a large number of companies in these particular sectors that are set up to return capital to equity holders in this way. In some respects it is also cultural, as the expectation arises that companies will pay a dividend.

Dividends in danger?

When a company sees its earning falling, there are typically two things that could happen: first, the company could carry on paying its dividend, regardless. If its dividend payout is larger than the amount of earnings it has made in any given year, we call this 'uncovered', which basically means that it is not sustainable over the long term. The company could probably sustain this for one or two years, depending on the amount of cash built up on its balance sheet, but over the long term a company cannot carry on paying dividends that are greater than its earnings.

The other action that a company may take is to cut its dividend. Traditionally, equity income investors look for a sustained increase in growth in dividend payout, which requires a steady stream of earnings. If a mature company cuts its dividend, that could be quite a loud alarm bell for shareholders, particularly if they have bought the shares for an equity income fund, as they may be forced to sell the shares, depending on the fund's mandate restrictions. Typically, company management will therefore be cautious when deciding to cut dividends, and if they do decide to do so, it can have quite a large impact upon the share price, particularly if the markets do not expect it.

Ex-dividend date

Initially, the proposed dividend is announced by the company and voted on by shareholders, and once confirmed, the shares go 'ex dividend'. This means that if you own the company's shares on that given date, you are entitled to receive that dividend. Even if you sell your shares the following day, you are still entitled to receive that dividend, whereas the buyer of your shares is not – the buyer purchases the shares 'ex dividend', i.e. without the entitlement to receive the most recently announced dividend. The ex-dividend date is also called the 'record date'.

For example, if you look at a large, well-established company with a large dividend payout, you often see that the share price will fall on the day after the ex-dividend date, which reflects that some of the money has now been distributed to the shareholders. At some point in the future, perhaps the next month or the next quarter, the actual dividend will be posted and physically payed to the investors who held the shares on the ex-dividend date.

Income versus capital gains

When considering dividends, it is important to look at the difference between income and capital gains. Dividend payments are taxed as income in the UK, which is not the case with capital gains. Investors can largely (although not always) choose when to take their capital gain, for example by selling their shares, in contrast to income, where dividends are paid according to the company's schedule.
Capital in the UK is taxed as capital gains, and there are different rates which can vary over time. So there are situations where it may be more preferable to receive a capital payment rather than income payment.

Clearly, anything equity-related is not predictable, although dividends are usually more predictable than equity market movements (and the consequent impact upon your investment value), as most larger companies will have a schedule and a goal of how much they will distribute in dividends over the near-term, provided that their earnings are in line with expectations. By contrast, capital gains are inherently unknowable, on account of the fact that they are affected not only by the company's earnings, but also by unpredictable factors such as market sentiment towards a particular sector, or indeed towards the company itself.

