Investing in shares for income

Investors scanning the markets for the best income generating opportunities tend to alight on bonds and equities. You can read about [investing in bonds] in our guide on that subject. In this guide, we'll be looking at what you need to consider when shopping for dividend paying shares.

Buying shares is not risk-free - nothing is - but pick the right companies and they can provide a steady stream of respectable income for years on end. There's also the additional prospect of capital growth thrown in.

In this guide we'll tell you where to find them - you may need to travel for the biggest returns - and what to look for - everything is not always what it seems. We point out the potential pitfalls, too, and tell you how to avoid them.

Surely, the highest yield is best?

There are some extremely high yielding stocks around, but don't be greedy. Headline-grabbing yields carry an obvious health warning and tend to scream "distress". Just a little digging normally uncovers a plunging share price, which flatters the historical yield. Find out why. Has there been a profits warning, or cut in the dividend? Is the company even paying a dividend anymore?

As a rule, risk tends to increase with the yield, and a company offering much above 6 per cent should cause alarm bells to ring. According to research, seven out of ten companies on a forecast yield of 7-8 per cent actually cut the dividend. Above 10 per cent, and it's nine out of ten. Doing your homework is crucial.

What, then, is the "right" equity dividend yield? Most fund managers are more than happy with 4-5 per cent where there is much lower risk of a dividend default.

The dividend yield trap

Working out the dividend yield is simple - annual dividend divided by share price multiplied by 100. The one variable on a daily basis is price. Clearly, if the price of a share falls, the yield improves and vice versa.

That's why attempting to pick a stock for income based purely on a quick glance at the financial press or investment websites could lose you money. Yields commonly quoted are nearly always historic, the so-called trailing yield. That means they reflect the last interim and final dividends paid, not necessarily the dividends you will receive in future.

For a more accurate idea of what you could receive if you buy the shares now, the forecast yield, based on what the well-informed analysts think the company will pay in the year ahead, is much more useful. Of course, much of the time they will assume the company in question does continue to pay a dividend. That's why it's best to use this method for the larger, well researched blue chip companies with balance sheets more able to absorb short-term financial shocks. The City is quite good at spotting the warning signs, too, and will be quick to flag up any problems.

Part 1: Avoid the pitfalls

Remember, a company can only pay cash to shareholders if it's making money, or if it has enough funds in reserve to keep up the dividend through the lean times. So, investors must subject company balance sheets to a thorough health check. Paying down debt and investing for growth tells us earnings are probably improving and that free cash flow will drive future dividend growth.

Look at the transport sector. A lot of the bus and train operators yield way above average, but chaos surrounding the rail franchise system has called into question whether some of them can keep paying the dividend out of earnings from bus operations alone.

Here's a check list of what to look out for:

- Good free cash flow
- History of earnings growth
- Track record of dividend growth
- Dividend cover of >1.5x
- Positive profit forecasts

Dividend cover and payout ratio - sustainability

It's essential that any income seeker knows whether a company can actually afford to pay shareholders a dividend, and finding out how sustainable payouts are is extremely straightforward.

Simply dividing the earnings per share (EPS) by the dividend gives what is called dividend cover. The accepted rule is that earning should be about twice the size of the dividend, but a ratio of 1.5 is usually acceptable. However, anything below that suggests the company may struggle to finance returns in the future, and less than 1 means any payout will have to come from retained earnings in previous years. That cannot go on forever.

Of course, dividend cover can also tell us whether a company is not being generous enough. Yes, management will need money to fund their growth aspirations, but cash piles can also be a big red flag and increase the temptation for ambitious chief executives to make value destroying acquisitions.

Analysts, especially those in the US, like to refer to the payout ratio when deciding if there's scope for dividends to grow. It's the same as dividend cover, just expressed as a percentage of earnings rather than a multiple. Currently, the payout ratio for the MSCI World index is just 40 per cent compared with an average of over 44 per cent since 1996.

It's about the same for the UK, but that's well below the 30-year average and much lower than the previous best ratio up in the high 50s. Of course, each sector is different. Utilities have tended to pay around 60 per cent of earnings back to shareholders, whereas miners, whose profits are highly cyclical, prefer to throw their excess cash at acquisitions and new projects. On the whole, many companies are generating higher margins and profit than ever and will find it increasingly difficult to justify keeping payout ratios at historic lows.

Part 2: Where to find the best dividends

Naturally, all the big UK income funds plunder the FTSE 100. It's home to the biggest companies and some of the most generous dividend payers around.

In 2011, companies listed in the blue chip index paid out £68bn in dividends to shareholders. In 2012 it should be around £79bn, according to Capita Registrars, rising to £81bn in 2013. It is worth noting, too, that just 15 FTSE 100 companies pay out over two thirds of all the money received by shareholders from UK-listed companies. However, you won't find any young dynamic growth companies among them - they pump all their spare cash back into the business. Think more defensive heavyweights like Vodafone, Royal Dutch Shell, HSBC, BP, National Grid and GlaxoSmithKline.

