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A brighter way

Dividend Barometer

October 2023

What is the Dividend Barometer?

Much of the UK equity income conversation is focused on a narrow set of large companies. This overlooks businesses outside the FTSE 100 with strong dividend cover and a track record of growing dividend distributions. The barometer is a report, compiled by the Quoted Funds team at Octopus Investments, which champions the lesser-known dividend credentials of small and mid-cap income stocks.

> ***Barometer (n.)** something that can show how a particular situation is developing, or how people's opinions on a particular matter are changing.*

Headlines

Earnings growth and valuations are disconnected, presenting a significant opportunity for investors in UK growth companies.

Dividend cover has increased for every index except the FTSE 100, which has decreased.

In the UK, dividend growth remains stronger away from FTSE 100, in mid and small cap stocks.

AIM dividend payouts are now significantly higher than levels seen during Covid-19, growing by almost 75% since 2015.

The 'double discount' opportunity

Solid trading continues to be reported across small and mid-cap stocks. Companies are well capitalised, and the outlook remains solid, with the potential for interest rate stabilisation. Yet valuations remain at a material discount to historic levels.

This presents a significant opportunity for UK equity income investors.

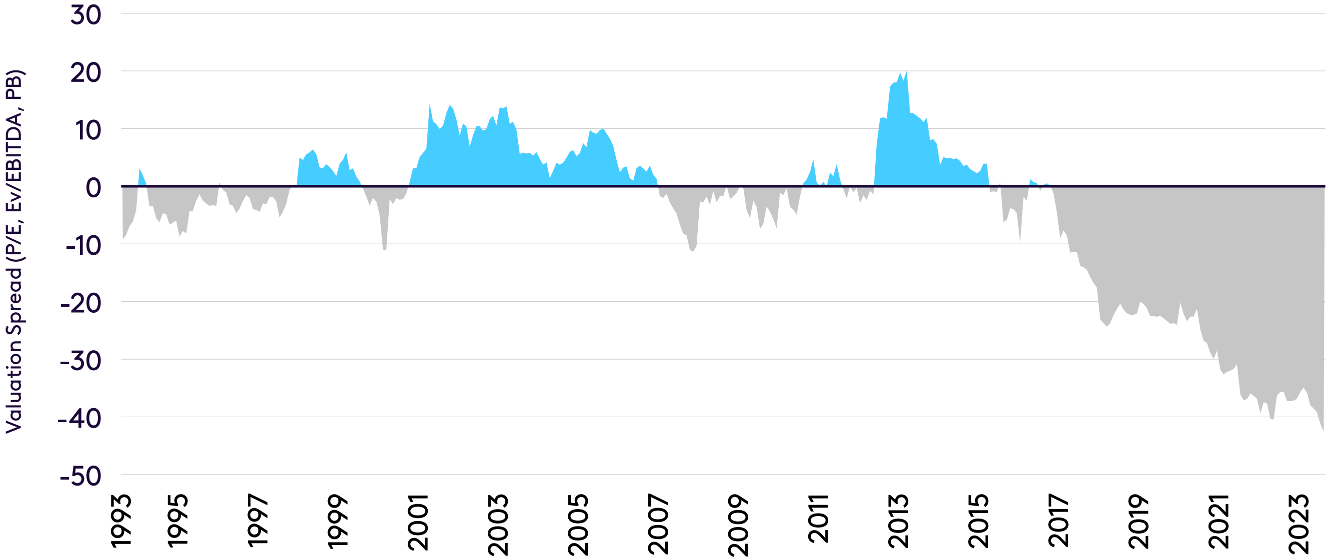
UK equities are now trading close to a 40% discount to the rest of the developed world. The FTSE 100 is at a material discount to long term average multiples. This can be seen starkly in the following charts.

But UK equities appear even more attractively priced when you look at smaller companies. These, despite strong underlying performance, are trading at a significant discount to an already cheap UK equity market.

The following chart shows that FTSE Smaller Companies are trading at an 18% discount to the FTSE 100 forward price to earnings multiple. This is versus an average historical discount of just 9%.

