Dividends – An answer in a low-interest rate world

THE question on many financial advisers' minds currently, especially after September's 50-basis point rate cut by the South African Reserve Bank, is what advice to give to their clients who need a growing income amid a low-interest rate environment and volatile equity markets?

According to Feroz Basa, portfolio manager at Old Mutual Investment Group's Value Equity Investments boutique, dividends could help in resolving this dilemma. They play a much larger part in the performance of a portfolio than many realise, especially over the longer-term, and in this kind of environment, they can help to steady returns over time and boost those returns for investors looking for income.

He says: "Research on the JSE's returns by [global investment bank] UBS shows that dividends have contributed over half of total returns over 25 years. Funds that focus on holding shares of high dividend-paying companies have defensive qualities that help them to perform well in uncertain market conditions. This can be important for those investors who would like some regular income and can tolerate equity risk."

With low interest rates set to prevail for at least the next 12 months or longer, a dividend-focused equity investment looks to be a smart option, Basa notes. High-dividend shares have a history of outperforming other shares in a falling or low interest-rate environment. Furthermore, dividends are likely to make up a higher portion of total equity returns during these times as capital growth slows.

Feroz Basa

A good example of the benefits offered by dividends is the Old Mutual High Yield Opportunity Fund. Jointly managed by Basa and Michael Schroder, it is ranked sixth out of the 83 unit trusts in the General Equity category for the 12 months to 31 August 2010, returning an annual 14,7 percent compared to the category average of 9,5 percent a year. It is also a top-quartile performer among its peers since its inception over ten years ago.

As of the end of August 2010, the fund was trading on a dividend yield of 4,1 percent, almost double that of the FTSE/JSE All Share Index (Alsi) at 2,4 percent, and outperforming its mandate of 1,5 times the Alsi's dividend yield. The fund's top holding currently is Sasol, with other favourites being British American Tobacco, Pick 'n Pay, Astral, Standard Bank and Vodacom.

Basa says the main issues that have underpinned his assessment of Sasol include the growing potential demand for oil, an undemanding price:earnings ratio of 10 times (a 35 percent discount to the SWIX index) and a very strong balance sheet, with R16bn in cash, which underpins a dividend yield of 4-5 percent going forward.

"I've just returned from China and was amazed to see it's currently selling one million cars a month – and that's just the start. Compare that with South Africa's record annual sales of around 500 000 cars. That's set to be a big driver of oil in future and excludes other rapidly growing emerging markets. I'm extremely bullish on both China and oil."

In conclusion, Basa believes that, as both our own and global interest rates are likely to stay lower for longer amid the uncertain economic recovery, dividend-focused unit trusts should continue to be an attractive option for investors who can tolerate some equity risk.

"Remaining solely in cash or money market funds, as many investors are choosing to do, will not result in inflation-beating income over the longer-term," he says.