Viewpoint

threadneedle investments

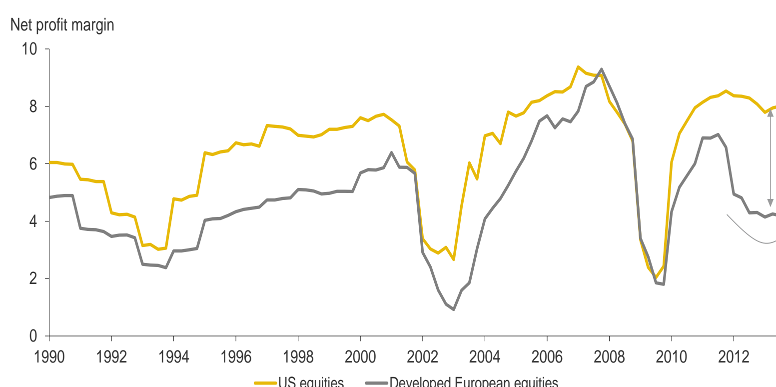
European Equities – January 2014

Nick Davis
Fund manager

Encouraging outlook for European dividends

Challenges remain as Europe strives to resolves its issues, but we are encouraged by the developments that have taken place over the past 18 months. There is more to be done and the European Central Bank (ECB) must remain vigilant over the threat posed by deflation. That said, there are good reasons for optimism. Purchasing Managers' Indices have recovered, current accounts have re-balanced, some progress has been made towards banking union and company managements believe the nadir in Europe has been reached. Moreover, we are at an early point in the European profit cycle and the gap between US and European profit margins should start to narrow.

Figure 1: Profit margins in Europe have considerable scope for expansion



Source: Barclays Research, Datastream

Corporate balance sheets are also strong in historical terms. We do not expect a wholesale re-risking of balance sheets (i.e. companies taking on more debt), but as confidence improves, businesses may put any spare cash to use either through capital expenditure or M&A. More importantly, healthy balance sheets enable and encourage progressive dividend policies. In terms of our strategy, we will focus on picking companies that can make good decisions that achieve attractive returns for shareholders.

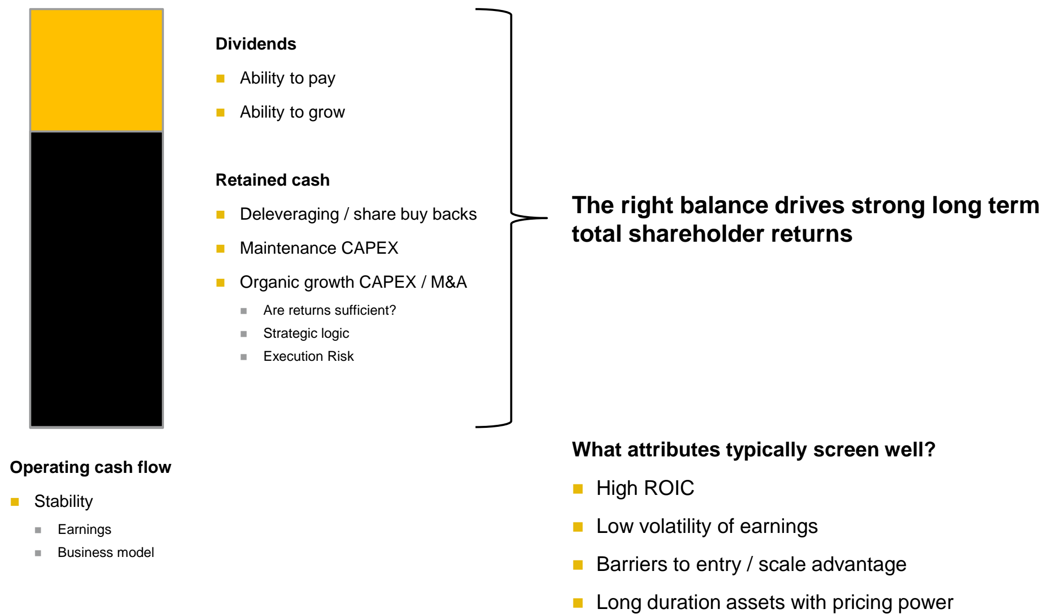
What happens if bond yields rise?

