

An x y and zee Equity Income Update

Unsustainable Yields

We know that earnings downgrades (and subsequent share price declines) do help when predicting dividend cuts. In price performance terms, the clear winners during 2014 were the Health Care and Technology sectors but both pay very little in terms of dividend yield and the losers were the Oil & Gas and Mining sectors. For 2015, currency weakness (or strength in the case of the US Dollar) is likely to be a major factor to earnings. But sales growth in the US is currently forecast to be flat and earnings growth, which has been dramatically revised down, now stands at just 3%. With earnings momentum so weak and valuations so high, corporates may decide to keep a lid on dividend growth.

Unsustainable Yields: The Higher the Yield, the Greater the Risk

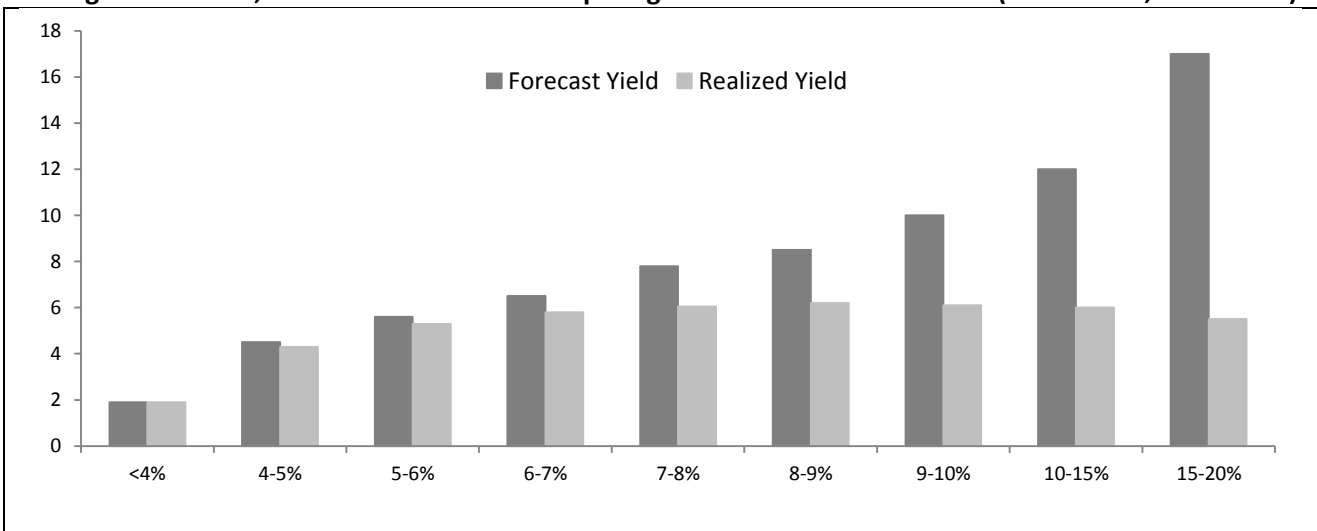
The year end results season has begun in earnest. Many US companies pre-announce quarterly dividends, with the generally accepted principle of a stable quarterly run rate usually with a small up-lift set at the same quarter each year but the results season in Europe and elsewhere is very different. Dividend announcements generally accompany earnings announcements or – for some companies in the Eurozone – are announced as late as the AGM. In many cases it means that consensus forecasts are generally lagging and when a big dividend surprise does occur, it very often comes as quite a shock.

Whilst dividends for the fourth quarter are very much “in-the-bag”, we believe that dividend surprises will occur as we go through 2015. Dividends in the Eurozone are also often ratio-based upon earnings and with a larger degree of management discretion, so this is where we believe the biggest risk lies. That said, the appreciation of the US Dollar will likely cause headaches for US corporates with international operations. Given the lagging nature of dividend payments, how can we predict dividend cuts?