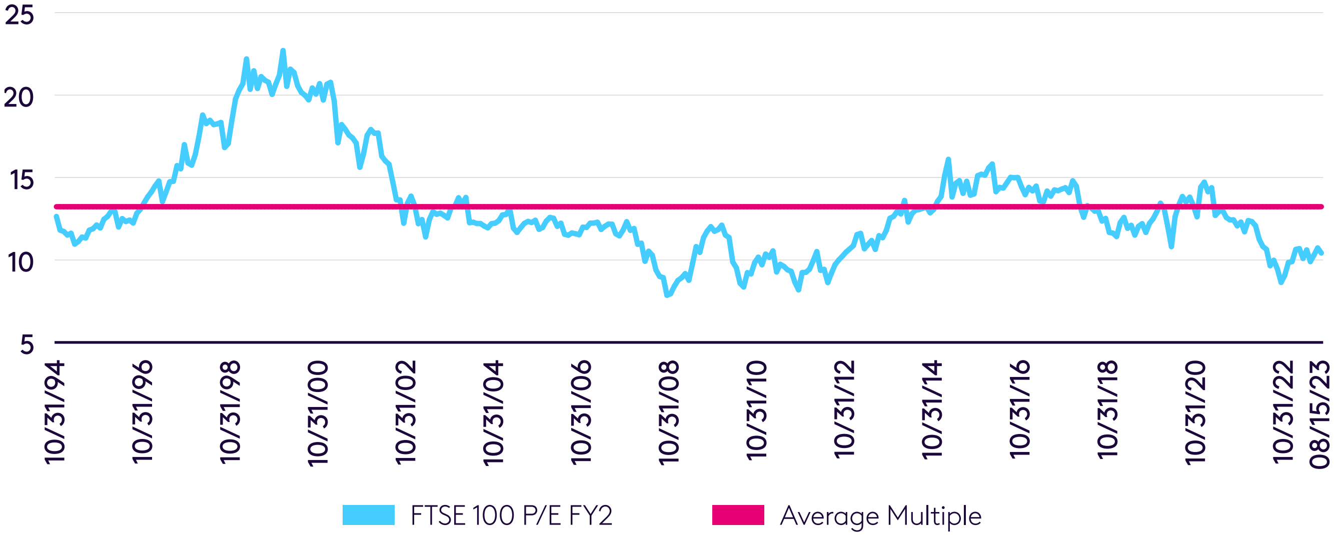
It's clear that this "double discount" is an exciting opportunity for investors seeking high quality small and mid-cap UK stocks at an attractive price.

UK equity market valuation discount vs RoW



Source: Simon French, Panmure Gordon 31 July 2023. **Past performance is not a reliable indicator of future results.**

FTSE 100 P/E vs long run average



Source: Octopus Investments and Factset 31 July 2023. **Past performance is not a reliable indicator of future results.**

Exceptional growth profile

With UK equities trading at a discount, growth companies look to be an extraordinary opportunity. Looking at the FTSE Small Cap EX IT and FTSE AIM indices, there is a significantly better growth profile. Growth rates of around 20% are comfortably ahead of the FTSE 100. What's more, these companies are offering a similar earnings profile to Nasdaq at half the price to earnings multiple.

Renewed support for UK growth companies

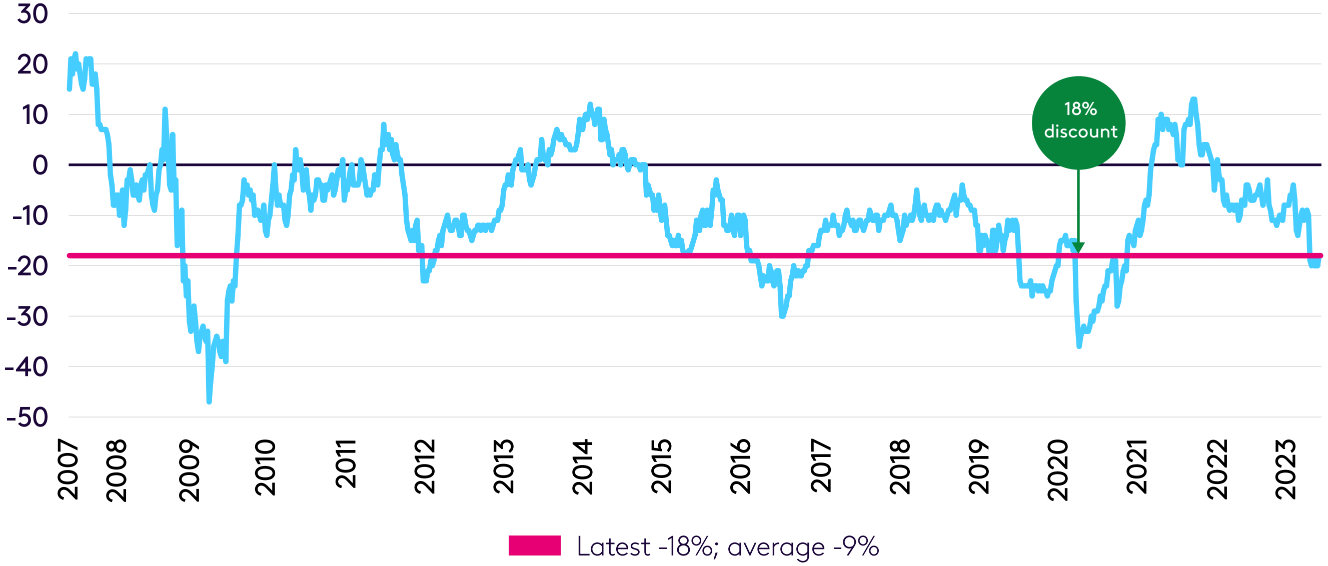
Chancellor Jeremy Hunt's Mansion House speech in July announced some interesting reforms to pension policy. The Mansion House package aims to attract £50 billion into high growth assets by 2030 and re-assert the London Stock Exchange as a primary listing venue for rapidly growing businesses.