These are the classic equity income plays; businesses in defensive industries such as utilities, tobacco, pharmaceuticals, insurance and telecommunications, where earnings are more predictable, even during an economic crisis. That tends to guarantee a steady stream of dividend income and a gradual increase in profits should deliver higher payouts over time, too.

Indeed, British American Tobacco, for example, yields four per cent and has increased its payout by 17 per cent for the past five years. There's even an index in the US - the S&P 500 Dividend Aristocrats - formed solely from large blue chip companies that have increased dividends every year for at least 25 years in a row.

Beware, though, a history of dividend payments is no guarantee that a company will continue to do so, and that includes even the biggest. Remember the oil spill in the Gulf of Mexico that forced BP to cancel its payout? Speculation that Vodafone - which relies on its US joint venture Verizon Wireless to bankroll its dividend - will cut the payout is never far away either.

That said, companies will do all they can to avoid reducing the dividend given the destructive impact it can have on investor confidence, and the share price. A war on costs during the first recession means companies have built up huge nest eggs, too. A report published by economic think tank, the Ernst & Young ITEM Club, revealed British businesses are sitting on £754bn of surplus cash.

Diversification

Diversification is one of the classic rules of investment and one worth following when building an income portfolio. By diversification, we mean spreading risk across sectors – utilities may be reliable, but dividend growth is likely to be greater elsewhere – and geographies, too – the UK has an established commitment to shareholder payouts, but there are also plenty of opportunities overseas.

Sectoral

First, let's look at sectors. True, defensive industries provide greater safety, but there's been a sea change in attitudes to dividends across the technology sector over the past few years, and more are returning cash to shareholders.

IT software firm Sage is one of the more generous - the shares trade on a prospective yield of 3.6 per cent. However, there's been a renaissance in IT on the other side of the Atlantic where the availability of credit is being used to produce future growth.

Apple has paid its first dividend since 1995 - it was sitting on over $100bn of cash, so it could afford to. So can others. Dell's decision to join the dividend list will undoubtedly attract income investors and push up the share price, generating capital growth as well. Other like Intel will also benefit. The chip giant has grown its payout by 10 per cent a year for the past five years, and on around 10 times forward earnings, the shares are not expensive, either. Microsoft, Cisco and Texas Instruments have increased payouts, too, and will see their shareholder base widen.

"It may still have a higher beta than other dividend issues, but (the IT sector) is a player, and the dividends need to be incorporated into the total return risk-reward formula," says Howard Silverblatt, senior index analyst at S&P Dow Jones Indices.

Part 3: Dividends from overseas

Investors have already started to look overseas for diversification and it's clear why. "More S&P 500 issues are paying a dividend than at any time since December 1999," says Howard Silverblatt, senior index analyst at S&P Dow Jones Indices. However, yields in the US are historically lower than in Europe and certainly lag emerging markets.

Indeed, S&P Capital IQ's world equity income league table reveals the UK, Germany and Switzerland are Europe's "income sweet-spot." In fact, the FTSE 100 yields above 4 per cent which, if you strip out the post-credit crunch spike, is higher than it’s been in over 20 years. So, returns are good and there's a reasonable payout ratio, too. And it's no coincidence that the same influential institutions appear on share registers across Europe.

However, just looking at headline rates can be misleading. For Spain, the estimated yield for 2013 is 6.5 per cent, the highest of the major economies, but the payout ratio is 150 per cent. This suggests you are being rewarded for risk, but the likelihood of receiving such a high return is very low indeed and dividend cuts, rather than growth, are more likely.

Further afield, the tiger economies of Asia are fast coming round to the idea of dividends. Attitudes began to change after the Asian financial crisis of the late-90s. Family-owned businesses lost a lot of money and decided the best way to spread their assets more evenly was to pay themselves a dividend and reinvest in property or other assets.

Asia also widens the field in terms of exposure to themes as well. It's much harder getting access to long term growth trends such as dietary change, agriculture and Far East defence spending from the UK, says Mark Whitehead, manager of Sarasin's International Equity Income Fund.

Asian companies tend to have less debt than western counterparts and will enjoy faster growth for a number of years. The IMF expects emerging markets to grow 5.6 per cent in 2013 compared with just 1.5 per cent in advanced economies. Transparency is improving, too, and analysts at S&P Capital IQ see "plenty of room for future emerging market income growth." Consensus forecasts are for a 10 per cent increase in 2013, equivalent to a yield of 3.3 per cent.

See our feature on The World's Best Dividends

Part 4: Dividend reinvestment

If you own dividend paying shares, but aren't dependent on the income from them, you may want to consider using the money to buy more shares. They, too, will generate dividends to reinvest, and so on. It's called compounding and the cumulative effect over a number of years can be astounding.

