HB Markets

High Yield Stocks
The £64bn Giveaway

June 2011

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Introduction:

It is nearly four years since summer 2007, and the start of the Credit Crunch. It is also three years since the introduction of the ultra-low interest rate policy by the Bank of England and other leading economy Central banks.

In previous post war downturns, the Government of the day would almost invariably have used interest rates as a tool to deal with a booming economy, but with an arguably unprecedented scenario to deal with, when the bubble burst this time, the cost of borrowing was lowered to prevent a recession turning into a depression. This in itself has consequences: excessive speculation during a low interest rate phase can lead to inflation resulting from soaring prices. While this has not happened in the housing market, soaring commodity prices, (especially Crude Oil, Wheat and Cotton) have meant that consumers are facing a resurgence in CPI (4% in April) / RPI (already above 5%) both standing well above 5% by the end of 2011, as predicted by the Bank of England's latest May quarterly inflation report.

At the time of publishing our report, the current betting is on a stagflation scenario with the BoE having just cut its 2011 GDP growth estimate to 2.75% from 3.1% - not that many believed that 3% plus was a viable target in the first place.

With savings on deposit earning next to nothing, and now delivering negative real returns, the strategy of investing in high yield and income from the stock market has become a more compelling and practical solution than ever. There is challenge though. With the FTSE100 having traded more or less flat between 5,000 – 6,000 for the past 10-years, a creative strategy is required to identify the best situations where dividend payouts are substantial and consistent. Further backing from this strategy comes from the fact that many of the companies that have performed well in the recent past have effectively been "stress tested" against some of the worst economic conditions in living memory. In this regard there are also numerous quality opportunities to pick from.

Dividend Bonanza:

According to the latest data from Capita Registrars UK Plc, it is not only the bonus addicted bankers enjoying a decent payout, but investor and shareholders are seeing a decent flow of cash and dividend income trickling their way too.

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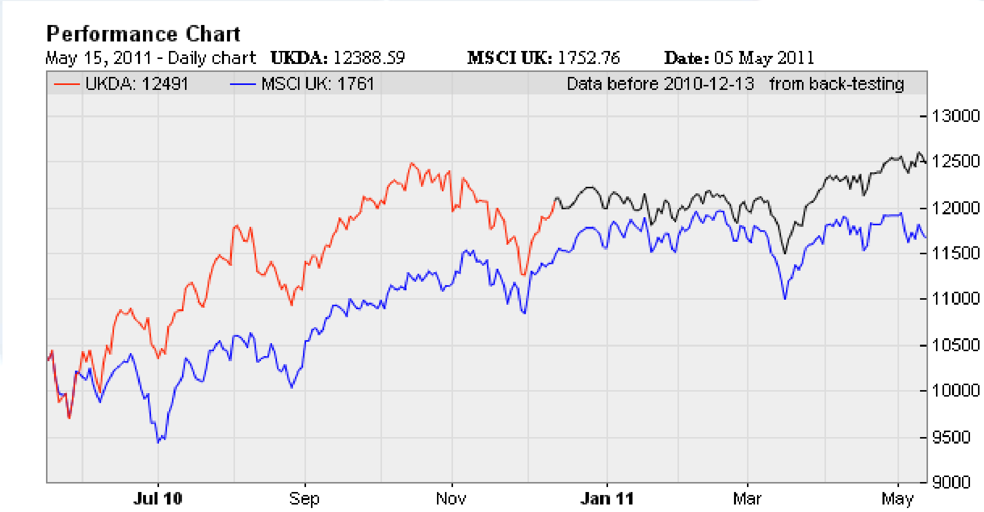
Q1 2011 saw a 10% rise in dividend payouts to £15bn with the forecast for the full year up to £64bn. This level of payout is the most generous for over three years, with the ratio of those companies reinstating or raising dividends versus cutting or reducing now standing at 3 to 1. Ultimately, it may very well be that the continuing dearth of lending from the banks is forcing corporates to provide higher, more attractive yields to lure shareholder funding.

As can be seen from the chart, the UK Dividend Achievers Index has outperformed its benchmark in the past year, and consists of companies that have increased their dividend payout each year for the last ten or more consecutive years.



Source ShareScope (www.sharescope.co.uk)

Inflation: Back From The "Dead":

At the end of the last decade, most market professionals and observers had more or less agreed that the world economy was in the happy position of having witnessed the death of inflation, largely due to the strength of the U.S. Dollar and the growth of low cost manufacturing from emerging markets such as China which effectively forced down the price of many consumer goods. So convincing was the notion to one keen follower of the financial markets that he decided it was time to sell Gold.