We know that earnings downgrades (and subsequent share price declines) do help when predicting dividend cuts. In price performance terms, the clear winners during 2014 were the Health Care and Technology sectors but both pay very little in terms of dividend yield and the losers were the Oil & Gas and Mining sectors. For 2015, currency weakness (or strength in the case of the US Dollar) is likely to be a major factor to earnings. But sales growth in the US is currently forecast to be flat and earnings growth, which has been dramatically revised down, now stands at just 3%. With earnings momentum so weak and valuations so high, corporates may decide to keep a lid on dividend growth.

We also know that a higher prospective dividend yield isn't always a better dividend yield. Dividends are sometimes cut and dividend yields that look too good to be true usually are. The following chart compares realised dividend yields with forecast dividend yields, with a clear cut-off point at around 6%.

The Higher the Yield, the Greater the Risk: Comparing Forecast to Realised Yields (FTSE World, Since 1995)



Source: Factset, IBES

The market's obsession with EPS figures (particularly in the US), coupled with the fact that analysts are notoriously slow at updating dividend forecasts (which obviously feed into consensus numbers) means that dividend cuts usually come as a surprise. For example, Banco Santander has already announced that it intends to cut its annual dividend from EURO.6 to EURO.2, to be paid in three cash installments and one scrip dividend - equivalent to a 3% yield and not the 8.8% yield quoted - but the current consensus dividend forecast remains EURO.6.

When we simply take a look at those companies currently trading on a prospective yield in excess of 6%, it's easy to see where the risk lies: 18 of the 53 names are in the Energy sectors and 15 in Financials. Perhaps more interestingly, eight companies in the list are in the Consumer Discretionary sector.

Companies with a Dividend Yield Above 6%

Rank	Company	Sector	Country	Yield (%)	Div. Rank
1	Penn West Petroleum	Energy	Canada	28.11	794
2	Pacific Rubiales Energy	Energy	Canada	20.79	860
3	Seadrill	Energy	Norway	19.70	225
4	Canadian Oil Sands	Energy	Canada	18.16	385
5	Transocean (SWX)	Energy	Switzerland	16.79	242
6	Baytex Energy	Energy	Canada	14.18	558
7	American Capital Agency	Financials	US	12.09	246
8	Windstream Holdings	Telecoms	US	12.08	361
9	Bezeq, The Israeli Telecom Corp.	Telecoms	Israel	12.04	404
10	Repsol YPF	Energy	Spain	11.90	57
11	Annaly Capital Management	Financials	US	11.26	195
12	American Real. Cap. Props.	Financials	US	10.77	249
13	Diamond Offshore Dril.	Energy	US	10.77	440
14	EnSCO Class A	Energy	US	9.91	307
15	Hollyfrontier	Energy	US	9.88	337
16	Hutchison Whampoa	Industrials	Hong Kong	9.68	27
17	Enerplus	Energy	Canada	9.57	908
18	Crescent Point Energy	Energy	Canada	9.49	224
19	Woodside Petroleum	Energy	Australia	9.17	95
20	Iron Mountain	Financials	US	8.95	306
21	Metcash	Consumer Staples	Australia	8.90	1146
22	Noble Corporation	Energy	US	8.89	531
23	Banco Santander	Financials	Spain	8.84	8
24	WorleyParsons	Energy	Australia	8.69	966
25	SJM Holdings	Consumer Discretionary	Hong Kong	8.09	316
26	Li & Fung	Consumer Discretionary	Hong Kong	7.72	357
27	Swiss Re	Financials	Switzerland	7.57	70
28	Hutchison Port Hldg. Trust	Industrials	Singapore	7.45	456
29	Cheung Kong Holdings	Financials	Hong Kong	7.42	53
30	ENI	Energy	Italy	7.34	32
31	Suncorp Group	Financials	Australia	6.95	219
32	Gjensidige Forsikring	Financials	Norway	6.90	379
33	Admiral Group	Financials	UK	6.83	493
34	Harvey Norman Holdings	Consumer Discretionary	Australia	6.82	785
35	Direct Line Insurance Group	Financials	UK	6.70	451
36	Unipolsai	Financials	Italy	6.61	501
37	Meridian Energy	Utilities	New Zealand	6.52	1095
38	Transalta	Utilities	Canada	6.50	955
39	Centrica	Utilities	UK	6.45	163
40	Morrison (WM) Supermarkets	Consumer Staples	UK	6.38	473
41	RTL Group (XET)	Consumer Discretionary	Germany	6.34	247
42	New York Community Banc	Financials	US	6.25	474
43	Novion Property Group	Financials	Australia	6.25	580
44	Freeport-McMoran	Materials	US	6.25	166
45	MGM China Holdings	Consumer Discretionary	Hong Kong	6.16	401
46	ICL	Materials	Israel	6.15	375
47	Petrofac	Energy	UK	6.12	806
48	Nokian Renkaat	Consumer Discretionary	Finland	6.10	823
49	Sands China	Consumer Discretionary	Hong Kong	6.08	77
50	BP	Energy	UK	6.07	14
51	Wynn Macau	Consumer Discretionary	Hong Kong	6.05	267
52	Bank of Queensland	Financials	Australia	6.05	813
53	Ausnet Services	Utilities	Australia	6.04	769

