Index insights:
Good yield hunting

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- Superficially at least, dividend payouts across the globe look robust. Companies are growing their payouts in most major markets, fuelled by rising earnings
- Scratch beneath the surface however and the picture is less clear cut. Dividend cover is stretched thin in some parts of the world, but opportunities are out there
- Possible changes in policy direction still present a challenge, so selectivity is vital

Why are dividends so important?

Reinvesting dividends has historically provided around 60% of an investor's overall real return. But there are also behavioural reasons why investors might seek to focus on dividends: If a company's management team is committed to paying a dividend, they tend to be more disciplined about how they spend their cash, and better at avoiding vanity acquisitions and value-destroying projects. Equally, the share prices of companies that pay dividends tend to be less volatile.

How does dividend coverage look today?

Well, such discipline isn't universal. When rates are low, as they are today, dividends are more prized by investors, prompting some companies to pay them regardless of their earnings. This can lead to a significant decline in dividend cover. We saw this earlier in the year in the UK, when coverage dropped to just 0.8x - the lowest level since 2009.

That may well have set alarm bells ringing for income investors, but the strengthening global economy, and the weaker pound, duly combined to push dividends to an all-time record in Q2 of over £33bn. Miners and banks were at the forefront. The FTSE 100 should now deliver a yield of around 4% in 2017, still well ahead of other UK asset classes.

What about earnings?

Company earnings continue to hold up well in Europe and the US. Natural resources companies have been able to rebuild their cash flow. With interest rates on the rise, financial sector profits could now recover.

In the US, Societe Generale economists expect one more hike this year (in December) but there may be more should inflation resume its rise. Up to now, central bank largesse has driven equity markets higher, so tighter financial conditions pose a threat. If bond yields rise and economic growth slows, there will be more downside risk in equities for the rest of the year. We'll be watching the Fed closely. Other central banks still have a way to go.

Is income expensive?

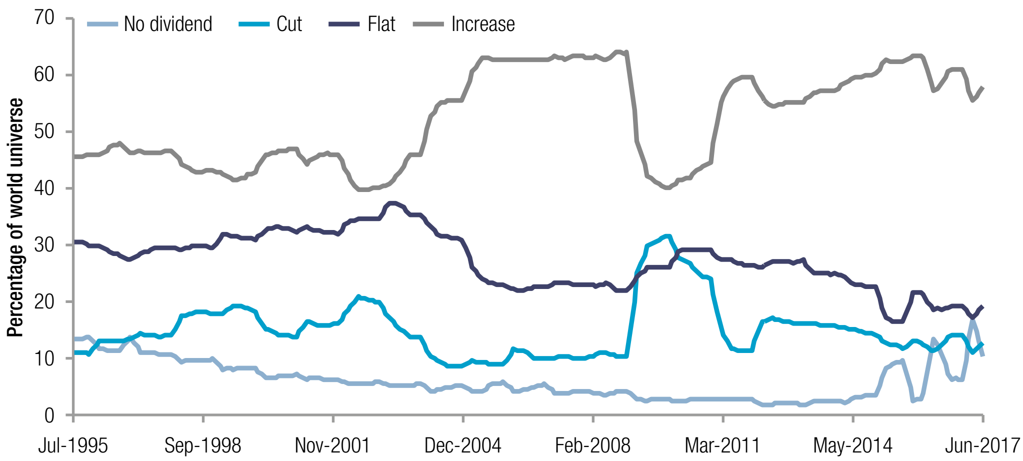
The price investors are paying for income is high by historic standards, partly because of that largesse. The dividend yield on the MSCI World is in fact the lowest in 10 years. The growth in global dividend payouts may look robust, but beneath the surface is a problem of peak dividend payouts and peak share prices. Overpaying for income is a real danger.

For the time being, investors are tolerating this because if bonds are yielding 0% or 1%, then a 2% yield from equities is acceptable. However, equities are a risky asset and need to offer higher expected returns to compensate for the greater risk of loss.

Are dividend cuts on the rise?