The then Chancellor of the UK and future Prime Minister Gordon Brown spent the first couple of years of the noughties selling the bulk of the U.K.'s gold reserves. This was not only a bad idea at the time, (he largely sold out within $50 of the decades low price near $250 an ounce) it also meant that if there ever was a time when inflation returned, the UK would not have this traditional hedge against rising prices in its armoury. In fact, the Chancellor selling at the bottom for an extended 5-year period was one of price rather than necessary commonsense.

The subsequent boom of 2003 - 2007 for many assets was one of the biggest since the 1920s, although inflation in CPI or retail terms remained surprisingly low with major economies in many instances rarely seeing levels of more than 3%.

However, the aftermath of the 2007-2008 financial crisis and the repercussions across the banking sector dramatically changed a hitherto stable situation. For the first time in recent history, Governments assumed that it was their duty to stave off Depression. Normally at the start of a period of economic contraction it is the consumer that goes bust via unemployment or mortgage default, but this time around as countries like Portugal, Ireland and Greece have shown, the State has stepped in to take the hit. For Governments, the only weapon left in the armoury is to shrink the relative value of their debt with competitive currency devaluation via severe interest rate reductions and with so called Quantitative Easing – largely bond purchases (printing money) to reduce the relative size of the debt burden they are carrying.

The U.S. Dollar Issue:

While devaluation is viewed as a perfectly sound way for a country to improve its competitiveness in terms of exports, for the U.S the situation is rather different. The U.S. dollar is the world's reserve currency and all the major commodities including food and resources and of course crude oil, are all priced, traded and speculated on in dollars. Consequently, any devaluation of the dollar either through economic weakness or the kind of fiscal stimulus and money printing seen from the Federal reserve, leads to a rise in the price of wheat, corn, silver, platinum or any other commodity that one can think of, even if all other fundamental factors remained unchanged.

The Dollar Index, (the greenback's weighting against a basket of other currencies) is down by more than 15% over the past year, and in excess of 50% in the past 10 years, something that means that even if demand remains unchanged, consumers and manufacturers are feeling a significant extra financial pressure. Added to this, and tying in with the dollar weakness is of course the emergence in the past decade of economies such as China, India, Russia and Brazil, (so-called BRIC nations) all in a headlong rush to be the next leading world economic power. These nations have devoured raw materials at an astonishing rate in order to produce manufactured goods for export to the West.

But while the return of inflation could have been predicted by year 1 economic students up and down the country, (but not Gordon Brown) it may be that the real twist in the current crisis is not the return of inflation back to 5%, (still quite modest compared to the 10-20% levels from the UK in the 1970s at the time of the post-oil crisis meltdown, but it is actually the strategy that governments have adopted in order to prevent a 1930s style collapse. Away from the worst of the PIIGS nations, the strategy has arguably worked, but the irony is that the old "Boom and Bust" model had at its core the process by which raising interest rates could accelerate the end of the down cycle by forcing capitulation. This would typically result in many sectors such as manufacturing services going bust and a spate of repossessions in the housing market. From such rock bottom levels a new up wave of growth could begin once again.

But in the brave new post Credit Crunch era, the State idea has been to preserve both consumers and corporates at all costs in the hope that this will give them enough time to regroup. Historical precedents though would suggest that rather than the typical post war boom and bust and then boom again, the strategy of sustained lower interest rates merely ensures that we enter a Japan style scenario of a rolling recession or living death, extending for years if not decades. The answer to this conundrum is still a work in progress.

The Quest For High Returns:

It cannot be stated or emphasised too greatly what a momentous move the strategy of lowering of interest rates at a time of economic weaknesses has been. In addition, the strategy has raised a number of moral issues, not least of these being the fact that the low interest rate cycle has actually saved those who gambled biggest at the time of the last growth phase both in business and real estate terms. In previous cycles, interest rates doubling as recession and inflation loomed would certainly have resulted in such speculators falling by the wayside. Apart from the moral hazards of protecting the greedy, those who saved for a rainy day have now seen their savings rates fall to close to zero in actual terms and to negative in cash in real terms.