Source: Thomson Reuters Datastream

Dividend Yields by Country

Whilst US companies account for just under 40% of all dividends paid globally, with an average yield of just 2% and regular quarterly distributions, US stocks are normally quite predictable and rather boring. It is in Europe where some yields look particularly stretched and where many companies may pay just one annual dividend, ratio-based on earnings, and also heavily dependent on management discretion.

Some yields in Australia also look stretched, particularly those heavily dependent on commodities-driven, Chinese-based demand. With a favourable dividend credit taxation system in Australia, and an institutional investment base that favours dividends in the UK, on a country-by-country basis, the higher dividend yielders historically have been in these countries. Most Spanish, Portuguese, Belgian, Greek, Brazilian and Chinese companies usually announce gross dividends (rather than net of withholding taxes, 21% in Spain, for example) so these yields are artificially high.

One of the arguments for investing globally is not so much about returns, but about diversifying dividend risk away from dividend “darlings” in one particular market. Dividend concentration risk is not only a problem in the UK, it’s even more acute in other major markets. For example, the top five dividend payers in Australia account for 52% of all dividends paid (four of them are Banks and one of them is a Miner!) It’s the same in Brazil (two Banks, two Energy stocks, one Miner), whilst in Europe it’s a bit more diversified but even more concentrated. This “dividend concentration risk” worries us a great deal.

Expected Dividends and Yields by Country

	<u>Free Float</u> <u>Mkt. Cap</u> <u>(US\$)</u>	<u>As a</u> <u>% of</u> <u>Total</u>	<u>Dividend</u> <u>Contribution</u> <u>(US\$bn)</u>	<u>Change</u> <u>(%)</u>	<u>By</u> <u>Country</u> <u>(%)</u>	<u>Dividend</u> <u>Yield</u> <u>(%)</u>
Australia	875,553	2.6%	43,123.9	5.4%	5.0%	4.9%
Brazil	254,820	0.8%	12,528.6	51.2%	1.5%	4.9%
Canada	1,076,625	3.3%	32,494.9	5.8%	3.8%	3.0%
China	531,570	1.6%	18,275.6	16.2%	2.1%	3.4%
France	991,593	3.0%	34,404.8	-0.9%	4.0%	3.5%
Germany	1,009,240	3.1%	30,518.6	15.4%	3.5%	3.0%
Hong Kong	609,803	1.8%	20,140.4	16.7%	2.3%	3.3%
Japan	2,760,652	8.3%	50,863.0	11.7%	5.9%	1.8%
Netherlands	378,888	1.1%	18,692.0	5.1%	2.2%	4.9%
Spain	406,528	1.2%	27,390.0	30.3%	3.2%	6.7%
Switzerland	1,157,925	3.5%	36,685.8	0.8%	4.2%	3.2%
Taiwan	446,902	1.4%	13,872.8	15.6%	1.6%	3.1%
United Kingdom	2,189,027	6.6%	80,802.4	1.8%	9.4%	3.7%
United States	16,771,882	50.7%	343,047.0	10.9%	39.7%	2.0%
Other Europe	1,490,564	4.5%	47,059.0	12.2%	5.4%	3.2%
Other World	2,126,909	6.4%	53,977.9	24.9%	6.2%	2.5%
FTSE World	33,078,481	100.0%	863,877	10.7%	100.0%	2.6%

