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Elston Insights

16th February 2024

Dividends are key to UK equity returns

- Since 2008, dividends represent 42% of UK equity total returns
- Dividend oriented strategies help underpin returns
- Dividend Yield factor equities typically outperform in falling rate regime

Dividends are key to total returns. Factor-based research shows that yield-factor equities tend to outperform in a falling interest regime. As Central Bank policy pivots to a falling interest regime, a tilt to Yield factor within a UK equity allocation makes sense.

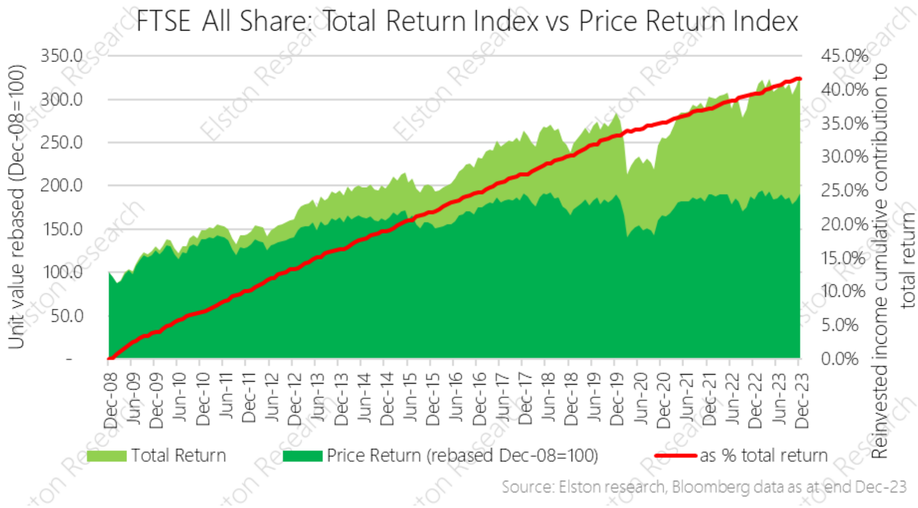
Dividends are key to total returns

Dividends are one of the key drivers of total returns in all equity markets. But this is particularly the case for the UK equity market, where other drivers – such as earnings growth and multiple expansion has been weaker relative to the US. That relative weakness is a broader topic, but its main reason is the lack of large-scale growth oriented (e.g. technology companies) domiciled and listed in the UK.

Whilst UK equity market returns since 2008 have been lagged the US, the picture would have been worse without the underpin of dividends.

Looking at the returns of the FTSE All-Share Index Total Returns (which includes reinvested dividends) and the FTSE All-Share Price Index (which assumes dividends are paid out and not reinvested), we can see that reinvested dividends represent 41.6% of cumulative total return of the UK equity market since 2008 (see Fig.1).

Fig.1. FTSE All Share: Total and Price Return and reinvested income contribution to returns



Dividend oriented strategies could help underpin returns

With such clear evidence that dividends are a major contributor to total returns, it follows that allocation to dividend-oriented strategies could help underpin expected returns for this asset class exposure.

But differentiation is required between UK equity income-oriented strategies.

Actively selected: the most traditional way of implementing a UK equity income strategy is to use an actively managed fund where income-oriented companies are held as holdings within an actively managed fund. The advantage of this approach is selection of an income-oriented strategy is delegated to an active manager. The disadvantage of this approach are that actively managed fund are typically higher cost than income-oriented index-tracking funds, raising the burden of proof under value-for-money considerations.

Systematically selected: systematic, or "rules-based", specialist indices embed an income-oriented approach within their index rules to select and size index holdings. For example:

- Yield-ranked: some UK equity indices (and the funds that track them) use a yield-ranked approach selecting the highest yielding companies in the market. Whilst this is certain to result in an index with the highest available yield, the high yield can be an indication of the poor prospects for that company and the price-return of those companies (and hence index may be lack-lustre). High yield is not high quality, and dividends may be unstable. Furthermore it is backward looking in nature.
- Backward-looking dividend-contribution-weighted: this index methodology looks at the largest recent contributors to overall dividends, and weights them accordingly. The advantage of this approach is that focuses on the sources of income by company, rather than companies' size by market capitalisation. The disadvantage of this approach is that dividend contributions can be concentrated, so weightings limits need apply. Also the

strategy is backward-looking: companies that were doing well in the past and paying good dividends, may not be able to do so in the future.

- Forward-looking dividend-contribution-weighted: this index methodology looks at the largest expected contributors to future dividends, based on regularly update consensus forecasts, and weights them accordingly. The advantage of this approach is that focuses on the sources of income by company, rather than companies' size by market capitalisation, and is also forward-looking in nature to capture earnings (and dividend) upgrades or downgrades. The disadvantage of this approach is that dividend contributions can be concentrated, so weightings limits need apply. Also actual and expected dividends may differ. This is the approach taken in our Elston Smart-Beta UK Dividend Index.

For more on other types of systematic UK Equity Income indices available, please refer to our article UK Equity Income Similar or Different to the FTSE 100? (January 2018).

