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HIGH DIVIDEND YIELDING STOCKS

HIGH RETURNS FOR FIRM BELIEVERS

A 'rollercoaster' time, maybe, but faith in high dividend yielding stocks remains strong since 2003

The year 2003 was a turbulent one for investors in European equities. The Iraq war, and concerns about geopolitical risks, weighed heavily on the markets in the first few months of the year. Between the beginning of 2003 and 12 March, the MSCI Europe index lost nearly 20 per cent of its value. It then proceeded to recoup most of those losses in the following two months, and ended the year up nearly 16 per cent. A bit of a roller-coaster ride!

As was the case with 2001 and 2002, the divergence in performance between the best and worst performing stocks was large. However, in 2003 it was the high beta end of the market that performed the best.

Has the way the market performed in 2003 made us question our belief in high dividend yielding stocks? The answer to that question remains "no". The reasons for this answer are as follows. First, investing in high dividend yielding stocks is a strategy that can deliver results over the long term; we will produce evidence to support that. Second, we believe that intelligent stock picking of high dividend yielding stocks is key to superior performance. Simply selecting stocks on the basis of an apparently high dividend yield will not necessarily produce superior investment performance.

'Simply selecting stocks on the basis of an apparently high dividend yield will not necessarily produce superior investment performance'
Tom Mann, CSAM

LONG TERM

Selecting high dividend yielding stocks is a strategy that has worked over the long term.

As can be seen from Chart 1, a high dividend yield strategy has quite clearly outperformed since 1992. What is interesting to note is that this period included the Internet bubble of the late 1990s, where low-yielding stocks outperformed their higher yielding counterparts. In spite of this, the high dividend yield strategy has outperformed over the long term.

We have also obtained some interesting evidence from the US market concerning the importance of dividend yield over the long term. A recent study examined the returns of US equities from 1802 to 2002. This found that of the total annualised return of 7.9 per cent over this period, 5 per cent came from dividends and a further 0.9 per cent came from real growth in those dividends. The remainder came from inflation, and falling yields and rising valuation levels, a surprisingly small amount.[1]

Using dividend yield as a screening tool has not just worked well at a total market level. It has also proved effective as a screening tool at the sector level.

Although Chart 2 seems complicated at first glance, the message it contains remains simple: picking stocks using dividend yield as a screen has generally worked well at the sector level. For example, if you had bought the top 20 per cent dividend yielding stocks in the energy sector, you would have outperformed the bottom 20 per cent dividend yielding stocks by an annualised average of 16 per cent. Similarly, using dividend yield in the consumer staples sector also would have brought success.

SELECTIONS

If, however, you had used dividend yield as your screening tool in the telecommunications sector, you would have underperformed. This brings us on to a very important point to note in high dividend yield investing:

just using dividend yield to select stocks may not necessarily lead to outperformance.

If investors had bought telecommunications stocks on the basis of dividend yield, without looking at the industry fundamentals and the subsequent impact that these had on valuation, they would most likely have underperformed.

Over the last 10 years, the telecommunications industry has seen many changes in its fundamentals.

DEBT BURDEN

Towards the end of the 1990s, the story in the industry was about growth, and the potential growth that "third generation" (3G) services would give. Telecommunications companies spent billions of euros acquiring licences to offer 3G services and, in doing so, built up enormous amounts of debt. In some cases, this debt burden was too large for companies to handle. Financial markets became increasingly concerned about the levels of debt in the industry, and these telecoms companies subsequently underperformed the market.

Consequently, attention turned to repairing balance sheets through raising fresh capital. A number of these recapitalised companies then became some of the market's best performers.

The key point to note is that, in this instance, focusing purely on dividend yield at the expense of analysing companies and their valuation would have been a sub-optimal strategy.

At Credit Suisse Asset Management (CSAM), we use a combination of dividend yield and valuation to build our European high dividend yield portfolio. We ask each of our analysts to produce a long-term dividend discount model for all of the stocks that they cover in their sector. This gives us insight into what we believe is the intrinsic value of each company.

In addition, through the process of building the model, the analyst must explicitly forecast dividend payments from companies. This enables us to identify companies that may be at risk of cutting their dividends – which normally leads to the stock underperforming when the market realises that a dividend cut is imminent, or when an unexpected cut is announced.