Source: Thomson Reuters Datastream

Top Five Dividend Payers, Selected Countries

Company	Sector	Dividend Contribution (US\$bn)	Dividend Contribution as a % of Total (%)	Dividend Yield (%)
Comm. Bank of Aust.	Banks	5,367.9	12.6%	5.0%
Westpac	Banks	4,636.8	10.9%	5.7%
ANZ Banking Group	Banks	4,077.9	9.6%	5.9%
National Australia Bank	Banks	3,874.6	9.1%	6.1%
BHP Billiton Ltd	Mining	4,043.6	9.5%	5.4%
Top 5		22,000.8	51.7%	
Australia		42,557.1		
Total	Oil & Gas Producers	5,929.6	18.2%	5.5%
Sanofi-Aventis	Pharmaceuticals & Biotechnology	3,736.1	11.4%	3.5%
AXA	Nonlife Insurance	1,922.2	5.9%	4.4%
BNP Paribas	Banks	1,648.9	5.1%	3.1%
GDF Suez	Gas, Water & Multi-Utilities	1,601.2	4.9%	5.2%
Top 5		14,838.0	45.5%	
France		32,642.9		
Allianz	Nonlife Insurance	3,587.4	12.4%	4.8%
Siemens	General Industrials	3,123.0	10.8%	3.4%
BASF	Chemicals	2,909.4	10.1%	3.7%
Daimler	Automobiles & Parts	2,580.5	9.0%	3.0%
Bayer	Chemicals	2,094.3	7.3%	1.8%
Top 5		14,294.6	49.6%	
Germany		28,826.6		
Telefonica	Fixed Line Telecommunications	3,280.0	12.3%	5.6%
BBVA	Banks	2,391.2	9.0%	4.4%
Repsol	Oil & Gas Producers	2,268.6	8.5%	12.3%
Iberdrola	Electricity	1,535.4	5.8%	4.4%
Inditex	General Retailers	608.3	2.3%	1.9%
Top 5 (Excluding Banco Santander)		10,083.6	37.9%	
Spain		26,589.4		
Nestle (R)	Food Producers	7,953.8	19.9%	3.3%
Novartis (R)	Pharmaceuticals & Biotechnology	6,413.3	16.1%	2.9%
Roche	Pharmaceuticals & Biotechnology	6,415.4	16.1%	3.3%
Zurich Fin Svs	Nonlife Insurance	2,879.0	7.2%	5.8%
Swiss Re	Nonlife Insurance	2,376.5	6.0%	7.7%
Top 5		26,037.9	65.3%	
Switzerland		39,884.1		
HSBC	Banks	9,725.7	12.1%	5.4%
BP	Oil & Gas Producers	7,203.8	9.0%	6.0%
GlaxoSmithKline	Pharmaceuticals & Biotechnology	5,853.9	7.3%	5.4%
BAT	Tobacco	4,093.5	5.1%	3.9%
AstraZeneca	Pharmaceuticals & Biotechnology	3,533.5	4.4%	4.0%
Top 5		30,410.4	37.9%	
UK		80,144.1		