If payouts and share prices are at a peak, inevitably there is a greater risk of dividend cuts. After all, a high yield isn't always a good yield, and often signifies something else entirely.

Global dividend cuts, increases and non-payers



Source: SG Cross Asset Research/Equity Quant, MSCI, Factset.

There will be some companies where the dividend is high because there is an element of distress. We've no interest in these companies. Our focus is those less fashionable, more mature companies that can pay, and can keep paying, a high dividend. They still represent a solid, lower risk investment.

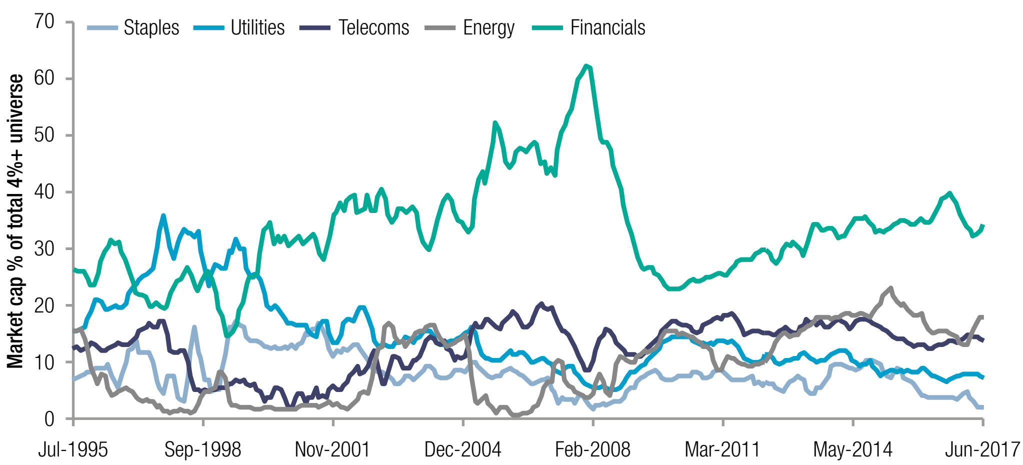
How do your indices work?

We use nine key tests to analyse balance sheet strength and cash flow in order to determine whether a business is of sufficiently high quality or not. From there, we look at whether we can buy them with a sufficiently high dividend yield.

Metrics like poor 12-month share price performance, high share price volatility, poor profitability and poor balance sheet strength all indicate a possible dividend cut. Any dividend payment is a discretionary decision taken by the management team according to what a company can afford. We can model this.

The type of business this leads us to will shift over time. Right now, it's difficult to pick up consumer staples businesses with a high enough yield. While we can buy GlaxoSmithKline, we cannot buy Coca-Cola. This means our global portfolio is currently weighted towards telecoms, utilities, industrials and pharmaceuticals. This tends to ebb and flow with the markets: As they get more expensive, the fund will naturally move towards more defensive and less popular areas. Then there is a rotation and this defensive bias helps protect performance.

Sectors: Defining the 4%+ yield universe



Source: SG Cross Asset Research/Equity Quant, MSCI, Factset.

What about miners?

We tend not to include mining or semi-conductor businesses because of their cyclicality. A utility company has monopolistic cash flows so investors have reasonable certainty on what those cash flows will be. As such, they are more willing to see more leverage on the balance sheet. Cash flows are a lot more variable for semi-conductor businesses, so a lot of debt becomes a much riskier proposition.

The methodology also excludes all financials. We know of no systematic way of understanding the leverage on a bank's balance sheet. The balance sheet determines the dividends, so we cannot invest. We do review this policy from time to time, but have yet to come across a methodology which compels us to change it.

Once in our portfolios, each stock is equally weighted. This means our indices will look very different from their market-weighted benchmarks.

What are your yield criteria?

Stocks need to pay a 4% dividend on the way in and 3.5% on the way out. This remains unchanged through the interest rate cycle. The only exception is for our Japanese index, which has a starting yield of around 2.5%.

Where are you looking for it?

