The British tax code is currently in excess of 20,000 pages long and has more than trebled in size since 1997. Over 3,000 pages have been added since George Osbourne became chancellor (Hong Kong's tax code is under 300 pages long in total!) and it is no small task to keep up with the changes made at each Budget to both personal savings and pension allowances. You could be forgiven therefore for not celebrating the latest change – the introduction of a new dividend allowance that came into force at the beginning of this tax year.

This new legislation states that everybody will now receive the first £5,000 of dividends income tax free which is good news for many with income from investments at a relatively low level. Whilst this seems on the face of it to be a generous gift from our Chancellor, those investors with dividends over and above this level of investment income will now be charged at a higher rate than previously, with the top rate for additional tax payers now 38.1% as compared to 30.55% previously. The changes will raise an estimated further £6.8billion for the Treasury, primarily as a result of the increased tax take on self-employed dividends. At the same time capital gains tax has been slashed from 28% to 20% for higher earners and from 18% to 10% for everyone else. This is one extra page in our tax code that we are delighted to see created.

The search for yield

As bank interest rates fell to ultralow levels, investors increasingly searched for alternative sources of investment income and so dividend generating companies have become ever more popular. High dividends should be a sign that companies are generating good profits and that they are therefore distributing those profits to shareholders. Annually increasing dividends should show that not only are those companies making good profits but that they are increasing those profits each year.

However, in light of these significant changes in the budget, higher-rate tax payers in particular could see some or all of the benefits of a sensible, increasing dividend policy eroded by the taxman. We thought it worth reviewing the case for high dividend generating investments vis-à-vis those generating capital growth because from a tax perspective at the very least, capital gains have never looked more attractive than income generation and therefore investors have an increasingly difficult choice to make between the two.

Equity yields are higher than gilt yields

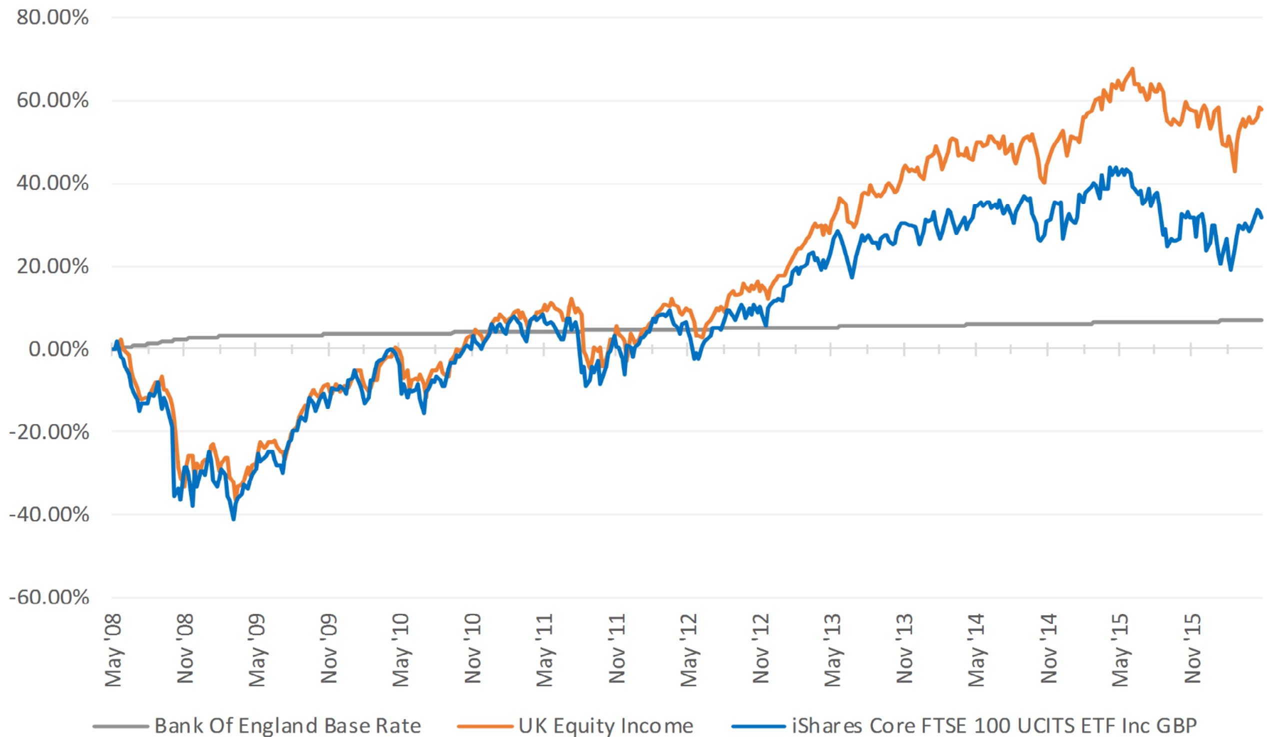
Historically, bonds have paid more income than equities, as investors expected defensive and secure income from lower risk bonds compared to higher capital growth and lower dividend income from equities. However, that was all turned on its head during the credit crunch in 2007/08 and the chart below shows the lines crossing in 2007 as equities started to yield more than bonds, for two principle reasons. Firstly interest rates plummeted and paltry current account rates were offered as central banks slashed base rates to boost the economy. This dragged down the income available from all bond investments. Secondly, during the crisis equities fell in value significantly and dividends weren't cut anywhere near as quickly as share prices fell (apart from the banks and a few other selected sectors). This boosted yields from equities to around 6% but as noted this premium was quickly eroded as financials and other high dividend yielding stocks reduced their income payments by a third to reflect collapsing earnings. If earnings are slowing or indeed falling, then companies are going to struggle to continue to meet their income commitments or indeed their shareholders' expectations for rising dividend payments.

