

ARTICLE FOR THE HERALD FUNDAMENTALS COLUMN

31 March 2009

Colin McLean, Managing Director, SVM Asset Management Ltd

Recent weeks have brought a welcome bounce in share prices, but it is still too soon to call the end of the bear market. With the immediate prospect of deflation, one worrying pattern seems set to continue; dividend cuts. By contrast, previous bear markets in the past half century saw income from shares little changed even as share prices fell. Shares still currently offer higher yields than bank deposits, but how safe are the dividends?

Already this year, the biggest dividend payer on the UK market, HSBC, has halved its dividend. This follows cancelled dividends from the banks that sought government help. March saw insurers join the list, with no 2009 dividend at Old Mutual and a halved final dividend at Legal & General. Some consumer businesses have also scrapped pay-outs. It seems that only more defensive sectors like pharmaceuticals, oil majors, tobaccos, utilities and food offer soundly based income. However, the economy is still too far away from a sustainable upturn to be sure about even those sectors.

There is a pattern to the dividend cuts. Companies with high bank debt have concluded that adding to borrowings by paying out cash makes no sense. It has taken the reality of recent discussions with bankers to drive this message home. But other types of negotiations could imperil dividends more widely. Even in supposedly defensive areas, some companies will need to address pensions deficits or seek help with contracts. A warning last month from the Pensions Regulator, that pensions must come before dividends, shocked many companies with pension funding deficits. Several long-privatised businesses, like BT, British Airways and BAe Systems are still labouring under the burden of retirement benefits for their formerly much larger workforces.

And, utilities and bus & rail operators could also find that discussions on easing the terms of their franchises might involve lower dividends. Very high current dividend yields seem to be pointing to this. Indeed, companies with dividend yields of 6% or more are being given little credit in their share prices for the payout. Low share prices relative to

the cash paid out by companies are a stockmarket signal to boards to be more prudent with cash. Institutional investors would rather suffer less immediate income if it saved the penalty of later refinancing in prudent companies with heavily discounted shares. Company boards do not want to end up controlled by banks.

Despite the recent pick-up in inflationary expectations, with higher commodity prices, the major economies still have a lot of spare capacity. This should contain inflationary pressures, and make it less likely that higher import prices will find a way onto the high street. Until companies feel confident that activity is picking up or prices can be passed on, dividends will remain under threat.

In deflationary times dividend yields were high as investors became more risk averse. In future, investors seeking income may make more use of corporate bonds, rather than relying on shares. However, shares have a role to play in providing income with growth prospects. Where dividends have been re-based to sustainable levels, investors should be encouraged. But the dividend yields that still look too good to be true, may prove to be just that.

SVM Asset Management Limited, its clients and/or employees may have an investment in any of the companies mentioned in this article.

This article is for informational purposes only, and to the extent that it is passed on, care must be taken to ensure that it is in a form which accurately presents the information presented here. The information and opinions presented in this article have been obtained from sources believed by SVM to be reliable, however, SVM makes no representation as to their accuracy or completeness and accept no liability for loss arising from the use of the material.

*Issued by SVM Asset Management Limited
which is authorised and regulated by the
Financial Services Authority.*

*SVM Asset Management Ltd, 7 Castle Street,
Edinburgh EH2 3AH Tel: 0131 226 6699*