With inflation forecast to hit 5% in the UK over the next year and with deposit rates at best half this figure, the past few years post the crisis have not been a great time for those with cash in the bank. This may account in part for the rush towards resources plays and tech stocks, both high growth sectors. There are also the more predictable areas, where “defensive” firms such as utilities and tobacco stocks offer high yields. Nevertheless, in spite of low interest rates “forcing” investors to seek decent returns in the stock market, it is interesting to note that the 6,000 level for the FTSE 100 in mid 2011 is almost exactly the same level at which it started the last decade. One shudders to think where it would be had there not been the enticement to buy shares courtesy of 0.5% base rates? Notwithstanding this, the markets are where they are, and probably more now than at any time over the past decade, there are stocks offering exceptionally high rates of return.

Growth Versus Income:

One of the perennial questions when investing into equities is the decision over growth or yield, or of course ideally finding a mixture of the two. Normally, a private investor portfolio will be a mix of companies and sectors that are either out and out growth plays, (for example ARM Holdings (ARM) or Autonomy (AU.) from the tech stock area, or Copper specialist Antofagasta (ANTO) from the mining sector) and “safe” dividend plays such as utilities, insurers or supermarkets.

Conventional wisdom says it is very difficult to combine growth and yield in the same company, if only on the basis that for fast rising stocks, the yield will dwindle in relative terms. That said, as will be seen in a study of FTSE100 stocks over the past five years via data trawling, a surprising number of stocks fall into the category of growth situations and income plays. Before we look at what might play out in the future, it is worth analysing the best picks of the past decade as shown in the table below.

Stock	EPIC	LAST	10 YEAR GAIN %	YIELD %
ICAP	IAP	492	409	3.5
BAT	BATS	2704	386	4.2
Imperial Tobacco	IMT	2231	305	3.6
Reckitt Benckiser	RB.	3435	260	3.3
Next	NXT	2281	136	3.4

Source ShareScope (www.sharescope.co.uk)

The criteria here for the best of the best winners over the past 10 years is that they yield the same or more than the 10 year Gilt (currently 3.38%) and have doubled or more over the period. This leaves us with arguably three "predictable" super stocks combining growth and income in the form of tobacco giants BAT and Imperial Tobacco, while household goods group Reckitt Benckiser also stands out as another non-cyclical star. Further down the list in share price performance, but still well into triple digit gains since 2001 is High Street fashion group Next (NXT), where even rising VAT, commodity prices and a consumer cash squeeze have not been able to halt the pace of growth.

But the contender topping the pile may now in retrospect make sense given the white-knuckle volatility ride since the financial crisis started four years ago. Even with this outperformance, the generous dividend payout is not something that might have been expected from a financial services group such as interdealer broker ICAP. The fact the group has been such an effective play on volatility explains the group's success, with events such as the fall of Lehman Brothers, and more recently turmoil in North Africa and the earthquake in Japan all contributing the ICAP balance sheet. It was only logical that at the end of March the FTSE 100 group reported a "solid" fourth quarter due to the geopolitical and seismic jolts to start 2011.

Future High Yield Plays:

No.	Name	EPIC	Close	Price% 5 years ago	Price% 1 year ago	Forecast EPS Growth	**Projected Yield**
1	RSA Insurance Group PLC	RSA	£1.37¼	0.88	11.00	28.11	6.82
2	Resolution Ltd	RSL	£2.98½		11.11	-69.06	6.33
3	Standard Life PLC	SL.	£2.14½		9.00	-19.98	6.27
4	Aviva PLC	AV.	£4.35¾	-43.51	27.65	-3.69	6.21
5	National Grid PLC	NG.	£6.19½	26.61	11.28	-13.58	5.87
6	Man Group PLC	EMG	£2.45¾	-48.83	6.97	-22.93	5.65
7	Scottish & Southern Energy PLC	SSE	£13.35	19.84	21.36	-22.86	5.55
8	BAE Systems PLC	BA.	£3.39¼	-17.17	-1.14	0.67	5.47
9	Vodafone Group PLC	VOD	£1.67½	35.39	21.41	-23.20	5.27
10	AstraZeneca PLC	AZN	£31.93½	11.78	8.84	0.59	5.26
11	GlaxoSmithKline PLC	GSK	£13.48½	-10.99	12.56	80.58	5.11
12	Lloyds Banking Group PLC	LLOY	54¾p	-78.21	-9.66	112.67	4.83
13	United Utilities Group PLC	UU.	£6.22	-2.52	17.69	-21.12	4.82
14	Royal Dutch Shell PLC	RDSB	£21.48	14.32	17.86	23.31	4.80
15	TUI Travel PLC	TT.	£2.50		-5.55	34.60	4.70
16	Centrica PLC	CNA	£3.17¼	22.94	10.87	-37.77	4.68
17	Legal & General Group PLC	LGEN	£1.16¼	-14.80	39.95	2.65	4.56
18	British American Tobacco PLC	BATS	£27.04	100.30	30.09	8.16	4.53
19	Admiral Group PLC	ADM	£17.51	158.64	32.95	16.35	4.52
20	British Land Co PLC	BLND	£5.84½	-45.06	31.50	20.78	4.45