However in the post credit crunch environment, earnings have now stabilised at a healthy 4% per annum and as interest rates have yet to rise, you can see from the chart below that **equity dividends are still materially higher than bond yields**. We expect this to be maintained for some time to come:

UK equity income has outperformed UK equity growth

It hasn't always been the case that investing in dividends has proved a defensive entry to the UK market. Exposure to companies distributing above average dividends did not provide investors with a great deal of protection from the equity market downturn in 2008. This was primarily as a result of exposure to the banking sector, with the likes of Lloyds and RBS ceasing dividend payments altogether during the financial crisis. Since March 2009 however, equity income investors have enjoyed a period of significant outperformance relative to both the FTSE 100 and alternative income sources such as cash deposits and corporate bonds, as demonstrated overleaf:

High Yielding equities have outperformed the FTSE 100 by more than 20% over the last 5 years:



How secure are these dividends?

Dividend 'cover', a ratio comparing the current level of earnings to dividend payments, gives us guidance as to the company's future ability to maintain or increase dividends. Generally, companies aim to sustain a dividend cover of at least 2 (earnings are at least twice the paid dividend) and a ratio consistently below 1.5 may suggest that the company might not be able to maintain the present level of dividends if earnings continue to come under pressure. Maintaining or increasing cover is therefore important.

Closer analysis of the make-up of those companies distributing income highlights that the yield premium afforded by equities is dependent upon a very small number of its constituents within the FTSE.

77% - Percentage of total UK dividends accounted for by top-15 stocks

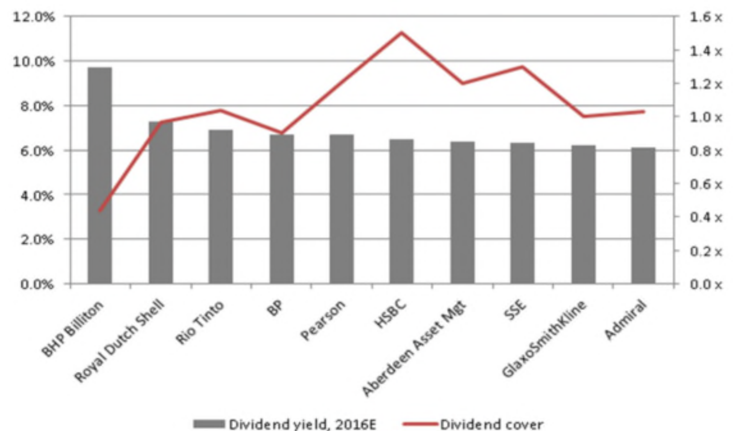
£10.9bn - Amount of dividends paid by the top-15 UK companies in the first quarter of 2016

53% - Percentage of total UK dividends accounted for by the top-five companies in the first quarter of 2016

Source: Capita UK Dividend Monitor – April 2016

We have already witnessed Tesco, Rolls-Royce and Barclays cut their dividend pay-outs this year but fears of a substantial cut from the key dividend distributors in the energy sector such as Shell and BP have yet to materialise. Royal Dutch Shell's CEO vehemently defended the firm's dividend policy but perhaps if earnings continue to slump it is likely that we will see a slew of dividend cuts from some of the larger yielders, as their dividend cover starts to slip. Currently the majority of the top-ten yielding stocks in the FTSE 100 at the end of 2015 have a dividend cover of less than 1 x as per the following chart:

