UK EQUITIES

FRANKLIN TEMPLETON

MARTIN CURRIE

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FTSE 100: IT PAYS DIVIDENDS

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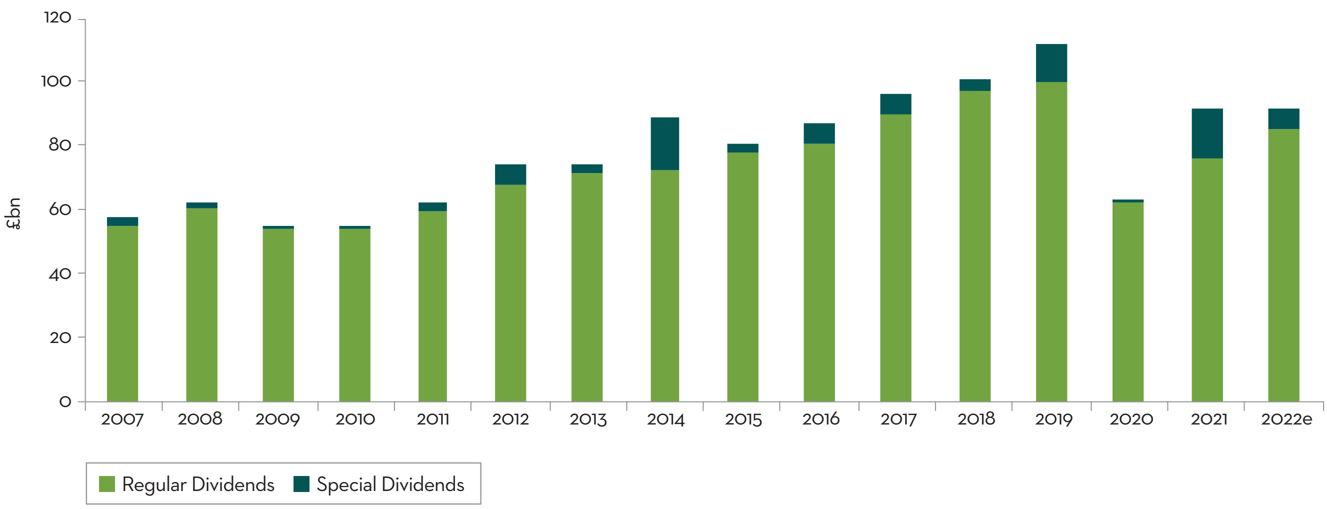
The opportunity for income across the UK is one of the most dynamic amid global markets. Remaining popular with investors not least due to the low level of returns available on traditional sources of income, equity income investing offers a unique opportunity to benefit from both a company's dividend yield as well as their long-term capital growth. With UK CPI currently overheating to levels not witnessed since 1982, investors are weighing up the opportunity cost of investing in equities for income whilst global interest rates remain on an upward trajectory looking to combat inflation.

In spite of this the UK still offers a generous dividend yield relative to the income on offer elsewhere across the globe. The 3.5% yield on the FTSE All Share exceeds the FTSE World yield of 2.25% and is well in excess of the existing Bank of England (BOE) base rate at 1%.[1] That being said, the world is still recovering from a COVID-19 dividend hangover as the UK continues its recovery toward pre-pandemic dividend levels. Whilst the short-term threat of further rate rises becomes an increasing reality, the importance of positioning an equity income portfolio towards those companies that can preserve and sustain their profits through diverse market environments cannot be understated.

UK Dividends (full year basis)



Source: Link Dividend Monitor, 31 March 2022.

Historically speaking, larger companies lag their smaller counterparts through an economic recovery as confidence begins to flourish from the depths of a recession. The COVID-19 pandemic sparked a brief recession and whilst we consequently saw a recovery in the markets and economy, the FTSE 250 started to underperform around summer last year as inflation and interest rate concerns started to take hold. The domestic and consumer focussed FTSE 250 has continued to lag the FTSE 100 as the humanitarian tragedies witnessed in Ukraine exacerbate squeezed consumer budgets amid surging fuel costs.

One rule that has stood the test of time is the lower dividend yield on offer as one descends the UK capitalisation spectrum. Investors rarely invest for large scale income in small and mid-cap indices and the reasons why become apparent when comparing the FTSE 250 forward dividend yield of 2.4% vs the FTSE 100 forward dividend yield of 3.8%.[2] Small and mid-cap companies are typically less mature businesses and consequently excess capital is far better served reinvested into the future growth of the business rather than returned to shareholders.

