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SOLUTIONS FOR EUROPEAN DISTRIBUTORS

INVESTING FOR INCOME

EQUITIES OFFERING A YIELD INCENTIVE

A number of European listed companies offer dividend yields above those of 10-year government bonds, alongside potential for capital growth

Investors have continued to face a challenging investment environment in 2003, although this has been tempered to some extent by the second quarter rally where stock markets have risen from some very depressed levels. The question is whether the earlier-than-expected resolution to the Iraq war and better-than-expected Q2 earnings from US companies are sufficient to maintain this momentum.

Our view is that we are not yet out of the woods, with economic conditions continuing to be weak and company statements somewhat muted on the outlook for the remainder of 2003. This, coupled with three years of negative equity returns between 2000 and 2002, still leaves investors with reasonable cause for continued caution.

COST CUTTING

Of equal significance is the much-changed economic environment we are now living in, compared to the 1980s and early to mid 1990s. During this period, high inflation enabled companies to generate robust top-line sales growth through ever-increasing price rises. This, in turn, boosted earnings growth to above-average levels and, ultimately, drove share prices higher.

These factors played a central role in shaping investor expectations that stock markets could generate double-digit returns indefinitely, interrupted by short, sharp bear markets.

With inflation in the major economies now firmly under control, pricing power is far less effective as a strategy for improving sales and earnings. So far this year, much of the improvement in companies' earnings has come from cost cutting, rather than top-line growth.

EQUITY REWARDS

While a recovery in capital spending is likely to drive a top-line recovery in the medium-to-longer term, given the extent of monetary easing in the US, we do not believe such a recovery is imminent in Europe.

Given this new investment climate, at Credit Suisse Asset Management (CSAM), we expect annual returns from equities to be more modest, and in the region of 7–8 per cent over the next five to 10 years.

Also, the general market consensus that interest rates in the major economies are likely to remain at relatively low levels for the foreseeable future means that yields available from core fixed income and money market asset classes are not particularly attractive.

'The general consensus that interest rates in the major economies are likely to remain at relatively low levels means that yields available from core fixed income and money market asset classes are not particularly attractive'
Tom Mann, CSAM

At first glance, it would appear that investors have

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little room for manoeuvre in the current climate of modest stock market returns, and relatively low fixed-income or cash yields.

A more detailed investigation, however, reveals that there are some attractive strategies, which may prove rewarding for investors contemplating an equity market investment.

DIVIDENDS

For investors seeking products that have the potential to out-perform in the current environment, one such equity investment strategy is available.

This focuses on companies that generate high dividend yields that are now favourably comparable to yields available from fixed-income and cash products, as well as offering investors the potential capital growth of a stock market investment. There are currently a number of European companies where the dividend yield is close to or above the yield on 10-year government bonds.

The average dividend yield for European equities is approximately 3.03 per cent, against a yield of 4.05 per cent on 10-year German government bonds, according to CSAM’s research.

With the equity yield differential compared to that of bonds now attractive, this provides for a compelling investment case.

10-YEAR ANALYSIS

An analysis of historical returns over the last 10 years demonstrates that by focusing on equities with an income bias, attractive levels of total returns have been generated for significant periods of time. (See Chart 1.)

Over the last 10 years, high-yielding stocks have, on the whole, out-performed the wider European stock market and despite there being periods of under-performance, these have generally been for short periods of time. (See Chart 2.)

An equity investment strategy has the following features:

- it seeks to take advantage of the more modest returns expected from stock markets by generating a high level of income;
- it offers the potential for capital gains, and
- it provides investors with an attractive product proposition.

Key benefits

A high yield equity strategy provides the following advantages:

- **offers a compelling investment strategy in a world of more modest equity market returns;**
- **provides a European equity product that aims to offer investors an attractive dividend yield, together with the potential to benefit from the capital appreciation of stock markets;**
- **builds a well-diversified portfolio by focusing on companies whose profitability is not solely dependent on prevailing economic conditions.**

1

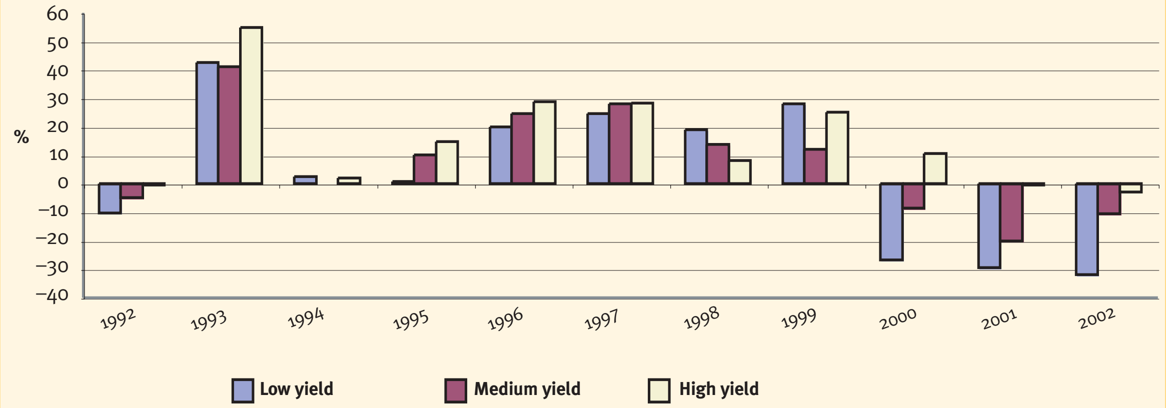
An analysis of historical returns shows out-performance of stocks with an income bias

* To July 31, 2003 – the DJ Stoxx index contains 600 of the biggest large-cap European stocks

Source: Citigroup

2

Annual total returns of high, medium and low-yielding stocks



Source: Citigroup; CSAM

High-yielding stocks have out-performed over most economic periods

IMPLEMENTATION

In order to implement such a strategy successfully, a portfolio management team must focus on identifying opportunities to invest in companies that are able to manage their businesses effectively and profitably, throughout different market cycles.

These are essentially organisations that possess healthy balance sheets; enjoy strong cash flow generation; pay sustainable dividends and are attractively valued.

Any given stocks, which no longer meet these criteria, must be replaced in the portfolio.

The team should assess the sustainability of a stock’s dividend yield in order to establish the robustness of a company’s cash-flow generation.

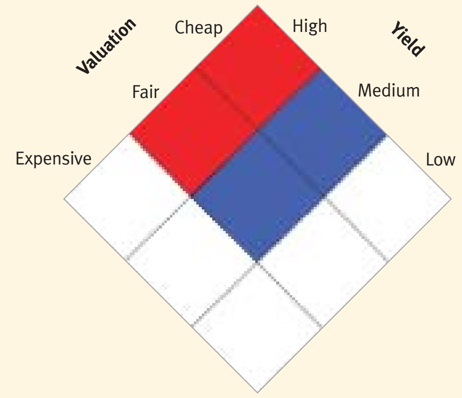
The analysts can then rank the companies by attractiveness within each sector as offering ‘cheap’, ‘fair’ or ‘expensive’ value, and finally divide the universe of stocks into high, medium and low yield segments. (See Chart 3.)

This income filter can be used to overlay the investment process for investing in European equities, where portfolio managers adopt a bottom-up approach to stock selection, driven by the fundamental research generated by in-house research analysts.

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

3

Credit Suisse Asset Management’s European Equity Income product selects stocks that have an above average yield and are attractively valued



Using the ‘diamond’ approach, portfolio managers can identify those stocks that are attractively ranked and rated.