It also enables us to identify companies that may be able to grow their dividend from current levels, while still maintaining sufficient investment to achieve long term growth in their core business.

VALUATION

The typical stock we would like to buy for our portfolio therefore exhibits a high dividend yield *and* attractive

1

Historical outperformance of stocks with an income bias

Source: Smith Barney; to 31 March 2004 *(The DJ Stoxx index contains 600 of the largest large-cap European stocks)*

ANNUALISED AVERAGE PERFORMANCE SPREAD
BETWEEN HIGH (TOP 20%) AND LOW (BOTTOM 20%) FACTOR PORTFOLIOS: 1 JAN 95 – 31 MAR 04 2

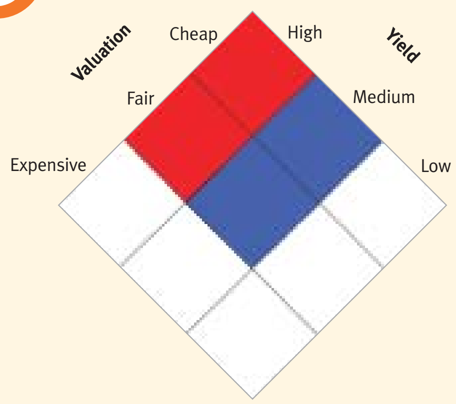
Factors	Energy	Materials	Consumer staples	Financials	Telecoms	MSCI Europe
Dividend Yield	15.3%	14.2%	20.5%	20.1%	–7.3%	14.8%
Earnings Yield – 12 months forward	1.9%	12.5%	8.1%	22.6%	–11.4%	11.9%
PEG Ratio	5.4%	6.4%	–1.4%	–10.8%	–15.3%	–3.6%

Source: Smith Barney (extracted from "What Works in Equity Markets – 6 April 2004")

‘If investors had bought telecommunications stocks on the basis of dividend yield, without looking at the industry fundamentals and the subsequent impact that these had on valuation, they would most likely have underperformed’

3

The CSAM Diamond



valuation, with the added proviso that the dividend is safe (a company with the potential to increase dividends is even more attractive).

This approach, shown in Chart 3, uses a concept we call the CSAM Diamond.

Key benefits

European high dividend yield strategies win in three main ways:

- **Providing an equity vehicle that aims to offer investors an attractive dividend yield, together with the potential to benefit from the capital appreciation of stock markets.**
- **Building an actively managed, diversified portfolio that looks to deliver value through superior stock selection.**
- **Leveraging the research insights provided by in-house research analysts.**

The target market

The investment strategy of a well designed European equity income fund is likely to prove attractive to a diverse range of investors. Such products offer investors the opportunity to obtain:

- **High levels of dividend income from companies paying sustainable dividend yields.**
- **Potential upside from a stock market investment.**
- **European blue chip equity exposure.**

‘We ask each of our analysts to produce a long-term dividend discount model for all of the stocks that they cover in their sector’

The chart shows that effectively we are looking at stocks in two dimensions – valuation and dividend yield. Our portfolio will typically hold the vast majority of stocks in the shaded squares, ie stocks with cheap to fair valuation, and medium to high dividend yield.

We maintain our belief that high dividend yield investing is a compelling investment strategy for the long term. However, we urge investors to look at fundamentals and valuation in their investment decision. We do not believe that use of a single narrow focus when investing in high dividend yielding stocks will necessarily lead to outperformance.

Tom Mann, portfolio manager, European equities, Credit Suisse Asset Management

Notes:

[1] *Financial Analysts Journal*, Vol 59 No 2 March/April 2003, p 4. Data covering 1802 to 2002, based on Schwert (1990) data for 1801 – 1870, a blend of Schwert and Siegel (2002) data for 1871 – 1925, and S&P 500 Index data since 1926. Schwert, G. William. 1990: “Indexes of United States Stock Prices from 1802 to 1987”, *Journal of Business*, Vol 63 No 3, July, pp 399-426. Siegel, Jeremy J. 2002: *Stocks for the Long Run*, 3rd ed. New York: Mcgraw Hill.

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