Source: Thomson Reuters Datastream

The Most Important Dividend Payers in Europe

<u>Div. Rank</u>	<u>Company</u>	<u>Sector</u>	<u>Country</u>	<u>Mkt. Cap. Rank</u>	<u>Dividend Contribution (US\$bn)</u>	<u>Yield (%)</u>
3	HSBC	Banks	UK	19	9,725.7	5.7%
8	Bco. Santander	Banks	Spain	53	8,543.0	8.6%
11	BP	Oil & Gas Producers	UK	44	7,203.8	6.7%
12	Royal Dutch Shell (A)	Oil & Gas Producers	Netherlands	36	7,140.2	6.0%
13	Nestle (R)	Food Producers	Switzerland	8	7,119.6	3.2%
17	Novartis (R)	Pharmaceuticals & Biotechnology	Switzerland	10	6,091.9	2.9%
19	Total	Oil & Gas Producers	France	56	5,998.7	6.2%
21	GlaxoSmithKline	Pharmaceuticals & Biotechnology	UK	51	5,900.2	5.9%
22	Roche	Pharmaceuticals & Biotechnology	Switzerland	14	5,734.4	3.0%
28	Royal Dutch Shell (B)	Oil & Gas Producers	Netherlands	73	4,610.9	5.8%
33	BAT	Tobacco	UK	55	4,100.2	4.2%
37	Sanofi-Aventis	Pharmaceuticals & Biotechnology	France	50	3,956.4	3.9%
40	Allianz	Nonlife Insurance	Germany	85	3,798.9	5.2%
43	AstraZeneca	Pharmaceuticals & Biotechnology	UK	63	3,533.5	4.1%
45	Telefonica	Fixed Line Telecommunications	Spain	125	3,473.4	6.4%
46	Siemens	General Industrials	Germany	64	3,307.1	3.9%
47	ENI	Oil & Gas Producers	Italy	180	3,288.5	8.3%
52	BASF	Chemicals	Germany	83	3,080.9	4.2%
53	Vodafone	Mobile Telecommunications	UK	62	2,909.7	5.2%
56	Daimler	Automobiles & Parts	Germany	79	2,732.6	3.6%
57	BHP Billiton plc	Mining	UK	171	2,671.8	6.3%
58	Rio Tinto Plc	Mining	UK	118	2,632.5	4.7%
60	BBVA	Banks	Spain	123	2,539.5	4.7%
61	Zurich Fin Svs	Nonlife Insurance	Switzerland	157	2,507.0	5.6%
63	An-Busch InBev	Beverages	Belgium	65	2,476.6	2.9%
64	National Grid	Gas, Water & Multiutilities	UK	132	2,473.8	4.8%
67	Repsol	Oil & Gas Producers	Spain	445	2,376.7	13.3%
68	Swiss Re	Nonlife Insurance	Switzerland	277	2,256.8	8.1%

Source: Thomson Reuters Datastream

Dividend Yields by Sector

By sector, dividend contributions also look out of kilter. Whilst fourth quarter/second half/year end dividends are pretty much in the bag, Energy stocks may not be able to live up to expectations in 2015 and Financials, which are expected to contribute over 25% of all dividends paid globally, may also disappoint. We hope that the Technology sector raises dividend distributions to take up some of the slack!