Source ShareScope (www.sharescope.co.uk)

When seeking out future high dividend yield companies, the easiest course of action is simply to screen by historic yield; in other words the payouts from a company in the past, or at least over the previous 12 months. This might be fine for the likes of Standard Life where the yield has been between 5% - 6% for the past 3 years, but those chasing the 11% plus dividend for Man Group of 2009 and 2010 might not be so keen at the forecast 5.65% - albeit still a great return.

This survey has also avoided the easy path of just looking at the yield. There is little point buying into a stock on the basis of an apparently secure 5% plus payout only to find after a few months that the company in question reduces earnings guidance, or worse, delivers a profits warning. Therefore we are adding earnings per share growth (EPS) into the equation, stipulating that it must be in positive territory. This metric sees RSA win out over Resolution, and Aviva among the insurers, and also knocks out the utilities, a would-be favourite for many, including United Utilities, Scottish & Southern and National Grid. Instead, GlaxoSmithkline almost self-selects with it's EPS of 80, along with Royal Dutch Shell, British Land and Admiral Group where there are significant growth gains expected along with income levels of 4% or more.

High Yield Company Profiles:

Admiral Group (ADM): 1,751p
Forecast Yield 4.5%
Sector: Non Life Insurance
Market Cap: £4.7bn
52 Week High / Low: 1,753p / 1,238p

Source ShareScope (www.sharescope.co.uk)

Latest Trading Update:

May 6th Motor insurer Admiral Group said that turnover was up by 56% in the first quarter compared with the same period last year at £539m. Admiral's UK car insurance business was described as having had another great quarter and continued to benefit from positive market conditions.

Fundamental Commentary:

While fuel costs are the bain of the motorist, it does seem that rising insurance premiums are almost accepted without question, and thanks to this Admiral Group has been able to maximise profits. The forecast yield of 4.5% is a standout for a company, which is proving to be a genuine non cyclical growth story, and with the shares being near 52-week highs, Admiral is set to further benefit from the EU ruling on gender based insurance fees next year.

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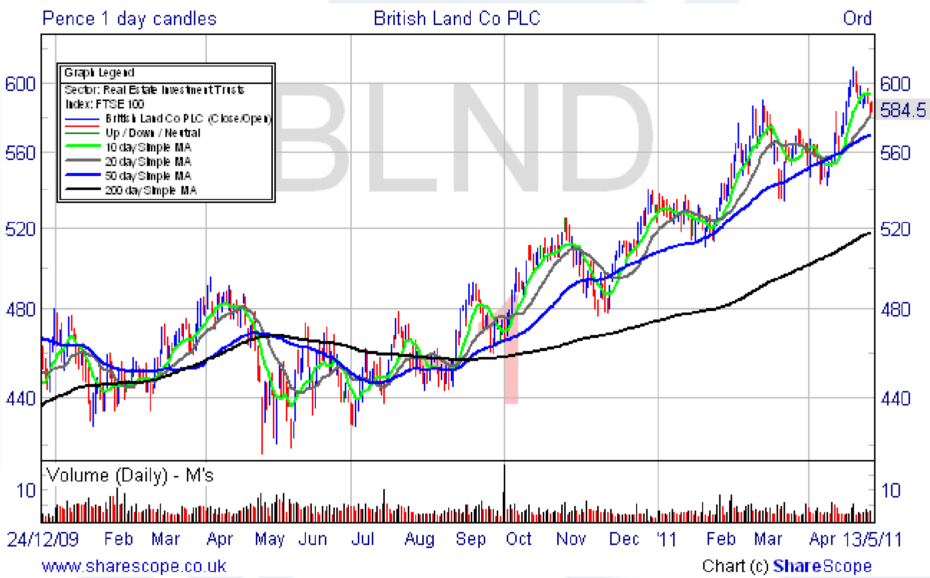
British Land (BLND): 584p
Forecast Yield: 4.45%
Sector: Real Estate IT
Market Cap: 5.1bn
52 Week High / Low: 604p / 418p