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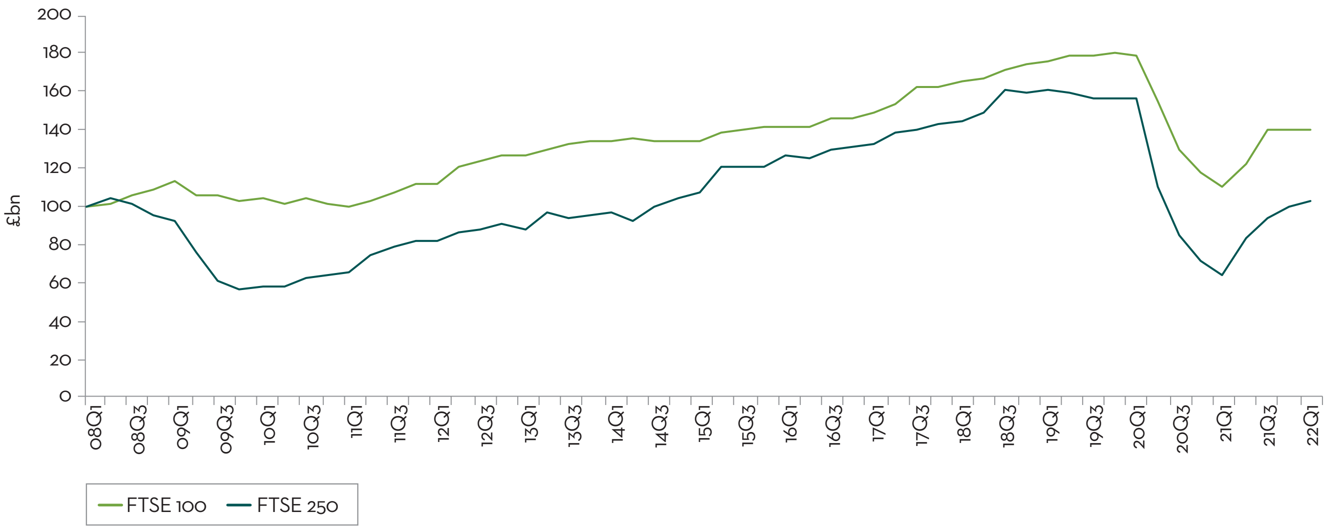
[1]Source: FTSE and Bank of England as at 30 April 2022.

[2]Source: Morningstar as at 30 April 2022.

The composition of the FTSE 250 relative to the FTSE 100 explains the disproportionate impact of dividend cuts throughout the COVID-19 pandemic. Emerging and disruptive industries typically pay a lower dividend than blue chip companies in mature sectors and we find that their earnings can be less consistent and much more volatile. In severe market downturns as witnessed in 2020 dividend cuts are usually far more amplified in these small and mid-sized companies. Whilst there has been a strong rebound since, FTSE 250 dividends remain nearly 1/6 beneath their pre-pandemic levels.[3]

A colossal 87% of all Q1 2022 UK equity market dividends were sourced from FTSE 100 companies where earnings are far less sensitive to consumer trends and offer superior diversification characteristics from a geographical perspective.[3] Here we encounter dominant sectors such as banks, insurers and resources all of which are generally better positioned to weather the inflationary storm and are natural hunting grounds for income investors. The UK has defended an extended period on the sidelines, but we continue to believe that the tide is turning and that the opportunity for income remains superior within the UK's largest companies.

FTSE 100 v FTSE 250 underlying dividends, indexed



Source: Link Dividend Monitor, 31 March 2022.

So far in 2022 the FTSE 100 appears to be one of the leading darlings of global investing. When you break the index down it is easy to see why: *70% of revenue generated overseas, during a period of US dollar strength relative to the pound,* over 35% exposure to "defensive" sectors, over 15% exposure to financials, the majority of which will benefit from rising interest rates and over 12.5% to oil-sensitive energy companies.[4]

With the price of oil oscillating at around $100 per barrel it comes as no surprise that oil companies were the largest contributor to Q1 2022 dividend growth in the UK, increasing dividend payouts 29% year-on-year.[3] This level of oil price provide the likes of BP and Shell much more headroom to continue to return cash to shareholders, as well as investing in their businesses and remaining key players in the energy transition story.

Elsewhere the largest absolute value of dividends in Q1 2022 came from the Healthcare and Pharmaceutical industry, paying out £3.2bn to shareholders.[3] Pharma stocks tend to exhibit recession-resistant tendencies as products and services remain in demand in good and bad times.

AstraZeneca was a significant contributor to this Healthcare and Pharmaceutical dividend, taking the opportunity to increase its dividend for the first time in a decade.

