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MARKET STRATEGY

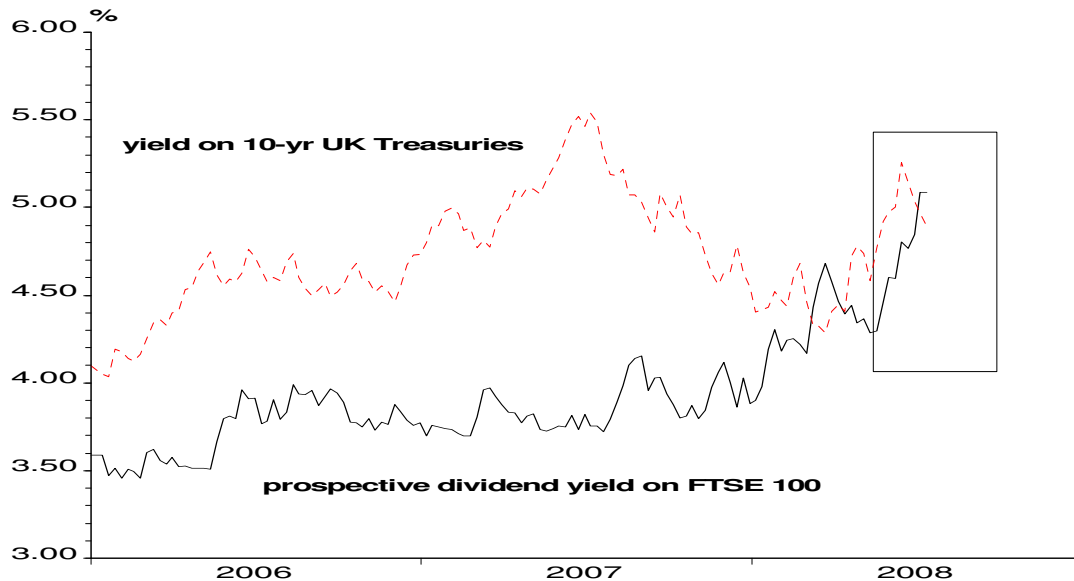
INVESTMENT RESEARCH

16 July 2008

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High yielders for value investors.



Source: DATASTREAM

It says a lot about the beast out there when equity markets can't find the wherewithal to sustain a rally from a technically oversold condition, particularly an extreme oversold condition, such as that for the UK equity market. We'll come back to that another time.

Part of the rationale for diversifying portfolios, not just through stock selection but through asset allocation, is to reduce the volatility of portfolio returns. As noted recently (*Revising down my year-end FTSE 100 forecast* 9 July 2008), stagflation has been a fertile backdrop for index-linked government stocks, which have proved to be a superb absolute return type vehicle. In a recessionary environment, where output contracts and disinflation prevails, conventional gilts are the more likely beneficiary.

The point is that, in regard to the appropriate balance in portfolios between cash, bonds, absolute return type vehicles and equities, government stocks provide a hedge against a painful and possibly prolonged recession and can help mitigate the volatility arising in portfolios from the exposure to equity markets.

That said, equity markets are discounting even more bad news than before. The forward p/e ratio for the FTSE 100 has dropped to around 9.5, which is what it was at the end of 1990, at the time of the last major recession in the UK. However, with corporate earnings heading downward and estimates being cut, there is distrust in the p/e ratios. Better then to trust the dividend yield. Dividends are vulnerable to cuts too but they are far less volatile than earnings.

For example, over the past 40 years, UK earnings growth averaged close to 11 percent - i.e., nominal earnings growth. As a measure of volatility, the standard deviation associated with that growth was 15.5. Dividend growth, on the other hand, averaged 8.5 percent. The standard deviation associated with this growth was 7.5. Having fluctuated less than earnings in the bad times as well as in the good times, dividend growth has been half as volatile as earnings growth. The dividend yield you see may not be quite the dividend yield you get but it is still likely to be a good guide to value.

As the chart shows, the prospective dividend yield for the FTSE 100 is over 5 percent. It is also higher now (for the second time this year) than the yield on 10-year conventional gilts, suggesting value is returning to the UK equity market.

The shares in the table are 'high yielders' for value investors. They are taken from our universe. Not only are their dividend yields above average but they are also the shares of companies for which the risk of a dividend cut is judged to be minimal. There are two points to note. First, there are no banks on this list, although Close Brothers is there as a financial services company. Second, a variety of sectors are represented, e.g., Food Producers, General Retailers, the Utilities, Travel & Leisure, Telecoms, Industrial Engineering and Oil & Gas.

Company Name	Sector	Dividend Yield		
		FY0	FY1	FY2
PREMIER FOODS	Food Producers	8.9	10.2	11.1
KESA ELECTRICALS	General Retailers	0.0	10.0	10.2
MARKS & SPENCER GROUP	General Retailers	9.9	9.3	9.3
CLOSE BROTHERS GROUP	Financial Services (Sector)	7.6	8.2	8.8
DRAX GROUP	Electricity	1.9	7.4	8.5
GREENE KING	Travel & Leisure	6.1	6.4	7.0
INCHCAPE	General Retailers	5.5	5.9	6.4
LAND SECURITIES GROUP	Real Estate Investment Trusts	5.5	5.8	6.0
CABLE & WIRELESS	Fixed Line Telecommunications	4.9	5.6	6.2
NATIONAL GRID	Gas, Water & Multiutilities	5.1	5.5	5.9
VODAFONE GROUP	Mobile Telecommunications	5.1	5.5	5.8
CARNIVAL	Travel & Leisure	4.8	5.5	6.0
SEVERN TRENT	Gas, Water & Multiutilities	5.2	5.4	5.7
IMI	Industrial Engineering	5.0	5.4	5.7
BP	Oil & Gas Producers	3.9	5.1	5.5

Note: The dividend yields in the table are based on consensus estimates for dividends

On average, the yield for this small sample of shares is 6.75 percent. This illustrates the kind of 'up front' return that is now available in the UK equity market and, in comparison to that available on cash and gilts, it's pretty good. Although the list reflects our conviction that the dividends will not be cut, there is always a risk attached to a share. Also, the growth of dividends itself remains at risk, but where there is no risk, there is not much prospect of return either!

While the dividend yield may offer a good guide to value, value is seldom a good guide to market timing. There may be better buying opportunities. But as we have said so often in the past, buying opportunities only look like buying opportunities well after the event. What matters is whether an investment in the UK equity market at dividend yields available today will prove rewarding eventually. We think it will but, as always, it's a judgement call. You pay your money and you take your choice. And time will tell.

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