Source ShareScope (www.sharescope.co.uk)

Latest Trading Update:

February 15th British Land underlying profit before tax in the three months to 31 December 2010 grew 10% from a year earlier at £64m. The group's portfolio at the end of the year was valued at £9.3bn, up 2.3% over the quarter and 13.1% higher than a year earlier. NAV per share rose 4.4% in the quarter to 548p. End-year NAV per share was 25% higher than the end-2009 figure of 438p

Fundamental Commentary:

The recovery at British Land appeared to be gathering momentum at the turn of this year, with the NAV rise of 25% underpinning a 10% pre-tax profits jump of 10%. The relative fundamentals stability of Brit Land helps to back the security of the high yield on offer.

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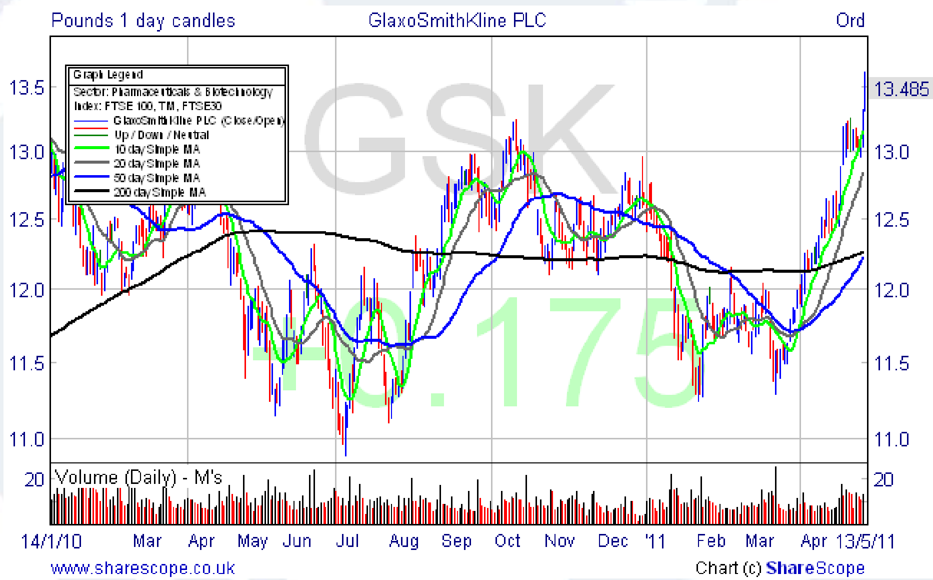
GlaxoSmithkline (GSK): 1,348p
Forecast Yield: 5.1%
Sector: Pharmaceuticals
Market Cap: £69.6bn
52 Week High / Low: 1,348p / 1,095p



Source ShareScope (www.sharescope.co.uk)

Latest Trading Update:

April 27th GlaxoSmithkline first quarter results revealed turnover had fallen by 10% to £6.585bn, but earnings per share climbed by 5% to 32.2p as underlying sales rose. This was driven by emerging markets sales, which jumped by 23% to £830m while Japan saw a 53% rise to £465m. Sales in the US and Europe were down by 4% to £1.571m and 5% to £1.418m respectively.

Fundamental Commentary:

The evolution of drugs giant GlaxoSmithline into an emerging markets play is a process which already seems to be well under way when taking into account the Q1 sales boost from these regions. Thus far this boost is more than enough to offset public health spending concerns in developed countries.

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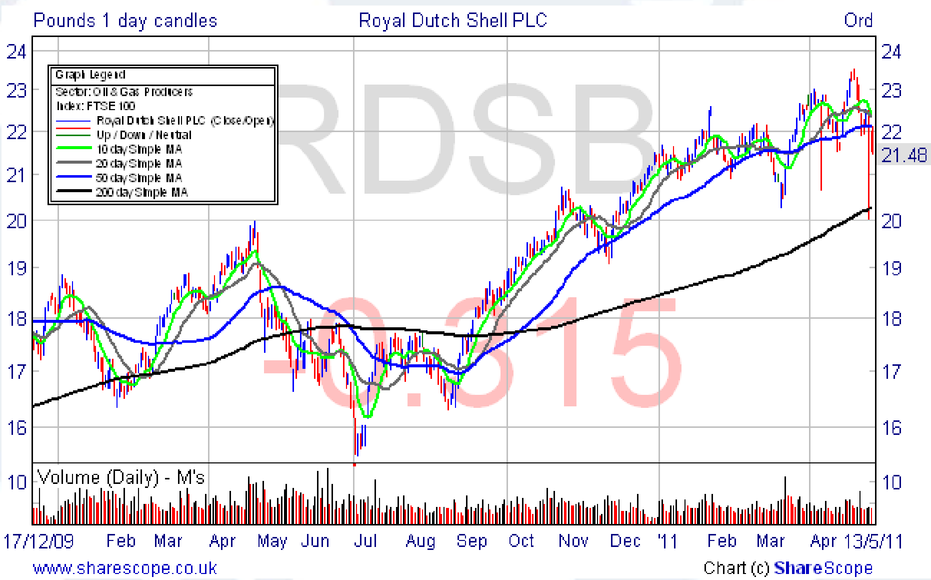
Royal Dutch Shell (RDSB): 2,148p
Forecast Yield: 4.8%
Sector: Oil & Gas Producers
Market Cap: £57.9bn
52 Week High / Low: 2,336p / 1,554p



