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Investors seek higher dividend pay-outs

By Alice Ross

As inflation hits new highs, UK shares with high dividend yields have become one of the few investments offering an income over and above the rise in consumer prices.

In August, the annual rise in the consumer prices index hit 4.5 per cent – which means that basic-rate taxpayers now have to earn 5.63 per cent on their capital to beat inflation, while higher-rate taxpayers need to make 7.51 per cent.

No conventional savings account can provide such returns but, with a number of UK stocks now yielding between 7 and 8 per cent, investors are showing increased interest in exchange traded funds and indices focused on dividend payments.

iShares says that its FTSE UK Dividend Plus exchange traded fund (ETF) is now one of its most popular products, attracting more than £420m. It tracks those shares in the FTSE All-Share index that have the highest one-year dividend forecasts, selecting the top 50 and weighting them by how large and liquid they are.

At the end of August, its top holdings were **Drax Group**, **Provident Financial**, **National Grid**, **Scottish and Southern Energy** and **GlaxoSmithKline**.

How profitable a high-yield strategy can be depends on market conditions. David Bower, head of UK sales at iShares, says good dividend payers tend do best when equity markets are stable. They also do well when bond yields are lower – as is the case at present – as more investors are prompted to buy higher yielding equities in search of income.

However, investing in companies purely based on their projected dividend pay-outs can be problematic. Analysts can get dividend forecasts wrong, and income stocks can be affected by unexpected events ways – as demonstrated by the failure of banks to pay dividends after the financial crisis of 2008, and the suspension of BP's dividend after last year's oil rig disaster.

Brian Dennehy of Dennehy Weller & Co points out that this is one of the drawbacks of using index tracking funds, such as ETFs. In 2008, the iShares fund was "chock a block full of banks", he points out – and fell in value by more than 60 per cent that year.

"People say buy an ETF, it's much cheaper, but you have to engage your brain," he cautions. "You might end up horribly overweight in one sector whereas if you'd thought about it, you might not have bought it."

A high dividend yield can also be a warning sign. As yields move inversely to prices, in some cases higher yields simply indicate that investors are selling a stock.

For example, the yield on the iShares fund stood at 5.54 per cent this week. On August 18, it was 5.36 per cent. There had been no rebalancing of the index – the rising yield was simply a function of the sell off in the markets.

Other indices track the best dividend payers in different ways. A new UK Dividend Achievers Index from Indxis looks at companies' historical dividends and ignores forecasts of future pay-outs. It will only select stocks that have increased their dividends for the past five years in a row.

"It provides companies that are very stable due to their nature with good cash reserves," says Alan Price, sales director at Indxis.

Dennehy says that this backwards-looking search for consistent dividends can help to identify those companies genuinely committed to paying out a regular income – as the past five years spans the Lehman Brothers crisis, when many companies stopped paying dividends altogether.

"It's people who can manage their businesses to ensure they can still increase their dividend through thick and thin: they're the ones investors should be interested in," he says.

This index was only created last year and is not yet tracked by a fund that private investors can buy into. But it can still be used to identify reliable income stocks. Top holdings currently include: **Vodafone**, yielding 5.6 per cent; **British American Tobacco**, 4.2 per cent; **BHP Billiton**, 4.8 per cent; **BG Group**, 1.1 per cent; and **AstraZeneca**, 5.5 per cent.

However, the index also contains stocks whose yields look more like warning signs than reasons to buy. One example is **Young & Co**, which is currently yielding more than 20 per cent.

Others yield between 7 and 8 per cent, which Dennehy believes look more realistic. These include **Numis Corp**, yielding 8 per cent; **RSA Insurance**, 7.8 per cent; **RM**, 7.7 per cent, **Amlin** and **Chesnara**, both 7.4 per cent; and **Halfords Group**, 7.2 per cent.

But Dennehy says investors should not necessarily seek out higher yielding stocks if they are looking for income over the longer term. He suggests an alternative strategy is to look for steady dividend payers that have lower starting yields, and the potential to increase their dividends over time – and recommends this approach to people in retirement needing to grow their income in line with inflation.

Some active fund managers instead buy into companies that have cut their dividends and seen their share prices fall – in the expectation that they will start paying again in the near future, and see their share prices rise sharply. Henderson's UK Equity Income fund takes this approach and currently yields 3.16 per cent.

However, Dennehy warns there are still risks attached to dividend pay-outs, with global economies looking increasingly shaky. "We can't expect dividends to keep increasing at the rate they've done in the past months," he says. "If we can identify those companies with an ethos to keep it going, that would be good."