Dividend yields cast UK stocks in favourable light

Relative to government bonds, UK equity dividend yields are more generous than they've been for 60 years. That's something investors can't ignore, Brexit or no Brexit

The UK equity market can't seem to catch a break. Any good news is almost immediately swamped by the latest glum Brexit headlines.

Some market commentators have gone so far as to argue that toxic politics makes British equities "uninvestable". No wonder savers have pulled $1.01 trillion from UK equity funds since June 2016 when the British voted to leave the European Union*.

The latest gloom centres on whether Prime Minister Theresa May will ever manage to convince enough of her party to buy into the deal she's struck with Britain's EU partners to win a House of Commons vote. Or whether the country will face the prospect of a disorderly divorce on Brexit day at the end of next March.

In our view, investors with robust risk appetites might consider the market a buy whatever the outcome.

That contrarian take is supported by the handsome dividend yield British equities now offer, not just relative to government bonds and other developed stock markets, but relative to the market's own history.

Apart from a short period during the great financial crisis, the 4.1 per cent dividend yield currently offered by UK stocks is the highest it's been since the mid-1990s.

That also happens to be bang on its average since 1900, which includes the 1970s when dividend yields rocketed into the double digits with inflation.

Historic returns

Meanwhile, relative to yields on 10-year British government bonds, the dividend yield is close to as high as it has ever been. Indeed, that positive differential of 2.7 per cent is nearly 4 percentage points above its 118-year average.

So what's going on? To begin with, the big premium on equity over bond yields is bound to have more than a little to do with financial repression. Quantitative easing and regulatory demands that pension funds more closely match their liabilities with secure income flows have forced up the price of 'safe' government bonds – which is to say, driven down their yields. And with the 10-year gilt yielding 1.3 per cent when markets are also anticipating a 3 per cent inflation rate, this merely means investors in UK government bonds will grow steadily poorer.

But in the UK, this isn't just a fixed income story. British companies have always tended to have high dividend payout ratios. The latest data show that British firms are paying 60 per cent of earnings to investors as dividends, against 38 per cent and 42 per cent for German and American companies respectively.

That could be because, historically, the UK has had more favourable tax treatment of dividends, or because of large institutional demand for income versus capital appreciation, or because the composition of the UK market is tilted towards mature, defensive companies.

At the same time, Brexit has forced up the implied equity risk premium on the UK equity market to close to 10-year highs, in essence projecting a corporate earnings growth rate of just 0.8 per cent on average over the long term. That's well below the 6.1 per cent average annual growth firms actually managed over the past quarter century. In other words, the UK equity market looks exceptionally cheap to anyone expecting the equity risk premium to drop back towards more normal levels.

In a world where investors are routinely starved of income, a 4.1 per cent yield starts to look fetching – especially considering that companies tend to be loath to cut dividends and payouts rarely fall across whole markets. Investors – like us – agnostic as to the source of return, whether it comes from income or capital appreciation, should find the UK's dividend yield in an environment of weak economic growth attractive even if Brexit turns out to be of a harder variety than the one the government is aiming for.

Written by Andrew Cole, head of multi-asset, London, Pictet Asset Management

In association with

*Data from EPFR cited in the Financial Times. https://www.ft.com/content/bd81b917-658a-3b99-a810-7f1b343ecb1e
Data sources: Pictet Asset Management, Thomson Reuters Datastream, Barclays Equity-Gilt Study, November 2018.