Dividend Contribution by Sector, FTSE World

	<u>Free Float</u> <u>Market Cap</u>	<u>% of</u> <u>Total</u>	<u>Dividend</u> <u>Contribution</u>	<u>Change</u> <u>(%)</u>	<u>Div. as a %</u> <u>Of Total</u>	<u>Dividend</u> <u>Yield</u>
Aerospace & Defence	541,744	1.6%	11,869	51.7%	1.4%	2.19%
Alternative Energy	19,662	0.1%	208	220.7%	0.0%	1.06%
Automobiles & Parts	1,020,323	3.0%	24,058	19.9%	2.8%	2.36%
Banks	3,782,308	11.0%	130,660	16.6%	15.0%	3.45%
Beverages	741,061	2.2%	17,355	10.0%	2.0%	2.34%
Chemicals	1,024,032	3.0%	23,464	18.7%	2.7%	2.29%
Construction & Materials	399,699	1.2%	8,882	18.1%	1.0%	2.22%
Electricity	733,756	2.1%	29,952	22.1%	3.4%	4.08%
Electronic & Electrical Equipment	486,197	1.4%	8,447	14.3%	1.0%	1.74%
Financial Services	1,216,954	3.5%	23,255	32.0%	2.7%	1.91%
Fixed Line Telecommunications	677,259	2.0%	31,942	51.3%	3.7%	4.72%
Food & Drug Retailers	559,398	1.6%	9,414	-15.9%	1.1%	1.68%
Food Producers	777,768	2.3%	17,176	3.4%	2.0%	2.21%
Forestry & Paper	57,100	0.2%	1,484	8.0%	0.2%	2.60%
Gas, Water & Multi-Utilities	463,064	1.3%	17,399	-1.7%	2.0%	3.76%
General Industrials	906,913	2.6%	24,094	36.3%	2.8%	2.66%
General Retailers	1,303,478	3.8%	19,988	12.9%	2.3%	1.53%
Health Care Equipment & Services	925,299	2.7%	9,542	5.1%	1.1%	1.03%
Household Goods & Home Construction	515,954	1.5%	12,217	7.3%	1.4%	2.37%
Industrial Engineering	717,754	2.1%	15,164	14.3%	1.7%	2.11%
Industrial Metals & Mining	275,831	0.8%	7,474	1.7%	0.9%	2.71%
Industrial Transportation	629,234	1.8%	11,845	17.9%	1.4%	1.88%
Leisure Goods	287,890	0.8%	3,570	6.9%	0.4%	1.24%
Life Insurance	636,277	1.9%	15,748	21.2%	1.8%	2.48%
Media	964,671	2.8%	15,204	2.0%	1.7%	1.58%
Mining	441,003	1.3%	18,884	10.3%	2.2%	4.28%
Mobile Telecommunications	574,770	1.7%	18,313	3.8%	2.1%	3.19%
Nonlife Insurance	1,094,495	3.2%	25,507	6.4%	2.9%	2.33%
Oil & Gas Producers	2,173,522	6.3%	83,216	11.3%	9.6%	3.83%
Oil Equipment, Services & Distribution	393,447	1.1%	12,052	52.1%	1.4%	3.06%
Personal Goods	685,874	2.0%	14,659	10.1%	1.7%	2.14%
Pharmaceuticals & Biotechnology	2,877,270	8.4%	61,685	22.0%	7.1%	2.14%
Real Estate Investment & Services	296,701	0.9%	8,156	20.1%	0.9%	2.75%
Real Estate Investment Trusts	629,275	1.8%	21,458	16.2%	2.5%	3.41%
Software & Computer Services	1,451,162	4.2%	20,512	53.7%	2.4%	1.41%
Support Services	563,593	1.6%	12,886	8.4%	1.5%	2.29%
Technology Hardware & Equipment	2,201,312	6.4%	46,297	28.5%	5.3%	2.10%
Tobacco	497,761	1.5%	19,915	14.4%	2.3%	4.00%
Travel & Leisure	780,951	2.3%	14,965	52.2%	1.7%	1.92%
FTSE World	34,324,767	100.0%	868,918	17.8%	100.0%	2.53%

Source: Thomson Reuters Datastream

Dividend Yields – A Quick Screen

A quick screen comparing the dividend ranking of companies with their market capitalisation ranking highlights those that are “easily able to afford more” and those which are “in over their heads”. Whilst the ranking is in no way scientific, this very simple screening has served us very well in the past.