Following the speech, Simon French, Economist at Panmure Gordon commented that: "the UK's Mansion House Compact has set in motion those rarest of things — an expectation of structural inflows into UK Small and Mid-Cap equities"

While we know that we won't see an instant rush of inflows and there are details that need to be ironed out, these reforms could provide a growing base of support for UK growth equities, as well as:

- Make it easier for small companies to raise money.
- Drive a transformation in the UK from "old economy" into a research-intensive innovation hub, a far cry from the perception that the market has earned in recent years.

FTSE Smaller Companies v FTSE 100 12m fwd index PE prem/disc



Source: Ian Williams, Peel Hunt 31 July 2023. **Past performance is not a reliable indicator of future results.**

Growth equities: an even better opportunity

	FTSE 100	FTSE 250	FTSE Small Cap Ex IT	FTSE AIM	Nasdaq Composite
3 Year EPS CAGR to 2025e	0.7%	9.0%	19%	22.4%	18.9%
P/E Dec 2024 (x)	10.3x	10.4x	8.9x	12.4x	24.2x

Source: Octopus Investments / Factset 31 July 2023. **Past performance is not a reliable indicator of future results.**

Don't concentrate

There's significant dividend concentration in the FTSE 100, where the bulk of dividend yields come from a small number of big names. These companies form the cornerstone of most traditional equity income funds and investors should consider how exposed they are to stock-specific risk.

Other indices benefit from a wider base of dividend yielding stocks.

Dividend concentration looks to be fairly consistent following our March Dividend Barometer, albeit the FTSE 100 has risen slightly from 55% to 58%.

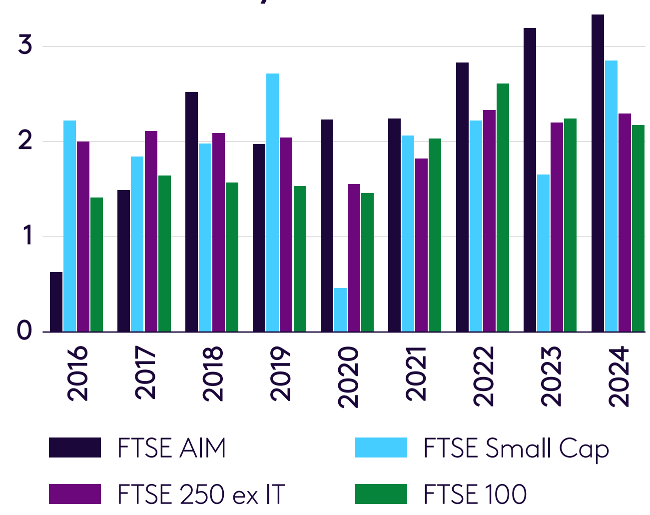
Investors who take a traditional approach to build an equity income fund are therefore tied to the fortunes of a relatively narrow number of companies, across a limited number of sectors and miss out on some of the more exciting, faster growth, income generating stocks outside of the FTSE 100.