Projected dividend payouts almost equal total profits for most of the FTSE 100 top ten, as per the chart below. Something has to give:



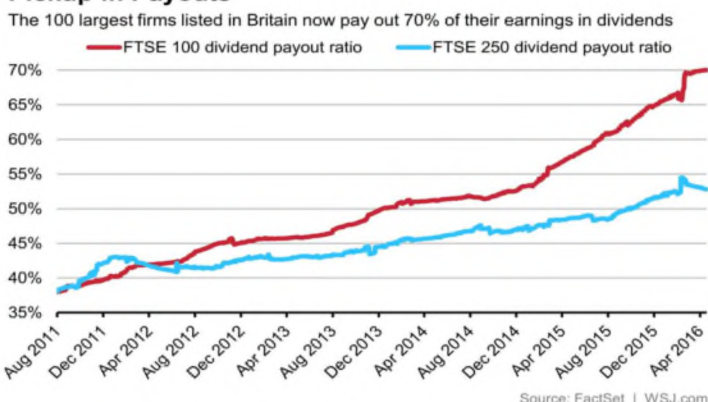
'A business whose dividend is not covered by free cash flow will be using increased borrowings to fund some of its dividend. This is clearly not sustainable over the long term.' Hugh Yarrow – Evenlode Income

Income prospects below the FTSE 100

We believe that it pays to look for income outside of the FTSE 100 in light of concerns about some of these larger dividend payers.

Within the FTSE 250 segment of the market, numerous firms actually increased their dividend pay-outs year-on-year in the first quarter of 2016 and in contrast to the FTSE100 these payments have been funded primarily by a growth in earnings. In fact, since 2012 FTSE 100 earnings per share have declined by 27% whilst

FTSE250 earnings per share have risen by just over 13%. Also FTSE 250 companies retain a greater share of their profits and therefore have more scope to increase their dividends than the FTSE 100, as per the chart below:

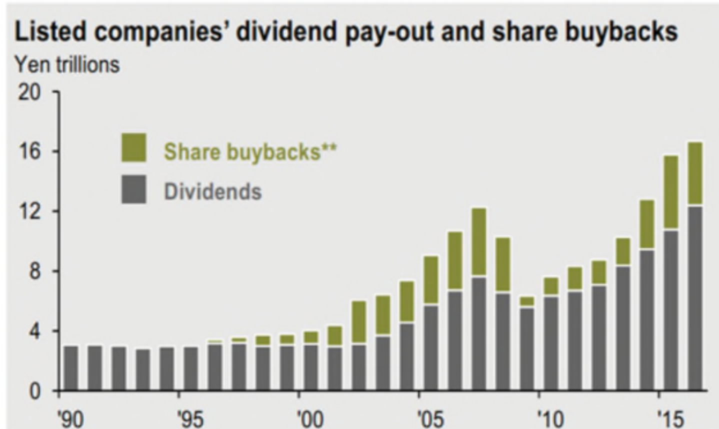


We have therefore diversified our equity income exposure across the FTSE ALL Share, including FTSE 250 exposure whilst at the same time reducing exposure to passive dividend trackers whose weightings are determined by the size of the dividend rather than the ability to pay that dividend.

That said many of these smaller companies will retain their profits to re-invest or grow and this should be taken into consideration.

What about dividend income overseas?

Historically the UK market has been the standard bearer for dividend payments globally but in recent years there has been a shift in focus towards overseas markets as well. This is most keenly demonstrated by the change in the level of dividend pay-outs and share buybacks in Japan (as shown below).



The pay-out ratios however are still significantly lower than in the FTSE 100. For example, the S&P 500 pay-out ratio is 37.5% compared with the FTSE 100 at just over 70%. We expect therefore that improving shareholder returns, primarily through dividend distributions, will continue to appeal to investors in overseas markets for some time to come.

Summary

There is now less value in high income yielding companies than there has been in the past. Also the income tax regime is less friendly towards dividends relative to capital gains. That said, whilst personal tax considerations are important they are not all important and you should never "let the tax tail wag the invest-ment dog".

We should also be mindful that interest rates will start to rise and then equity yields will become less attractive again relative to bonds. In the meantime, investors can be pleased with the performance of yielding equities but should tread carefully in the months ahead. Looking further down the market scale for smaller businesses with reliable income streams seems a sensible approach to equity income investing in the UK.