The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the securities discussed here were, or will prove to be, profitable.

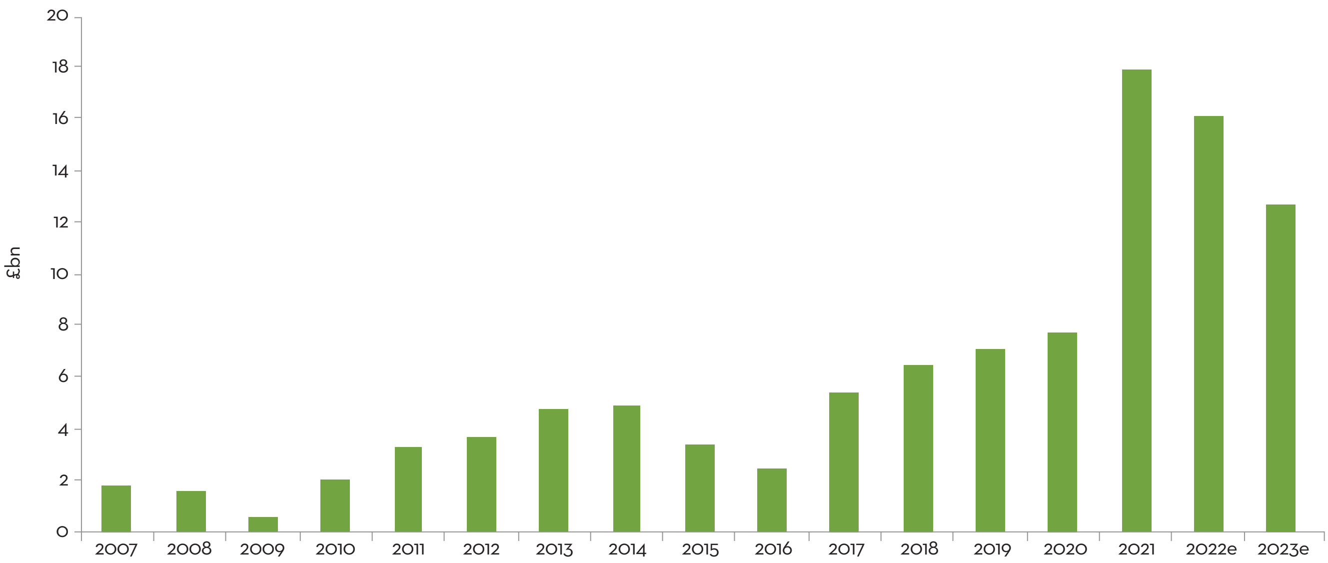
[3]Source: Link Dividend Monitor, 31 March 2022

[4]Source: Morningstar, 31 March 2022

Inflation remains a primary concern for investors in the UK where at time of writing CPI just hit 9%.[5] Assets that can protect against periods of higher inflation can sometimes be a valuable addition to a portfolio to hedge rising costs, such as real assets. Investors tend to seek out exposure to real assets in periods of high expected inflation and we have seen this theme play out so far in 2022 in the FTSE 100 where over 11% of the index is composed of mining stocks.

Miners have been reaping the benefits of strong commodity prices, increasing their dividend by over £10bn in 2021 and leveraging the opportunity to distribute special dividends to their shareholders. The industry's contribution to the FTSE100 looks likely to tail off, given the impact of BHP, Evraz and Polymetal all moving out of the index. However, Rio Tinto remains set to pay a dividend of over £7.4bn in 2022, which will make it the largest single dividend contributor within the FTSE 100.

Total FTSE 100 'miners' dividends



Source: Company accounts, Marketscreener, consensus analyst's forecasts, 31 March 2022. Excludes special dividends.

Dividends within the regular corporate calendar can be considered the most traditional means of returning capital to shareholders. However, share buybacks are becoming increasingly important. Buybacks can illustrate capital discipline and reflect the confidence management have in the valuation of the business. Both BP and Shell for instance have announced large buyback programmes.

The FTSE 100 looks set to complete £37bn of share buybacks in 2022, surpassing the prior record of £34.9bn in 2018. Aggregating the 3.8% FTSE 100 forward dividend yield and the expected 1.8% return from share buybacks, the forward cash yield on the FTSE 100 increases to 5.6%. Usually indicative of undervalued share prices, we believe that this enhanced buyback activity is further testament to the value still inherent in UK equities despite the strong relative returns earned so far in 2022.

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[5]Source: ONS, 18 May 2022.

Important information

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