Source ShareScope (www.sharescope.co.uk)

Latest Trading Update:

April 28th First quarter 2011 earnings were $6.3bn, compared with $4.8bn in the first quarter of 2010. Cash flow from operating activities for the first quarter 2011 was $8.6bn, compared with $4.8bn in the same quarter last year. Cash flow from operating activities in the first quarter 2011 was $13.1bn, compared with $10.4bn in the same quarter last year. Return on average capital employed (ROACE) at the end of the first quarter 2011, on a reported income basis, was 12.9%.

Fundamental Commentary:

Higher industry margins, along with rocketing Crude Oil prices has already resulted in significant gains to start 2011 compared to the previous year. The figure of $6.3bn in earnings was up to 10% ahead of market expectations.

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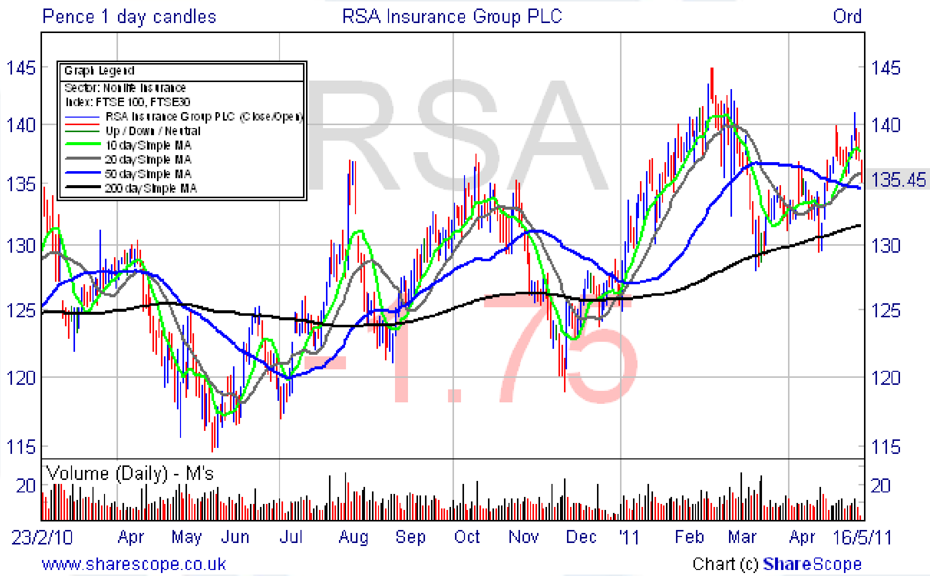
RSA Group (RSA): 137p
Forecast Yield: 6.8%
Sector: Non Life Insurance
Market Cap: £4.8bn
52 Week High / Low: 143p / 115p



Source ShareScope (www.sharescope.co.uk)

Latest Trading Update:

May 12th RSA Group net written premiums hit £2.1bn in the first quarter, up 8% on a year earlier. All regions were said to have delivered good growth. The group remains confident of achieving full year premium growth of around 10% in International, targeted growth in the UK and double digit growth in Emerging Markets.

Total net asset value climbed to 105p at the end of the quarter from 104p at the beginning.

Fundamental Commentary:

RSA has converted a strong 2010 performance into an ongoing positive top line momentum situation, with strong prospects backed by rising premiums. Natural catastrophe exposure in Japan and Australia / New Zealand has been limited.

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Jim Dolan, ***Retail Broking Director***
June 2011

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Report Name: **High Yield Stocks - The £64bn Giveaway**

Relevant Disclosures: **6**

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