Comparing methodologies

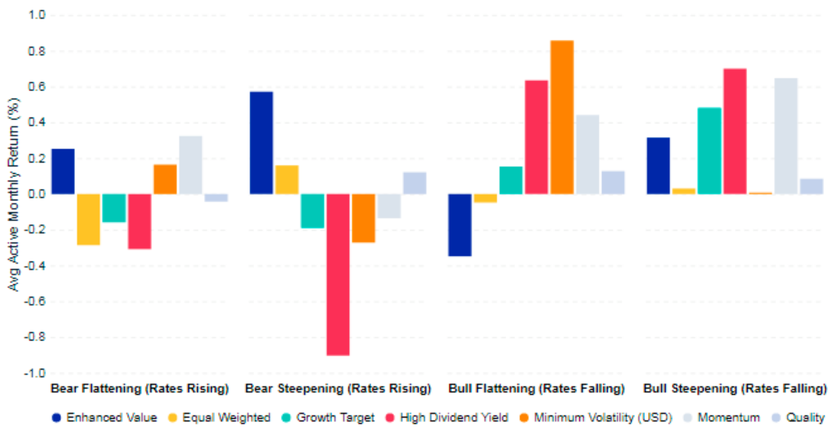
Traditional equity indices are market-capitalisation weighted. The resulting dividend income for an index is therefore a function of each company's size. The alternative approach outlined above is to weight the holding in each company by its contribution to overall dividends. This way the index is focused on the biggest dividend payers, rather than the biggest companies by size. This creates a direct bias towards yield, from a factor-exposure perspective, and concentration limits can be applied.

Active equity income managers typically look at forward-looking dividend estimates whereas many index-based "passive" equity income strategies often at historic dividend yield or contributions purposes. This is sub-optimal. We believe that index strategies that focus on equity income should use forward-looking estimates to systematically capture upswings in earnings and dividend estimates.

Yield factor equities typically outperform in falling rate regime

As interest rates start to fall, investors often seek out higher yielding investors to maintain returns. A study by MSCI shows that Yield factor investing has traditionally outperformed in a falling interest rate regime, based on historical data 1994-2021.

Fig.2. MSCI World Factor performance, by regime

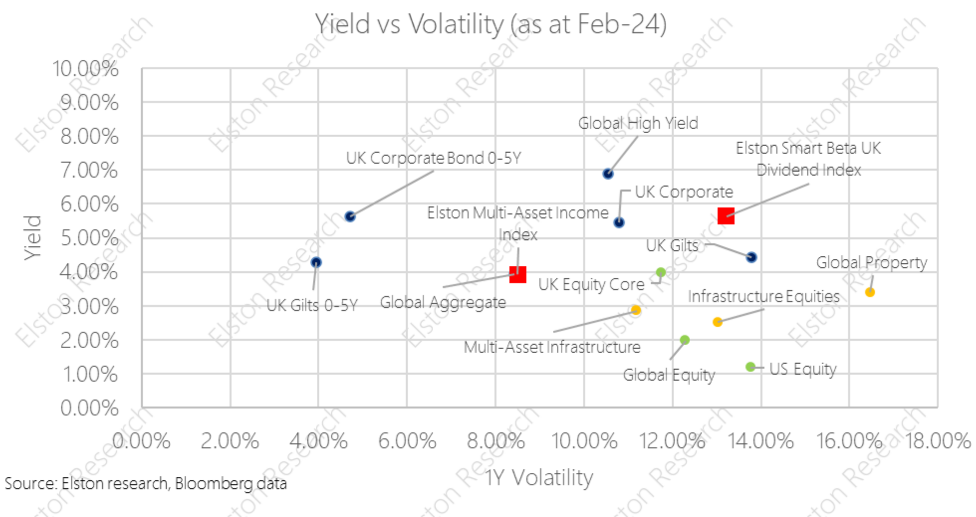


Source: MSCI Factors in Focus: Are Your Equity Styles Ahead of the Curve?, January 2022

Broadening the asset mix for diversified income

For investors concerned about taking about the volatility associated with an equity-only approach to income investing, a multi-asset income strategy could make sense. This enables investors receive income streams from diversified sources of income in addition to equity dividends, such as bond income and alternative income such as property and infrastructure. Sizing risk when combining these income-generative assets is key. The chart below shows the current yield vs volatility for each asset class exposure and for our Elston Multi-Asset Income Index and our Elston Smart-Beta UK Dividend Index.

Fig.3. Multi-asset Yield vs 1Y Volatility



Source: Elston research, Bloomberg data, as at February 2024

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Summary

For investors constructing a UK allocation, it's worth considering a balanced exposure between 1) low-cost core holdings, 2) dividend-focused yield-factor strategies to underpin returns and 3) opportunistic holdings in small- and mid- cap exposures for growth where there is higher potential for alpha. Meanwhile multi-asset income strategies offer more diversified income streams, as well as a balanced approach to risk.

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Our Research & CPD focuses on multi-asset strategies, index funds and ETFs.

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