In our global portfolio, we tend to have significant, enduring exposures to countries like Canada or Australia, where the dividend regimes are tax-friendly and well-established. We also favour countries where the right kinds of businesses have a firm foothold, such as the UK (pharmaceuticals) and Switzerland (consumer goods producers).

In the US, the S&P 500's yield habitually hovers around 2%. Finding a higher yield means narrowing your search. We can find plenty of high quality businesses, but their tendency to substitute dividend payments with share buybacks means our process cannot identify enough good companies with high enough dividend yields to justify a higher weighting in our global portfolio. Other strategies might do the job. For us, Europe and Asia with their higher propensity to pay dividends are better hunting grounds.

What's so appealing for Europe?

In a word, diversity. Around a third of the global 4% dividend yield universe can be found in Europe, and around 30% of European stocks come with a yield of 4% or more. The dividend pool is therefore less concentrated than in the UK; where just a few companies account for a great deal of the total dividend haul.

All European equity sectors currently offer a dividend yield in excess of the 10-yr bund. Six offer a yield greater than 4%, but our search currently focuses on traditional areas like utilities, telecoms and consumer services. All in all, the ground is fertile enough for our European portfolio to yield more than 4.5%.

Do benchmarks bother you?

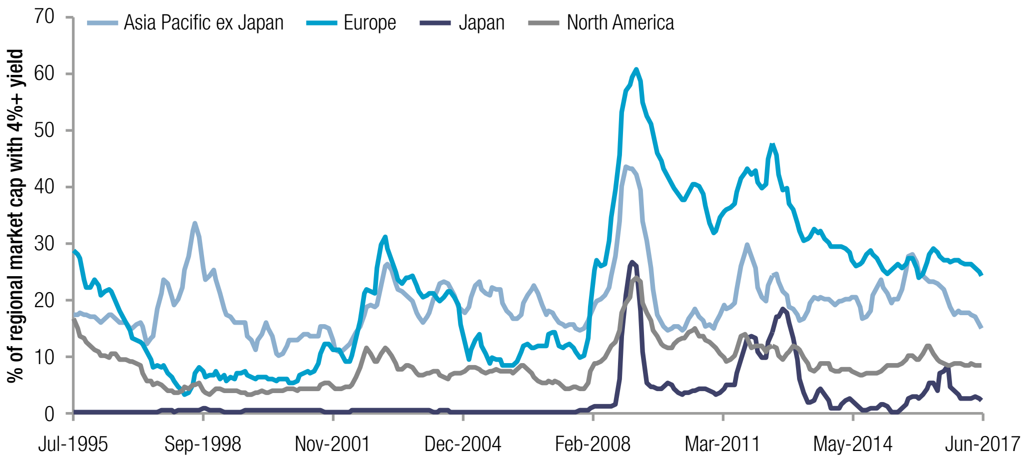
Put simply, no. Take Europe - our search for the companies most capable of keeping their dividend promises leads to significant country and sector overweights in our index relative to the MSCI Europe. Spain, Finland, Belgium and Austria are among our key mainland exposures, but the UK - one of Europe's highest-yielding major indices - is one of our most significant underweights because of the preponderance of miners and banks. Big-hitters like Germany and France are also under-represented.

What excites you right now?

Asia, undoubtedly. Companies across the region have steadily been increasing their dividends for some time. There is much more scope here for dividend growth than in the UK market for example. You also get more natural diversification – dividend payers come from across the industry spectrum, including technology.

Countries such as Japan have long been less fertile ground for dividend seekers, with yields low and valuations high. As corporate governance has improved, and the Japanese market has fallen, this has changed. The market now has the best dividend cover and payout ratio in the world. Companies carry net cash on their balance sheets. We're now much more interested in Japan, and are launching an ETF shortly. This takes the same methodology used for the global fund and applies it to the Japanese market.

Regions: Defining the 4%+ yield universe



Source: SG Cross Asset Research/Equity Quant, MSCI, Factset.

What's your take?

These are unusual times for income seekers and it pays to be discerning and to have conviction. Parts of the market may see dividend cuts: Isolating and avoiding those companies that look most vulnerable will be crucial to the delivery of long-term, sustainable returns.