Some fear that higher-yield stocks will prove vulnerable to any rise in bond yields – even though the policy currently pursued by the ECB is a powerful reason why bond yields should not deteriorate in the foreseeable future. However, the question of what happens when bond yields rise is certainly a valid one, given that dividend yield relative to corporate bond yield is one of the arguments advanced as to why equities offer good value.

The answer, we believe, is that there will be a divergence in performance between those stocks with high but static dividend yields and those with reasonable dividend yields that can grow dividends over time. Our clients should benefit from our strategy of favouring companies with solid balance sheets, which should perform well (at the expense of weaker competitors) if the cost of servicing debt increases.

We are keen to avoid companies that allow abundant cheap capital to distort management decisions. Some acquisitions that were earnings-accretive in a low interest rate environment may appear much less astute when the cost of funding increases! As stewards of our clients' capital we have always believed it is vital to identify good managers and place faith in their decisions.

Figure 2: Understanding cash generation and how cash is deployed is the key to identifying good businesses



Source: Threadneedle, January 2014.

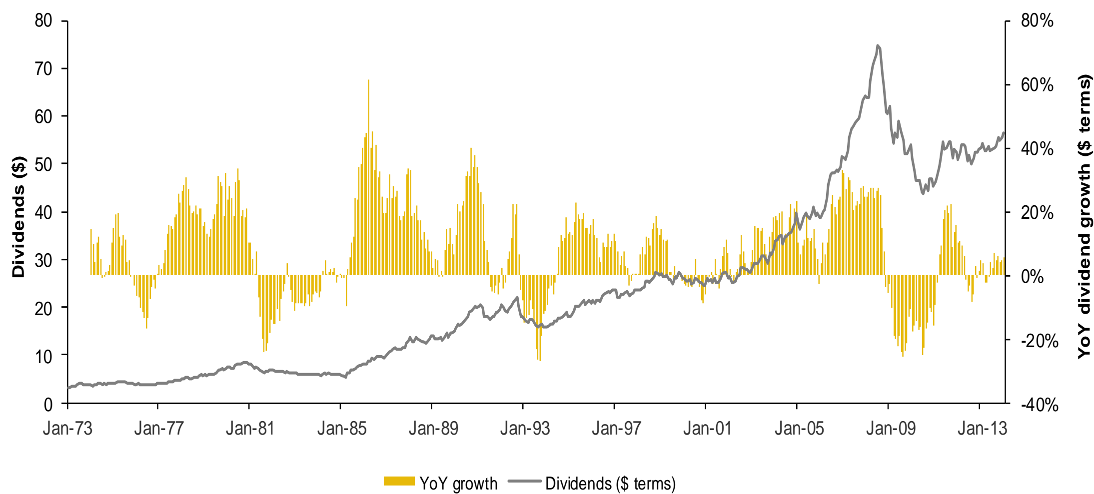
Buy-backs versus dividends

Equity income investors prefer sustainable dividend growth to share buy-backs, and certainly dividends offer certain advantages in terms of their predictability and repeatability, to all investors. Buy-backs can be more appropriate than dividends in terms of a one-off solution to an excess of capital. However, a progressive dividend policy encourages financial rectitude since it prompts management to target the long-term growth required to sustain such a policy. Buy-backs are easier to justify when valuations are low (e.g., where financial stocks are trading below book value). However, the logic becomes less persuasive as the valuation of the shares becomes more expensive. In the worst case, companies buy back shares when the share price is at its peak and then issue new capital at the bottom of the cycle. Unfortunately, company managers are not necessarily the best judges of when is the right time to buy their own shares!

What next for dividends?