Let's assume you bought 1,000 shares in XYZ Plc for 400p each with a yield of 4 per cent (16p a year). Let's also assume it grows the dividend by 5 per cent a year - not overly optimistic - and its share price increases by a similar figure.

Over 20 years, the stake would be worth £16,200, including £5,500 of dividends, giving an annualised return, or compound annual growth rate (CAGR), of 7.2 per cent. However, if you had used income from the original holding to buy shares in the company, your investment would now be worth £23,200 (£8,800 of dividends used to buy shares), a return of 9.2 per cent.

If that same stock had paid out 6 per cent each year, the final stake would have been worth over $34,000 - an annualised return over 11.3 per cent.

A taxing issue

No one enjoys paying tax, so make sure you're not penalised unfairly on income from foreign shares. Double taxation treaties should guarantee that UK residents pay no more than 15 per cent withholding tax in most instances, much less than most country's actual rate - it's 35 per cent in Switzerland and over 26 per cent in Germany. Unfortunately, most execution-only brokers settle foreign trades through Crest, which is rather inflexible and will only claw back the difference on US and Canadian stocks once you've filled in your W8-BEN form. Investors can reclaim what's owed but many find it too time consuming for the sums involved, which are usually quite small. If the sums stack up claim yourself, otherwise find a broker who'll do the hard work for you.

Part 5: Dividend arithmetic

If you invest in high yielding shares you might come across one or two adjustments that can be puzzling. Why, for example, do high-yielding shares always drop sharply on two Wednesdays each year? And what does that little 'xd' symbol by the side of the price in the newspaper share price listings mean?

The falls are harmless and the cause is mundane. It is because of the way the market takes account of dividend payments.

The reason is a simple one. It's because investors and professional dealers and market-makers need to have a dividing line that determines precisely when shareholders qualify for a dividend and when they do not, and to know exactly how and when that fact will be taken into account by the market.

All dividend announcements by companies give at least two key dates, and most give a third one as well. These dates are:

■ **the 'record' date.** This is the date after which new buyers of the shares will not qualify for the pending dividend payments. In other words if you sell a share just before or buy a share just after the record date, you won't be entitled to the dividend. This is not necessarily called the record date in a company announcement. The phrase generally used will be something like '…….will be paid on [payment date] to shareholders on the register at [record date].

■ **the payment date.** This is the date that dividend cheques are posted or dividends paid into shareholders' bank accounts. This may be some weeks or even months after the record date, so it is important to be aware precisely when the payment is likely to be made. It's particularly important for investors who (like me) rely on receiving a steady flow of dividends from their investments to be aware of the - generally two, but sometimes four - dividend payment dates before they buy a share. Company web sites and data services like Sharescope have these details, as do printed company announcements mailed to shareholders.

■ **the 'ex-dividend' date.** This is the third key date and the reason for that little 'xd' symbol beside the share price in the paper. The ex-dividend, or 'xd', date is normally the second business day prior to the record date. Since record dates are generally a Friday, this means that most ex-dividend dates are on a Wednesday. Ex-dividend dates are fixed this way because of settlement times. On the T+3 system operated in the UK (i.e. a trade settles three days after it is executed), investors need to buy a stock three days prior to the record date (that's to say, the day before the ex-dividend date) to be sure of qualifying for the dividend payment. This is because the new shareholder's name will only go on the register once the three settlement days have elapsed.

While that explains why these dates are when they are, the significance of the 'xd' really lies elsewhere. It is that the share price adjusts downwards by the amount of the pending per share dividend payment at the market opening on the ex-dividend date. For high yielding shares the adjustment can be a large one, and alarming if you are not expecting it. It happens in order to recognise the fact that buyers of the share on or after that day will not qualify for the imminent dividend.

For instance, a share that closes at 425p the day before going 'ex' a 15p dividend payment being paid on 3 December to shareholders on the register on Friday 2 November, will go 'ex' on Wednesday 31 October. On that day, other things being equal, the price would open at 410p 'xd'. The 15p dividend - the reason for the adjustment - would only be paid to those shareholders entitled to it some 33 days later.

On an ex-dividend date, any notional underlying change in the price compared to the previous day can be worked out by subtracting the dividend from the previous day's close and then comparing the resulting price with subsequent day's quotation.

And why the little 'xd' symbol on the prices pages and on broker contract notes? That's simply to emphasise that the shares are now being bought without entitlement to the pending dividend payment, although of course they will - if you continue to hold them - qualify for any subsequent ones.

But investors do need to be aware that there could be quite a gap between the share price adjusting on the xd date and them receiving the dividend payment that the adjustment represent. This can be several weeks, or sometimes even a few months. That's because the timing of the ex-dividend is dependent on the record date for the share register, and not the day the dividend will be paid, which are two entirely different and unrelated dates.