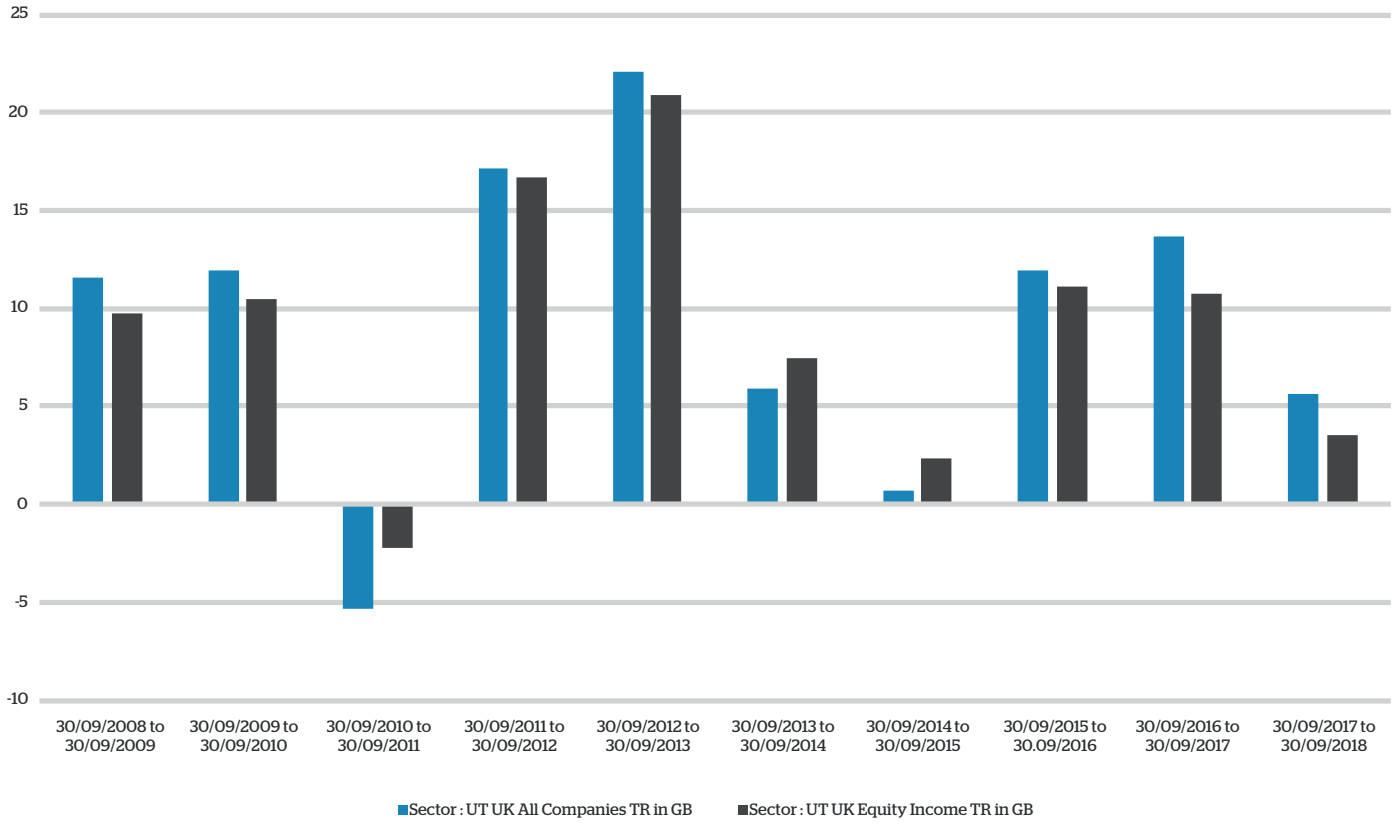
Typically, we would expect dividends from a company to increase over time, reflecting both inflation risk, and the fact that earnings would also be expected to increase over time. Capital gains on the other hand will be more volatile, on account of equity market movements.

One final point is that some companies, particularly in the US, will look (because of relatively different tax rates) to produce capital gains by buying back shares from investors, rather than providing income in the form of dividends. In this scenario, when a company has performed particularly well and has a significant amount of spare cash sitting on its balance sheet, it may decide to go out into the market and buy back its shares from existing investors. Rather than distributing this additional cash to investors as income in the form of dividends, they will return the money to investors by buying back their shares. And the effect is similar to that of paying a dividend.

Equity income and volatility

Looking at the previous decade of equity market returns (up to the end of September 2018), we can compare standard equity fund returns (by looking at the peer group returns, shown below), to the returns from funds focused on generating equity income. What we can see for the standard equity mandates (in blue), is that typically, in a year when equity markets are doing particularly well, they will tend to do better than equity income mandates. This is mainly due to the fact that standard equity funds are able to invest in slightly smaller companies which are typically growing their earnings but are not yet at the stage where they would pay a dividend, and so would be excluded from equity income funds. In a situation where we are in a 'bull market' (equities are performing well and equity sentiment is positive), typically smaller companies that are generating more earnings tend to do better than larger companies that are paying out dividends.

But if we look at 2010-2011, which was a negative year for stock markets, in this situation you would typically stand to lose more money in a standard equity mandate than you would from an equity income fund. Even if you are seeing capital losses, you would still receive that dividend stream which would support your total return (income plus capital gains), and mitigate the overall impact of the capital loss. Additionally, sectors such as utilities and healthcare as mentioned above, are more likely to pay dividends, and therefore feature in greater proportions in equity income funds. These sectors also tend to be 'defensive', meaning that they are less affected by broader market movements, and tend to perform better than 'cyclical' sectors such as financials, when equity markets hit a downturn. In a low-return environment, payment or regular dividends is also important in terms of supporting total returns.



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