After the nadir of 2008 and 2009, dividends have since been steadily recovering. We expect 2014 to see a further acceleration to 7% dividend growth, following 5% dividend growth in 2013. This expansion should be driven by improved earnings support from the macro environment and less of a drag from sectors that have consistently been cutting dividends during the crisis. To give this some historical context, over the last 40 years, Pan European dividends have grown 8% (CAGR) in dollar terms. With corporate balance sheets in good shape and improving macroeconomic confidence, we continue to see medium-term growth prospects for dividends as robust.

Figure 3: Dividend growth remains below its long-term average suggesting further scope for improvement



Source: ASR, December 2013

Conclusion

Income is important for not only is it a major component of total returns, but dividend policy is also a good indicator of the state of a business and the attitudes and intentions of management. As experienced equity income investors, we use our analysis of dividend streams as a means of accessing the high and growing levels of income emanating from European equities at a time when yields on other asset classes (for example, government bonds and cash) are low.

Important information: For use by investment professionals only (not to be passed on to any third party). Past performance is not a guide to future performance. The value of investments and any income is not guaranteed and can go down as well as up and may be affected by exchange rate fluctuations. This means that an investor may not get back the amount invested. The research and analysis included in this document has been produced by Threadneedle Investments for its own investment management activities, may have been acted upon prior to publication and is made available here incidentally. Any opinions expressed are made as at the date of publication but are subject to change without notice. Information obtained from external sources is believed to be reliable but its accuracy or completeness cannot be guaranteed. The mention of any specific shares or bonds should not be taken as a recommendation to deal. Issued by Threadneedle Asset Management Limited ("TAML"). Registered in England and Wales, No. 573204. Registered Office: 60 St Mary Axe, London EC3A 8JQ. Authorised and regulated in the UK by the Financial Conduct Authority. TAML has a cross-border licence from the Korean Financial Services Commission for Discretionary Investment Management Business. Issued in Australia by Threadneedle International Limited ("TINTL") (ARBN 133 982 055). To the extent that this document contains financial product advice, that advice is provided by TINTL. TINTL is exempt from the requirement to hold an Australian financial services licence under the Corporations Act in respect of the financial services it provides. TINTL is regulated by the Financial Conduct Authority under UK laws, which differ from Australian laws. Issued in Hong Kong by Threadneedle Portfolio Services Hong Kong Limited 天利投資管理香港有限公司 ("TPSHKL"). Registered Office: Unit 3004, Two Exchange Square, 8 Connaught Place Hong Kong. Registered in Hong Kong under the Companies Ordinance (Chapter 32), No. 1173058. Authorised and regulated in Hong Kong by the Securities and Futures Commission. Authorisation does not imply official approval or recommendation. The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this document you should obtain independent professional advice. This document is distributed by Threadneedle Portfolio Services Hong Kong Limited Dubai branch, which is regulated by the Dubai Financial Services Authority ("DFSA"). The information in this document is not intended as financial advice and is only intended for persons with appropriate investment knowledge and who meet the regulatory criteria to be classified as a Professional Client under the DFSA Rules. Issued in Singapore by Threadneedle Investments Singapore (Pte.) Limited, 3 Killiney Road, #07-07 Winsland House 1, Singapore 239519. License Number: CMS100182-1. This document is being issued in Singapore to and is directed only at persons who are either institutional investors or accredited investors (as defined in the Securities and Futures Act, Chapter 289 of Singapore) in Singapore. This document must not be relied or acted upon by any persons in Singapore other than an institutional or accredited investor. Issued in the US by Threadneedle International Limited ("TINTL"), a UK-based investment management firm that provides financial services to individual and institutional investors. TINTL is registered as an investment adviser with the U.S. Securities and Exchange Commission and is authorised and regulated in the conduct of its investment business in the UK by the UK Financial Conduct Authority.Threadneedle Investments is a brand name and both the Threadneedle Investments name and logo are trademarks or registered trademarks of the Threadneedle group of companies.
www.threadneedle.com