Yields and cover

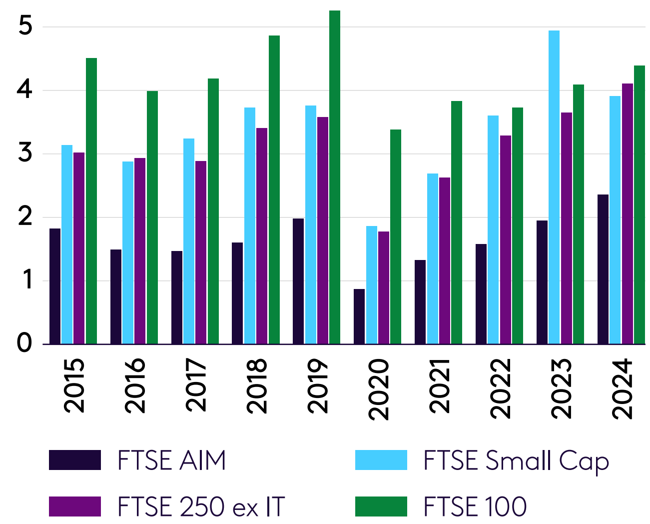
Dividend cover is an important consideration for income investors. It's a simple measure that shows the amount of profit a company has available to meet its obligations to pay shareholders a dividend. Cover below 1.5x can put a stock at risk of reducing or postponing a dividend, since it has less flexibility to continue paying a dividend should its profits fall.

For 2024, dividend cover will increase for every index except the FTSE 100, which has decreased. Dividend cover for the FTSE 100 is also lower than any other index. This gives small and mid-cap companies scope to grow their dividends ahead of larger FTSE 100 companies.

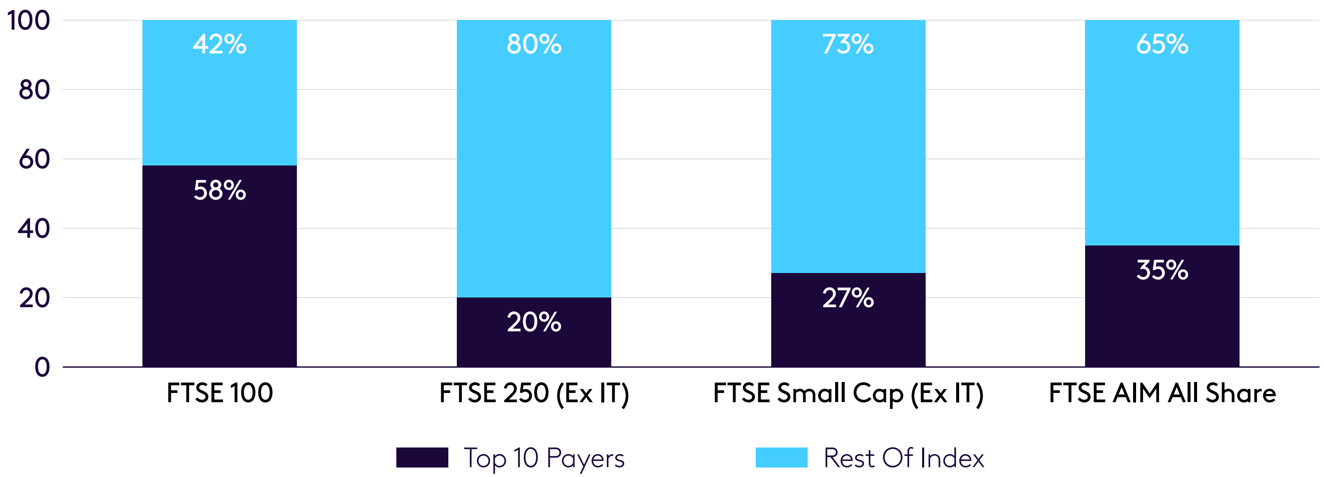
Dividend cover by index



Dividend yield by index



Dividend concentration by index to December 2023



Source: Octopus Investments/Factset to 31 July 2023. **Past performance is not a reliable indicator of future results.**

