

Paying dividends pays dividends

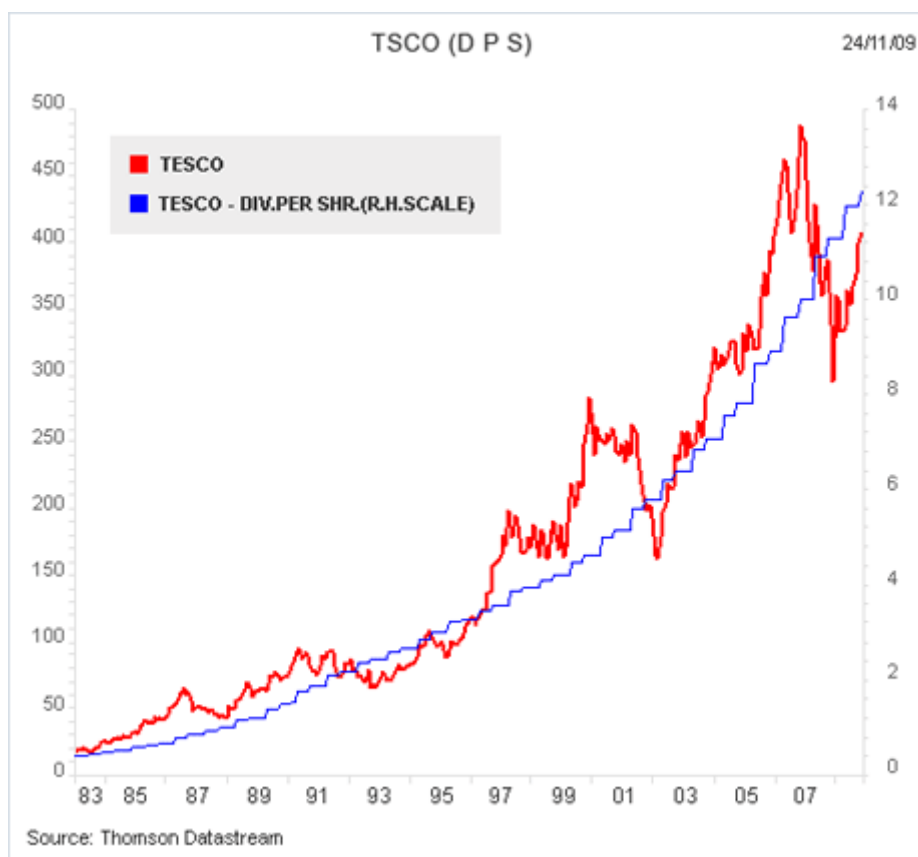
By Tom Stevenson, 25 November 2009

Dividend payers have been left behind in the 2009 rally but their time could have come.

If you thought a company's dividend-paying ability had nothing to do with its share price performance, the chart below of Tesco over the past 25 years might change your mind. Tesco has not failed to raise its dividend payout in any year over that period and it is one of only a handful of companies in the UK in this enviable position. It is a policy that has paid off handsomely for loyal investors.



"A dividend paid out to investors represents money that cannot be reinvested in the business." Tom Stevenson



Tesco is not a particularly high-yielding stock but this kind of relentless yearly growth means that a long-term investor has been rewarded not only with excellent capital growth over the period but with an income that has

risen steadily too. It goes to show that there is more to income investing than just buying the biggest yield – the ability of a company to keep increasing the payout matters too.

Dividends are very important for investors because over time the compounded growth of income can represent a very significant part of the total return from an equity investment. Rising dividend streams are also a very good indicator that a company is husbanding its cash resources with care. A dividend paid out to investors represents money that cannot be reinvested in the business. This means that development projects are competing for what cash is left over after dividends so only the best ideas will win funding. It's a good discipline for managers in other words.

The past year or so has been difficult for income investors because the rally that began in March has tended to favour cyclical stocks such as consumer discretionary companies and financials. This year especially these have often not been dividend payers so investors for whom income is a key attraction have tended to ignore these shooting stars.

Falling profits have also resulted in many companies reducing their dividend payouts during the economic downturn. This has taken away the main prop for their share prices and investors have been hit by both falling capital values and less income. Dividend income for the European market as a whole has fallen by 29% since October 2008.

The good news is that there is some evidence that this process is finally coming to an end. According to Nomura, more European companies have raised their dividends by more than 2% over the past month than have cut them. This is the first month this has been true since the market troughed in March.

Another reason for investors to look at dividend paying stocks is that dividend yields in some sectors still look relatively attractive despite an overall fall in the market's dividend yield as prices have rallied. Perhaps unsurprisingly, given the leadership of cyclicals during the rally, the most attractive dividend yields are to be found in more defensive sectors.

According to JP Morgan Securities, utility companies are yielding on average 6.1% which compares with a yield of just 4.0% on the corporate debt of the very same companies. The 2.1% premium for the shares versus the bonds is the opposite of the long-term relationship between the two – utility company bonds usually yield around 1% more than their shares.

There is a similar story with telecoms, energy, chemicals and real estate companies, suggesting that all of these sectors have lagged the upturn and could be relatively attractive if the rally runs out of steam. At the other end of the scale, auto manufacturers, building materials companies and technology stocks are yielding much less than their bonds suggesting the shares are less well protected by their income.

Picking single income stocks can be difficult and time-consuming because a high yield on its own is not necessarily a reason to buy a share. Indeed the high yield itself might be an indication that the market believes the dividend is going to be cut. Making money out of income investing is as much about avoiding dividend cutters as it is finding dividend growers and, for that reason, a diversified income fund is the safer bet for most investors.

If you are lucky, some of the shares in your fund will emulate Tesco and still be raising their dividends in 25 years time.

Note the value of an investment and the income from it can go down as well as up, so you may get less than you invested. The ideas and conclusions in this column are the author's own and do not necessarily reflect the views of Fidelity's portfolio managers. They are for general interest only and should not be taken as investment advice or as an invitation to purchase or sell any specific security. Past performance is not a guide to what may happen in the future. Investments in small and emerging markets can be more volatile than more established markets. For funds that invest in overseas markets, changes in currency exchange rates may affect the value of your investment.