The Top 40 Most Important Dividend Payers Globally

<u>Div. Rank</u>	<u>Company</u>	<u>Sector</u>	<u>Country</u>	<u>Market Cap. Rank</u>	<u>Dividend Yr1E (US\$bn)</u>	<u>Yield Yr1E (%)</u>
1	Apple	Technology Hardware & Equipment	US	1	11,471.6	1.8%
2	Exxon Mobil	Oil & Gas Producers	US	2	11,433.2	3.0%
3	HSBC	Banks	UK	19	9,725.7	5.7%
4	AT&T	Fixed Line Telecommunications	US	17	9,668.1	5.5%
5	Microsoft	Software & Computer Services	US	3	8,995.6	2.7%
6	Verizon	Fixed Line Telecommunications	US	13	8,924.2	4.6%
7	General Electric	General Industrials	US	7	8,829.2	3.7%
8	Banco Santander	Banks	Spain	53	8,543.0	8.6%
9	Chevron	Oil & Gas Producers	US	11	7,958.7	3.9%
10	Johnson & Johnson	Pharmaceuticals & Biotechnology	US	4	7,579.7	2.7%
11	BP	Oil & Gas Producers	UK	44	7,203.8	6.7%
12	Royal Dutch Shell (A)	Oil & Gas Producers	Netherlands	36	7,140.2	6.0%
13	Nestle (R)	Food Producers	Switzerland	8	7,119.6	3.2%
14	Procter & Gamble	Household Goods & Home Construction	US	6	7,108.2	2.9%
15	Wells Fargo	Banks	US	5	7,047.5	2.6%
16	Pfizer	Pharmaceuticals & Biotechnology	US	12	6,552.7	3.3%
17	Novartis (R)	Pharmaceuticals & Biotechnology	Switzerland	10	6,091.9	2.9%
18	Philip Morris	Tobacco	US	34	6,061.1	4.8%
19	Total	Oil & Gas Producers	France	56	5,998.7	6.2%
20	JP Morgan Chase	Banks	US	9	5,942.8	2.7%
21	GlaxoSmithKline	Pharmaceuticals & Biotechnology	UK	51	5,900.2	5.9%
22	Roche	Pharmaceuticals & Biotechnology	Switzerland	14	5,734.4	3.0%
23	Comm. Bank of Aust.	Banks	Australia	40	5,496.6	4.9%
24	Coca Cola	Beverages	US	16	5,094.0	2.9%
25	Merck	Pharmaceuticals & Biotechnology	US	18	5,017.5	2.9%
26	Westpac	Banks	Australia	70	4,748.0	5.8%
27	Royal Dutch Shell (B)	Oil & Gas Producers	Netherlands	73	4,610.9	5.8%
28	Toyota	Automobiles & Parts	Japan	22	4,462.7	2.7%
29	Intel	Technology Hardware & Equipment	US	20	4,351.5	2.6%
30	IBM	Software & Computer Services	US	24	4,239.8	2.7%
31	ANZ Banking Group	Banks	Australia	86	4,175.7	5.9%
32	BAT	Tobacco	UK	55	4,100.2	4.2%
33	BHP Billiton Ltd	Mining	Australia	84	4,075.7	5.6%
34	National Aust. Bank	Banks	Australia	98	3,967.5	6.2%
35	Altria Group	Tobacco	US	54	3,966.9	4.1%
36	Sanofi-Aventis	Pharmaceuticals & Biotechnology	France	50	3,956.4	3.9%
37	Cisco	Technology Hardware & Equipment	US	31	3,915.0	2.8%
38	Pepsico	Beverages	US	29	3,812.2	2.7%
39	Allianz	Nonlife Insurance	Germany	85	3,798.9	5.2%
40	Royal Bank Of Canada	Banks	Canada	58	3,763.6	3.9%

Source: Thomson Reuters Datastream

As ever, I'd very much welcome any comments, suggestions or constructive criticisms regarding anything included in this note. If you would like any further explanation of commentary contained within this document or any additional data, please let me know. Lastly, if you would like to reproduce any part of this document, please contact me before doing so. Many thanks. Zee.

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