Trade Booster

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Three-thinking ETPs

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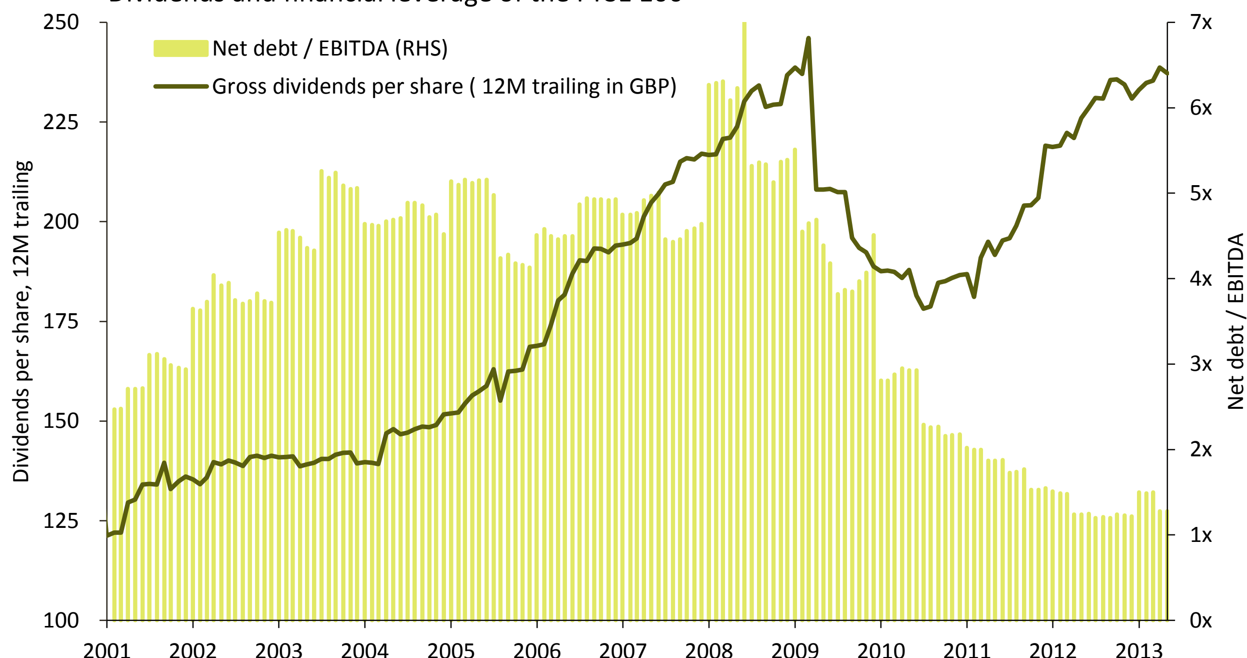
Sustainable dividends should lure investors into UK stocks

Summary

- **The restructured UK corporate sector is helping the FTSE 100 regain appeal from investors seeking income yield**
- **Balance sheet deleveraging and cost reductions have put dividend growth on a sustainable longer term footing and should help preserve UK equity market's competitive edge**
- **Investors seeking a leveraged exposure in high income yielding stocks may consider the Boost FTSE 100 3x Leverage Daily ETP (3UKL)**



Source: Boost ETP Research, Bloomberg. Data as at 30 April 2013

The UK equity market is regaining appeal to investors. Driving this is the continued demand for high yield asset classes in an environment where bond yields are at record low levels. Against slowing growth expectations, the relative high dividend yields of UK equities offer investors a viable alternative to cyclical equity markets in the US and continental Europe. Investors seeking a leveraged exposure in high income yielding stocks may consider the Boost FTSE 100 3x Leverage Daily ETP (3UKL).

Last year, the UK equity market significantly underperformed against Germany, and so far this year, also against the US. In 2012, the 15% rise by the FTSE 100 was low in comparison to the 31% rally of the DAX 30. As of 30 April 2013, the FTSE 100 rally YTD had fallen 7% short of the S&P 500, which had risen 13%.

This underperformance is in part due to the growth and cyclical nature of the S&P 500 and DAX 30. Their industry make-up and export exposure require higher reinvestment rates of retained earnings. As this is driving corporate growth, US and German stocks returns become more capital gains led rather than

income led. For the UK however, the key driver to equity returns has always been the relative high and stable streams of dividend income which have contributed the most to UK equity markets' total return performance. Since 1990, reinvested dividend income contributed 68% to the total return performance of the FTSE 100. This is in contrast to the US, where dividends only contributed 45% to the total return on the S&P 500 over the same period. When the equities cycle is entering a slowdown phase, dividends generally become the sole driver of returns when reinvested. Alternatively they become an attractive source of income when the equities cycle enters a downturn.

As economies around the world are slowing down, investors are likely to find higher yielding asset classes more attractive. Within fixed income, the search looks exhausted given the extent of the rallies on high-yield and EM bonds, which have suppressed bond yields. On a risk adjusted basis, investors are growing concerned about the prospective returns that fixed income can provide investors, even amidst a subdued inflation outlook.

As a result, dividend-driven equity markets may now look comparatively more appealing than many bond markets. The differential between developed market equity yields and sovereign bond yields is high and in positive territory, suggesting that the bond market looks increasingly overbought relative to equities.

The relative high dividends UK companies are paying should attract investor interest in UK equities. For example, since 1994, the FTSE 100 has on average offered investors a dividend yield 1.2% higher than the S&P 500. Moreover, the current 3.7% dividend yield is higher than the yield on Gilts.

Aside from the attractive yield proposition the UK equity market has to offer, the significant restructuring of UK companies since the aftermath of the 2008 credit crisis has provided another confidence boost for investors. Following significant balance sheet deleveraging, the ability to sustain high and competitive dividends looks better than at any time since the last decade. In terms of deleveraging, the gradual reduction of debt since 2008 has reduced the net debt to EBITDA ratio from 6x to close to 1x today. On top of this, the restructuring drive has resulted in significant headcount reductions. Despite facing continued difficulty, the UK banking sector stands out as having achieved the most on both fronts. The difficulties include tighter capital requirements, increased regulation and on-going litigation charges. In spite of these, HSBC and Barclays both increased their dividend per share last year by 5% and 8%, respectively.

Restructuring is also happening in the heavy weights outside of the banking sector. BP, currently the 3rd largest stock in the FTSE 100 and traditionally a large dividend contributor, has undergone huge asset sales to pay for the Gulf of Mexico oil disaster. In 2009, the year before the disaster, BP's weighting in the FTSE 100 was around 9% and paid more than GBP 10bn in cash dividends, a whopping 12% share of all cash dividends in the FTSE 100. Like the banks, it too has resumed paying higher dividends to shareholders and currently offers a dividend yield in excess of 5%.

With corporate balance sheets on the mend, investors' confidence in UK equities to pay competitive dividends on a sustained basis has gradually been restored. In a slowing growth environment, the FTSE should become more attractive versus other lower yielding equity markets.

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