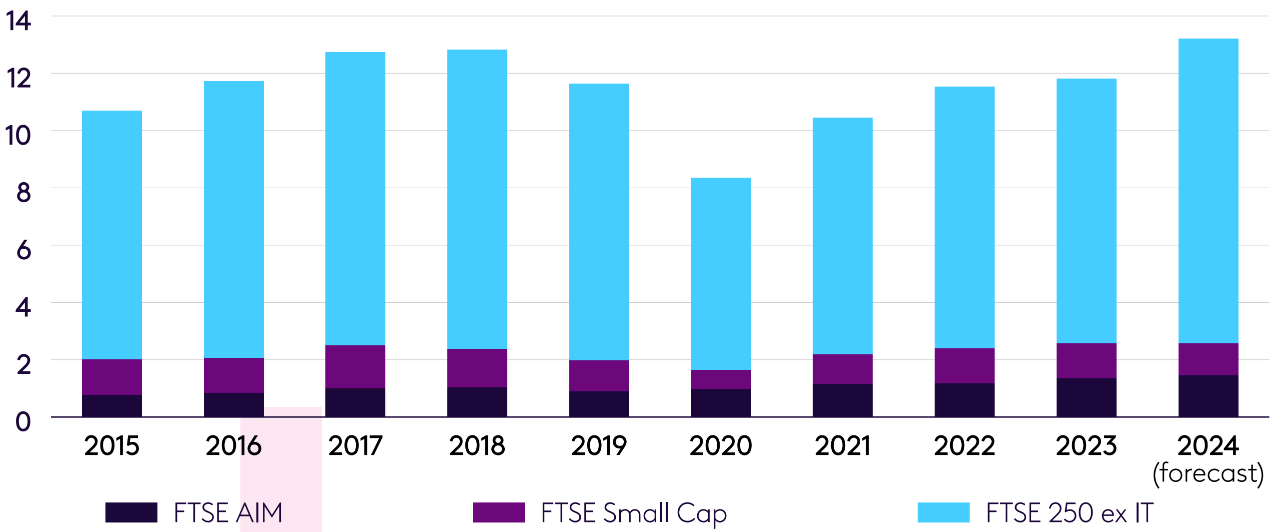
Growth standing strong

Dividend growth remains stronger away from FTSE 100. Mid cap is growing ahead of AIM, but we are seeing mid-teens growth for both.

AIM dividend payouts are now significantly higher than levels seen during Covid-19, growing by almost 75% since 2015. Both the AIM and FTSE 250 indices have bounced back from pre-Covid levels. The FTSE 100 and FTSE small cap indices, however, are lagging behind.

This performance is largely being driven by underlying earnings growth. Many AIM and FTSE 250 companies have stronger balance sheets and are in a more exciting stage of development. By buying high-quality growth companies, you can expect attractive dividend yields.

Overall cash payments by index (£bn)



Source: Octopus Investments/Factset to 31 July 2023. **Past performance is not a reliable indicator of future results.**

Dividend diamonds

We wanted to highlight two current stocks held in our portfolios, that we believe have shone over the last six months:

H&T

The UK's leading pawnbroker.

Sector: Finance

Index: FTSE AIM

H&T has delivered fantastic growth in dividend per share over the recent year, from 4.8p for the year ended December 2013, to over 20p expected for the year ended December 2023. It has maintained the company's stated progressive dividend policy with dividend cover more than 2x.

Looking ahead to the financial year ended 2024, the business is once again expected to generate solid growth of circa 24% year-on-year in dividend per share, leaving the stock with a generous yield of 6.1%. The business is also trading on an attractive prospective price to earnings multiple of just 6.1x.

XPS Pensions Group

A leading pensions consulting and administration business.

Sector: Business Services

Index: FTSE Small Cap Index

A relative newcomer to the public markets having listed in 2017, this business is building a solid track record of earnings growth, which is underpinning its dividend progression.

For the year to March 2023, the group delivered a dividend of 8.4p, a 17% increase on a year earlier, providing investors with a historic dividend yield of 5.3%. Whilst the stock price has rerated over recent months, it remains attractively valued at 14.3x to March 2024.

These companies are for illustrative purposes only and are not an investment recommendation.

Conclusion

Taking into account the 'double discount' opportunity and the renewed support from the government for UK growth companies, we believe looking more closely at small and mid-cap income stocks should be considered. If you would like to discuss how this can fit into your UK equity income strategy, or any other information included in this edition of the Dividend Barometer, please get in touch with the Quoted Team at Octopus Investments.

Discrete 1-year performance % return to August 2023

	2023	2022	2021	2020	2019
FTSE 100 TR	6.2	6.2	23.6	-14.3	1.5
FTSE 250 TR GBP	0.9	-18.9	38.2	-6.2	-3.4
FTSE Small Cap TR	-0.8	-14.1	52.9	-2.3	-4.8
FTSE AIM TR	-14.4	-30.9	35.3	11.8	-20.0
NASDAQ Composite TR	10.1	-7.7	27.0	35.8	6.0
H&T Group	-12.7	55.8	7.9	-24.9	19.0
XPS Pension Group	33.9	-2.8	8.3	19.3	-37.5

Source: Lipper to 31/08/2023. Returns are based on published dealing prices, single price mid to mid with net income reinvested, net of fees, in sterling.

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Risks to bear in mind

The value of an investment can fall or rise and you may not get back the full amount you invest. Smaller company shares are also likely to fall and rise in value more than shares in larger, more established companies listed on the main market of the London Stock Exchange. They may also be harder to sell.