The Hunt for Yield

The hunt is on to source high and more importantly sustainable income. Graham Spooner, Investment Adviser leads the way.

Investors with savings do not need reminding that interest rates are as close to zero as they have ever been. That steady income from savings accounts and cash ISAs has all but disappeared. With the equity market close to a 6 year low and with equity yields at historically high levels compared with Gilts, the temptation is there for investors to switch into shares; not only in the hunt for income but also factoring in that one day the equity market will recover. It is at this point that alarm bells should start to ring, with the peal of risk, risk, risk. Moving out of a cash based product into shares always increases the risk and in the present economic climate the risk is that much higher.

However, lovers of statistics can also reflect on the fact that since 1900, high yielding shares have outperformed the stock market as a whole, 85% of the time over 10 year periods. They've also outperformed the market since 1 September 2008 when the markets really went into freefall.

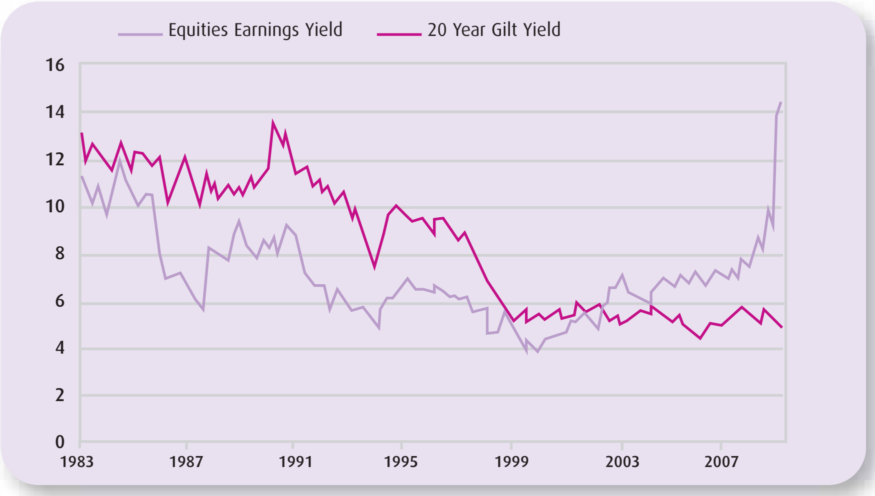
As an example of the relationship between risk and yield let's compare two well known blue chips with apparent dividend attractions: BP and BT.

At the time of writing the current yield on BT is 20%. Sounds good but remember the old adage "if it looks too good to be true, it probably is". Every analyst in the City expects BT to cut its dividend next time round. Investors should be cautious of above average share yields: the market is telling you 'the higher the yield the higher the risk'.

BP has a yield of 7%. Recently, there has been speculation that the low oil price may force the company to cut the dividend. This rumour has proved unfounded, as the management have announced that the dividend will be maintained for this year and that the company will try to maintain it into 2010, even if the oil price stays at current levels. So here we have some medium term visibility and potential for capital growth if, as we believe, the oil price rises over the medium term.

When considering an investment for yield note the dividend cover; this is how many times the profits cover the dividend and is an indicator of whether a company can pay future dividends. It is calculated by dividing the net earnings per share by the net dividend per share. For example, if a company has earnings per share of 5p and it pays out a dividend of 2.5p, the dividend cover will be 5/2.5 = 2. The higher the cover, the better the chance of maintaining the dividend if profits fall. However; a lower figure may be acceptable if the group's profits are relatively stable.

Shares to consider are: BP, BAT, Glaxo, Imperial Tobacco, National Grid, Scottish & Southern, Shell, Vodafone.



Source: Capital Economics

At the time of writing we are approaching the end of one of the main reporting periods for company results. There were fears that there would be a stampede of companies cutting the dividend in order to preserve cash and reduce debt. Whilst there have been cuts they have not been as widespread as feared, although for some favoured sectors such as banking there have been aggressive reductions and the threat of more dividend cuts remains high. Consider also that if a dividend is cut, the shares may also fall in price.

Income seekers could consider the small number of Preference Shares available but this market has been in decline over the last 20 years and liquidity in some is limited. However; they do pay a fixed rate of interest.

UK Corporate Bonds are yielding above 5% and the excess yield available on Corporate Bonds over government Bonds (the spread) is at unprecedented levels. This suggests that the market is pricing in the potential for significant levels of default. Yes, companies are going through hard times, as the recession gains momentum, but are there really going to be defaults in the numbers indicated?

Due to technical and fundamental reasons, such as forced selling by banks and hedge funds, supply has at times exceeded demand driving down prices on Bonds.

As with equities, look for strong balance sheets and good visibility on earnings. Consider investment grade names like Tesco, Vodafone and National Grid.

Income funds also provide diversification and income generation and there is a large and growing choice. In the enclosed issue of The Fundholder we focus on two of our favourites.

Lower risk investors have always used the Gilt market for predictable income; but as the chart shows government Bond yields have fallen significantly, with 20 year Gilts now only yielding around 4%.

At a glance

Equity yields are historically high compared to Gilts.

Be cautious: the higher the yield, the higher the risk.

Consider the dividend cover before investing for yield.

Find out more

For more information on yields please contact our Advice team on 01296 41 43 45.

Here to help you...

Shortly after leaving school, Gemma embarked on a 3 year Modern Apprenticeship with the AFA Group (Quantity Surveyors) which led to an NVQ Level 2 and 3 in Business Administration. There, she worked her way up from Clerical Assistant to Administration Manager before leaving the job she loved to accompany her husband in his career placements. Further administrative roles followed, based wherever her husband's career took them before they settled locally five years ago.

Now keen to build a long-term career, Gemma joined The Share Centre Customer Service team in 2004. She provided administrative and telephone support to our customers in addition to providing training and support to new members of staff. Eager to expand both her knowledge and her qualifications, Gemma transferred to the Dealing team in 2006 as a Dealing Assistant where her duties included processing dealing instructions from all sources, reconciliations, customer liaison and assisting the Equity Trading team in busy periods. She has now successfully completed all three levels of the Investment Administration Qualification plus the Unit 2 Securities Certificate through the Securities and Investment Institute.

In early 2008 Gemma was promoted to Senior Dealing Assistant and in August 2008 promoted again to Dealing Team Leader: quite an achievement that recognises the contribution Gemma makes to the Dealing Team. In her current role, Gemma leads an effective and compliant order-taking team who are there to ensure your orders are dealt quickly and efficiently and who look after those orders for shares or funds that can't be dealt online. On your request they also provide the latest prices, change price limits or check on the latest position with any outstanding certificate sales or limit orders.

Gemma is actively involved in her local community. She is a Member of the Royal British Legion and plays darts for the Ladies Team. She was also a member of The Share Centre team that took part in the '24 peaks in 24 hours' challenge in the Lake District that raised £11,000 for charity in 2007.

Gemma and other members of the Dealing team can be contacted on 01296 41 42 43.

Gemma Gardner

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